LONG EQUITY

Annual Letter

Long Equity Fund

2023

20 December 2023

Dear Reader,

The portfolio's market performance in 2023

Like most years, 2023 was a good year for quality growth investing. Since 2009, there have only been four years in which the MSCI World Quality index underperformed the MSCI World index. While 2022 was one of those underperforming years, 2023 has so far seen the quality index outperform the wider market by 8.16 percentage points. This is reflected in the performance of our portfolio. At the time of writing, **we are up 30.2% year to date**. With the exception of **MSCI**, all our other positions outperformed the S&P 500 (see table below). The positions new to the portfolio this year are **Alphabet** (up 24% since buying in March), **Fair Isaac** (up 37% since buying in July) and **Applied Materials** (up 4% since buying in September). The share price growth of our positions has been, for the most part, fairly linear - with only **MSCI** and **ASML** not demonstrating 1-year share price linearity greater than 0.90.

Company	1yr CAGR	1yr Linearity
NVIDIA	206%	0.94
Fair Isaac	101%	0.97
Cadence	71%	0.96
Alphabet	60%	0.96
Novo Nordisk	56%	0.97
Microsoft	56%	0.93
Applied Materials	56%	0.95
Constellation Software	51%	0.96
Visa	27%	0.93
ASML	26%	0.34
Mastercard	25%	0.90
S&P 500	25%	0.92
MSCI	18%	0.31

The portfolio's quality and growth in 2023

We continue to endeavour to only own the highest quality growth companies available. The below table sets out the portfolio's weighted average for a selection of financial metrics. Over the last 5 years FCF per share had an annualised growth rate of 20%, while revenue grew at 14%. The 6 percentage point spread here reflects that our portfolio companies are selling more, raising their prices - typically above the rate of inflation - and becoming increasingly efficient through cost cutting. The return on capital is considerably above average at 31%, with approximately 79% of profits being retained and reinvested at this high rate of return. Share-based compensation continues to be employed by many companies for attracting and retaining talent. We monitor (i) the ratio of share-based compensation to operating cash flow (SBC/OCF), and (ii) the 5-year change in share count, to help get a sense of the cost and dilutive effect of this practice. While a 10% SBC/OCF is not a low figure, this is considerably below the +25% figure seen in some companies. It's also comforting to see a decline in share count over the last 5 years by -8%, which further concentrates the interest of shareholders. With regard to balance sheet strength, our holdings are conservatively financed, with long-term debt representing only 30% of the balance sheet and the cost of servicing this debt (interest expense) being only 5% of operating profit. In conclusion, we continue to own conservatively financed, cash-generating, price setting, compounding assets.

Financial metric	Portfolio
5yr FCF/share CAGR	20%
5yr Revenue CAGR	14%
FCF ROC	31%
Retention ratio	79%
FCF Margin	34%
SBC/OCF	10%
5yr Δ share count	-8%
Long-term debt	30%
Interest expense	5%

We frequently revisit and update our process for identifying quality growth companies. This year saw the addition of a new metric to the toolkit: the 10-year minimum FCF ROC. This involves taking the return on capital for each of the previous 10 years and then identifying the lowest value in that 10 year time period. For example, the lowest **Novo Nordisk's** return on capital has been over the last 10 years is 43% - a return that many companies fail to ascend to, let alone drop to. The following table sets out how the portfolio companies rank on this metric.

Company	Min. 10yr FCF ROC
Novo Nordisk	43%
Mastercard	32%
Constellation Software	31%
Microsoft	16%
Cadence	15%
Fair Isaac	11%
Alphabet	11%
MSCI	10%
NVIDIA	10%
Visa	8%
ASML	7%
Applied Materials	5%

The portfolio's valuation in 2023

The reaction of many investors to share price growth is the assumption that it has been driven by a change in the multiple (i.e. companies becoming more expensive). Interestingly, at the beginning of the year the portfolio was sitting on a free cash flow yield of 2.48%, which has since risen to 3.32%. This indicates that our portfolio is now less expensive, despite its 30.2% growth. In contrast, in 2023 the S&P 500 became more expensive, with its earnings yield declining from 4.38% to 3.85%. As things stand, **Applied Materials** is our cheapest holding, and **NVIDIA** - perhaps unsurprisingly - is our most expensive. The market is clearly pricing in a lot of future growth for the semiconductor industry. **NVIDIA's** current price is only justified if the priced-in future growth is realised. Time will tell. We will continue to closely monitor **NVIDIA's** valuation, as we do with all the other companies in our portfolio, and remain mindful that its valuation may possibly be a headwind in 2024.

The portfolio's turnover in 2023

One of the most significant changes to the portfolio in 2023 has been its concentration. We started the year with 23 positions and ended with 12. In the coming year we do not expect this number to decrease below 12 or increase above 14. Despite its concentration, the portfolio still benefits from diversification. The portfolio is invested in a range of sectors, including payments, semiconductors, software and healthcare. All our holdings are multinationals, generating revenues from across the globe and from a wide range of products and services. 12 positions, in the types of companies we invest in, should be sufficient to mitigate much of the diversifiable risk seen in equities. One of the benefits of this higher concentration has been that it has allowed us to increase the weighted quality of the portfolio. For example, the free cash flow return on capital (FCF ROC) started the year at 26% and now sits at 31%.

We maintain a watchlist of quality growth companies that we would be willing to own. In the financial market infrastructure space, this includes the credit rating agencies: **S&P Global** and **Moody's**. In the software space, this includes **Fortinet**, **Qualys** and **TechnologyOne**. In the semiconductor space, this includes **Lam Research** and **Synopsys**. And in the healthcare space, this includes **IDEXX** and **Sartorius Stedim Biotech**.

In an effort to reduce turnover in the coming years, our factsheet now records the number of positions that have been held for less than 1 year. The number currently sits at 3 out of 12. While we expect this to drop to 2 out of 12 in the coming months, we will continue to prioritise only owning the highest quality growth stocks over having the lowest turnover. This means we won't hesitate to sell if the quality of one of our holdings deteriorates, or to buy if we think a company's quality and growth justify it having a position in our portfolio.

Final greetings

We look forward to 2024 and wish you all a Merry Christmas and a Happy New Year.

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