2021 Interim Letter

The first half of 2021 has provided no shortage of 'big picture' topics to be concerned about: take your pick between the pace of vaccine-rollouts, ongoing border closures, geopolitical sabre-rattling, the risk of personal and corporate tax increases, or fears of rapidly increasing inflation requiring an offsetting rise in interest rates.

Unsurprisingly, whether the current pick-up in inflation is 'transitory' or 'structural' is the topic *du jour*. It remains a question that will only be answered towards the end of 2021. While we remain mindful of the risk of inflation, the AIM Global High Conviction Fund owns on your behalf a concentrated portfolio of highly cash generative businesses with pricing power, meaning we should benefit from a possible uptick in inflation. As an investment team, we remain focused on the fundamentals of the businesses we own and understanding their long-term destination, rather than trying to predict short-term macro-economic outcomes in which we have very little edge.

As an example: around this time last year, the 'shape' of the economic recovery following the COVID-induced global recession was endlessly debated. Would we have a V-, U-, L-, J-, or K-shaped recovery? (Or our favourite: the 'Nike swoosh'-shaped recovery, which is really just a J-shaped recovery with better branding!) This topic is hardly mentioned these days, despite the vast amount of energy expended on predicting it last year.

To our thinking, the lesson is not that the macro-economic backdrop does not matter, but rather that long-term investors are better served in trying to understand how the businesses they own (or might look to own, should they go on sale) are positioned to navigate periods of distress and subsequent recovery. Given that we favour well-capitalised and cash-generative businesses with deep economic moats, we believe that most of our holdings took the opportunity presented by the pandemic to a) take market share, b) allocate capital to attractive acquisition opportunities, or c) permanently reduce costs without reducing their capability to service their clients, which will lead to sustainably higher margins.

FY2021 Performance Summary

For the **financial year ended 30 June 2021**, the AIM Global High Conviction Fund (GHCF) delivered a return of **+25.80% after all fees**. This compares to a benchmark return of +27.52% over the same period.

Though we have slightly lagged the benchmark over the measured period, a deeper analysis of the drivers of our performance (see Part One of this letter) gives us confidence that our process in identifying and owning high-quality businesses on your behalf is functioning as desired. Since November 2020 – when vaccines were first announced – there has been a meaningful rally in sectors that we simply consider outside the bounds of our investable universe due to the businesses not meeting our minimum sustainable return on invested capital hurdle-rate. This includes the banking sector, as well as most commodity-based sectors (such as energy, mining, etc.) and real estate.

We believe that being able to keep pace with the benchmark over the financial year despite not owning businesses in the abovementioned sectors reflects positively on our stock selection and balanced portfolio construction processes.

The table below presents the annualised return since the Fund inception (7 July 2015) and the major change in strategy (30 June 2019) which I discussed in more detail in our 2020 Annual Letter (available on our website.)

Compound Returns (annualised)	*GHCF*	*Benchmark*
Since Strategy Inception (30 June 2019)	+17.8%	+15.6%
Since Fund Inception (7 July 2015)	+6.7%	+9.2%

All returns measured in AUD and presented net of fees. Past performance is not a guarantee of future performance. 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.

From a risk-adjusted perspective, independently sourced data from Fundmonitors places the Fund as one of the lowest volatility global equity funds in Australia over the last two years. In our view, this is due to our aversion to compromise on the quality of the businesses we own on your behalf. We are prepared to underwrite that our businesses have far less fundamental risk than the average business traded on public equity markets, and that this quality focus should stand us in good stead if the next period proves to be more challenging for markets to navigate.

In addition, it is worth pointing out that over as short an investment horizon as one year, the vagaries of what is currently in vogue (“Value! Growth! Reflation! Deflation!”) is largely driven by narrative and sentiment. We believe that fundamentals win out over the longer term, meaning that as time goes by, the performance we aim to deliver to you will increasingly be attributable to the hard work of the management teams and staff employed by the businesses we own on your behalf. Our job is to prudently allocate your hard-earned capital to trustworthy people at an attractive price, and then to let them get on with creating value. This business-ownership perspective has served us well during the extraordinary circumstances of the past 18 months, and we believe it will do so again in future.

Looking Ahead in Markets

After two years of strong absolute returns (with a once-in-a-generation disruptive pandemic in the middle), it is sensible to wonder ‘what comes next?’ While we can speculate about such matters at length, the honest answer is always that no-one truly knows. There are a variety of macro-economic risks that could see markets come in for a pullback. Whether or not any of these downside scenarios materialise, we believe that the fundamental quality of the businesses we own positions us well for multiple situations. We seek to build resilience into the Fund, and not to optimize for just one potential outcome.

As mentioned above, our quality focus has seen us exhibit lower volatility than markets over the past 24 months, and we would expect such a strategy to hold up better during future periods of market volatility. (The quality characteristics of our businesses are presented in Part Two of this letter). However, we would highlight that market volatility is not the same as fundamental business risk. Investing is about staying the course in good businesses and allowing your wealth the time to compound.

Mathematically, markets hypothetically rising 30% next year and falling 10% the year after has the same investment return as when the order is reversed (a 10% drop followed by a 30% rally). As such, it becomes clear that the medium-term *destination* (i.e., us being right about the quality of our businesses) is more important than the *journey* (volatility) along the way... as long as we maintain the resilience to avoid the psychological error of selling out in a declining market.

Science has demonstrated that our minds perceive immediate reward differently than delayed gratification, because different parts of the brain are activated in response to either. During stressful periods, our hard-wired survival mechanism can override our ability to think analytically. Practically speaking, this means humans prefer short-term rewards over a greater long-term gain, and we absolutely despise short-term losses. This is a built-in ‘fight-or-flight’ survival reflex, and it can lead to significant behavioural risk for investors in periods of market distress. One of our key learnings from that last 18 months is that long-term investors should recognize and work to overcome this risk. Part Three of this letter details how we have designed our own investment process to account for and take advantage of these psychological pitfalls. We believe it is well worth your time to read.

It is inevitable that markets will suffer a setback at some point, but whether that is tomorrow or three years from now is not accurately forecastable, and therefore has very little informational value to us as long-term business owners. We would encourage our investors to take the same view: periods of market volatility often provide opportunities for considered capital allocation rather than reasons to worry.

Developments at AIM

Over the past two-and-a-half years, I have overseen a systematic rebuilding of our investment team and process.

Etienne Vlok – with a track record of managing a Morningstar award-winning global equity fund from South Africa – was the first to join in June of 2019. Andrew Strasser followed in November 2019; his background in corporate credit has added further depth in our understanding of the balance sheet risk of the businesses we analyse and own. Most recently, Daniel Gerdis joined in March, bringing more than a decade of global equity experience to our investment capability.

Les Andrews (who is legitimately a part of the furniture, having been with AIM since day 1) and Gemma Yeates (who joined in 2017) round out our risk, operations, and client services functions. Their focus on prompt and efficient assistance underlines the fact that I want AIM to be a boutique fund manager where the entire team is willing and capable to engage directly with our investors.

I believe I have the right people in the right seats alongside me in managing your capital. Feel free to reach out at any time if you have any questions, either regarding your investment in the Fund, or the businesses we own on your behalf. We would be very happy to be of assistance.

Reduction of Fees

I am happy to inform our investors that – as we have done in each of the past three years – we are again adjusting our fees downward. From 1 July 2021 going forward, our performance fee is reduced to 10% (excluding GST) from the previous level of 15%. Performance fees will still be subject to outperforming our benchmark and surpassing our high-water mark.

Client Communications

As we promised in our Investor Handbook and reiterated in our 2020 Annual Letter, we are dedicated to providing our investors with high levels of transparency into our investment process and holdings. We believe that investors who understand what they own are better able to make intelligent decisions around buying, holding and selling, particularly in periods of market distress. With this in mind, we regard our Interim and Annual Letters as crucial communication tools to keep you informed as to our performance, and to hold ourselves to account for how we have allocated the capital you have entrusted to us.

In this letter, you will find:

- In Part One, a detailed review of the drivers of performance for the 12-month period ended 30 June 2021
- In Part Two, an update regarding our current Fund positioning and composition
- In Part Three, a discussion of how we have structured our investment process to deliver repeatable outcomes
- In Part Four, an introduction to HEICO Corporation, which is a recent addition to the Fund

We conclude with a one-page summary of our investment philosophy, which guides our actions as long-term stewards of your capital. This is the same summary presented at the end of our 2020 Annual Letter; we intend to include it in all future Interim and Annual Letters for ease of reference.

Conclusion

I would like to take this opportunity to thank all our investors – new and long-standing – for partnering with AIM. Our goal remains the building of long-term wealth by sensibly allocating your capital over time.

With regards

Charlie Aitken

Chief Investment Officer

AIM

Part One: Performance Review

The table below presents the Fund's return for the four calendar quarters (CQ) comprising Financial Year 2021 (FY2021).

	3rd CQ2020	4th CQ2020	1st CQ2021	2nd CQ2021	FY2021
AIM Global High Conviction Fund	+5.8%	+3.4%	+2.8%	+11.8%	+25.8%
MSCI World Net Total Return (AUD)	+3.7%	+5.9%	+6.3%	+9.3%	+27.5%

All returns measured in AUD and presented net of fees. Source AIM, MSCI, FactSet. Past performance is not a guarantee of future performance.

As always, we believe that breaking down our return profile by quarter helps to highlight some nuances that may not be visible in simply showing you the outcome. This is particularly true in a financial year where market leadership swung wildly from one type of stock to another about half-way through.

As can be seen, the fund lagged the overall market during the 6-month period from 1 October 2020 to 31 March 2021. This coincided with the announcement of several effective vaccines in November, which lead to the stock prices of businesses and sectors highly dependent on the reopening of the global economy (and the subsequent recovery in economic activity) rallying from very depressed levels. This has been the so-called 'value rally' experienced in markets.

Since our businesses faced less fundamental risk and held up better in the crash of February/March 2020, their stock prices recovered sooner than those of businesses that were highly affected or faced a much greater risk of failure. Put differently, our businesses simply had less to recover from, and thus did not participate to the same extent in the rally sparked by the announcement of effective vaccines.

However, during the final quarter of the financial year, the 'recovery trade' had largely been priced in, and the underlying durability and quality of the businesses we own were again reflected in our performance. As we wrote in December 2020:

> *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.*

This dynamic has almost exactly played out over an extremely compressed timeframe: from February 2020 to June 2021.

Performance Drivers

Our average cash position throughout the financial year was around 5.3%. The cash did not add or subtract to our absolute performance of +25.8% but was a modest drag on relative performance.

- On the positive side of the ledger, our list of businesses that added value in absolute terms far outnumbered those that did not. In fact, only one business detracted from our absolute performance over the financial year. The business in question was a recent purchase, made in April 2021.
- We can happily say that we avoided businesses that precipitously underperformed over the financial year. However, it should be noted that markets have generally risen over the period, and thus having only one detractor from absolute performance may not be highly informative in this particular financial year.
- A far bigger drag on absolute performance was the strength of the Australian dollar relative to many other currencies, but particularly the US dollar.

Currency

Over the financial year, AUD strength detracted from our underlying equity returns. Most of these headwinds were experienced from November through February. Since then, the AUD has mostly traded within a narrow band, and strengthened more recently. We estimate that the Fund's 2021 financial year performance (after fees) in US dollars would have been around +37.4% (compared to a USD benchmark return of +39.0%).

Contributors

The top ten businesses contributing positively to absolute performance were:

Business	*Contribution (AUD)*	*Total Return (AUD)*
Alphabet Inc.	3.8%	62.6%
Berkshire Hathaway	3.0%	42.8%
LVMH	2.7%	66.8%
Estee Lauder Co.	2.2%	55.8%
Nike Inc.	2.0%	45.7%
PayPal Holdings	1.8%	45.6%
Microsoft Corp.	1.8%	23.3%
UnitedHealth Group	1.6%	26.4%
Accenture PLC	1.3%	27.7%
Mastercard Inc.	0.9%	13.8%

- After ad budgets were initially slashed in the face of the lockdowns of March to June 2020, it soon became clear that for businesses wanting to reach consumers where they were spending time – that is to say, online – **Alphabet** provided several of the most vital channels to do so in Google and YouTube. Combined with strength in Google Cloud, a positive step-change in online advertising demand (with retail becoming increasingly omnichannel), and a new focus on both cost discipline and capital allocation, business fundamentals developed very favourably over the period.
- A year ago, a business of **Berkshire Hathaway's** obvious quality was simply much too cheap. Ongoing improvement in the US economic outlook combined with a step-up in capital returns to owners underpinned our return this year. As the economic cycle in the US looks to have some way to go, we believe Berkshire still offers a high-quality, differentiated cyclical exposure to the Fund. Looking out a bit further, alternative avenues for capital allocation seem to be taking shape in Omaha; given the dry powder and quality of allocator, we look forward to developments over the medium term.
- **LVMH** benefitted substantially from shifting consumer spending priorities during the pandemic, as travel budgets were reallocated to tangible luxury spend. Over the medium term, the outlook for LVMH remains very positive, as we see its long-term competitive position (underpinned by the desirability of its wide array of luxury heritage brands, none of which are getting replicated or disrupted by a newcomer in 2021) as fundamentally strengthened.
- **Estee Lauder** also benefitted from the same premium positioning and brand strength as LVMH. A shift-towards higher-margin skin care products, higher-margin regions (Asia Pacific and EMEA) and a greater component of online sales (which structurally reduces costs) underpinned profitability over the period. Combined with the potential for the growth of prestige beauty products in under-served markets, we believe the outlook for revenue and free cash flow growth remains attractive.
- While largely seen as a 'stay-at-home/work-from-home' winner, **Nike** has been in the process of a business model shift towards becoming a direct-to-consumer (DTC) business that happened to coincide with the disruption caused by the pandemic. Given that DTC channels will be materially more profitable for Nike in the long term, the pathway to meaningful margin expansion over the next several years seems very clear to us. Nike is also stepping up its efforts in the underserved Women's apparel & footwear categories, which we believe will benefit revenue growth.
    - We published a recent note about our Nike investment thesis – see here for more detail.

Detractors

Only one stock detracted from absolute performance.

Business	*Contribution (AUD)*	*Total Return (AUD)*
Tencent Holdings	-0.1%	-2.9%

Tencent was only acquired in April after deciding to switch our holding from Prosus. As such, we do not think commenting on its performance in the Fund over such a short period of time will add much value to your understanding of our performance. Instead, we will discuss the reasons behind our decision to sell Prosus and purchase Tencent.

- After a prolonged and thorough debate, we concluded that **Prosus'** recent capital allocation decisions have changed its risk/reward prospects for the worse.
    - Part of our long-term investment thesis was that Prosus would use the opportunity of further reductions in its Tencent shareholding to intelligently allocate capital either via accelerated buybacks or further investment into existing capital-light businesses. We saw these avenues as the most attractive opportunities to sustainably address the discount to NAV.
    - Instead, it would appear that management have doubled down on investing in the food delivery space, which we believe will become increasingly capital intensive as competition between the major food delivery players (JustEats, UberEats etc.) is ramping up. Additionally, we expect medium to long-term margins in this industry to be razor thin. We are therefore sceptical of taking good money (raised by reducing the Tencent stake) and spending it on what we expect is going to be a prolonged period of cash-burn in food delivery. Ultimately, we expect one or two dominant players to emerge, but even then, the industry has questionable long-term economics.
    - Considering these developments, we believe directly owning Tencent improves the risk/reward balance, as we still gain exposure to the main cash-generating asset while lowering the risk of capital misallocation.
    - Following our decision to sell in April, Prosus management announced a scheme to effectively acquire a portion of its South African parent company (Naspers) in a cross-holding structure aimed at closing the discount to net asset value. This structure makes very little sense to us, adds unwarranted complexity to the investment case, and would have triggered a review of the holding regardless.

Hidden detractors: sectors not owned

For the calendar year ended 31 December 2020, the Fund's relative performance benefitted substantially from having no exposure to any energy, real estate, utilities, mining or banking businesses. However, given the rally experienced by these sectors from November onwards, our choice to have zero effective exposure to these types of businesses resulted in a meaningful drag on relative performance for the financial year ended 30 June 2021.

Our strong stock selection managed to mostly offset the drag of not having any exposure to these types of businesses.

Given our bias for businesses that earn high returns on their capital base with modest amounts of leverage, very few (if any) companies in the abovementioned sectors meet our quality investment criteria, and they are unlikely to be considered for investment in future.

Businesses sold

To stay true to label in our commitment to transparency, the table below indicates the return and contribution of the six businesses we sold during the financial year. The purpose of this disclosure is to give you comfort that we do not attempt to hide any analytical mistake we may make by simply getting the stock out of the Fund by the end of the review period. If we sell a business – regardless of whether we generate a capital gain – we commit to disclose these figures to you.

Business	*Contribution (AUD)*	*Total Return (AUD)*
Apple Inc.	0.8%	17.8%
Salesforce.com	0.5%	3.6%
Prosus	0.3%	6.6%
Netflix	0.3%	5.8%
Heineken	0.3%	14.3%
Novo Nordisk	0.2%	4.5%

These businesses were sold either because we saw better opportunities elsewhere (Apple, Netflix, Heineken), we have concerns about the capital allocation strategy followed by management (Salesforce.com, Prosus) or we had lower relative conviction about the moat of the business going forward (Novo Nordisk).

Part Two: Portfolio Positioning & Characteristics

At the end of June 2021, cash (held in Australian dollars) accounted for 2.1% of the net asset value of the Fund. The Fund owned 22 businesses, with a median position size of 4.3% and an average position size of 4.5%.

In the table below are the full holdings of the Fund (excluding cash), presented alphabetically.

Business	MSCI Sector	AIM Internal Classification
Accenture PLC	Information Technology	IT Services
Alphabet Inc.	Communication Services	Internet Platform
Amazon.com Inc.	Consumer Discretionary	Internet Platform
Berkshire Hathaway	Financials	US Cyclical
Coca-Cola Co.	Consumer Staples	Beverages
Constellation Software Inc.	Information Technology	Software
Croda Intl. PLC	Materials	Speciality Chemicals
Estee Lauder Co.	Consumer Staples	Personal Care
Fastenal Co.	Industrials	US Cyclical
HEICO Corp.	Industrials	US Cyclical
ICON PLC	Health Care	Health Care Services
Intuitive Surgical	Health Care	Medical Devices
Keyence Corp.	Information Technology	Industrial Automation
LVMH	Consumer Discretionary	Luxury Goods
Mastercard Inc.	Information Technology	Payments
Microsoft Corp.	Information Technology	Software
Nike Inc.	Consumer Discretionary	Luxury Goods
Nintendo Co., Ltd.	Communication Services	Internet Platform
PayPal Holdings	Information Technology	Payments
Tencent Holdings Ltd.	Communication Services	Internet Platform
Thermo Fisher Scientific Inc.	Health Care	Medical Devices

Source: AIM, MSCI. Data as of 30 June 2021.

Portfolio Characteristics: Quality First

Given our objective of providing investors with high levels of transparency, we believe that providing you with a quantifiable way to hold our feet to the fire regarding the quality of the businesses we own is of vital importance.

The table below presents the fundamental characteristics of the businesses owned by the Fund in comparison with the broad MSCI World index. It is constructed by taking the relevant metric for each individual business we own, and then weighting it for the size of the investment in the Fund.

We will update this table over time to enable you to track whether we remain true to label over long periods.

Portfolio Characteristic	AIM GHCF	MSCI World
Profitability		
Gross Margin	45.0%	29.7%
Operating Margin	22.4%	12.2%
Free Cash Flow Margin	22.1%	11.8%
Returns on Capital		
Return on Assets (ROA)	11.9%	1.7%
Return on Equity (ROE)	24.7%	11.3%
Return on Invested Capital (ROIC)	17.1%	5.7%
Leverage		
Debt/Equity	73.1%	95.6%
Net Debt/Equity	11.5%	64.1%
Valuation		
Free Cash Flow Yield	3.0%	3.6%
12m Forward Free Cash Flow Yield	3.4%	4.3%
24m Forward Free Cash Flow Yield	3.9%	4.9%
Holdings		
Number of positions	22	1563
Active Share	87.9%	0.0%

Source: AIM, MSCI. Data as of 30 June 2021.

Profitability

The businesses we own are highly profitable, and certainly much more profitable than the average business in the benchmark. For every $100 of sales, our businesses generate roughly $45 in gross profit (about 1.5x the index average), $22.40 in operating profit (roughly 1.8x the index average) and – most importantly – about $22.10 in free cash flow (nearly 1.9x the index average). This margin profile speaks to the competitive moats our businesses possess, as they have either the ability to charge more for their products/services (pricing power) or deliver them for less (cost advantages).

Returns on Capital

These high margins translate to high returns on capital, which is a measure of how efficiently a business deploys its internal capital base in the course of operations. Our preferred measure is return on invested capital (ROIC) since it considers both equity and debt capital invested in the business. Return on equity remains a very relevant measure, but can be flattered by high amounts of debt, which we prefer to avoid. Regardless of how we measure it, the returns on capital our businesses generate are multiples of the index average, and certainly well above any reasonable average of the cost of capital. Our businesses create economic value, year-in and year-out.

Leverage

On the topic of debt, our businesses use materially less debt to generate their high returns on capital. From a net debt/equity perspective, the Fund is reasonably close to being in a net cash position. The combination of high profitability, high returns on capital, superior cash generation and lower leverage underpins our belief that our businesses have much less fundamental risk than the average business listed on public equity markets. In the event of an unforeseen crisis (of which the COVID-crash was a case in point,) lightly-geared and cash generative businesses simply have more room to manoeuvre – or even act opportunistically when lower quality businesses are forced onto the back foot.

Valuation

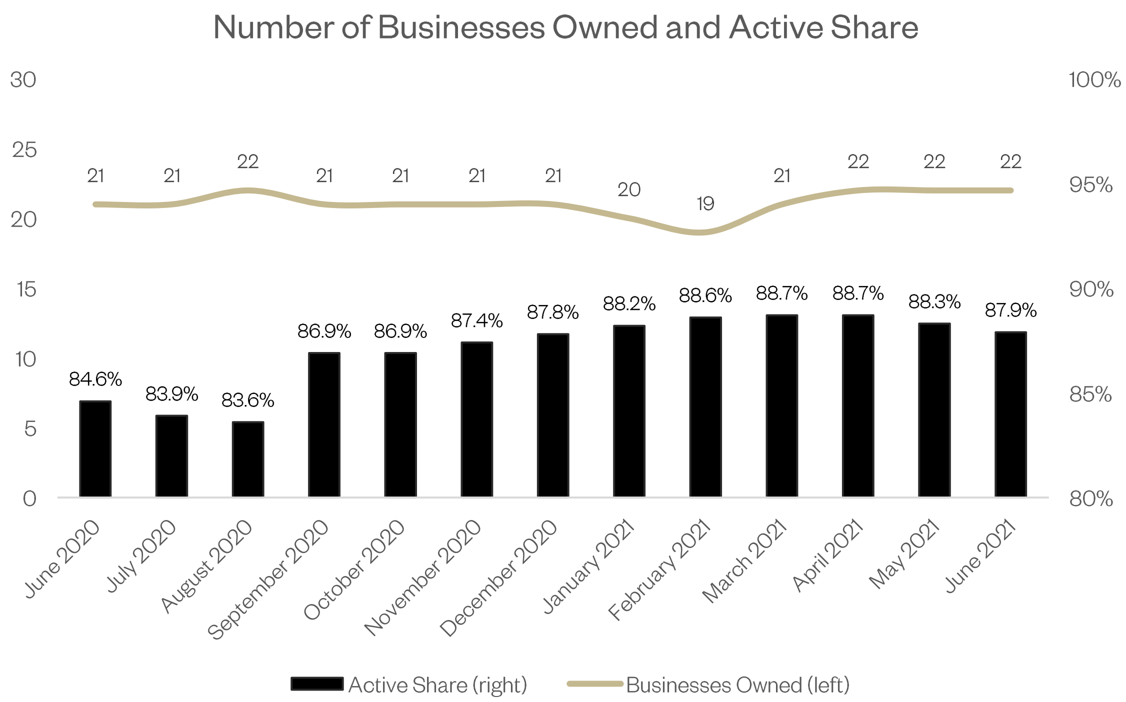
Admittedly, the Fund is more expensive than the index, as can be seen from the lower free cash flow yield. (In this case, a lower number implies a higher valuation). We believe we must balance the trade-off between quality and valuation, and where we cannot reasonably justify the long-term expectations embedded in current market valuations, we will act accordingly. However, we believe the significantly higher quality of the businesses we own justifies a modest valuation premium.

Holdings

The Fund is highly concentrated, owning only 22 businesses as at the end of the financial year, of which two are not included in our benchmark. Over the course of the last twelve months, we have owned between 19 and 22 businesses, which places us in the middle of our target range of 15 to 25 businesses.

As a result, we have a high active share. In simple terms, 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 83.6% and 88.7% for the full year, meaning we differ materially from our benchmark.

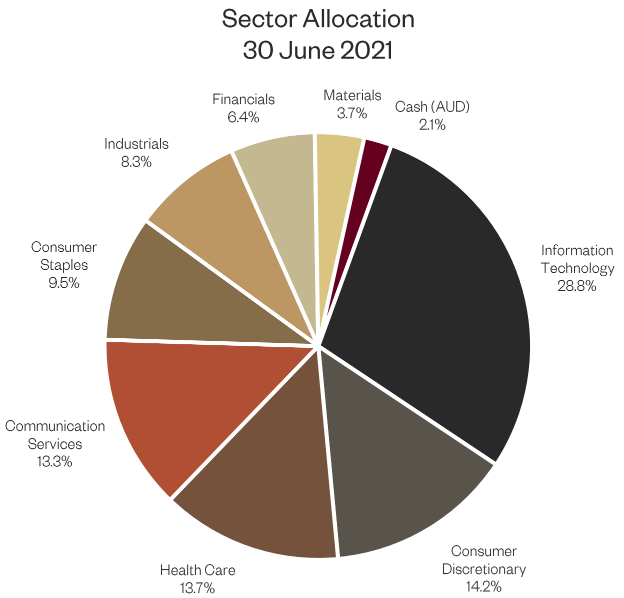
The graph below presents these two data points graphically.

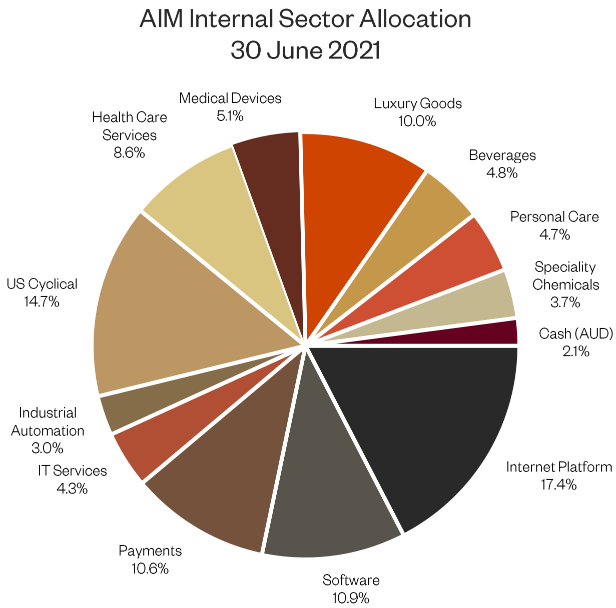


Source: AIM, FactSet. Data as of 30 June 2021.

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.

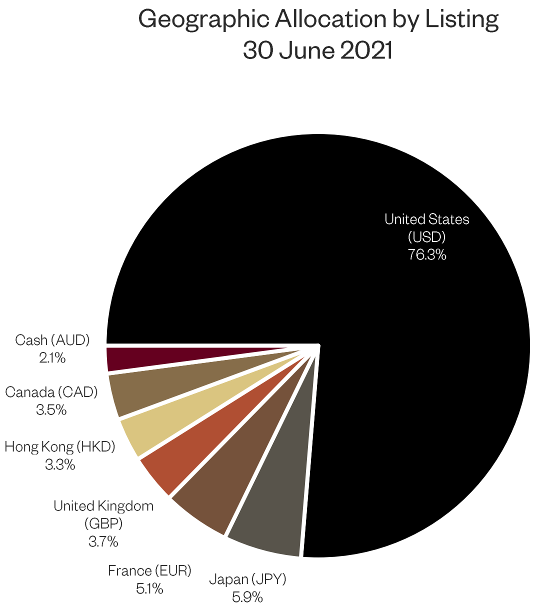


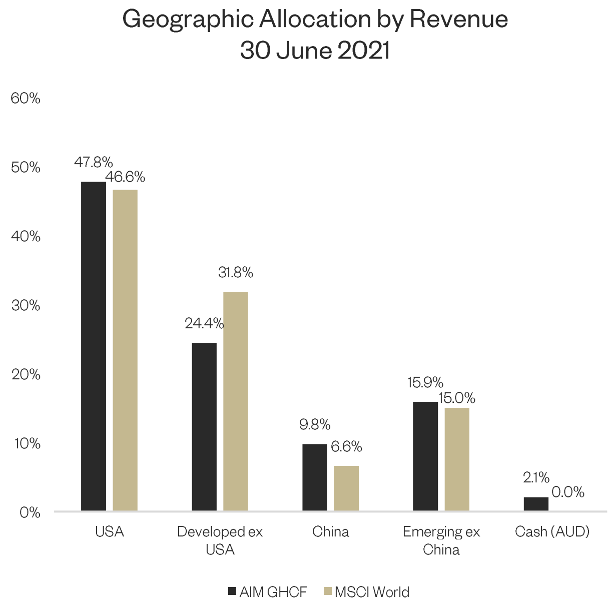


Source: AIM, MSCI. Data as of 30 June 2021.

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.





Source: AIM, MSCI. Data as of 30 June 2021.

Part Three: Commentary

What makes for a good investment process?

To most people, the answer to this seemingly simple question is straightforward: a good outcome in the form of superior investment performance.

However, focusing only on the outcome does not fully capture what makes an investment process ‘good’. Michael Mauboussin – noted investment scholar and practitioner – writes in *More Than You Know: Finding Financial Wisdom in Unconventional Places* (Columbia University Press, 2006):

> *“…investors often make the critical mistake of assuming that good outcomes are the result of a good process and that bad outcomes imply a bad process. In contrast, the best long-term performers in any probabilistic field – such as investing […] all emphasize process over outcome.”*

Mauboussin is effectively pointing out that one can experience a ‘good’ outcome without necessarily following a ‘good’ process. The following table – drawn from the work done on the field of decision theory by J. Edward Russo & Paul Schoemaker in their book *Winning Decisions* (Currency, 2002) – makes the same point rather eloquently:

	Good Outcome	**Bad Outcome**
Good Process	Deserved Success	Bad Break
Bad Process	Dumb Luck	Poetic Justice

Source: Winning Decisions, Russo & Schoemaker, 2002

As can be seen, it is entirely possible to have a ‘good’ outcome by following a ‘bad’ process (what the authors refer to as ‘Dumb Luck’) or a ‘bad’ outcome by following a ‘good’ process (a ‘Bad Break’).

By way of example: a private investor known to the investment team was an aggressive buyer of equities during the March 2020 crash, on the premise that ‘the risk from COVID was completely overblown and the world would be back to normal by May 2020’. In hindsight, buying in March was the ‘right’ decision as it led to a good outcome, but their process for reaching this conclusion was fundamentally flawed. The key lesson of this anecdote is that without distinguishing between a ‘good’ and ‘bad’ process, rather than just a ‘good’ or ‘bad’ outcome, an investor will not know whether their success is repeatable or not.

We believe that to achieve long-term investment success – in other words, a repeated series of ‘good’ outcomes – it is critical to focus on having a ‘good’ process which can be repeated. In focusing on having a ‘good’ process and trusting it will generate good outcomes, we maximise the probability of avoiding ‘bad’ outcomes over time (while accepting we will suffer from the odd ‘Bad Break’ along the way).

The concept of ‘avoiding bad outcomes rather than pursuing good outcomes’ is not a novel idea. We are simply following Charlie Munger’s advice (which he gleaned from German mathematician Carl Jacobi): “invert, always invert.” Following this line of thought to its logical conclusion, it turns out the surest way to “win” in markets is to avoid “losing”.

Good Outcomes Start with a Good Process

To us, a good investment process is not merely about the methods used to identify new ideas, conduct research, size positions, or manage risk. All these factors will necessarily form part of a good process, but it is not sufficient to guarantee success.

We believe a ‘good’ process provides objectivity and grounding during periods of market distress by design. In so doing, the process empowers an investor to a) rationally identify and assess opportunities during periods of market dislocation, and b) overcome the natural temptation to give in to the ingrained emotional and behavioural biases that result in poor decision making during a crash.

It is worth emphasising the latter point, because we do not think it is addressed enough in our industry: we genuinely believe that a key part of a good process is that it must provide sufficient psychological resilience to the investor to help them avoid making emotionally influenced decisions. (Basically: a good process needs to have enough safeguards to keep you from panicking and selling at the bottom but be flexible enough to recognize when your investment thesis has been invalidated).

To achieve this, we believe a good process must exhibit three key characteristics: it should be **well-defined**, **account for bias**, and be **repeatable**.

Well-defined

The investment world is awash with opportunity. There are tens of thousands of listed equities trading across dozens of markets around the world. Any investor needs a methodology to whittle that down to a more manageable universe of businesses to monitor and possibly own.

Successful investment analysis involves a large component of pattern recognition. Some of these patterns are financial and can be screened for; others are purely qualitative and must be evaluated on a case-by-case basis. In our quality-focused process, we use a combination of quantitative and qualitative 'building blocks' to identify opportunities that merit further work.

Our Four Building Blocks of Quality

Return on Invested Capital (ROIC)	Focus on Cash Flow	Sensible Capital Structure	Management
Economic Profit (ROIC > WACC)	Intrinsic Value = PV of Future Free Cash Flow, Not Earnings	Debt vs. Equity	Capital Allocation Track Record
Moats Underpinning the Sustainability of Excess ROIC	Earnings Ignore Reinvestment Requirements	Solvency, Liquidity & Coverage	Long-term vs. Short-term Thinking
Industry Competitive Structure	Timing	Maturity Profile	Integrity, Governance & Culture
Runway for Growth	Ownership Mindset	Off-Balance Sheet Liabilities	Dealing with Adversity

Source: AIM

Several of the quantitative factors are reasonably straightforward to identify: a business with very little debt persistently earning a 20%-plus return on invested capital is clearly doing something right.

The qualitative factors can often lead to less obvious places. Long-tenured management (oftentimes owner-operators) with a history of acting with integrity towards all stakeholders and a superior capital allocation track record is a 'quality' pattern that we have found offers a rich vein of underappreciated opportunity. Improving industry competitive structures can similarly lead to qualitative insights that are not yet obviously quantifiable; the same goes for analysing shifts in the underlying business models and resulting improvements in return on capital.

By iterating through these factors (amongst others) in combination, our process can identify high-quality businesses across geographies and market capitalisation ranges. We make no secret of the fact that we look for a reasonably rare breed of business: those that are competitively advantaged to the degree that they can consistently compound in value over time, without facing an excessive amount of fundamental or financial risk.

The practical implication of adhering to this process is that the vast majority of businesses are of little interest to us; entire swathes of the equity market simply do not meet our quality criteria. At most, we plan to hold 25 businesses in the Fund at any given moment; this means we have to say 'no' a lot more frequently than "yes". Admittedly, one risk of a 'well-defined' process is that it may become too rigid to allow for new ideas to make it through the filter. We continuously work to expand our circle of competence and knowledge to counteract this risk, whilst remaining profoundly aware of not trying to get too far over our skis and into areas where we would be ill-equipped to make informed investment decisions.

Accounting for Bias

The real world is a complex place, full of unseen cause-and-effect linkages that defy the ability to easily analyse. In fact, research conducted several decades ago (Herbert Simon, *Models of Man*, Wiley & Sons, 1957) and subsequently confirmed by others suggests that due to the natural limits of the human mind, it cannot directly deal with the full complexity of the world. As such, we all construct a simplified 'mental model' of the world in our minds, and then base our decisions on this simplified model. We tend to behave rationally *within* the confines of our mental model, but the clear risk is that the model does not adequately reflect reality.

The primary reason our mental models fail to reflect reality is because our minds tend to favour easy narratives with clear cause-and-effect patterns. We all prefer the route of least resistance and construct a version of reality most consistent with our existing prior beliefs and recent experiences or data points. This problem is exquisitely summarised by Richards. J. Heuer in *Psychology of Intelligence Analysis* (Centre for the Study of Intelligence, 1999) in the following short statement: "we tend to perceive what we expect to perceive."

This leads to a whole host of problems when it comes to constructing an investment process. For example, the more work one does on a stock idea, the more one's confidence and conviction increases, without a corresponding increase in accuracy of forecast. Our minds literally talk us into liking a stock simply because of the fact that we have done work on it and *expect* to like it.

This is a risk we must be consistently aware of: if something makes it through our process, we are naturally disposed to believe it is of 'superior quality'. To guard against falling in love with a business, we believe a 'good' process needs to hard-wire circuit breakers into it to minimise the risk of bias. This means checklists – a lot of them.

As boring as it may seem, the good old-fashioned checklist forces an investor to structure their process in a manner that seeks to deliver answers to the same questions over and over. There are multiple benefits from this approach, in our opinion: it enforces discipline (no businesses can be purchased without considering the same set of fundamental questions – i.e., no shortcuts), enables comparability (between different businesses, as well as over different periods of time), and hammers home the fundamentals underpinning our building blocks of quality, which helps to avoid panic in periods of rapid price declines.

We also extend this approach to our portfolio construction process by quantifying the qualitative (and often highly subjective) elements of the investment process. We achieve this by evaluating every business for a range of non-financial factors (for example: strength of the moat, level of conviction and optionality, among others) and assign each a score from 1 to 5 (with 1 being 'bad' and 5 being 'good.') Investment team members undertake this scoring independently, after which the individual scores are collated and interrogated. This process frequently reveals fascinating differences of opinion between a core group of people looking at the same facts and highlights how each member of the team weights information differently. We constructively question the reasons for this divergence in view before ultimately settling on a weighted 'quality score', which we can then compare both to other businesses in our monitored universe, and periodically through time.

This 'quality score' helps us avoid one good quality ("we think the moat is impenetrable") from casting a halo that overrides other qualities that don't score as well ("the range of forecastable outcomes are very wide.") Combined with our assessment of valuation (using multiple scenarios), this scoring helps set guidelines for position-sizing any individual stock to ensure a robust, balanced portfolio. As an added bonus, it also helps us ask the right questions when reviewing the portfolio as a whole (for example: "do we own too many businesses where the value is dependent on future optionality?", "do we own too many businesses where non-financial risks can lead to a permanent impairment of value?", or "do we own enough businesses that can benefit from a pickup in cyclical activity?", etc.)

Repeatability

In our view, the robustness of the process will determine its repeatability across geographies, sectors and over time. This means the fundamental factors we have chosen to focus on (our four building blocks of quality previously articulated) need to remain relevant through multiple market cycles. Repeated evaluation of the fundamental factors enhances the probability of repeatable shareholder returns generated by the businesses in the Fund.

We believe repeatability infers an element of 'simplicity' – again, something that can be deployed in extreme scenarios. Highly complex processes dependent on certain market conditions or relationships persisting are fragile to external shocks and unlikely to be repeatable by nature. The simplicity of our quality-focused, long-only global equity process is designed to be robust should markets go into a tailspin. It is simple, but it is not simplistic.

Concluding Thoughts on Process

It takes all sorts to make a market. We do not contend our quality-focused process is the only way to make money. We simply believe it is a proven way to compound wealth in a low-volatility manner over multi-year time periods. 'Quality' will not always be in vogue – and that is fine by us. When the market chases labels such as 'value' or 'growth' or tries to position for a cyclical upswing or against a cyclical downswing, 'quality' businesses can frequently become mispriced, providing the patient investor an opportunity to purchase an ownership stake at very attractive prices.

Thus, while we cannot promise a specific return, or even that our process will deliver outperformance on a month-by-month basis, we can promise our investors that we have structured our investment process such that it aligns with being a 'good' process. We believe that if we get our process right, we will over time be able to deliver what we strive to achieve: the 'good' outcome of compounding in value ahead of the market.

Part Four: Stock in Focus

HEICO Corporation: A Ticket to Fly

At AIM, we look to own businesses that can sustainably compound our investors' capital through economic cycles. Our investment process seeks to identify cash flow compounders that are run by management teams with the ability and skill to allocate the surplus capital the business produces into new opportunities which accelerate the organic growth profile or widen the moat of the business. A recent addition to the fund that possesses many of the qualities we look for is HEICO Corporation, an aerospace and electronics company that provides mission critical parts for aircraft.

HEICO first became a public company in 1960, though it initially focused on manufacturing laboratory equipment. The business only expanded into parts for the aerospace industry in the 1970s. The Mendelson family acquired a controlling stake in the business in the early 1990s. Since then, CEO Laurans 'Larry' Mendelson has commendably steered the group, ably assisted by his two sons, Eric and Victor, who serve as co-presidents and divisional CEOs. In 1997, Lufthansa took a 20% stake in one of HEICO's subsidiary companies, demonstrating the credibility of their reputation within the airline industry as a provider of cost-effective replacement parts, and as an alternative option to more costly OEM parts for airlines.

A Sky-High Barrier to Entry Business

A typical airline can have as many as four hundred thousand parts that they require on an ongoing basis to service their fleet, and without which they would not be able to safely transport passengers and goods around the world. HEICO is a core provider of many of these highly specialised parts, ranging from wheels, brakes, engine and power generation components, through to airplane interior solutions (such as tray tables, electric seats, etc.), all of which are essential to the safe and reliable operation of an aircraft.

In the US, the Federal Aviation Administration (FAA) regulates who can provide parts to airlines under their Parts Manufacturer Approval (PMA) program, creating a significant barrier to entry into this market. In addition, the process of designing an aircraft part – from initial design, through to testing the product and then eventual FAA certification – can take several years and involve considerable upfront cash cost. HEICO has built an almost unassailable lead over their closest peers through manufacturing, design and engineering expertise at scale.

HEICO's business model is designed to benefit from ongoing technological innovation within the aerospace industry. Many years after an aircraft has first left the factory floor, more precise production methods combined with the development of cheaper and stronger composite materials create the opportunity for HEICO to redesign and re-engineer the individual parts and components that were originally installed on that aircraft. Modern production methods allow HEICO to reverse engineer parts (often at the customer's request) after gaining the PMA stamp of approval.

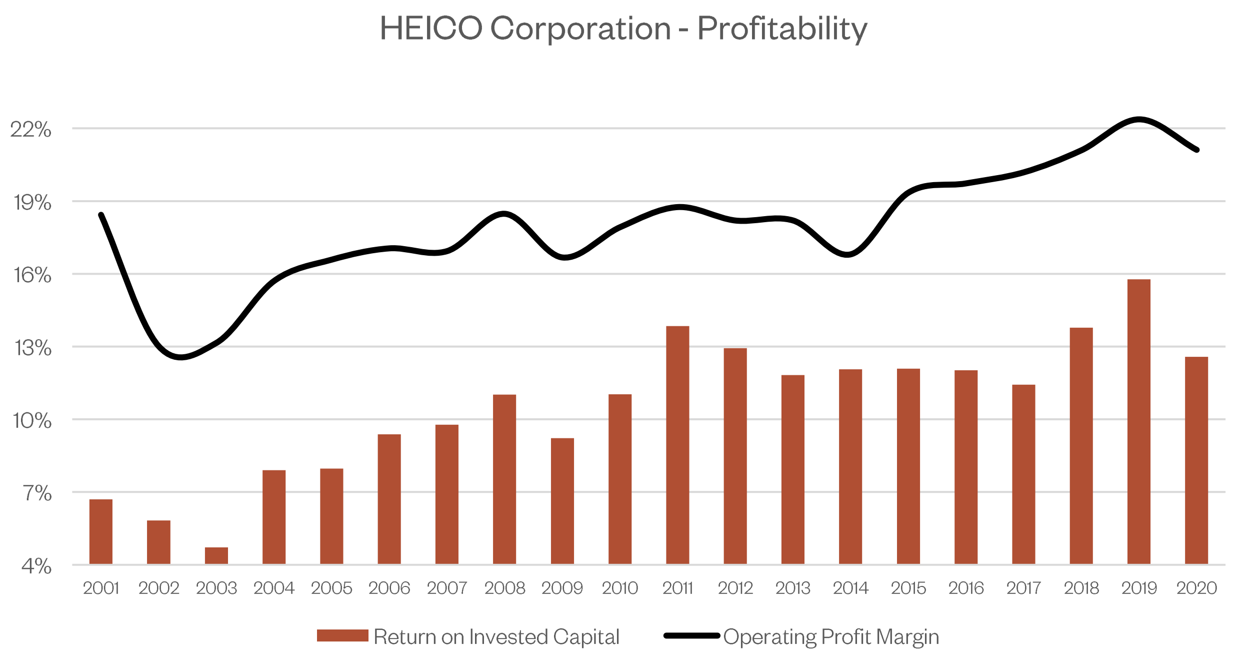
However, these barriers to entry are not sufficient to guarantee long term success; what keeps the competitive advantages intact in any business is how management responds to the ever-evolving demands of their customer. HEICO approaches this challenge by ensuring that their parts are on average 50% cheaper than the equivalent OEM parts, while delivering a similar (or better) level of quality. For customers with a long-standing relationship with the group, this discount can widen to as much as 80%. HEICO management makes a point of sharing value with the customer and offering a high-quality product at a very fair price. Any would-be competitor thinking about entering the market would find it almost impossible to compete on the basis of undercutting HEICO.

We like investing in businesses that provide mission critical products with high switching costs to their customers, which is exactly what HEICO does. As aircraft manufacturers (who have had new aircraft orders cancelled hand over fist during the past 12 months) look to make up for the lost year of 2020, one way would be to increase replacement part pricing. Should this happen, we would not be surprised to see HEICO benefit as cash-strapped airlines look to keep their own costs under control.

A Capital Allocation Machine

Over an extended period of time, the Mendelson family has collectively proven out their ability to prudently allocate shareholder capital to accelerate the growth of the group while also enhancing the competitive advantage and rewarding shareholders. HEICO has compounded revenues at 15% per annum for 30 years – more than 3x the rate of the broader aircraft components industry. Despite this incredible track record, HEICO today still only has 2% market share of their core replacement parts market, indicating the many years of growth ahead of the group.

One of HEICO's most successful capital allocation avenues has been the repeated redeployment of the group's cash generation into small acquisitions that continually expand the product set. The Mendelson's have notched up more than 80 acquisitions over a three-decade innings, paid for by internally generated cash flow. Especially noteworthy is the fact that returns on invested capital have remained solidly above any reasonable estimate of the cost of capital for decades, suggesting a strong valuation discipline underpinning the capital allocation capability.

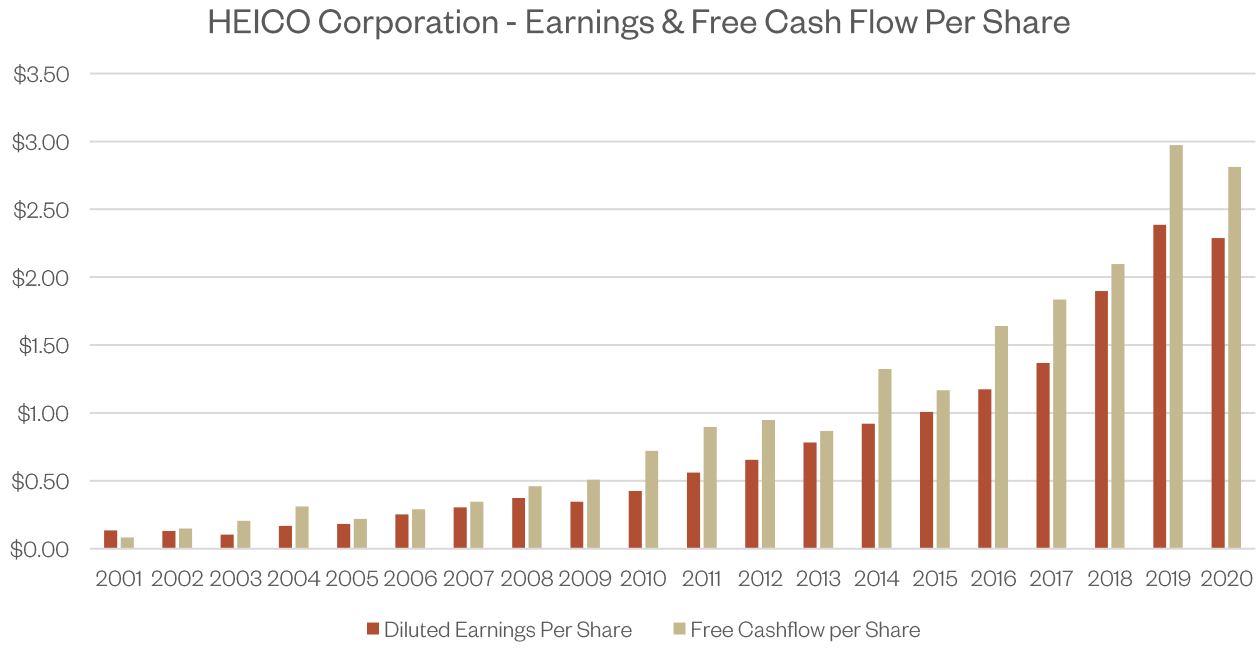


Source: HEICO Corporation

At the same time, the business has rewarded shareholders along the way with more than 40 years of uninterrupted dividends (paid even in the *annus horribilis* of 2020).

HEICO makes sure that the management team of the businesses they acquire continue to run them; in turn, HEICO expands the addressable customer base for their products and accelerates their research and development pipelines. Adding niche products to HEICO's existing product basket simplifies the purchasing decisions of their customers who can buy a wider product set from one supplier, further widening their moat and supporting their operating margins.

One of the core principles of our investment process is to focus on the cash flow that a business can repeatedly generate through time, and not on accounting earnings. HEICO is one example of a business that has managed to maximise its cash generating potential, not its accounting earnings (a fact that the CEO frequently and rightly points out to investors). This is evidenced by its consistent delivery of free cashflow per share greater than earnings per share as illustrated below:



Source: HEICO Corporation

The airline industry has a history of deep cyclicality: think back to the attack on the World Trade Centre in 2001, or the Global Financial Crisis of 2008/2009 – not to mention the extraordinary circumstances introduced by the COVID-19 pandemic since last year. Viewed in isolation, any one of these events would be more than enough to dissuade a short-term investor from owning HEICO. However, when viewed over a longer time frame, each recession has provided HEICO a once-in-a-decade opportunity to deploy their extremely conservatively managed balance sheet to accelerate the acquisitive growth engine. We anticipate a repeat of this pattern as air travel returns in a post-COVID world. Winston Churchill reputedly said, "never let a good crisis go to waste". We would be hard pressed to find a better-suited company to capitalise on the pandemic-induced recession in the aerospace industry, where financially constrained competitors look to partner as a function of their own survival, and similarly constrained customers look to cut costs by switching to cheaper replacement part providers.

We believe that AIM investors who may have read William Thorndike's exceptional book *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success* would find parallels between the select group of well-known CEOs studied by Thorndike, and the Mendelson's excellent track record of capital allocation. (In fact, were Mr. Thorndike looking to write a sequel, we would suggest that the Mendelson's should be a contender for the headline act!)

Seatbelts Fastened: An Enviable Safety Track Record

HEICO is the only supplier globally to have never caused an in-flight shutdown or malfunction of an aircraft due to one of their products. This proven safety track record is the best in the industry and speaks to the rigour inherent in their design process. The cost to an airline from a mission critical defective part that either grounds an airplane (at best) or causes a crash (at worst) can be devastating to both their reputation and bottom line. By buying HEICO products, airlines know they are obtaining the best possible product at a fraction of the price from an alternative provider, allowing maximum uptime for their fleet. Similarly, through years of experience, the HEICO brand in the eyes of the FAA is synonymous with trust and reliability, resulting in faster FAA approval times than peers.

Conclusion

In our opinion, HEICO is one of the best companies most people would never have heard of. Operating in an obscure segment of the airline industry, it is unlikely to come up on the radar of many investors. Being a boutique manager with a focused approach for investing in businesses that compound their cash flow through cycles, we own HEICO on your behalf for the quality, diversification and differentiation it brings to the Fund. In doing so, we partner with an aligned management team that has a demonstrable track record of creating value for staff, customers and shareholders over decades.

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 AUD5bn to guarantee sufficient liquidity to our investors.