FORAGER

CHIEF INVESTMENT OFFICER LETTER

QUARTERLY LETTER SEPTEMBER 2023

FORAGER FUNDS PERFORMANCE SUMMARY (as at 30 September 2023. Net of all fees and expenses)

	1 month return	3 month return	6 month return	1 year return	3 year return (p.a.)	5 year return (p.a.)	10 year return (p.a.)	Since inception* (p.a.)
Forager Australian Shares Fund	-0.54%	5.18%	8.66%	15.46%	9.76%	2.71%	6.84%	9.10%
Forager International Shares Fund	-3.73%	0.12%	6.00%	20.26%	5.19%	7.06%	10.38%	11.50%

Past performance is not indicative of future performance and the value of your investments can rise or fall. Performance in FASF is calculated using Net Asset Value (NAV), not the market price.

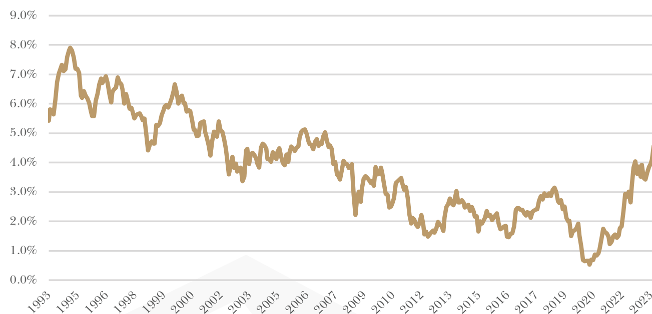
*8 February 2013 for FISF and 30 October 2009 for FASF

REASONS TO WELCOME THE DEATH OF TINA

Tina Turner wasn't the only Tina to die in 2023. The TINA that drove more than a decade of rising equity prices is dead, too.

With interest rates near zero, commercial property yields not much better and junk bonds offering returns of less than 5%, even conservative investors felt There Is No Alternative to equities. Whether that theory was ever right or not, it certainly isn't true anymore. Long-term interest rates have been rising since 2020 and rocketed still higher in the September quarter of 2023. Yields on US Government 10-year bonds hit 4.5% in late September, a level not seen since the mid-2000s.

10-YEAR US GOVERNMENT BOND YIELDS



Source: Bloomberg

There are now alternatives to equities, some as simple as putting money in a government-guaranteed bank account.

So does the death of TINA mean disaster for equity markets? You would certainly think so. As I write this in early October, the homepage of *The Australian Financial Review* is full of bearish headlines including "Echos of 1987" and "Why Fear Rules Markets."

I do not doubt that we are in for some tumultuous times. There is too much leverage in the system for a smooth adjustment process. But it's not all doom and gloom.

TINA was not helpful for many investors, us included. It distorted the capital allocation process, stunted the profitability of many businesses and, in my opinion, was a significant contributor to worryingly low productivity growth over the past decade.

Large swathes of global equity markets didn't participate in the TINA rally. You could argue the whole Australian index, heavily weighted to mining and finance businesses, meets this definition. We started our Forager Australian Shares Fund almost 14 years ago. Since then, the All Ordinaries Index has returned 7.6% per annum, including dividends. The FTSE 100 has returned 6.9% per annum over the same period. Even in the US, where the S&P 500 has returned a more TINAish 12.9% per annum, the rally has been driven by a smaller and smaller number of giant tech companies. The seven tech giants that are the largest companies in the S&P 500 have contributed 11% of this year's 13% total return (see page 1 of the Forager International Shares Fund report). The other 493 companies have, on average, delivered next to nothing.

This leaves many stocks trading at valuations that still make perfect sense in a world of higher interest rates. Our two UK stalwarts, **Tesco** and **Lloyds Bank**, should generate returns well north of 10% without any growth whatsoever (the current earnings are returned to shareholders via dividends and buybacks). Whether rates are 4%, 5%, or 6%, the valuations are attractive.

What's more, the earnings of many of these traditional businesses have been muted, not helped, by the age of free money.

THE CAPITAL CYCLE GRAVEYARD

Capital Returns: Investing Through the Capital Cycle is a collation of investment reports from Marathon Asset Management (edited by author, investor and historian Edward Chancellor) about the role capital plays in corporate profitability. High returns attract new capital. Lots of new capital drives down profitability. Low returns cause capital to flee and profitability recovers again. The book covers 60 successful Marathon investments between 2002 and 2014, all based on the capital cycle.

Between 2014 and 2022, capital cycle investing has been a graveyard.

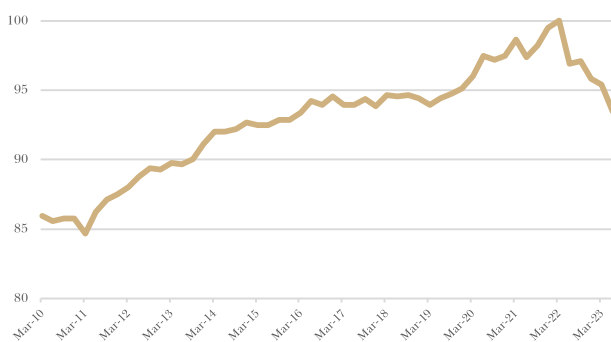
Abundant capital keeps zombie competitors alive and allows uneconomic new entrants to erode the profits of established, well-run businesses. The likes of ASX-listed crane owner **Boom Logistics** were horrible investments for Forager over long investment horizons.

I'm not sure whether it's enough to solve Boom's endless union problems, but the capital cycle is back. We won't be seeing any new neobanks or online grocery startups in the post TINA world. New cranes, LNG carriers and office towers won't be built unless the returns on existing assets are higher than 10%. Companies that own existing assets should finally be able to earn an adequate return.

As an aside, I'm tipping that the death of TINA has a positive impact on productivity growth in Western economies. Productivity is the main contributor to increasing standards of living and its absence over the past decade is a significant concern. According to the Australian Treasury, in the decade to 2020, Australia's productivity growth was the slowest in 60 years.

It's my contention that low interest rates were correlated with and one of the causes of low productivity. Efficient investment markets play a key role in the economy, allocating investment to the most prospective businesses and starving the worst of capital. In the TINA world, there was money available for everyone.

AUSTRALIAN LABOUR PRODUCTIVITY



GDP per hour worked, Index (March 2022 = 100), seasonally adjusted

Source: ABS

The return of more disciplined capital allocation forces discipline, efficiency and innovation. It might just alleviate the problem.

SOME STOCKS ARE WORKING

But it's the impact on the investment world I am far more interested in.

Our Forager International Shares Fund has an investment in **Gulf Marine Services** (LSE:GMS), an owner of lift boats used to service offshore oil, gas and renewable energy infrastructure. The company is tiny and has a lot of debt, so was a very small investment in the Fund. It is an instructive example, however, of how the death of TINA can be good for some businesses.

Gulf Marine's boats cost almost US$1bn to build. Today, averaging 14 years old, they have a depreciated book value of about US$600m. At the start of 2023, you could have bought the whole company, including its US$330m of debt, for less than US$400m (the market capitalisation was US$50m).

GULF MARINE SERVICES PLC SHARE PRICE

Source: Bloomberg

That's because it could not earn a decent return on those assets. A few years ago, a new entrant could borrow 80% of the cost of a new vessel and pay an interest rate of 3-4% on the financing. Today it costs you 20% more to build a vessel, thanks to inflation, there is little appetite for lending against the assets and what financing can be obtained costs closer to 10% per annum.

As a result, there is very little new competition and the day rates Gulf Marine can charge are increasing at 15-20% per annum. Profits and cash generation are suddenly looking healthy and the share price has increased more than 130% this calendar year.

Many stocks haven't "worked" as investments for more than a decade. They are cheap because they haven't been able to grow. They have become so cheap that today's buyer doesn't need them to grow. But there is every chance of a positive surprise in a post TINA world.

A BETTER INVESTMENT ENVIRONMENT

There are still plenty of asset valuations that don't make sense if higher interest rates are permanent. While commercial property owners have finally started to revalue their asset values down, there is a long way to go if 4-5% interest rates are here to stay (which is why listed property trusts trade at 30-40% discounts to their asset "value").

But a return to a more normal interest rate environment is not universally bad. There are plenty of listed stocks that are already priced for a higher interest rate environment. And some that will be beneficiaries.

Forager's funds have done relatively well this calendar year, with takeovers in both funds boosting returns and some asset-heavy stocks like Gulf Marine finally getting some attention. Nine months of a year mean nothing, of course, especially after the ups and downs of the past few years.

For me personally, though, I feel far more comfortable with TINA in the ground.

Kind regards,

Steven Johnson
Chief Investment Officer

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