

2020 Annual Letter

2020 has been a decidedly difficult and strange year. If you had asked me a year ago 'what concerns are top of mind?', I would not have ranked 'living through a global pandemic' high on the list.

The measures required to deal with the spread of COVID-19 have led to widespread job losses, and robbed us all of the enjoyment of normal social interaction with family, friends and colleagues. Of course, this does not even consider the actual human cost of lives lost to the virus itself. As such, I sincerely hope this letter finds you and your loved ones well, and that you have weathered the challenges of 2020 in good health.

The purpose of this letter is to provide you with a review of the drivers of our performance, as well as the major decisions taken and how they influenced the 2020 calendar year returns. We also provide an update regarding our current Fund positioning and composition, and comment on the risks and opportunities in the year ahead. Lastly, we conclude with a one-page summary of our investment philosophy, which underpins our actions as long-term stewards of your capital.

Performance Summary

For the calendar year ended 2020, the AIM Global High Conviction Fund (GHCF) delivered a return of +14.18% after all fees. This compares to a benchmark return of +5.58%. Given the extreme challenges of 2020, we are happy with this outcome.

The table below presents the calendar year returns of the Fund since inception (7 July 2015) to present, net of all fees.

<u>Calendar Year Returns</u>	<u>GHCF</u>	<u>Benchmark</u>
2020	+14.2%	+5.6%
2019	+15.7%	+26.0%
2018	-23.8%	-10.4%
2017	+21.5%	+20.1%
2016	+3.9%	+5.3%
2015 (Inception: 7 July 2015)	+0.9%	-3.6%

Compound Return (annualised)

Since Process Change (30 June 2019)	+13.3%	+9.8%
Since Inception (7 July 2015)	+4.6%	+7.0%

Please note: the benchmark was changed from the MSCI World Index in USD (price only) on 1 July 2019 to the MSCI World Total Return Index in AUD. The benchmark return above reflects this change. Past performance is not indicative of future performance.

After the unacceptable result of 2018, I undertook a wide-ranging review of our investment and risk management processes and made substantial changes to both during the early part of 2019. In brief, these changes simplified and focused the AIM philosophy by closing down our short book and unhedging the Fund's currency exposures. In addition, our approach to investing in China is now focused on owning global businesses that generate meaningful revenues there as opposed to businesses listed there. I am happy to say that following these changes our performance has improved. From June 2019 to December 2020, the Fund delivered a cumulative (i.e. non-annualised) net return of +20.7% compared to the MSCI World Total Return Index (AUD) of +15.0%. (On an annualised basis, this equates to +13.3% vs +9.8% respectively).

We have recently received a 'Favourable' rating from SQM Research, who assessed the returns and investment process of the Fund from 30 June 2019 onwards. If you would like a copy of this research report, please do not hesitate to ask and we will gladly send it to you via email.

I know that the investment journey in the Fund has not been smooth. While I am pleased with the result we have been able to generate since making the above-mentioned changes, we shall continue to work to earn the trust that you place in us. There are simply no shortcuts: we need to knuckle down and do the job of prudently managing your money by following our

process. Rest assured that we take the responsibility as custodians of your capital seriously. We are confident that the results will justify your patience.

Lessons Learnt in 2020

In reflecting on our actions during this very strange year in markets, we believe these are our main learnings as an investment team:

- **Stay invested.** Tempting as it was to exit markets in March, there were simply too many buying opportunities on offer to raise cash and move to the sidelines. The adage 'time in the market beats timing the market' is true.
- **Volatility is not the primary risk to the patient, long-term investor.** It is the psychological cost of long-term returns. Short term share price movements provide opportunities to buy quality businesses at attractive prices. We manage risk by focusing on the possibility of a permanent loss of capital, not short-term price volatility.
- **Beware macro-economic forecasts.** Focusing on business-specific risks was much more important than trying to guess the next unemployment number or GDP print.
- **Avoid overtrading.** While our portfolio activity this year was higher than what we would consider normal given the changes we made in March, we created more value by hanging on to high-quality businesses.
- **Staying within our circle of competence.** We very quickly realised we had little value to add in predicting the trajectory of COVID cases or the timeline of a possible vaccine. We tried to learn as much about these subjects as was relevant to where we felt we *could* add value: analysing businesses for risk, trying to understand changes in consumer or business spending, finding mispriced opportunities, and deploying capital.
- **Hang on to businesses that offer unique and difficult-to-replicate products or services.** If the balance sheet is risky, size the investment appropriately in a portfolio context. However, the probability that capital providers will step in to help support a unique business during periods of distress is high.

Client Communications

I believe the single most important advantage we can have is a long-term time-horizon. In a world where performance is frequently evaluated month-to-month, being able to take the long view and invest accordingly creates our divergent view to the market consensus. To avoid a mismatch between the time horizon of the investments we make and your expectations, we hope that you will share our view on this point. To that end, explaining *exactly* how we manage your capital can only help to build an understanding of what to expect from us.

I also believe in holding ourselves accountable by providing you with sufficient information (avoiding technical jargon as much as possible) to allow you to judge whether we are operating and performing in line with our stated investment philosophy. As such, this annual letter forms an integral part of our communications to you.

Additionally, our Investor Handbook was published in the 3rd quarter of 2020. The Handbook provides a detailed overview of our process and philosophy. If you would like a copy, please get in touch with us and indicate whether you prefer a digital or physical version; I will make sure it is dispatched promptly.

If there is anything we can do to assist you with regards to your investment with AIM, please do not hesitate to get in touch with myself, Les or Gemma. We would be very happy to help.

Conclusion

I would like to take this opportunity to thank all investors – new and long-standing – your ongoing support.

I wish you and your loved ones a happy, prosperous (and decidedly more normal) 2021.

With regards

Charlie Aitken

CEO: AIM

Part One: Performance Review

The table below presents the Fund's return for all four calendar quarters as well as the full year.

	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter	2020
AIM Global High Conviction Fund	-2.5%	+7.0%	+5.8%	+3.4%	14.2%
MSCI World Net Total Return (AUD)	-9.3%	+6.1%	+3.7%	+5.9%	+5.6%

All returns measured in AUD and presented net of fees. Source AIM, MSCI, FactSet

Breaking down our 2020 return profile by quarter is instructive, as it demonstrates how and when we believe our quality-focused strategy will outperform.

In brief, our strategy should hold up better during periods of market distress due to our focus on balance sheet strength. Following a market crash, our preference for cash producing (and cash-rich) businesses should generally see us perform well; however, when the crisis abates and the next cyclical rally starts, we will likely only match (or possibly lag) the general market index for a period. As the business cycle matures, we expect our businesses to outperform due to their intrinsic competitive advantages allowing them to compound their internal pool of capital at a high rate of return. In our experience, excess returns (also referred to as 'alpha') are typically earned unevenly and unpredictably over time, which is why we believe that time in the markets allows the patient investor to capture this alpha by staying the course through these cycles.

If you study the table above, you will note that the expected return profile outlined is indeed the pattern we managed to deliver: outperforming markedly in the March crash, achieving modestly better returns over the second and third quarters, and then lagging the market slightly in the final quarter as the news of vaccines being approved kicked off a rally in more cyclical assets. If there is anything odd about this year, it is that this pattern played out in the space of only ten months. Normally, a market recovery would take longer. The thanks (or blame, depending on your view) for this rapid recovery can in large part be laid at the feet of the massive amounts of monetary and fiscal stimulus deployed by central banks and governments this year.

Over a full economic cycle, we think our strategy will be able to produce a fine result, but we do not expect to be able to outperform markets every month, and we certainly do not position the Fund to try and do so.

Performance Drivers

Our average cash position throughout the year was around 8.9%. The cash did not add or subtract to our absolute performance of +14.2% but was a modest drag on relative performance.

- On the positive side, our list of businesses that added value in absolute terms far outnumbered those that did not.
- Only six businesses detracted from our absolute performance in 2020.
- A far bigger drag on absolute performance was the strength of the Australian dollar relative to many other currencies (but particularly the US dollar) towards the end of the year.

Currency

Staying unhedged to global currencies did a lot to soften the blow to absolute performance in March, when the AUD weakened substantially. However, from then onwards, it has been one-way traffic in the other direction. On the whole, the currency functioned as an effective 'safety valve' of sorts – on days when global equity markets weakened, the currency mostly did the same (to our benefit). However, there is no getting around the fact that over the full year, AUD strength meaningfully detracted from our underlying equity returns. We estimate that the Fund's 2020 performance (after fees) in US dollars would have been around +25.4% (compared to a USD benchmark return of +15.9%).

To illustrate this dynamic a bit more practically, consider two businesses that we invested in around March and April:

- Our stake in Japanese vision sensor specialist Keyence was mostly acquired in March at prices around JPY31,000, and we modestly added to it in August around the JPY42,000 level. The business ended the year trading at a price of JPY58,000. Adjusting for the weighted purchases price, our total return in Japanese Yen was around +78.4%, but only +50.5% in AUD due to the latter strengthening relative to the Yen since March.
- The same occurred for our position in Berkshire Hathaway: the bulk of our buying occurred around USD175 in March and April, with an additional tranche around USD170 in mid-May. The business ended the year trading slightly below USD232, bringing our weighted total return in US dollars to roughly +31.8%. However, this was reduced to only +4.6% in AUD due to currency strength since our point of purchase in early 2020.

We should point out that a very meaningful component of the strength of the Australian dollar played out in November and December, meaning that our 4th quarter returns were most significantly impacted by this factor. While we are cognisant of the impact that currency movements can have on the returns over the short-term, we manage this through appropriate diversification and position sizing in the Fund. Our primary focus remains on investing in quality businesses that can sustainably compound returns over the long term.

Contributors

The top ten stocks that contributed most to our performance were:

<u>Business</u>	<u>Contribution</u>	<u>Total Return (AUD)</u>
Amazon.com Inc.	2.7%	60.6%
Microsoft Corp.	2.3%	29.8%
Netflix Inc.	1.8%	52.0%
Prosus NV.	1.5%	32.1%
Apple Inc.	1.5%	50.1%
Nike Inc.	1.2%	28.4%
Salesforce.com Inc.	1.1%	24.6%
Alphabet Inc.	1.1%	19.4%
Keyence Corp.	1.1%	50.5%
Accenture PLC	0.9%	14.8%

Berkshire Hathaway narrowly misses the list of top ten contributors by a few basis points.

- In the case of the majority of our top contributors (Amazon, Microsoft, Netflix, Apple and Alphabet), we believe the rationale explaining their strength in 2020 is straightforward: their businesses generally have strong balance sheets and – due to the digital nature of their operations – were not dramatically affected by the measures instituted to combat the spread of COVID-19.
- Prosus owns a material part of Tencent, and subsequently benefitted from ongoing strength enjoyed by the latter as Chinese consumers continued to use and engage with its wide variety of offerings. Its other, more nascent internet platform businesses in a variety of emerging markets suffered a more challenging year, with certain operations (such as online classifieds) heavily impacted by lockdown measures. Conversely, food delivery and education-technology businesses received a substantial boost from accelerated adoption.
- Nike was a very strong performer for three reasons. Firstly, the business has invested heavily in selling directly to consumers rather than through other wholesale retailers; as the pandemic drove shoppers to Nike's own channels, its margins benefitted (and stands to improve meaningfully over the medium term). Secondly, its strong brand recognition and ability to continue acquiring and engaging with customers (looking for comfier clothes during lockdown, we should add) supported strong demand in digital channels even as physical retail sales dropped. Finally, Nike's supply chain investment has put it in a position to more rapidly clear its inventory channels – a key win for any retailer.
- Despite its poor performance in December 2020, Salesforce.com saw strong demand for its products over the year. Our investment thesis is built on the belief that all businesses – regardless of industry – have come to the realization that an integrated view of their customers from a sales, marketing and service perspective will be critical in driving future success. This proved to be true in 2020, as the digital customer channel was increasingly the *main* customer channel for many businesses.

- Osaka-based Keyence provides vision sensors that are critical components in the industrial automation process. With the use of industrial robots in manufacturing set to steadily increase over the next decade, our thesis believes that the business is well positioned to capture this phenomenon via its combination of high-tech specialisation and capital light business model. The impact from COVID-19 likely accelerates this trend.
- Accenture is a round-about way to gain exposure to the digital transformation of business. The company provides technology consulting services to a wide array of global businesses spanning all industries. Given their broad expertise, they are not committed to any one technology provider or solution, meaning their business should benefit from a rising IT spending environment over time. In addition, a large component of the business relates to outsourced services, which have proven to be very stable even over the pandemic.

Hidden Contributors: Discount Rates & Underperformers Avoided

- The valuation of many of the businesses we own – those that delivered solid fundamental revenue and cash flow growth in 2020, and saw a multiyear pull-forward of demand due to the pandemic – benefitted disproportionately from the collapse in discount rates experienced this year.
- We would be remiss if we did not point out that a very meaningful component of our relative return was derived from having no holdings in the Energy, Real Estate and Utilities sectors for the entirety of the year. We also had no exposure to any Financials up until our purchases of Berkshire Hathaway. While Berkshire is classified as a Financial by MSCI due to its large insurance operations, its other lines of business are much more varied, with exposure to railways, retailing, manufacturing, and utilities.
 - Even though we did not predict the nature of the crisis brought on by COVID-19, our decision to avoid these sectors is deliberate. Given our bias for businesses that earn high returns on their capital base with modest amounts of leverage, very few companies in these sectors meet our quality investment criteria. We are unlikely to have material holdings of energy, mining, banking or retail estate businesses in future.

Detractors

The six stocks that detracted from our performance, ranked from most to least, were:

<u>Business</u>	<u>Contribution</u>	<u>Total Return (AUD)</u>
The Walt Disney Co.	-1.0%	-21.3%
Anthem Inc.	-0.8%	-29.1%
Heineken NV.	-0.5%	-9.3%
The Coca-Cola Co.	-0.5%	-6.7%
Starbucks Corp.	-0.4%	-5.6%
Booking Holdings	-0.1%	-8.6%

We will address each in turn.

- No decision has caused us quite as much second-guessing as the sale of Disney back in March. Our reasoning was based on our risk management approach: the company was entering the pandemic with a record amount of debt from the Fox acquisition in 2019, more than 50% of total revenues were at risk for an unknown period of time due to lockdown measures, and Disney+ was likely to be a net consumer of cash for several years. It was very clear to us that the business would have to raise a meaningful amount of capital. Given how poorly capital markets were beginning to function in the early parts of March, we simply could not assume the company would be able to do so on favourable terms. Essentially, we were faced with an open-ended risk and a highly geared balance sheet; the potential range of outcomes were wide, and the downside – to our thinking – significant. As we wrote to you in our March 2020 quarterly update, “while we prefer never selling great businesses – particularly since it was only purchased in early 2019 - we did not foresee the impact of COVID-19 hitting Disney while it was still in the deleveraging phase of the Fox acquisition.”
 - The company did manage to raise debt capital in March and April as the Fed stepped in to stabilise markets, and the Disney+ streaming service has performed exceptionally well, likely leading to a whole new audience of viewers engaging directly with Disney content. At its investor day in December 2020, management substantially raised the bar, both in terms of quantity and quality of content set to be produced for Disney+.

- With the benefit of hindsight, our decision to sell certainly looks like a mistake as at the end of 2020. It may turn out to be prudent over the medium term if the quantity of debt Disney must now service proves to be a bigger burden than the market anticipates, but the stock has recovered strongly (and ahead of business fundamentals: the theme parks and theatrical film releases remain mostly shut.)
- With that said, if we were presented with the same facts again – an open-ended risk to the operations and cash generation of the business, combined with a highly leveraged balance sheet – we are not sure we would make a different decision. Perhaps the best lesson here is ‘hang on, but size the position appropriately’ – henceforth, the ‘Disney lesson’ at AIM.
- We can at least point to the fact that we retained Nike, LVMH or Estee Lauder – three businesses whose competitive advantages are built around their brand, engaged in building more direct relationships with their customers, and squarely in the firing lines of the pandemic. (In the spirit of full disclosure, we did reduce our positions in LVMH and Estee Lauder in February and March). The key difference to us was that these three businesses had much less balance sheets risk heading into the crisis.
- Anthem was purchased in November 2019 as a way to gain exposure to the health care needs of the aging US population. We had initially assessed its attractiveness relative to the leading (and arguably higher quality) managed care organization, UnitedHealth. We elected to purchase Anthem, as the valuation was more attractive at the point of investment. As both businesses started to sell off in February and March, we took the opportunity to switch from Anthem fully into UnitedHealth, and in so doing improve the quality of the portfolio.
- Heineken and Coca-Cola remain in the Fund. The reason for their underperformance is straightforward: in both cases, meaningful components of revenue are generated from ‘on-premises’ sales channels (think restaurants, sports stadia, canteens, pubs, clubs, etc.) We see the impact to sales, profits and cash flows as temporary due to strictness of lockdown measures to contain COVID-19. In neither case do we believe there is a permanent impairment of earning power or brand. In fact, both businesses have reported strong at-home demand and market share gains in various markets around the world. We will monitor the end-markets of both to make sure there is not a permanent change in consumer behaviour or preferences that negatively impacts these businesses, but we believe both should do very well when people are finally free to go out and socialise again in public.
- Both Starbucks and Booking Holdings were sold to consolidate our positions into higher conviction names at the time of sale. Given that this was done in May, the timing of the disposals detracted from our overall performance.

Part Two: Portfolio Positioning & Characteristics

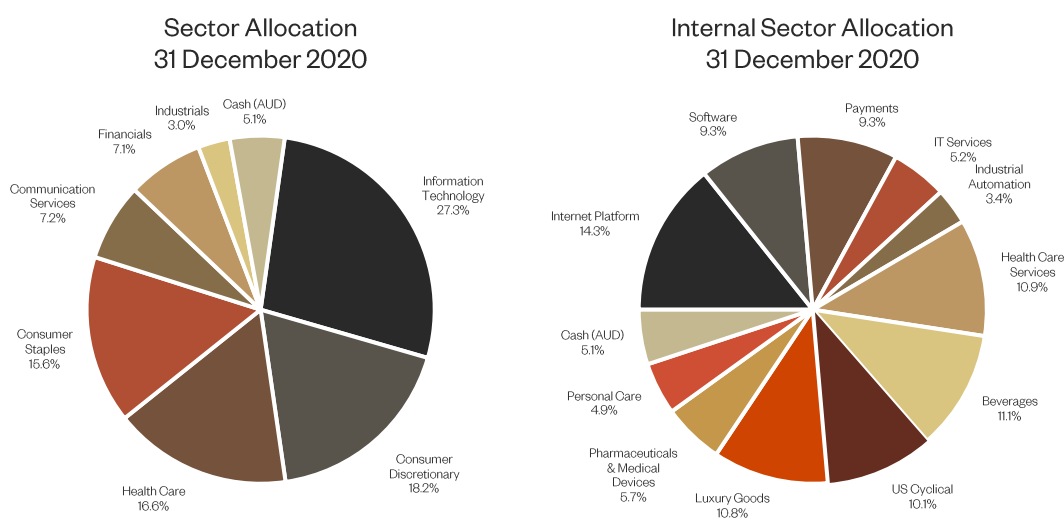
At the end of December 2020, cash (held in Australian dollars) accounted for 5.1% of the net asset value of the Fund. The Fund owned 21 businesses, and the median position size is 4.9%. The top ten holdings of the Fund were as follows:

Stock	Sector	Weight
Berkshire Hathaway	Financials	7.1%
Microsoft Corp	Information Technology	6.9%
The Coca-Cola Co.	Consumer Staples	6.2%
Alphabet Inc.	Communication Services	6.0%
MasterCard Inc.	Information Technology	5.6%
UnitedHealth Group Inc.	Health Care	5.5%
ICON PLC	Health Care	5.4%
Accenture PLC	Information Technology	5.2%
Nike Inc.	Consumer Discretionary	5.1%
Heineken NV	Consumer Staples	5.0%
Total		57.9%

Source: AIM, MSCI. Data as of 31 December 2020.

Sector Allocation

The charts below indicate the sector allocation of the Fund. In the left-hand chart, we use the standard sector classification as defined by MSCI. However, we feel the right-hand chart presents a more accurate view of our true portfolio diversification, using our internal classification system. (For example, MasterCard is classified as an Information Technology stock due to its business being reliant on the global payment network it administers. While we understand the logic, we think lumping it together with Microsoft or Salesforce.com – ‘traditional’ IT businesses – obscures the difference in end markets).

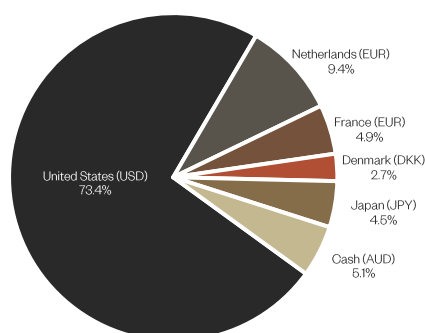


Source: AIM, MSCI. Data as of 31 December 2020.

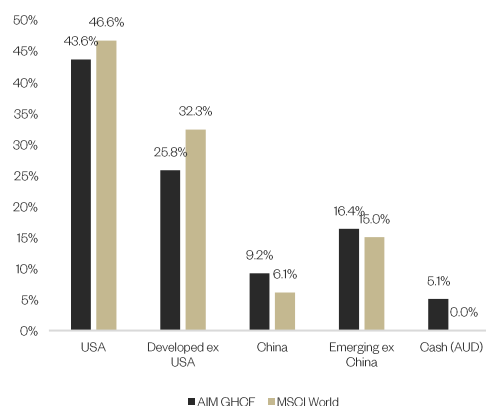
Geographic Allocation

The charts below indicate the geographic and currency allocation of the Fund. In the left-hand chart, we show the listing location and trading currency, whilst the right-hand chart shows the see-through revenue exposure of our businesses. As a reminder, we consider the latter far more relevant when constructing and evaluating the portfolio.

Geographic Allocation by Listing
31 December 2020



Geographic Allocation by Revenue
31 December 2020



Source: AIM, MSCI. Data as of 31 December 2020.

Portfolio Characteristics: Quality First

The table below indicates the fundamental characteristics of the businesses owned by the Fund in comparison with the broad MSCI World index.

Metric	AIM GHCF	MSCI World
<i>Profitability</i>		
Gross Margin	40.7%	31.9%
Operating Margin	15.3%	9.0%
ROE	17.5%	9.9%
ROIC	16.1%	4.7%
<i>Leverage</i>		
Debt/Equity	54.8%	159.7%
Net Debt/Equity	8.4%	64.5%
<i>Valuation</i>		
Free Cash Flow Yield	3.2%	5.3%

Source: AIM, MSCI, Bloomberg, FactSet. Data as of 31 December 2020.

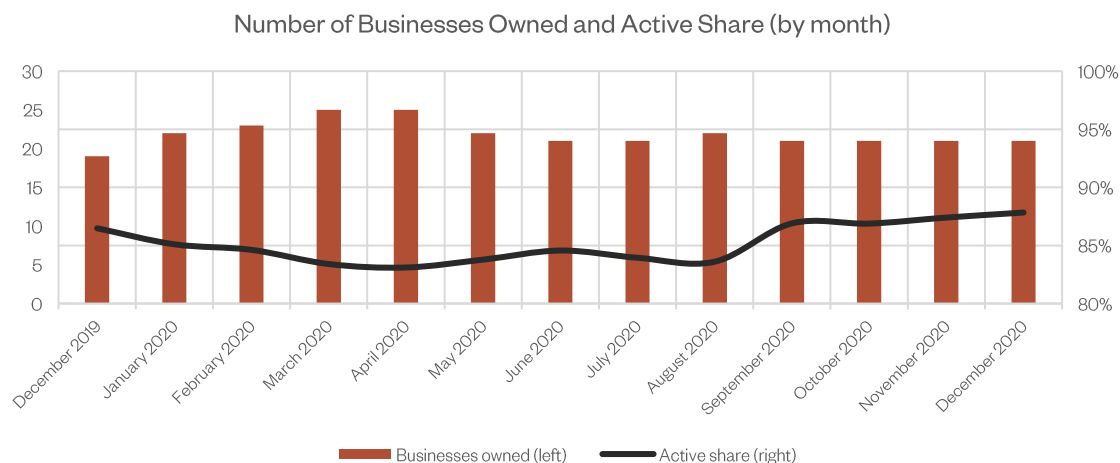
From an operating perspective, our businesses are much more profitable than the average, and we calculate the weighted average return on the tangible operating capital employed by the businesses owned in the Fund as 33.7%. On a similarly weighted basis, the businesses owned in the Fund have virtually no net debt. We believe we are true to label in owning high quality businesses that earn superior returns on capital and are very conservatively financed.

Admittedly, the Fund is more expensive than the index, and we believe we must balance the trade-off between quality and valuation. We have taken some actions to reduce our exposure to businesses trading on lofty valuations, but we believe the overall quality of the businesses we own justifies a valuation premium.

Other Key Metrics

As outlined in our Investor Handbook, we also provide you with several other metrics to help you understand a) whether we are sufficiently concentrated based on the number of businesses we own, b) if our portfolio differs sufficiently from the overall index, and c) whether our performance was driven by broad-based stock selection, or merely getting one or two calls right or wrong.

The chart below addresses points a) and b).



Source: AIM, Bloomberg PORT. Data as of 31 December 2020.

On the left-hand axis, you can track the number of businesses we owned (represented by the red bars) from December 2019 to December 2020. To make sure we remain concentrated, we limit ourselves to owning no more than 25 business, and set a lower limit of 15 to ensure adequate diversification.

As you can see, we increased our number of holdings to the maximum of 25 in March and April based on our purchasing activity during the crash. As we started to gain greater clarity into how our businesses were performing, we sold certain names to consolidate into our higher-conviction ideas.

On the right-hand axis, you can track the Fund's 'active share'. (This is the one bit of investing jargon we hope you forgive.) Simply put, active share measures how much a portfolio differs from the benchmark it is measured against. A portfolio that fully mirrors the benchmark would have an active share of 0%, whereas a portfolio that has nothing in common with the benchmark would have an active share of 100%. In general, a portfolio needs to have an active share above 60% to be considered as 'actively managed'. We target an active share above 80%, and managed to be between 83% and 88% for the full year.

Why do we think this measure is important? Essentially, having a low active share makes it nearly impossible to outperform our benchmark after fees. While having a high active share by no means guarantees outperformance, it places us in a better position to do so if our businesses perform as intended.

Our ratio of businesses that delivered a positive absolute contribution versus a negative absolute contribution is 81%-to-19% (i.e. the vast majority of our businesses delivered a positive contribution to the +14.2% return the Fund generated). The ratio of businesses that outperformed the benchmark is 62%-to-38%. The lower ratio means that some businesses that delivered a positive absolute result did lag the benchmark (+5.6% in AUD).

If we had to rate ourselves on this basis, we would say that we did not have too many businesses that dramatically underperformed but were hidden by strong performance elsewhere. Only Disney and Anthem fit the bill of performing dramatically worse than the rest of the portfolio, for the reasons explained in part one of this letter (selling in March.)

Part Three: Commentary

The Folly of Macro-Economic Prediction

Normally, this would be the point in an annual letter where we would provide some macro-economic prediction about what might happen over the next year or so. We will refrain from doing so in this letter and in all future letters, since 2020 has quite dramatically demonstrated to us how futile such an exercise really is.

We went from publishing a '2020 outlook' in January of last year to having to tear it up only six weeks later. Market commentators in March and April were forecasting doom, and yet global risk assets delivered a surprisingly good return, given the underlying economic disruption. In a year with a massive range of potential economic outcomes, investors were essentially forced to operate without a script, with all forecasts becoming 'best guess' attempts (our own included.)

We think providing highly specific macro-economic forecasts create an illusion of false precision for ourselves and investors. The fact that we have completed another orbit around the sun does not make a 2021 forecast likely to be any more accurate. As economist John Kenneth Galbraith once remarked about his own profession, 'the only function of economic forecasting is to make astrology look respectable'.

With that said, we definitely make forecasts about the future cash flows of the businesses we own, although admittedly we think our fundamental analysis at least enables us to be more informed when doing so. However, no amount of imagination or scenario analysis can predict or forecast every possible future outcome, good or bad. So, what to do?

We believe our focus should be on constructing the Fund to be robust and resilient to unexpected shocks. There will always be the risk of unforecastable high impact events, of which the 2020 pandemic is a prime example. Technology businesses were not only anti-fragile to a pandemic, but they were also part of the solution to help our economies continue to function. At the risk of sounding pessimistic, there is no guarantee that the next crisis does not cripple the global technology infrastructure: how much 'tech' would you want to own then?

Our goal is to ensure the Fund is not a one way bet on any specific scenario or theme, and rather than being highly optimised for only one outcome, is prepared to weather a range of outcomes. When it comes to macro-economic conditions, our motto is 'prepare, don't predict.'

This explains why we focus so heavily on owning businesses with very robust balance sheets. When an unexpected crisis occurs, leverage combined with a lack of readily accessible cash reserves is the most direct path to a liquidity crunch, with potentially dire consequences for equity owners. We may miss out on opportunities and lag somewhat in a bull market, but we do not think relaxing this criterion is a great way to compound capital over the long term.

In place of making any macro-economic or market predictions, we will outline what we think are the two main risks over the medium term, and how we are addressing them in the Fund. We will update you with our thoughts around the specific risks faced in the new year by our portfolio of businesses once we have had an opportunity to hear from them with updated results throughout January.

Unexpected Inflation & Higher Discount Rates

Many market participants are forecasting an increase in inflation over the next several years due to the vast amount of monetary and fiscal stimulus provided in 2020. In fact, central banks are telling markets they are willing to let inflation 'run hot' to achieve a level of average inflation above 2% over a period of time.

In and of itself, modest inflation (say, 2% to 4%) is not the end of the world, provided you own productive, real assets. With cash yields likely anchored close to zero for an extended period, we believe having too much capital allocated to cash is almost guaranteed to earn a negative real return for some time. (As an aside, we do not find this attractive, and therefore intend to stay within our 90% - 100% equity allocation in the Fund. You do not pay us to sit on cash, and we are not an asset allocation vehicle. If you entrust your capital to us, we will operate under the assumption that you want it managed in line with the equity-centric process and philosophy we follow.)

It is important to understand there will almost certainly be an acceleration in reported year-over-year inflation from April to June of 2021. This acceleration will not necessarily be because inflation is shifting structurally higher, but because there was *disinflation* (positive but slowing inflation) in April to June of 2020 as economies went through the worst of the lockdown. To oversimplify: because inflation was very weak in the second quarter of 2020, merely normalising to something closer to pre-lockdown levels in the second quarter of 2021 will mathematically look like a meaningful year-over-year acceleration. Do not be surprised if there is a lot of ink spilt on rising inflation during the second quarter of 2021.

The belief that inflation will run hot for some time is the basis of the 'reflation' trade many people are recommending: own commodities and banks, who a) have short duration cash flows, b) trade at cheaper starting valuations, c) will show tremendous year-over-year growth in earnings in 2021 (due to earnings collapsing in 2020) and d) will benefit from modestly rising interest rates.

If the extent of the pick-up in inflation is a spike in 2021 followed by an average of 2% - 3% thereafter, we are not overly concerned about our holdings. The stocks we own may underperform for a period as they go out of favour, but the underlying businesses we own should do just fine.

However, we believe that focusing on a short-term increase in inflation misses the greater point. The true risk we are concerned about is whether inflation will move materially higher (say, 4% or above) for several years, to the point where central banks feel the need to raise interest rates to bring it under control. Should this happen, the prevailing view is that owning commodities or commodity businesses will in theory provide an inflation hedge.

As 'business-first' rather than 'security-first' investors, we approach this issue from a slightly different angle. The primary effect of inflation on a business is that it causes input costs to increase in nominal terms. As such, we believe there are two critical questions to ask:

1. Does the business offer a service/product that is sufficiently differentiated to increase prices above the rate of cost inflation without impacting sales volumes? In other words, does the business have **pricing power** to grow its profits in real terms?
2. Does the business need to reinvest a lot of its profits back into tangible assets to grow and maintain its operations? Put differently, is the business **capital heavy** or **capital light**, reliant on physical or intangible assets?

The last time high inflation presented a major problem was in the 1970's and early 1980's. To understand its effect on businesses, there is likely no better source to turn to than Warren Buffett, who successfully navigated this period in markets and wrote about the impact of inflation extensively. Below, we quote the 1983 Berkshire Hathaway shareholder letter, which provides a very succinct summary for why we emphasise the two questions above.

For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.

In contrast, a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses.

Mr. Buffett specifically addressed the issue of pricing power in testimony at a Congressional hearing in 2010:

The single-most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by a tenth of a cent, then you've got a terrible business. I've been in both, and I know the difference.

If central banks are forced to raise interest rates to contain inflation, we think the risk of higher private sector defaults (given the quantum of outstanding debt) would increase materially, meaning banks would be negatively impacted. Also, an ongoing

increase in inflation will eventually erode the fundamental profitability of capital-heavy business models (such as commodity producers) who need to replace their physical capital at ever-higher price levels.

That addresses the *business risk* of inflation. However, there is also a short-term *market risk* to consider.

If interest rates do move meaningfully higher, discount rates for businesses will adjust upwards, with a negative impact on valuations. As we pointed out in part one of this letter, if lower discount rates disproportionately benefited high growth businesses in 2020, higher rates will disproportionately hurt them. Buying or owning any business with cash flows only occurring in the very distant future is therefore not too dissimilar from buying a 10- or 30-year government bond at present yields. (At least the equity has the advantage over a bond of being able to grow its cash flows.)

To paraphrase the famous quote about the cause of the global financial crisis of 2008, we do not want to mistake lower discount rates for investment genius. Loading up the Fund with a collection of such names is creating the exact type of one-way bet we want to avoid, because it assumes interest rates remain at present levels essentially forever. While we think yields on cash will remain very low, there is a reasonable risk that government bond yields can move higher if global economic growth improves and broadens out.

We do not pretend to know the magnitude of inflation over the next several years. If asked, our best estimate is that it will remain contained. At present, we believe we have a balanced exposure to long-duration businesses that can grow their cash flows at attractive rates of return. We believe these businesses have enduring competitive advantages that will see their *operations* through periods of rising inflation, even if their *stock* is volatile for a period if interest rates move suddenly higher.

How Our Portfolio is Positioned to Address These Risks

As economics professor Elroy Dimson once said: 'risk means more things can happen than will happen'. We believe the best way to protect against the risk of a meaningful and sustained increase in inflation is to own productive businesses that have strong balance sheets, have low tangible asset reinvestment requirements, and possess pricing power: in short, the kind of high-quality businesses we already own.

In addition, we have made a point of owning businesses where the valuation is not exclusively reliant on long-duration cash flows (Berkshire Hathaway), or that benefit from an increase in nominal prices (for example, MasterCard and PayPal both generate a component of revenue based on the dollar value of transactions in their ecosystem).

Our process generally guides us to three types of businesses: dominant consumer brands, scalable platforms/software, and those that provide non-core yet business-critical goods and services.

Dominant Consumer Brands

When well-managed and cared for over a period of years, brand recognition can provide one of the most powerful intangible moats any company can wish to have. However, not all brands create value for their owners. Brands are only valuable when a) they convince consumers to pay more for a specific product/service than for the equivalent, non-branded version, or b) they reduce consumer search costs. Let us briefly address both variants.

- The best brands essentially live rent-free in consumers' minds, with a combination of goodwill, affinity, desirability, scarcity, social signalling and affordability driving purchase decisions. The classic example is jeweller Tiffany: consumers are willing to pay a premium for an engagement ring that comes in the (trademarked) robin-egg blue Tiffany box compared to a ring with an identical diamond purchased from a lesser-known competitor. Brands that impart a societal status on the buyer, user or wearer of their goods are very difficult to disrupt. We look for these attributes in brand-driven businesses, as the buyer appeal can often lead to substantial pricing power over time.
 - Nike, Estee Lauder and LVMH (now the owner of Tiffany) are three businesses in the Fund where we think the strength of the consumer affinity towards their brand underpins their long-term competitive advantage. All three businesses are currently transitioning to the new era of omnichannel retail. The combination of reaching new consumers (who may not live near a store selling the product), building a more direct consumer relationship, cutting out the middleman and rationalising floor space should lead to sustainably higher margins over the medium term.
 - Combined with the abovementioned pricing power, we believe these businesses have the makings of fantastic long-term franchises that can grow cash flows in real terms.

- ‘Search-cost reduction’ brands create value because they lower the time consumers need to spend thinking about which product they want to buy. As a simple example, think about how you buy cooking oil when you shop: do you spend five minutes browsing through every bottle in the aisle, or do you simply grab the product from the brand you know and have come to trust? If it’s the latter, the brand you prefer lowers your mental cost of having to search and decide: if you trust the quality of the product, you may be more inclined to pay a specific price to acquire it over cheaper or lesser alternatives.
 - Brands that rely on search cost reduction are somewhat more easily disrupted in the days of ubiquitous online advertising. The traditional barrier to competition for businesses using this moat was the substantial marketing cost required to reach a wide consumer audience. Today, challenger brands can more easily catch your eye with affordable targeted marketing through Facebook, Instagram, YouTube, etc.
 - We think Coca-Cola and Heineken are both businesses where the ‘search-cost reduction’ function is still strong – if you walk into a restaurant in a foreign country (well, when we can travel or go to restaurants again!), you know what you are getting when you ask for a Coke or order a Heineken. During the pandemic, both businesses reported that consumers gravitated towards brands they knew and trusted due to lower in-store browse-times (less time in-store means a lower risk of potential infection), and both businesses reported robust underlying demand in the channels where they could still sell their product.
 - At a stretch, we think Amazon might also qualify as a ‘search-cost reduction’ brand. Amazon does not always offer the lowest price for every product, but the fact that your order arrives on-time, in good condition, and with a simple refund process means many consumers simply choose Amazon as their first and only port of call when shopping online. This element of trust is not easily replicated.

Scalable Platforms/Software

Many of the dominant technology companies of today fit this description. The most successful firms in this space benefit from an economic phenomenon known as ‘increasing returns to scale’ – essentially, as they become bigger and more dominant, they become more profitable as the market tends towards allowing only a few competitors. You may choose to join social network A over alternative platforms in order to engage with your friends, and by your very action, network A becomes more entrenched in your social circle. As technology is an industry in a state of relentless development and constant disruption – where yesterday’s winner is tomorrow’s also-ran – we choose to only own businesses with multiple overlapping and proven moats in this space. High switching costs and strong network effects are what we look for to minimise our risk of being wrong.

- We believe Microsoft, Alphabet, MasterCard, Amazon and PayPal all exhibit some combination of these traits today, and many of the businesses owned by Prosus have the ability to exhibit these traits in future.
- While less obvious, we think UnitedHealth is building (through its integrated Optum business, which offers a care network linked to a health care data & analytics business) a real-world scalable platform for offering value-based care in the US.

Non-Core, Business-Critical Goods and Services

These businesses generally benefit from being the tools that enable other professionals to perform their job. As long as the product/service is critical to ‘getting the job done’, and the cost of said product/service is relatively small in the bigger scheme of things, the efficiency and familiarity of the product/service is more important than being the lowest cost provider, leading to a ‘switching cost’ moat.

- Contract research organisation ICON PLC is a good example. ICON assists pharmaceutical companies in bringing drugs to market by managing and conducting the clinical trials required by regulators prior to drug approval. Because the clinical trial part of the drug approval process is regulated, it cannot be avoided. The cost of conducting a clinical trial is generally a smaller component of the overall cost of drug development, but is critical to the drug’s journey to market. Combined with steadily increasing research & development spend by the pharmaceutical industry to find the next blockbuster drug, we think this type of capital-light ‘picks and shovels’ exposure can outperform over time.
 - Though exposed to different end markets, we find similar characteristics in other portfolio holdings Accenture and Fastenal.

Berkshire Hathaway

Berkshire presents a unique investment proposition in the Fund that is largely uncorrelated to our other holdings. Being more reliant on physical assets, it is exposed to more cyclical sectors such as finance and heavy industry that are not as readily scalable. Suffice to say that the fact that it is different from all our other holdings – yet of exceptionally high quality – provides the Fund with attractive diversification in our view.

In addition, many of Berkshire's underlying businesses do have strong moats and are exposed to a cyclical upswing in the US economy. See's Candy demonstrates both pricing power and brand recognition, whilst the Burlington North Santa Fe Railway owns a near impossible-to-replicate railroad network.

Finally, one of Berkshire's historical differentiators – access to low-cost capital due to the positive returns earned on the insurance float – is less relevant in a world where the cost of capital is at multi-decade lows. Should the cost of capital increase, Berkshire's large cash position – combined with experienced capital allocators at the helm – position it very well. In short, we believe Berkshire offers attractive optionality and diversification for the fund, and it has more than one way to increase in intrinsic value.

Opportunities

We feel certain of only a few trends accelerated by COVID-19 as being truly lasting:

1. A permanently higher level of online shopping.
2. The accelerated adoption of digital payments.
3. Increasing digitisation: the adoption of software, tools and technology infrastructure that allows for more work, shopping, and entertainment experiences to move permanently online.

Within these three trends – and specifically, the ways they will interact – we believe there are a wide variety of possibilities to explore. The consumer of tomorrow may never know a world without remote working, online shopping or tap-and-go payments as these trends increasingly become the 'new normal' for younger generations.

A Permanently Higher Level of Online Shopping

We believe the term 'e-commerce' will slowly become redundant: all commerce will eventually become omnichannel, with the shopping journey interchangeably starting and ending online or in-store.

We see opportunities in businesses that are successfully using technology to adapt their operating models – either to be radically more efficient, or to open up new ways of doing business. In fact, if the portfolio expresses any theme, it is the idea that owning, knowing, and being closer to your consumer is going to be vitally important to conducting successful business going forward.

We think there are several speciality retailers who – by virtue of being forced to pursue a robust omnichannel retail strategy during the pandemic – have had a once-in-a-decade opportunity to acquire new customers for very little incremental marketing cost. Because shoppers essentially had no choice but to order online, there is now a way for retailers to understand consumer preferences and behaviour in a way that a basic in-store loyalty programme was never able to achieve. This data will provide new ways to drive engagement and improve purchase conversion for retailers across their entire store base. In addition, it will likely lead to optimising store sizes and in-store inventory levels.

There is also the opportunity for certain brands that enjoy strong consumer recognition to bypass their existing distribution channel and build a much more direct relationship with its customer base, which should be to the benefit of margins and brand loyalty over time.

Select industrial players in this space – primarily those of the logistics or 'picks and shovels' variety – are also of interest.

The Accelerated Adoption of Digital Payments

We can also gain exposure to increased levels of online shopping and omnichannel retail via the second-order effects they will have.

For example, if we believe e-commerce adoption shifts permanently higher, it stands to reason that businesses that provide the payment infrastructure to enable it will also benefit. We see several opportunities in the payments value chain – such as payment processors or payment gateways – that will profit from consumers and merchants preferring to have a more integrated digital payment experience, both online and in-store.

We look for businesses that can provide incremental value to merchants – higher conversion due to ease-of-use or capturing underbanked consumers, fewer failed/fraudulent payments, improved integration into existing accounting systems, easier reporting, and an integrated online/offline payment ecosystem – all without taking excessive amounts of credit risk.

Increasing Digitisation

Software businesses in general have had a stellar year in 2020 – particularly software-as-a-service (SaaS) businesses, which experienced a material pull-forward of demand. In general, software businesses exhibit natural switching costs – once integrated into a workflow, being replaced can entail an immense effort that can cause substantial business disruption. The accelerated adoption of software during the pandemic has been extremely instructive in indicating to us which businesses are truly providing an irreplaceable product or service.

There are certain software businesses that have been very successful in 2020 that we would consider owning at the right price. We prefer software businesses that are enterprise or developer-facing (so-called ‘API-first’ businesses), or those building the tools enabling developers to do their job (again, the picks and shovels play). However, we would want to either see very clear confirmation of the competitive advantage allowing it to defy the entry of new competition before investing, or an entry price where the embedded expectations allow for a greater margin of safety.

A Disciplined Approach

As patient custodians of your capital, any purchase we make will carefully consider the price offered by the market relative to the value we see in the company. If we do not like the price offered, there remain opportunities outside of the three trends pulled forward by the pandemic.

As we enter the new year, we are seeing better value in businesses in the \$5bn to \$30bn market capitalisation range. In addition, non-US businesses appear in general more attractive from a valuation standpoint.

We think businesses providing proprietary datasets in a business-to-business context are going to be increasingly in demand. Given the long history and specialised nature of the existing datasets, it can be prohibitively expensive – if not downright impossible – to replicate, meaning there is a lack of new competition in these markets.

We are studiously avoiding capital intensive businesses with substantial upcoming debt maturities. If rates do increase and debts need to be refinanced, the higher lending costs will negatively affect these businesses.

In Closing

Our goal is to own competitively advantaged, high-quality businesses that can compound in value over time. As tempting as it may be to try and switch into stocks that may do well for the short run, we know that compounding only happens if you allow it to. Businesses that can stay in the game, have strong balance sheets and can consistently earn high returns on invested capital are the ones with highest probability of finishing the race.

At present, we believe we own a portfolio of businesses that have strong competitive advantages, very strong balance sheets, high returns on capital, and good cash generating ability. This served us well in 2020. If the market decides that it prefers more cyclical or lower-quality businesses rebounding from depressed valuation levels in 2021, we will live with it. Prices vary more than intrinsic values do. We plan to earn our long-term return from the underlying compounding of internal capital of the businesses we own, not in trading their stocks.

The macro-economic landscape is, to some extent, like the weather – we will all have to deal with it. While we cannot mitigate every risk in every business we own, we have structured the Fund to be resilient to unexpected shocks, given the quality of the underlying businesses held.

Again, we thank you for your support in what has been a highly unusual year. Your trust means a lot to us, and we do not take it for granted.

With regards,

The AIM team

January 2021

How AIM Invests Your Capital

We are 'business-first' rather than 'security-first' investors, and see ourselves as part owners of the businesses we invest in. Because we subscribe to a business ownership mindset, the quality of the businesses we own matter a great deal to us.

We look for the following characteristics in the businesses we want to own:

- Strong competitive advantages that enable consistently high returns on capital throughout an economic cycle, combined with the ability to reinvest surplus capital at high marginal returns.
- A proven ability to generate and grow cash flows, rather than accounting based earnings.
- A strong balance sheet and sensible capital structure to reduce the risk of failure when the economic cycle ends or an unexpected crisis occurs.
- Honest and shareholder-aligned management teams that understand the principles behind value creation and have a proven track record of capital allocation.

We look to buy businesses that meet these criteria at attractive valuations, and then intend to hold them for long periods of time.

We will manage a concentrated portfolio of businesses and intend to own between 15 and 25 businesses at any given point.

We do not seek to generate returns by constantly having to trade in and out of businesses. Instead, we believe our long-term return will approximate the underlying economics of the businesses we own.

We are bottom-up, fundamental investors. While we are cognizant of macro-economic conditions and geo-political risks, we do not construct the Fund to take advantage of such events.

We are an equity fund and intend to be between 90% and 100% invested in this asset class. We operate under the belief that if you entrust us with your capital, you want it managed in line with the process and philosophy we follow; you do not expect us to make an asset allocation decision. We believe in time in the market, rather than timing the market.

We do not engage in shorting, nor do we use leverage to enhance our returns.

Our investable universe is global, and we look for businesses that have a market capitalisation of at least \$7.5bn to guarantee sufficient liquidity to our investors.

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