

Transcript

The Ideas Exchange

Episode 38: Finding the sustainable competitive advantage

March 2024

Jacinta King (00:00):

Welcome to the Ideas Exchange by ASX, connecting you with investment experts, market updates and ideas. I am Jacinta King, business development manager, investment products at ASX. And this is our regular podcast covering everything from investment trends through to different ways to invest using a variety of products.

Disclaimer (00:20):

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Jacinta King (00:48):

Welcome to the Ideas Exchange. I'm your host, Jacinta King, from ASX. Firetrail is an investment management boutique that specialises in high conviction investing, and they build concentrated portfolios of their best ideas to generate outstanding long-term performance for clients. Today I'm pleased to welcome Anthony Doyle, he's head of investment strategy at Firetrail. So Anthony, thank you for joining us.

Anthony Doyle (01:14):

Thanks for having me.

Jacinta King (01:16):

Now, before we get started, could you please share with our listeners who Firetrail are, and then also tell us a bit about the work that you do there.

Anthony Doyle (01:24):

So Firetrail, as you mentioned, is a high-conviction investment manager. So what we do is we invest in relatively few stocks relative to an index or a benchmark. So for example, the ASX 200 by definition has 200 companies in it. And we think the best way to outperform and generate long-term performance for our clients is by getting to know companies extremely thoroughly, conducting deep dive analysis on companies, looking at their business models, trying to get a handle on how the earnings profile might

look over the course of the next three years. And we build portfolios in a concentrated way, meaning we take relatively few positions within the fund.

And for us, if you want to outperform an index, then you should look very, very different to that index. So we've been around now for six years, but our pedigree is actually, most of the team actually came out of Macquarie six years ago to forge our own destiny, to start our own investment management boutique. And we have a minority shareholder in a firm that is listed on the ASX named Pinnacle Investment Management. And our relationship with them, they essentially undertake all of the back office, middle office, distribution, HR compliance responsibilities, allowing us to solely focus on delivering for our clients and for us, because we are so aligned with our clients as owners in our business, but also investors in the funds themselves, we have a lot of skin in the game. So we're working very, very hard on behalf of our investors.

Jacinta King (03:03):

Okay, thank you. Now, I also noticed that you're a panel member of RIAA, so that's the Responsible Investment Association of Australasia, since mid last year. So tell us a bit more about that and how that feeds through the work that you do perhaps daily, but also in the wider industry.

Anthony Doyle (03:19):

Yeah, so RIAA is an industry body that certifies products or funds as responsible investments. And my role there on that panel is to, on behalf of not only the industry, but also with other panel members, which can come from superannuation funds or other industry experts, with RIAA's employees, is to assess whether a company should be certified as a responsible investment. And the reason that this is important, that particular certification allows investors to understand that the fund is run in a responsible way or managed in a responsible way. So typically what you find to have a responsible certification, the fund cannot invest in tobacco stocks, obviously with harmful health outcomes and environmental outcomes, but also controversial weapons. So RIAA essentially take industry experts both from fixed income, equities, as I mentioned, investors such as myself, superannuation funds, and look and assess products to determine whether they should receive that responsible investment certification. So it's a really important role they play within the Australian funds management industry.

Jacinta King (04:38):

I was just going to say it sounds like it and quite important now with a lot more focus from investors on answering these kind of questions when they are assessing what investments they'd like to go into.

Now turning to our discussion now, I'm going to start with the big picture. So economists are currently saying that we have a return to sound money. So that's things such as real estate, gold, silver, and bonds. They're saying that

the sixty-forty portfolio is back, so 60% equities, 40% bonds in an ideal portfolio, and they're also reiterating the importance of virtues of diversification. So what are your thoughts around these themes?

Anthony Doyle (05:17):

Certainly there is no wealth creation machine like equities, like the equity market. So over a consistently long period of time since 1928, on average, for example, the US S&P 500 or the US market has delivered double-digit returns or high single digit returns. Now, one thing that Australian investors have to grasp with, particularly considering that the average age of a male or female is around about 85 years, is that that can leave 20 years of retirement. And so historically, there has been a high interest rate on defensive assets like bonds as you say, and there is a relatively high interest rate today given that our RBA cash rate is 4.1%. But investors have to continue to think about whether their portfolios of assets are generating a positive real return. And what I mean by that is a return above the rate of inflation. And as we know the last few years, inflation has been uncomfortably high.

Not only do investors have to consider the official rate of inflation, but also their own cost of living. So for a retiree, their cost of living in terms of what they spend their money on day in, day out will look very different to a young family, for example, that is spending money on baby formula and nappies, etc. So for the average investor when it comes to a 60/40 portfolio, there's no one rule for me, it all comes down to an investor's time horizon and an investor's ability to withstand volatility that is essentially the ticket, the price of admission for accepting or generating those higher returns over the long run. So for any investor that has a time horizon of over five years, historically speaking, they should be investing 100% in equities. Now for an investor that is maybe saving for a home deposit, that would be an extremely risky move to take because equity markets, by their definition are volatile, so they can have drawdowns. But it all comes down to diversification and it all comes down to taking a long-term time horizon.

Jacinta King (07:33):

Yes, in the work we do at ASX, that's what we talk about too is that age, stage, timeframe and your risk appetite, understanding that for yourself so that you can make an informed decision on what is the right investment at any one time. Now turning to look at Firetrail's portfolio, so how are valuations looking given that the interest rates are expected to stay elevated for longer? So we know this was coming.

Anthony Doyle (07:56):

Yeah, so I'm a specialist in global equities, Jacinta, and the name of the game in 2023, and I'm sure investors listening to the podcast are aware of this, it's been the magnificent seven. So what am I talking about there? Some of the largest companies in the United States and in global equity markets, companies like Microsoft, Alphabet, the big one more recently has been

Nvidia up 74% this year, trillions of dollars of valuation, Apple, Meta, also known previously as Facebook, Tesla as well. So these companies have generated absolutely eye-watering fantastic returns on behalf of investors over the course of 2023. And that momentum has continued into 2024. So for us, we think it is appropriate to have some exposure at the larger mega cap level. So we own Alphabet, we own Microsoft. These companies are benefiting from the growth of AI and cloud computing. But the really exceptional opportunities in the global equity market today from a valuation perspective certainly lie further down the market cap structure.

So when I talk about market capitalization, I'm talking about the size of companies and for us we think that on a five-year view, three to five-year view, it is a really great time to be looking at companies that are of a mid-sized nature or a small cap size nature in the global equity market. So the Firetrail is three global opportunities fund, for example, we invest in some of the largest companies in the world such as a Microsoft, such as an Alphabet, such as a GLP-1 weight loss drug manufacturer as Novo Nordisk, one of the largest companies in Europe. But our median market cap on our portfolio is \$30 billion, which places us firmly in that mid-cap part of the global equity market.

This is an area of the market where we can generate similar profiles of earnings growth over the medium term, but pay half the price that you would at the top end of town for some of those mega cap names such as Meta and Nvidia. And over the medium term, we think this is a really, really great opportunity and we're pretty confident that that will deliver our investors' returns above the index over a medium term time horizon.

Jacinta King (10:29):

So how would you feel the S3GO's position for the year ahead given some of these things you've just been talking about?

Anthony Doyle (10:36):

Yeah, so in terms of regions, we're about equal weight on North America. We're overweight Europe given some of the cheaper valuations on offer there, and we're underweight Asia Pacific. In terms of style of investing, one thing about Firetrail is we're not beholden to a particular style of investing. So what do I mean by that? Well, companies that are expected to grow at a faster rate and command a more expensive premium than the market, they're called growth companies. So a good example of a growth company would be Apple, for example. Companies that trade on a cheaper valuation than the market, but they may issue relatively high income or dividends, they're called value companies. So a company that would sit in there would be a utility-like company, for example, an electricity utility. So these are very sound businesses, but they're not growing very rapidly, but they do pay high income.

So what you tend to find is that some managers, fund managers might focus on growth style companies, they might focus on value style companies, but for us, we think that every company has a price and every company can trade away or trade below its intrinsic value. We look at simply very best opportunities in the marketplace. So that can be a value company or it can be a growth company. Today our portfolio has a slight overweight to growth style companies, but for that diversification perspective, we also own value companies as well. We own cyclical companies, companies that are more geared into the economic and business cycle. We own defensive style companies, companies that are more resilient such as insurance companies. We know that individuals continue to pay their insurance premiums and those premiums are rising above the rate of inflation as well.

For us, it's all about understanding these businesses, their business models, the sectors they operate in, their competitors, and getting a really great understanding on their revenues and their earnings. And if we differ significantly than the market and we think the market is wrong, that is where we'll take a high conviction position. Because what you find over time in the short term sentiment will really swing markets around. It can swing whole sectors around, it can swing individual companies around. But over the medium term share prices, follow earnings, and that's one of our core investment principles at Firetrail that we follow.

Jacinta King (13:07):

I'd like to dig a bit deeper into that and ask if I could for you to talk about Firetrail's investment philosophy and approach, because for many listeners who don't work in this industry or it's quite fascinating, I think, to try and understand from the outside in, how does an investment team work and what is your approach?

Anthony Doyle (13:26):

Yeah, sure. So there's individuals at Firetrail, and one thing that is common amongst our culture and the individuals that are employed at Firetrail is that we are very passionate about investment markets. So obviously we have a good handle on work-life balance and all the rest of it. We're a very close team, but certainly it's not uncommon for us to have conversations on the weekend. I think maybe because we do like each other about what's going on in markets and what the impacts might be on our portfolio. So we have four portfolios at Firetrail and I work in the global team, the listed fund, S3GO, as you say. So everyone is very passionate.

The other thing that you'll find is that we come from a diverse range of backgrounds. We have a trained immunobiologist in the team, we have civil engineers in the team, we have mining geologists in the team. I might be the only one with a pure finance background. So I was previously an economist at Macquarie before specializing in fixed income markets for almost 15 years in Europe and the UK before I came back to Australia. So we're all very

passionate. We come from diverse backgrounds, cognitively diverse. We have a strong emphasis on gender diversity as well. So we have a commitment that 30% of our employees at a minimum are female, and we obviously strive for equality there. So hopefully one day we'll be fifty-fifty. And I encourage any listener, investment management industry is a fantastic industry, so it's a fantastic pursuit to follow if you are a young female thinking about starting a career in the investment management industry. I think you can also confirm that, Jacinta.

Jacinta King (15:12):

Yes. Yep. It's been a really good industry. I've enjoyed it. Very interesting. A lot of changes, and you're always getting opportunity to delve deeper into something.

Anthony Doyle (15:22):

Yeah, I mean, you're only limited by your own ambition, really. And what's fantastic, as I said, I worked overseas, so you get the opportunity, the skill set is transferable to working in different markets as well. So the way that we approach investment markets, it is a unique philosophy. It's an investment approach that we've employed for over 17 years now, both at our time at Macquarie and at Firetrail with great success in different parts of the market, whether that be the small cap part of the market, the large cap part of the market, and now in the global equity space as well.

And the core philosophy that we follow is that every company has a price. As I mentioned, we look everywhere for opportunity. We believe that share prices will follow earnings, and we do a huge amount of bottom-up research. So we don't want to get caught up in the noise. We don't want to get caught up in the US election cycle and what might happen, we don't want to try and predict whether inflation will be higher or lower on a monthly basis or what the RBA or the US Federal Reserve might do with interest rates.

We want to cut through the noise and focus on what matters for a company. And that is typically only two or three things. We do all the financial modeling, we forensically assess balance sheets of these companies, but ultimately there's typically only going to be two or three things that really matter for a company's earnings. And if we can get a handle on that, as I said, that's a really good grounding for generating those returns that investors seek from our portfolios.

Jacinta King (16:56):

Fantastic. Thank you for explaining that because it leads nicely into now the way that you look at companies. Would you mind sharing a few stocks that you think are well positioned in the current climate?

Anthony Doyle (17:06):

No, of course. So any investor in the Firetrail S3 Global Opportunities Fund, or if you're interested, you can go onto our website or you can go onto the ASX website with the ticker S3GO, and see the full list of holdings within the fund. So very transparent, you can go on and see on a quarterly basis the companies that we own within the fund, the way that we are investing your money with other investors in the active ETF or the exchange traded mutual fund.

So some of the favorite positions in the portfolio today, I mean they're all high conviction positions. What you get is a highly differentiated portfolio than what will typically receive in a passive style of exposure to global equity markets. One that I've been discussing more recently is a company named AutoZone. So I think Australians will be very familiar with auto part retailing in the aftermarket, companies such as Babco or Repco, for example.

Well, in the US, the largest player there is a company named AutoZone, 6,000 stores throughout North and South America. And their business model, they're really in replication mode now. So they're rolling out 200 stores per year. To give you some context, they have 6,000 stores. Woolies has around about 800 stores. And so AutoZone are rolling out 200 stores per year, and they want to grow that over the course of the next couple of years to around 500 stores per year. Where they dominate and where, say an Amazon can't compete with them is that they have the largest distribution centres in the US. So they have 14 very large distribution centres that have the greatest range of products, and they can fulfill orders very, very quickly. So if you're a mechanic, what matters is that you can turn over a vehicle within your shop, you can turn that over and get it out the door relatively quickly.

AutoZone will make four deliveries a day to your workshop, and indeed, our analyst was over and did a tour of one of the distribution centres and there's a red light on the ceiling, and if an order isn't fulfilled within 10 minutes, then the store manager actually goes out and delivers it. So the staff at AutoZone are called AutoZoners. With Australians, we're very familiar with the Bunnings style model. It's similar in terms of a US customer going to AutoZone to get advice from experts, and particularly with those retail customers that are completing work on their own vehicles.

Now, what really matters, cutting through all that noise and what really matters for AutoZone is that they are in replication mode. They have a very successful model. They have a very high return on invested capital of over 25%, and if they don't meet those high hurdle rates for opening a new store, then they return cash to shareholders in the form of share buybacks.

So they've bought back over 90% of shares on issue since they listed in the early nineties. And the share price over the last few years is up, well, since they listed is up around 32000%. So fantastic company management,

fantastic and disciplined capital management, and they are increasingly expanding into the commercial space as well. So that's an example of a company that trades at a roundabout evaluation that is similar to the market, but fantastic earnings growth profile in the coming three years. And that's the top three position in the Firetrail S3 Global Opportunities Fund today.

Another more on the growth style of investing. So a company that would be growing faster than the market and commands a premium to the market in terms of its valuation is a company that I'm sure many Australians may be familiar with, Jacinta, I'm sure you're familiar with this company, is Booking.com.

Jacinta King (21:05):

Of course. Yep.

Anthony Doyle (21:07):

Yeah, so travel is-

Jacinta King (21:08):

Used it many times.

Anthony Doyle (21:09):

Yeah. Well, I'm thinking of going away this weekend with my wife, dumping the kids with the grandparents, and I've been on Booking.com trying to find a place to stay maybe down the south coast or something like that. But Booking.com, they obviously take a clip of every booking that is made on their website, and they're increasingly expanding into the private residence area. So competing with Airbnb. Now, what matters, again for Booking.com, they also own OpenTable. So many restaurants that use OpenTable as a booking system for reservations.

But Booking.com is a highly, or sorry, travel is a highly aspirational good that not only the developed markets, but also the emerging markets customers are continuing to consume. And what we've found is that in this whole reopening phase and an environment where inflation continues to move higher, the market got quite pessimistic about the outlook around travel as they had expected that consumers would really tighten their belts. And we just haven't seen that eventuate. The reason is we've seen a reduction in spending on stuff and an increase in spending on experiences and Booking.com in facilitating those experiences is taking a clip of every travel ticket that is bought and every residence that is booked, and every restaurant that is booked, every meal eaten. So obviously Booking.com has benefited from that reopening boom, and we are continually expecting further gains in the share price as they continue to replicate their very successful model and expand into new markets around the world.

Jacinta King (22:52):

Anthony, I also noticed when I was looking through the portfolio holdings, just the disclosures, but also you've got some flyers there, some reports actually on the top five investment themes. You've got sustainable investment themes marked against some of the funds there. Is that something that you run against each stock or just some of the key ones that are more higher weighting in the portfolio? We've got health and wellbeing, innovation and equality, climate impact, and sustainable world.

Anthony Doyle (23:22):

So for all listeners, every company in the fund shares similar characteristics, which is where the S3 comes from. So we want to own companies that have a sustainable business model. We don't want a company that's going to go belly up or bust or suffer materially in an economic downturn. We want resilient business models here, what we describe as sustainable business model from a financial perspective. We also want to see sustainable and growing earnings because of that linkage to the company's share price. If you see a company that is downgrading its earnings, meaning a company that is disappointing the market on its earnings, you're likely to see the share price decline. And that's something that we want to avoid. We want to find companies that are growing their earnings. This is why famously you listen to the Channel nine news or Channel seven news, and they'll say, one of the big banks has delivered \$2 billion in profit, but the share price falls.

The reason is the market was expecting two and a half, &2.2 billion in profit. So the share price falls accordingly. So we want a sustainable business model. We want sustainable and growing earnings. And then those sustainable positive change themes that you've just mentioned, these are long-term enduring structural themes that will persist for decades to come. Now we know that populations around the world, both from a government but also from a citizen perspective, there's a huge focus on improving health outcomes. And we know as populations age, that becomes an opportunity for many companies to deliver solutions and products that help in terms of generating better health outcomes.

So a great example of that at the moment, a company in the fund is a company named Novo Nordisk, which is a GLP-1 producer. And what are GLP-1s? Well, they've been around for over a decade now and longer as a treatment for type 2 diabetes. But they got significant prominence last year in relation to their ability to assist individuals lose weight. So typically it's an injectable that is injected on a weekly basis, and a patient will lose up to 20% of their body weight as it helps to suppress their appetite.

Now, what is interesting about these weight loss drugs, GLP-1s, is that they have fantastic benefits for other comorbidities such as cardiovascular disease, and with a significant portion of American citizens being classified as overweight, the addressable market for GLP-1s in the US alone has been

estimated at up to 130 million individuals. Today, there are only between one and 2 million individuals that are actually using these weight loss injectables. Now, the big game changer will be when it moves from injectable form to tablet style form, as that will really materially reduce the cost of obtaining these drugs. And also you'll see doctors and patients potentially more willing to prescribe these types of drugs for people that are classified as overweight.

So that will generate fantastic health outcomes for individuals and also mean a reduction in spending on some of those issues that often individuals face from being overweight, for example. So that is a company in the fund that we own today in terms of the health category. In terms of innovation and equality, well, this is where AI comes into it. So the AI beneficiaries. We know about Alphabet, we own that, we know about Microsoft, we own that. Other beneficiaries include the semiconductor manufacturers such as Taiwan Semiconductor, but also Micron Technology. Every year, computing and processing power gets faster and gets more power hungry. And these are the companies that are producing the chips that are allowing us to record this podcast today and allowing you, listener, to listen on your device, your mobile device, or on your PC at home or in your office. So that's innovation and equality.

In terms of climate impact, we have a company, Schneider Electric, that has also been benefiting from the increase in computing power and AI in terms of their componentry that they use in electronics. And they are dominant in that space in terms of they have all the regulatory approvals to supply things like switches. They're experts in everything from the electricity grid in terms of supplying for a builder or for an electrician, the components and products that they require to fit out a commercial or a residential property and help to reduce the emissions of those properties as we see buildings increasingly becoming smart buildings and becoming electrified.

And then in terms of climate impact, what we have is a company, for example, that produces renewable diesel, a company named Darling Ingredients based over in the US based in Texas, Irving, Texas. And what they do is basically take the parts of an animal that haven't been used for human consumption, and they essentially render that fat and produce renewable diesel. Now, the great thing about renewable diesel, which can be used from animal offcuts and use cooking oil or produced from those feedstocks, is that through the life cycle of the product, there's 95% fewer carbon emissions.

So in low carbon markets like California, Delaware, Washington State, New York State, there is great demand for logistics companies, but also other oil producers to lower the carbon footprint of their fleets or of their products. And so there's been strong demand for a product like renewable diesel that, as I said, has 95% fewer carbon emissions than a fossil fuel derived diesel.

Jacinta King (29:37):

That's fascinating. I did not know that. So I'm going to do some more reading on that area in particular. Anthony, I also particularly liked that you and your colleagues do a short update fairly regularly, a quick video update on your website, which is found in the insight section, and also going back to the way that your investment team work together, you share your thoughts of, is it Thoughts of the Week?

Anthony Doyle (30:01):

Yes. Yeah, yeah, of course. Yeah, we do Chart of the Week.

Jacinta King (30:04):

Yeah, Chart of the Week.

Anthony Doyle (30:05):

And there's a newsletter. Yes. And there's also a rival podcast to the ASX, but it's not... What we do is in under 10 minutes, either myself or one of my colleagues speak to one of the portfolio managers or one of the equity analysts about a particular stock, and we just ask them, what does the company do? What's the bull case, so if everything goes right and the share price goes up. But what's the bear case? And then what is the market missing as well? So we put a huge emphasis on articulating and being transparent to our clients, what we are doing with their money, as we are very much in a partnership. We are managing the money on behalf of them. We know our clients work very hard for their long-term investments and their savings. So we want to ensure that they're armed with all the information they require to make informed decisions.

And the beauty of investing in a fund like S3GO, is that we are essentially opening up our doors to our investment, our investment teams. It's very simple to trade on the exchange. There's no minimum investment apart from the price of a unit, which is around \$5.30 today, I believe. And we're opening up all that investment intelligence. So of course, we want to ensure that we are as transparent as we can be and provide that market knowledge and that market insight to our investors as well.

Jacinta King (31:32):

Yeah, thank you. So for anyone who's new to Firetrail or already invested and want to stay across what they do, make sure you spend some time on the insights page there. And as you've mentioned, the Firetrail S3 Global Opportunities Fund is under ticker code ASX S3GO. Anthony, thank you so much for joining us today. Really appreciate your time.

Anthony Doyle (31:56):

My pleasure. Thank you, Jacinta.

Jacinta King (31:57):

And thank you to all of our listeners. Please tune in again next month to the Ideas Exchange.

Disclaimer (32:03):

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