Investor Handbook

Global High Conviction Fund

AIM

AIM is a global equity investment manager with a singular focus: to sustainably compound wealth over time. We pursue this goal by following a quality-focused investment strategy.

About AIM

Selecting an investment manager can be a daunting task. As an investor, you need to decide what investment goal you would like to achieve, balanced against your appetite for risk and ability to weather short-term volatility.

At AIM, we appreciate these complexities, and we are committed to making it as easy as possible to understand our philosophy, process and Fund to aid you with your decision.

Our team is available to answer any questions you may have – big or small – and we provide full transparency around our investment process and the businesses we invest in on your behalf. We see our investors as long-term partners and, as with all good partnerships, we are committed to consistent communication, being accessible and engaged, and producing measurable results.

Contents

01

The goal of our Investor Handbook

The goal of our Investor Handbook is to explain – using straightforward language as much as possible – who we are, how we think about investing, and how we go about doing it.

As an investor, your understanding of what we are trying to achieve will be a critical component of us successfully attaining our goals: growing your wealth ahead of inflation, outperforming the market, and providing sensible downside protection from permanent capital loss over the medium to long term.

Providing you with this information upfront will hopefully be to the benefit of everyone involved. You will be better informed about what exactly to expect when investing with us, and we will be partnered with investors who are comfortable with our investment philosophy, process and target return profile.

02

Our investment beliefs

Investment is most intelligent when it is most business-like.

Underpinning our entire investment process are five fundamental beliefs:

- Investments are worth the net present value of their future cash flows.
- Successful investing is done from the perspective of a business owner, not a stock speculator.
- A business that cannot generate an economic profit is not creating value, even if they are growing.
- Long-term investing delivers better returns than short-term speculation.
- Compounding is the true engine of value creation.

Allow us to briefly address each of these beliefs in turn.

Valuation is determined by cash flows, not earnings

There is an allure with the concept of 'earnings per share' (EPS) and 'earnings growth' as the ultimate measure of corporate performance. Financial publications report on quarterly earnings; management teams frequently present strategies aimed at driving 'EPS growth'. The price/earnings (P/E) multiple is the most widely used valuation shorthand to quickly evaluate whether a company is cheap or expensive. It should come as no surprise that such wide usage fuels the belief that earnings and P/E multiples strongly influence the value of a business.

We disagree with this view.

Firstly, earnings growth is at best loosely correlated with the creation of value because it does not consider the capital invested to generate the growth or the return the business has earned on it. Moreover, earnings can differ substantially from cash flows due to different (yet equally acceptable) accounting policies management can choose to apply. Cash is fact; profit is an opinion. Most people intuitively understand this when calculating their household budgets – banks prefer mortgage payments in cash, not profits – but this intuition goes out the window when it comes to evaluating stocks.

As such, we focus on cash flows, which we believe allows us to estimate the intrinsic value of a business more accurately. Intrinsic value can be defined as the present value of all the future cash flows that owners can take out of a business over its existence. Logically, owners can only 'take out' of a business the cash that remains after all investments in fixed and working capital have been made, and external providers of capital (such as a bank providing a loan) have been paid. This measure is known as the free cash flow (as in, 'free' to be paid out to the owners of the business.) We use a variety of cash flow-based techniques to estimate the intrinsic value.

Secondly, a multiple like the P/E ratio embeds a huge number of fundamental assumptions about the future profitability and growth prospects of a business into a single number. When we value a business, we want to make our underlying assumptions apparent, so that we can compare it to historical averages or to other companies to see if we are being overly optimistic or biasing our forecasts. The P/E ratio can provide important information about embedded market expectations, but we do not believe when used in isolation as a valuation tool that it is a robust method to determine the intrinsic value of a business.

We own businesses, not stocks

Benjamin Graham – the man who literally wrote the book on investment analysis – famously said that 'investment is most intelligent when it is most business-like'.

What he meant was that thinking about a potential investment like someone who was considering buying a business (and not merely speculating about the price of a stock in the short term) is a superior way to select investment opportunities and evaluate whether the price one is asked to pay is a fair reflection of its intrinsic value. Again, most people intuitively understand this concept, but fail to apply it consistently when it comes to the stock market.

Consider the economics of a well-loved local coffee shop that the current owner wants to sell for personal reasons. An interested buyer would ask to see financial statements, and conduct research on the neighbourhood, the sensitivity of the coffee shop to the economic cycle, the long-term demand for coffee, the expense and investment profile of the shop, and the local competitive dynamics prior to making an offer to purchase based on what they calculated this business opportunity to be worth. Because the prospective buyer must live with the economics of owning this coffee shop, they are much less inclined to overpay for a good 'story' – they are thinking like a business owner, not a speculator.

We apply this same mindset to the businesses we look to invest in. Even though we will be a minority shareholder, it focuses our mind on committing capital to the best opportunities we can find if we ask ourselves whether we would be happy to own the economics of a business over the long term.

This also speaks to why we look for quality businesses, and why we accept that these businesses generally trade at a premium. We wouldn't want to own a business that only has the ability to generate favourable economics for a very short period of time (or worse, only once).

This mindset also provides our first line of psychological defence during a market correction, when stock prices are tumbling. Provided we have done our up-front work rigorously and the long-term outlook for the businesses we invest in is not materially impacted, the intrinsic value is unlikely to have changed much.

Not all growth creates value

Imagine an investment opportunity that promises a guaranteed 5% return over one year. Considering the uncertainty investors are faced with, this seems like an attractive prospect at face value. However, further assume that our hypothetical investor currently lacks any excess cash and will be forced to borrow the money from a bank if they wish to pursue the investment. The bank is willing to extend this credit at a 5% rate of interest.

Mathematically, borrowing money at a 5% interest rate to invest in an opportunity guaranteed to yield 5% means there has been no economic profit created – the interest payment and the return simply cancel out. However, if the investor in our example can borrow at 2%, the 5% return presents an attractive economic profit, whilst the opposite is true if the bank will only extend credit at a 7% rate of interest. In all three cases, the investor earns a 5% return, but without comparing it to the cost of capital, we cannot judge if there has been any economic value created, and whether this was an intelligent way to allocate capital.

We employ this logic to evaluate the businesses we want to own. As the simplified example above illustrates, an economic profit is different to an accounting profit reported on the income statement, because it measures whether the return on invested capital[1] exceeds the cost of invested capital (which is essentially the opportunity cost of an equity investor such as ourselves).

Consider a business with a cost of capital of 10%. If management invests $100 in a growth project, it should earn at least $10 in free cash flow to break-even from an economic perspective. If the return is below $10, the decision to invest in growth has generated an economic loss and shareholder value has been destroyed – despite the growth in revenues, profits and cash flow that is reflected in the financial statements.

We place a huge emphasis on finding and owning businesses that generate an economic profit on a sustainable basis. Many businesses report earnings growth but do so by delivering returns on the invested capital that do not sustainably exceed the cost of the capital. This creates one of the most dangerous types of investments: those that are optically growing (and as such are bid up by the market) but are destroying economic value in the process of growth. We seek to avoid such businesses under all circumstances, because we know not all growth creates value.

[1] Return on invested capital (ROIC) is a measure of profitability, similar to return on equity (ROE) or return on assets (ROA). It measures the return on all capital invested in the business, whether funded by debt or equity. The ROE focuses solely on the returns generated on shareholders' equity capital. Given that ROE can be inflated by taking on increasing amounts of debt, we believe that using the ROIC is a more reliable measure for assessing the overall capital efficiency of a business.

We are long-term, buy-and-hold investors, because we intend to own stocks that will compound in value over time.

Our investment beliefs

We are long-term investors

We are long-term, buy-and-hold investors, because we intend to own stocks that will compound in value over time.

The reason we intend to be long-term investors is because we know that great investment ideas and opportunities do not present themselves every week, month, quarter or even year. The impulse to do something just for the sake of looking active is one of the greatest temptations in investment management, and we plan to resist it.

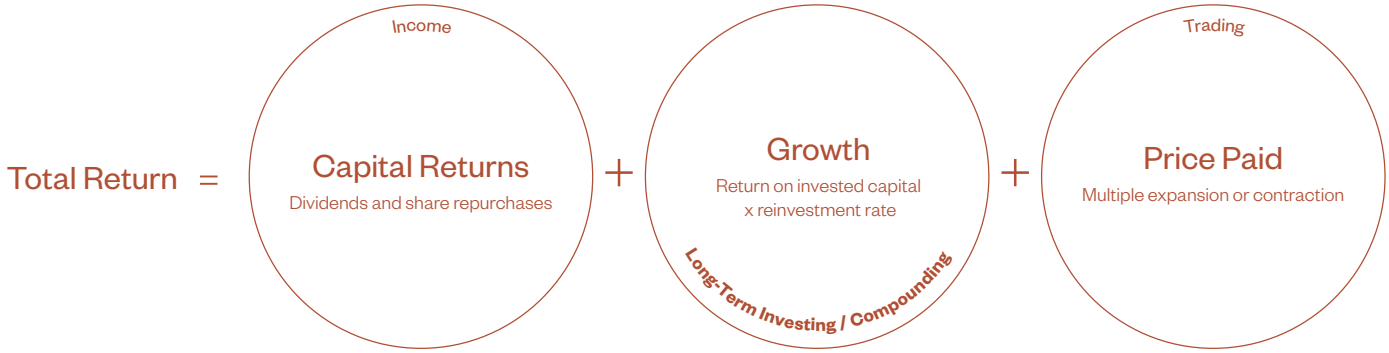
Assuming we have done our work and only allowed high quality businesses into the portfolio, there should be no need to continuously reposition our holdings. We generally intend to sell a business only when we find a better opportunity, when the investment case for our business has materially weakened, or when the business we own is egregiously overvalued relative to our assessment of the intrinsic value.

We should also be clear that we do not play the quarterly 'earnings expectations' game. This investment approach is based on identifying very short-term trends that allow us to more accurately estimate whether a company will 'beat' or 'miss' the market expectations for the revenue or earnings number for the upcoming quarter. Based on the company exceeding or disappointing relative to expectations, the stock usually reacts by moving a few percentage points lower or higher.

The problem with this approach is that to deliver superior long-term investment returns, we must by necessity estimate the 'beat' or 'miss' correctly dozens of times over many years, and place the 'correct' trade in advance of the earnings being announced to realise a gain. We would likely also have to apply substantial leverage to turn this into a meaningful return.

We disagree with the notion that speculating about three- or six-month trends will add much value to our process, or improve returns. It is simply too short a timeframe to make any lasting economic judgment on. We prefer to ask questions and seek answers with a long shelf-life, because it will add much more to our ability to outperform over the long term.

To beat the market, we must be different from the market. If the vast majority of the analytical effort in the market is focused on the next three to 12 months, we believe our choice to focus on the next 3 to 10 years will lead to us taking advantage from the short-term selling of long-term winners.



Our investment beliefs

The value creation engine

As equity investors, our returns are made up of several components: capital return, growth, and the price paid to acquire the investment, as illustrated above.

Our focus is on identifying businesses that can **sustainably** grow their cash flows over a long period of time. Growth is often seen as an external factor – something that just 'happens' to a business – but in reality, it is a function of what return the business can generate on the capital it has available to invest. Any individual looking to start a new venture understands this acutely – the amount of start-up capital available determines how quickly it can grow – but this dynamic is often ignored when investing in listed equities.

If a company has ample opportunities to deploy capital at high rates of return, management is absolutely correct to retain all cash flows and reinvest it in the business. In contrast, mature businesses have less opportunities to deploy capital at high rates of return, and so a component of cash flows is usually paid out to shareholders as income, either in the form of dividends or share repurchases.

The point is that the compounding effect of retained capital is extremely powerful over time – **as long as the marginal return on capital remains high**. Our primary analytical focus is on finding businesses with high returns on capital and assessing whether this can be maintained for a long period, to allow the compounding effect to take hold.

For example, if a 100% equity-funded business can consistently earn a 20% return on invested capital, and 60% of the return is retained to be reinvested in other projects that also earn a 20% return on invested capital, its intrinsic value should increase by 12% (20% x 60%) per year. $100 compounded at 12% per year for 10 years equals $310 – an excess of 200% return over the period. This is the **true value creation engine** of a business: an ever-growing pool of internal capital that can be reinvested at high rates of return.

What complicates this ideal compounding of capital is the price we pay as an investor: even a great business can be a poor investment if we substantially overpay. Our greatest risk is of overestimating the sustainability of the competitive advantage enabling a business to earn a high return on capital.

In this scenario, we lose out twice: firstly, because the market reprices the business downwards to reflect its diminished prospects, but more importantly, because the capital we allocated will not compound at the rates we forecast when investing in the business.

Having acknowledged this risk, research tells us that around 80% of stock returns over a 12-month period are purely driven by multiple expansion or contraction, which is mostly a factor of short-term changes in sentiment. Because investment time horizons have shortened substantially – the average holding period of a stock has gone from over six years in the 1950s to less than one year at present – traders and short-term investors focus hugely on picking the 'right' multiple, and then trading around it.

Our investment beliefs

We wish to be clear which side of that divide we land on: because the potential return from growth in intrinsic value is much greater than the potential return from short-term trading, we focus on taking the long view, and not trading over the short term.

History has shown that businesses with strong competitive advantages operating in industries with a benign competitive landscape and rational capital allocation dynamics can earn high returns on capital over exceedingly long periods of time, leading to the value compounding effect described above. These 'compounders' justifiably trade at higher valuations, and we will pay a reasonable price for them, but we do not chase growth at any cost. Our goal is to look for growth in intrinsic value at a reasonable price.

03

What we look for in a business

We look for businesses that have a competitive advantage that allows them to sustainably earn an economic profit over a long period of time.

As we have elaborated above, focusing exclusively on earnings and short-term earnings growth has several shortcomings in evaluating a business. The full picture needed to assess an investment opportunity must consider the ability of a business to generate free cash flows after working and fixed capital requirements, as well as the appropriateness of the overall capital structure relative to the cash flows generated.

At a high level, we think along four dimensions when evaluating a company for potential investment: the quality of the balance sheet, the sustainability of the competitive advantage, the medium- and long-term growth prospects, and the track record of the management team.

Quality of the balance sheet

Quality has a straightforward definition in our book: is the business conservatively financed? Most financial crises bring into dramatic focus the risk of owning businesses that rely on excessive gearing to generate an acceptable return on shareholders' equity. Over-optimising a balance sheet can boost shareholder returns in the near-term but proves fragile in a crisis. We believe a business with a 'just-in-case' approach to its capital structure wins out over extreme financial engineering in the long run.

This does not imply that we only own debt-free businesses, but rather that we seek out companies that have manageable debt levels and – critically – generate substantial amounts of free cash flow in order to service the debt. This will vary on an industry-by-industry basis, and businesses with higher levels of debt require more work to understand just how sustainable the cash flow profile is during a downturn.

Sustainability of the competitive advantage

We look for businesses that have a competitive advantage that allows them to sustainably earn an economic profit over a long period of time. If there is no sustainable competitive advantage, the ability to earn an economic profit will be eroded due to the iron law of economics: profits attract competition, which will see excess returns competed away, meaning all players eventually earn the cost of capital and no more.

A key consideration when assessing this metric is to understand the industry structure. Industries with low barriers to entry, highly fragmented market shares and a history of poor capital discipline rarely make for good investments over time, as most participants will eventually invest and compete so aggressively as to ensure that no participants can earn an economic profit.

Conversely, a business that sustainably earns an economic profit has to be in possession of some factor that allows it to fend off the competition: a very good indicator that the company likely has a moat or competitive advantage of some sort, justifying further analysis.

Most of our analytical effort is focused on identifying the source of competitive advantage that allows a company to earn economic profits, and then continually testing our assumptions to make sure this advantage remains intact.

Growth prospects

On the topic of growth, we think in terms of both revenue and free cash flow.

When considering revenue, we look for businesses that can generate organic growth that consistently exceeds GDP and inflation, generally in industries that have superior growth prospects to the general economy. It is critical to understand exactly what is driving this superior revenue growth profile to evaluate how long it can last and whether competition is increasing.

With regards to free cash flow, we try to understand the capital reinvestment requirements of a business. If a company aims to create economic value, the capital retained and invested by its management must earn an economic profit for us to consider owning a business. We look for companies that can reinvest a portion – or all –

of their excess economic profits back into the business, and still earn a high return on the capital reinvested. Over time, this is the surest way for a business to compound shareholder wealth – essentially generating more than a dollar of economic value for every dollar invested.

Our preferred businesses tend to grow revenues somewhere between 5% and 15% per year. Companies that consistently experience higher revenue growth than 15% tend to fall into the part of the market where speculation overwhelms fundamental valuation, whilst growth rates consistently below 5% possibly indicates a business (or industry) in secular decline.

Management track record

A proven and experienced management team is also an important indicator of quality, albeit a more subjective one, which makes it trickier to assess. However, since management ultimately functions as the custodians of the businesses we invest in, we have some yardsticks in place to assess their actions.

As a starting point, we consider their track record in being good stewards of the business. Do they act on behalf of their customers, employees and investors when managing the business, or are they principally interested in personal enrichment or empire building? Does management reinvest in the business to protect and expand its franchise value and brand for the long term, or are they focused on creating perceived short-term 'value' by artificially boosting earnings growth (usually done through acquisitions) or over-optimising the balance sheet (usually done through excess leverage)? These questions are inherently tied to their track record as capital allocators: do management make smart investment decisions that consistently generate economic profits?

We also carefully look at how management behave, particularly when talking to shareholders. Are they frank communicators, spelling out what they intend to do? Do they recognise and pro-actively flag problems down the road, or do they prefer not discussing such challenges until the issue has become a crisis? Do they own up to any mistakes? How do they deal with failure or adversity?

Finally, we are very much concerned with good governance practices and management incentives. While this may seem like a box-ticking exercise, we will not allocate any capital to a company with questionable governance practices or misaligned management incentives, no matter how good the business metrics screen or how attractive the 'story' is. We simply do not think it is worth the risk.

The businesses our process guides us to

04

In applying the principles laid out above, we find that our process delivers businesses that usually have a component of repeatable revenue, mostly in the form of recurring consumer purchases or ongoing delivery of critical services to businesses.

Consumers and businesses have different purchase priorities, and experience has taught us that it helps to focus on the point when the buying decision is made to better understand why a specific product or service is chosen.

What we have found when looking at the most successful businesses is that this decision is often driven by some combination of brand, distribution network, professional network, customer or supplier relationship, institutional knowledge, intellectual capital, or patents. These are all examples of intangible assets, which are not usually found on the reported financial statements. However, they confer a particularly important benefit to a business: pricing power.

Pricing power allows a business to adjust its selling prices for inflation without losing customers or sacrificing margins. It is not the be-all and end-all of revenue growth, but where a business can avail itself of this benefit, it is hugely beneficial to its owners.

As such, we prefer businesses where intangible assets drive the purchase decision, because they are difficult to replicate by competitors. Businesses built on these types of intangible assets tend to have more durable competitive advantages, which means they can sustainably earn an economic profit over a longer period. By contrast, physical assets – trucks, warehouses, machinery and so on – can be replicated by anyone with access to enough capital.

As soon as the purchase decision is based purely on price, the product or service is a commodity, and the ability to sustainably earn excess returns on capital is mostly dependent on either being the lowest cost producer, having economies of scale, or the strength of the economic cycle. Such industries also tend to attract more competition, since the only requirement for entry is a physical asset base, which can be acquired or built with access to cheap capital. This kind of competitive industry structure is not conducive to long-term compounding.

Ultimately, we wish to own businesses that deliver a differentiated product or service with no close substitute in the mind of the purchaser, and which is not subject to price regulation. When capably managed and conservatively financed, these types of businesses have the highest probability of compounding in intrinsic value over time.

Businesses or sectors we avoid

As explained above, we avoid businesses that sell commoditised products or services. We also avoid businesses with 'lumpy' or deeply cyclical revenues, as these companies have proven to deliver highly variable returns on invested capital over the full economic cycle. Finally, we avoid businesses that need a large amount of leverage to generate acceptable returns on shareholder's equity.

This means we tend to have no holdings in banks, commodity producers, real estate companies, telecommunication networks or utility providers.

- Banks are the prime candidates for businesses that need a lot of leverage to generate sufficient return on equity. In addition, their services or products are mostly commodities – a savings account does not materially differ from bank to bank – meaning that generating excess profitability requires them to take more aggressive risks. Given that these risks tend to materialise simultaneously when the economic cycle turns – largely at the expense of shareholders equity – they are now highly regulated entities. As such, we do not think they meet our definition of quality. Banks are ultimately just a geared play on economic activity, and we think we can find less risky ways to gain this kind of exposure.
- Commodity producers in the energy and materials space inherently sell undifferentiated products. As such, prices are purely driven by supply and demand. When the economic cycle is benign, history suggests these industries tend to over-invest, leading to periods of intense value destruction when the industry becomes over-supplied. Through the economic cycle, these businesses tend to not reliably produce economic profits.

- Real estate is another sector which requires excessive leverage to earn adequate returns on equity. In addition, the heavy use of leverage makes these businesses vulnerable when liquidity conditions tighten – usually during a financial crisis. Combined with their illiquid asset base, the consequences can be very negative for equity holders.
- Telecommunication networks deliver an undifferentiated service, are subject to intense regulation, and need a substantial amount of capital investment to just maintain the status quo. While the market structure suggests substantial barriers to entry, constant technological innovation drives pricing down, meaning rivals fiercely compete for market share – an unenviable place to allocate capital.
- Utilities are very capital intensive and need a large amount of leverage to generate an attractive return on equity. Critically, their ability to generate a return that exceeds inflation is almost entirely dependent on regulated pricing, which is ultimately subject to the prevailing political environment. These businesses can act as a bond proxy, providing a stable stream of income, but we believe there are businesses in other sectors that provide the same return profile without suffering from the same limitations as utilities.

How we invest your money

05

We refer to the companies that measure up across all the principles discussed in sections two and three as 'compounders': well managed businesses that are resilient enough to survive an economic shock, and can repeatably earn economic profits and compound their internal capital base well into the future. We look for them by employing a well-defined process.

Filtering our investable universe

Most of the financial metrics outlined above can be screened for; we do so several times a year. However, since our investment horizon stretches over years, and we look at the long-run track record of businesses, we tend not to find new ideas often.

This filtering process produces somewhere between 100 – 120 businesses that exhibit the characteristics we look for. However, this only serves as a first step. Before allocating any capital, we conduct fundamental research to further whittle this universe down to the best opportunities.

Future compounders

Very rarely, we come across a business that we believe exhibits all the traits outlined above, but the business is much earlier in its business life cycle. When we find a business like this, we do have the option to include it in our universe, with the understanding that it must clear a much higher bar for inclusion in the portfolio. We will discuss these elevated criteria below.

Fundamental research

Fundamental research is what we do on a day-to-day basis; we read up on and investigate the businesses we look to invest in, or further expand our knowledge about the businesses we already own. This stage of the process involves a full review of the financial reports of a business. Where necessary, we make certain adjustments to the financial statements (such as accounting for off-balance sheet liabilities, capitalising certain types of intangible investment, and distinguishing between maintenance and expansionary capital investment) to better evaluate whether a business generates an economic profit.

Whilst an in-depth understanding of the financial statements of our businesses is critical, the primary focus of our analysis is qualitative. If we want to benefit from the long-term effect of compounding, we need to be as sure as possible that the competitive advantages underpinning the business are sustainable. These measures are not quantified on financial statements, which means we must look further afield and consult with outside sources or industry experts to develop a fuller understanding whether a business truly qualifies as a well-managed, high-quality, sustainable compounder.

Valuation

We know from long experience that valuation cannot be ignored; what we pay for a business is ultimately the only variable we control.

If you believe as we do that earnings do not tell the full picture because it ignores the reinvestment requirements of a business, then using a P/E ratio in isolation has substantial limitations.

As mentioned, we try and determine the possible range of intrinsic values for our businesses by using various techniques, one of which is a discounted cash flow analysis.

However, a discounted cash flow analysis is sensitive to the inputs. As such, we supplement this analysis by also evaluating the free cash flow yield (free cash flow per share divided by the share price), which can be compared to both other equities and long-term interest rates. We adjust the free cash flow for non-maintenance capital investments, otherwise we would be penalising the business for choosing to invest in future growth.

The point is that we use multiple cash-flow based valuation techniques as additional commonsense checks at the point of allocating capital, to make sure we only invest when there is an appropriate margin of safety. The margin of safety we look for varies based on the individual characteristics of each business we evaluate. In addition, the margin of safety is frequently to be found in the durability of the competitive advantages a business has, meaning it does not explicitly show up in a financial model and requires subjective judgement.

Between these various approaches, we feel we have a reasonable number of warning signs to alert us when we are at risk of egregiously overpaying.

When it comes to valuation, we prefer a robust and simple approach with visible inputs. We would rather be roughly right rather than precisely wrong.

Figure 1

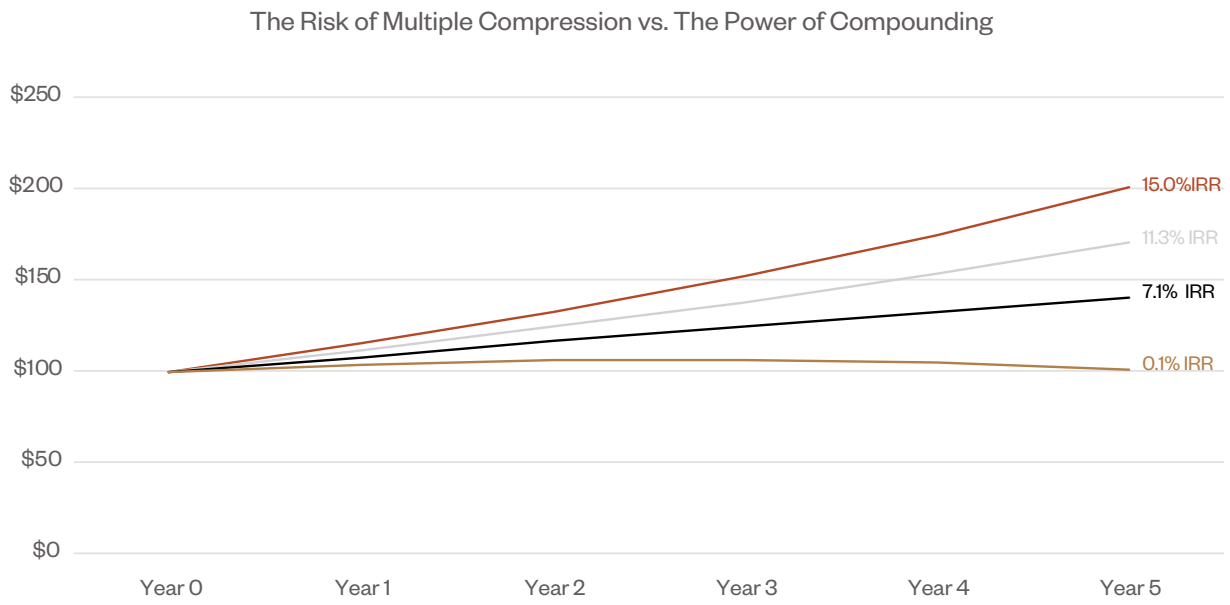


Figure 1

How we invest your money

Owning future compounders

When evaluating a 'future compounder' – a younger, faster-growing business that does not yet meet all of our investment criteria, but we have strong reason to believe it will in future – the bar for inclusion in the portfolio is higher. We must believe that we can acquire it at a significant discount to our assessment of the intrinsic value to compensate us for the risk we are taking.

We also have strict construction limits when owning such businesses: individually, such a position may not comprise more than 4% of the total value of the Fund. Should we own more than one future compounder at the same time, these businesses may collectively not exceed 10% of the value of the Fund. There may very well be periods of time where we own no businesses in this category if we deem the valuations for such businesses unattractive.

Paying a justified premium

Our primary concern lies in identifying quality businesses. Valuation is the final step in our investment process. Put differently, we first want to be sure we have identified a quality business; we can then debate about how much we are prepared to pay. There is no point in prematurely debating valuation until we understand a business well enough to know whether it meets our qualitative and quantitative criteria.

As mentioned earlier in this document, our return as equity investors is the sum of the income we receive, the growth the business delivers, and the price we pay. All else equal, paying less is better, but we look to pay a 'fair price for a wonderful business' instead of a 'wonderful price for a fair business'. By choosing to invest in quality businesses, we must by necessity accept that we most likely need to pay a premium to the average business.

The risk with this approach is that we overpay for a business that cannot sustainably generate a high return on invested capital and grow its free cash flows consistently. Phrased differently, what is the risk we overpay to such an extent that we permanently lose capital?

To quantify this risk, the two accompanying charts may be helpful.

The first chart (Figure 1) assumes a business generating $100 of free cash flow at the point of purchase, growing at 15% per year for the next five years. However, there are four different valuation scenarios: one in which the valuation multiple at the end of the five-year investment horizon is the same as at the point of purchase, and then three scenarios where the exit multiple declines by between 15% and 50%.

In the first scenario – where no multiple compression occurs – the investment simply compounds at a 15% rate of return. In the second and third scenario, the

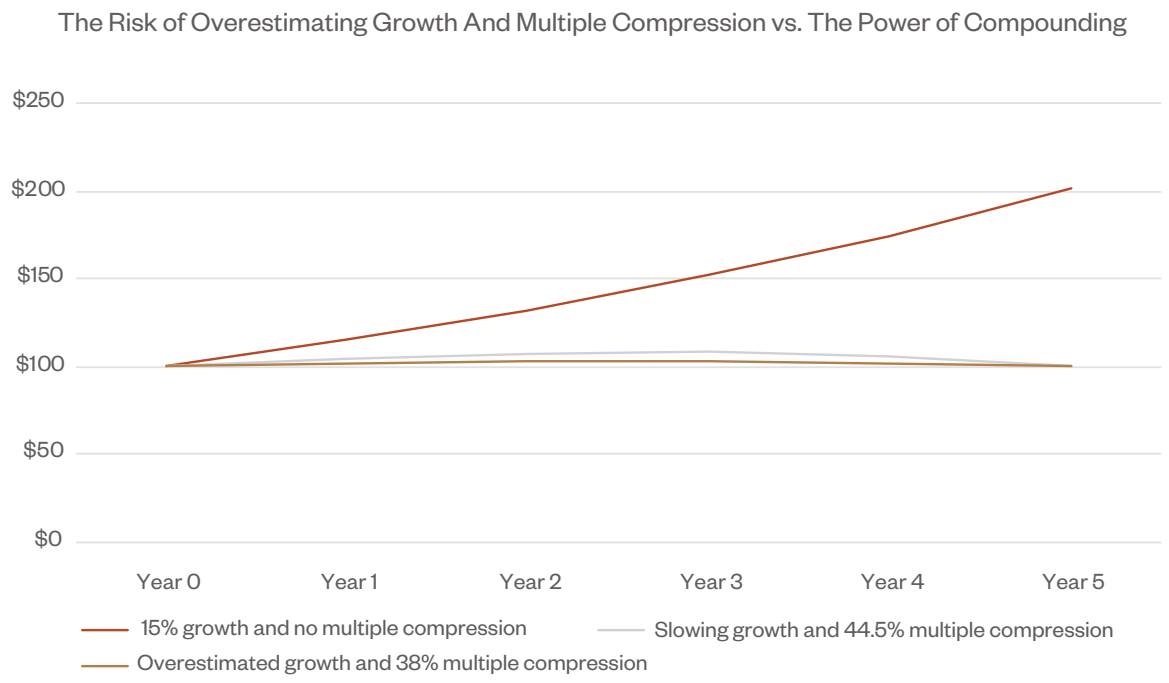


Figure 2

five-year return works out to 11.3% and 7.1% per year – hardly spectacular, but solidly above inflation. In the final scenario, the multiple compression negates the growth in cash flows entirely, meaning an investor earns 0% return over five years. While far from ideal, the investor has not permanently lost capital – and it implies that as long as we are correct about the sustainability of the competitive advantage underpinning the return on capital and growth in free cash flows, the multiple would have to collapse by more than 50% for us to permanently lose capital on a five-year basis.

The natural follow-up question is what happens if we are wrong about the growth in cash flows?

This second chart (Figure 2) shows three scenarios. The first again assumes growth in free cash flows of 15% and no multiple compression by the end of the five-year investment period. The second scenario starts by growing free cash flows at 15% in year one, but growth then slows by 1.25% per year so that by year five, growth is only 10%. The multiple would have to contract by more than 44.5% for this investment to generate a negative return. The final scenario posits that free cash flow growth is never 15% – we overestimated the growth from the outset, and it merely grows at 10% per year. In this case, the multiple compression would need to exceed 38% for us to permanently lose capital.

Time, patience, and compounding are the friends of the quality business. In a sense, compounders are generous – even if we overpay modestly in the short term, the ability of the business to consistently deliver free cash flow growth tends to compensate for any momentary multiple compression. The critical factor is the consistency and sustainability of the growth in cash flows and the returns on invested capital, which in turn depends on the competitive advantages of the business.

It is for this reason we spend the vast bulk of our time analysing the competitive landscape and economic moats of a business, and why valuation is the last step in our process. If we are not convinced of the sustainability of the competitive advantages, the valuation does not matter, since we are unlikely to buy the business.

Time, patience and compounding are the friends of the quality business.

What we want to deliver

06

While we have the best of intentions in delivering acceptable returns over time, we also believe such intentions must be measurable against the reality of what we produce.

As a starting point, we do not intend to engage in the proverbial practice of shooting the arrow of performance, painting a target around where it happens to land, and then claiming that we achieved our goals. We have enough confidence in our process that we feel we should explain what we look to achieve and be measured against that.

Our expected return profile

All investment is fundamentally grounded in the belief that money not spent but rather saved will lead to a better pay-off in future. Underpinning this belief is the assumption that your return will be greater than inflation. If this is not the case, your purchasing power will be eroded over time.

Over the last several decades, equities have been the one asset class most likely to consistently deliver an inflation-beating return. This is not to say that equities did not have periods of poor returns, but we believe that equities remain the best option to steadily compound your wealth.

Because we follow a quality strategy, our portfolio will naturally have less exposure to deeply cyclical businesses, as well as businesses with poor balance sheets. This means we expect our portfolio to outperform during periods of market distress and risk-aversion, as well as during a cyclical downturn.

Conversely, during the early stages of a bull market, a cyclical upswing or during an extended risk rally, our portfolio may underperform. This will be because the cheapest assets – likely the most cyclical or those with the weakest balance sheets – rally off very depressed levels.

Over a full business and investment cycle, we believe a quality strategy will handily outperform the market, mainly because it should protect the downside during periods of distress and keep up with or outperform the market during periods of growth.

What we want to deliver

Short-term underperformance

We readily acknowledge that – given our investment horizon and process – it is very unlikely that we will outperform in all market conditions, month after month. This creates a conundrum: you may be faced with short-term underperformance, while we believe our approach is working exactly as it should.

To aid you in measuring our performance, we commit to report to you on a quarterly basis the following measures:

- An in-depth discussion of the performance of the businesses we own – particularly the ones that have underperformed. We will discuss any challenges they may be facing, and whether we believe our investment thesis is impaired.
- The ratio of businesses that outperform the benchmark to the businesses that underperform the benchmark. We believe this will provide context to how well our entire portfolio of businesses are performing, and whether our out- or underperformance is being driven by the extremely good (or poor) performance of one business.

Clearly, we hope to maximise the ratio of outperformers to underperformers.

We hope that these metrics, read together with our reported performance, will provide you with enough information to judge whether we have remained true to our investment beliefs and process.

How we think about risk

07

Risk is a concept with a different meaning to many people, so it is worth spelling out precisely what we mean when we refer to it.

To us, risk is making an investment or portfolio management decision which suffers such a material loss that there is no reasonable chance of earning back the capital invested. To avoid this outcome, we believe our process as described above is designed to filter out businesses that suffer from an elevated likelihood of catastrophic failure. Over time, the truth of this statement will be tested by the results we deliver.

Benchmark risk

You will note that our definition of risk does not include underperforming a benchmark, particularly over the short term.

One of the fundamental truths of successful investing is that to do better than the market, one must by necessity be different to the market. Because our investment process disqualifies many companies and sectors for investment, there is no doubt that any portfolio we construct will differ from a market index. This will be further exacerbated by the fact that we will own a very concentrated portfolio of businesses.

These facts, combined with our investment horizon being measured in years and not months or quarters, means that there will unavoidably be periods where the Fund can underperform its benchmark. If this occurs because the market is favouring companies, sectors or regions that our process steers us away from, we do not see this as a failure in our commitment to you. Equally, if we underperform because we believe markets are being driven by valuations not justified by the fundamentals, we will have no misgivings about this. We will only be concerned if the underperformance is due to the permanent decrease in the intrinsic value of one of our businesses. Should this occur, we will clearly communicate it to you.

Managing the Fund to attempt to avoid even the potential for short-term underperformance will ultimately see us

either own too many businesses or trade the portfolio too actively. This might minimise our career and business risk, but we would be doing a disservice to you as an investor.

For these reasons, we recommend that you only invest in the Fund with money that you wish to see grow over an extended period of time, and managed in line with the principles and processes we describe in this document.

Price risk (Volatility)

Some investors see price volatility as risk and regard any chance of a short-term loss as an outcome to be avoided at all costs. We disagree with the notion that increased price fluctuations in and of itself constitutes risk. The risk comes from the natural human tendency to overreact when faced with sudden uncertainty and potential loss.

In behavioural economics, this tendency is known as 'loss aversion', when we experience the fear of a loss much more intensely than the prospect of an equivalent gain. Put differently, we would rather not lose $10 now than potentially gain $10 in the future. In investing, this usually manifests as selling a stock in panic after a sudden, steep price decline.

Psychologists believe this tendency to avoid any potential loss is part of our hardwired survival instinct developed over thousands of years. For example, the loss of one day's supply of food can cause death, whereas having two days' worth of food does not necessarily extend life (in the absence of a way to safely store the food).

Because we see ourselves as co-owners of businesses rather than short-term speculators, we strive to make sure any business we include in the portfolio is resilient enough to withstand a material external shock. Our process is critical in identifying businesses that meet this criterion. Keeping this in mind during periods of market volatility will help investors to avoid making costly errors when volatility increases, as it surely will.

During periods of market volatility, our approach is to be relatively sanguine about material changes in the market price of our investments. Unless the long-term business prospects of our investments have materially changed for the worse, their intrinsic value is unlikely to have declined materially.

Fundamental risk

As we have discussed in the preceding sections, we do not view underperforming a benchmark nor price volatility as true risk. The nature of the risk that can lead to us permanently losing capital are almost always related to the fundamental business activities of our investments.

Some examples of this type of risk include a changing competitive landscape, the deterioration of competitive advantages, an untrustworthy management team, or an over-indebted balance sheet. The risk that is most frequently existential is the latter.

As outlined in section three, we define a quality business as a conservatively financed one. Combined with strong cash generation, such businesses almost never get into such a precarious position as to fail entirely, meaning we run a significantly lower chance of suffering a permanent loss of capital.

What we will and won't do

08

We see ourselves as long-only equity investors and believe that by investing in high quality businesses we can deliver the long-term performance that meets our stated investment goals. We believe that this process and philosophy will lead to compounding over time, as long as we apply it rigorously and consistently. As such, we want to spell out what we will and will not do when managing the capital you entrust to us.

Concentration and diversification

We intend to hold between 15 and 25 businesses in the portfolio at any one time. For some context, this compares to roughly 1,600 businesses in our benchmark, and tens of thousands of businesses listed on stock exchanges around the world.

There are several reasons we choose to manage a concentrated portfolio.

- Investors intuitively understand why having all your proverbial eggs in one basket is risky, and therefore diversify their holdings amongst a variety of different assets and asset classes. It not only reduces the risk of failure of one particular investment, but also lowers the volatility of the investment portfolio. Research has shown that the additional reduction in volatility and risk achieved by adding a second, 5th or 15th holding to a portfolio is substantial. However, by the time a portfolio has between 20 to 25 holdings, the additional reduction in volatility from an additional holding is small; beyond 25, the benefit is negligible.
- Additionally, there are behavioural considerations to keep in mind. As one keeps adding holdings to the portfolio, one eventually ends up adding the 30th or 50th 'best idea'. Eventually, this means the number of low-conviction holdings in the portfolio starts to outnumber the actual

'best ideas' that should be backed with conviction and populate the top 5 or 10 holdings. Ultimately, the process becomes self-defeating: more holdings means less research effort and time spent on each individual holding, leading to lower conviction across the portfolio, which in turn leads to having more holdings. We prefer to own a limited number of businesses we know and understand well, leading to a competition for capital when introducing new holdings in the portfolio.

- Finally, adding enough additional holdings will eventually lead to owning the entire market. At this point, the investor will merely earn a market return. Because our goal is to outperform the market over time, a concentrated portfolio is a surer path to achieving this.

Choosing to manage a concentrated portfolio does not mean the portfolio has no diversification. The businesses we choose to invest in sell a variety of goods and services into diverse end markets around the world. As such, we look to the underlying fundamentals of these businesses to provide a measure of internal diversification to the portfolio.

We also employ a portfolio construction framework that ensures there is a sensible mix of exposures within the limited numbers of businesses we own. These limits are as follows:

- Maximum individual position size: 7.5%
- Minimum individual position size: 2.5%
- Maximum sector exposure: 30%
- Minimum sector exposure: 0%

Given the nature of the businesses our process guides us to, the likelihood of us having little or no exposure to several sectors largely energy, materials, financials, real estate, telecommunications and utilities will be a permanent feature of the Fund.

Active investing versus portfolio activity

'Active' is a piece of investing jargon that has multiple meanings, and therefore leads to frequent misunderstanding.

'Active' investing can be defined as owning a collection of assets that differs from an index, whereas passive investing is defined as simply replicating the index. The latter is most easily accomplished by purchasing a low-cost index tracking fund. Given our preference for managing a concentrated portfolio, we clearly do not intend to provide this kind of product.

On the other hand, 'portfolio activity' refers to the frequency of buying and selling shares. In this regard, we intend to be very much inactive, given our views on finding high quality businesses to own for the long term.

Because these two concepts each represent a key building block to our approach, it is worth discussing in a bit more detail.

Active share

It is easy for us to tell you that we intend to be 'active' with regards to how we construct the portfolio, but we also intend to prove it to you on an ongoing basis using an investment ratio called the 'active share'.

Simply put, active share measures how much the 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'. Active share below that represents what the industry calls 'closet indexing', whereas anything below 20% is essentially a passive index fund, as illustrated in the chart below.

We aim to maintain an active share between 80% and 100%, and we will report this number to you on our factsheet every month.

Why do we focus on this measure? Essentially, a higher active share gives us a higher probability of generating outperformance. We absolutely need to do the work to select and own the right stocks – and you should rightly evaluate us on that measure – but having a low active share makes it nearly impossible to outperform our benchmark after expenses.

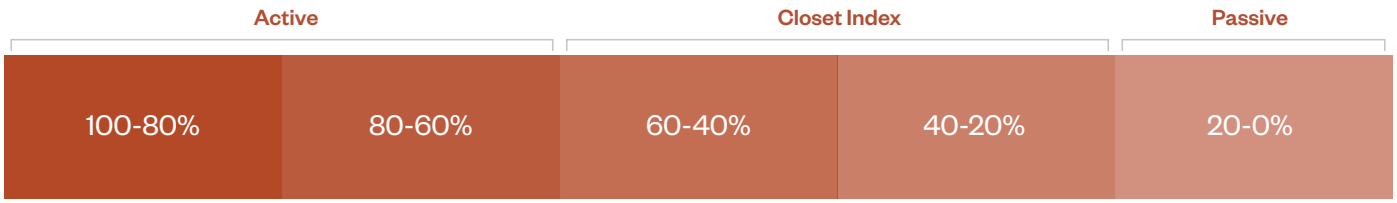
We would rather place ourselves in the position to deliver on our promise of outperformance than settle for the knowledge we are mathematically unlikely to do so by quietly mimicking the index. Stated plainly, our intent is to be active in how we construct the portfolio.

Trading activity and market timing

Based on our investment philosophy, we intend to keep our trading activity low. We seek to benefit from trends that play out over years, not quarters. If we actively tried to position for each weekly or monthly twist and turn of the market it is unlikely to add much value for you over the long run. We certainly do not intend to attempt to 'trade' earnings expectations, for reasons alluded to earlier in this document. In addition, excessive trading activity comes at a direct frictional cost to you as an investor. By minimising this cost – generated by an activity that we think is unlikely to repeatably add value to the return you receive – we hope to deliver a better outcome over the long term.

Our preference is to buy the right shares in the first place and hold onto them for a long period of time. With this in mind, a large component of our success will be in maintaining a sufficiently high bar to introducing a new business in the portfolio – essentially, doing a lot of work upfront to make sure we are, in fact, investing in high-quality sustainable growth businesses on your behalf. As such, we would expect our annual portfolio turnover to average between 10% and 20%, implying an average target holding period of between five and 10 years for every business we own.

We also do not intend to time the market by making substantial asset allocation calls between equity and cash. Practically speaking, we have a target cash allocation between 0% and 10%, with the view to hold more cash if we cannot find business that meet our criteria trading at valuation levels we consider attractive enough to warrant buying more at the price on offer.



Active Share Levels

Source: Cremers, K. J. Martijn and Petajisto, Antti, "How Active is Your Fund Manager? A New Measure That Predicts Performance", March 2009.

In the event of an unprecedented global shock – such as war, a natural disaster or a pandemic – our mandate allows us to hold up to 20% of the value of the Fund in cash. Given our belief (and fervent hope) that these are extremely rare occurrences, we do not intend to run such elevated cash levels for extended periods, if ever.

Ultimately, we understand that the Fund is not an asset allocation tool. If you have elected to invest in our Fund, we assume you have already elected to allocate a component of your wealth to be invested in international equities, managed in line with the principles we outline in this Guide.

International investing

Most investors have a natural home country bias in their portfolio allocation. This makes sense, given that their living costs are naturally going to be denominated in their home currency. However, in having this bias, most Australian investors tend to end up with portfolios that are concentrated in assets that are very closely correlated to the cyclical fortunes of the economy – specifically banking stocks, mining stocks and real estate. Conversely, it also means Australian investors tend to have low exposure to global opportunities in the technology, health care and consumer sectors.

We believe that by investing globally, we can give Australian investors access to a much wider set of opportunities. This is generally because the businesses we consider for investment have substantially larger end-markets into which they can sell their products or services than is generally the case for businesses listed in Australia.

Of course, where a company is listed often has little correlation with where it does business. There are some companies listed in Australia that generate most of their revenues in other parts of the world. However, we believe that most Australian investors can access these opportunities cheaply through other channels. We therefore intend to focus all our efforts on companies listed outside of Australia.

We also take advantage of the fact that where a business happens to be listed is not the determining factor of the underlying opportunities we are exposed to. Many of the companies we seek to invest in derive a substantial portion of their revenues from developing economies. This enables us to gain exposure to the growth opportunities in developing markets whilst simultaneously benefitting from the governance, legal and market structures of investing in a company listed on some of the major stock markets around the world.

Currency exposure

By investing in businesses listed outside of Australia, it means investors will naturally be exposed to currency fluctuations. Put simply, when the Australian dollar weakens, the value of your international investments will increase; when it strengthens, the value will decrease.

Our policy is not to hedge currency exposure, principally for two reasons.

First and foremost, we do not claim to be experts in currency trading, and we do not view it as a repeatable source of generating performance for our investors. If we do not think we have a repeatable edge in doing something, we refrain from doing it – particularly if it incurs a direct cost to investors, as is the case here.

Secondly, the nature of the Australian economy – being heavily reliant on commodity exports – means our currency is generally seen as a pro-cyclical commodity currency. This means that the Australian dollar tends to strengthen when the world economy is growing and investors are happy to take more risk, and weakens when the growth outlook dims and investors are more cautious. Because of this fact, it means that having exposure to global currencies mostly acts as a counter-cyclical safety valve for Australian investors: when markets become more risk averse and sell equities, they also tend to sell commodity currencies, which means the Australian dollar weakens. This interaction will protect the value of your global investment in Australian dollars during periods of market distress, as has been the case several times over the past few years (and most recently during the March 2020 market crash.)

As such, we believe that giving Australian investors exposure to global currencies (in addition to owning global businesses) provides a further measure of diversification to their investment portfolios.

Leverage

Certain funds choose to borrow more money than clients have invested in the fund to amplify the returns that can be generated.

Our Fund will not employ leverage to enhance its returns. Our decision to avoid leverage is based on a thorough

understanding of our investment process and the return profile it will deliver, as well as a healthy appreciation of real-world investment risk.

Given our intent to run a concentrated portfolio, volatility may very well be elevated. Because we do not believe price volatility is the same thing as investment risk, we are happy to accept the higher volatility to achieve superior long-term investment returns. The true risk to this strategy is being forced to sell a holding before our investment thesis has the chance to play out.

Because leverage acts as a magnifier of returns, it will also act as a magnifier of volatility.

Higher volatility combined with leverage is the surest way to increase the risk of us having to liquidate our investment in a high-quality business at an unfavourable price to meet a margin call. We do not intend to take such risks with your capital, and see it as unnecessary to achieving our long-term investment goals.

Shorting

Many people believe that in the process of finding high-quality businesses to own over the long term, one will simultaneously find many examples low-quality business with the opportunity to short. While this idea sounds intuitive, we know from experience that being a good shorter of stocks requires a very different set of skills, not to mention a different temperament. We regard shorting as being outside of our circle of competence.

In addition, the main risk of shorting is that there are too many ways in which we can lose a significant amount of capital very rapidly. Consider a fund reporting a low 'net exposure' to the market – say 95% long, 75% short, so a reported net exposure of 20%.

However, this low net exposure radically understates the risk the fund is running. It is entirely conceivable that the long positions can decline even as the short positions rally under certain market conditions, with significant negative implications for performance. Even if ultimately we were proven correct about the fundamental reasons for shorting a stock, the market can stay 'wrong' longer than we can stay solvent.

This is particularly true in the low-interest rate world we find ourselves in at present, as it does not require much good news to send an 'obvious' short candidate shooting higher at substantial cost to performance. In such cases, short-sellers may become forced buyers to close out a position with the potential for unlimited loss as the stock appreciates.

Shorting also comes at a direct cost to you as an investor, as we need to pay upfront fees to borrow the stock prior to selling it short.

We see ourselves as long-only equity investors and believe that by investing in high-quality businesses we can deliver the long-term performance that meets our stated investment goals. We can live with short-term volatility as we believe our portfolio of businesses are of sufficient quality to survive for the long term.

Fund structure and liquidity

09

Our Fund is structured to be liquid in all market conditions, because we believe this to be both fair and advantageous to our investors.

The companies we intend to invest in will generally have substantial market capitalisations and reasonable trading liquidity.

To be more specific, we look to invest in businesses with a market capitalisation no smaller than US$7.5 billion (classified as part of the 'mid-cap' universe), all the way up to some of the largest businesses in the world with market capitalisations well in excess of US$200 billion (the so called 'mega-cap' universe). We view this universe as more than sufficient in scope and breadth to afford us ample investment opportunities without having to take excessive market liquidity risk. If we need to trade – for whatever reason – we want there to be no doubt whatsoever that we can access the capital you have entrusted to us.

We will predominantly invest in businesses listed on developed market stock exchanges, though we have the ability to invest in businesses listed in emerging markets, should the investment case qualify on the merits.

The Fund is structured as an open-ended investment vehicle, with daily pricing and liquidity. That means there is no lock-up period, should you have a need to redeem from the Fund. If you subscribe to or redeem from the fund, there is a 0.07% buy/sell spread charged on the net value of your investment.

There is also no discount to our underlying investments, and no risk of a lack of liquidity in the units of the Fund.

We both understand and respect your need to be able to access your capital, particularly in emergencies. We want you to be able to come and go as you please, and it is important to us that you suffer no handicap for choosing to do so.

Fees

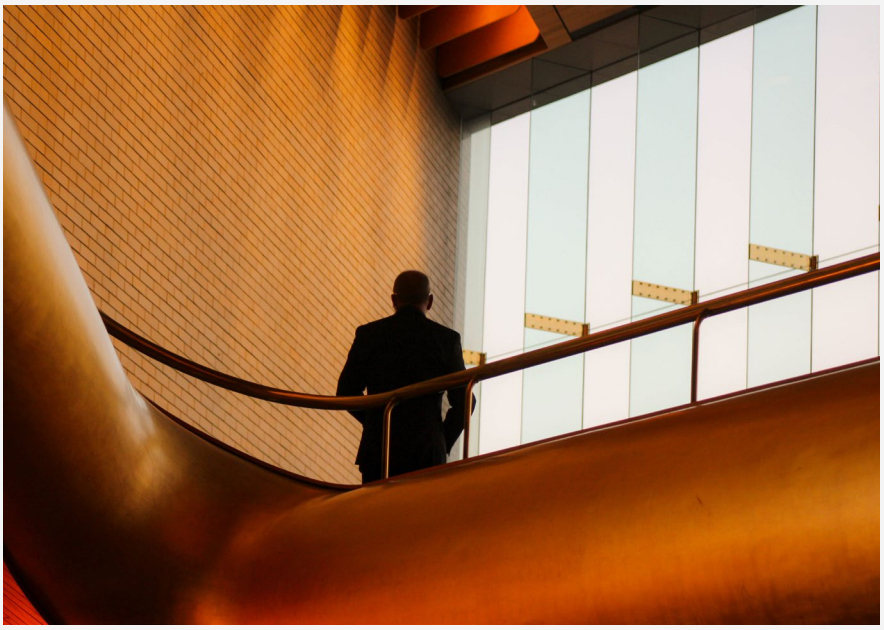
10

We want our fee structure to be simple, transparent, and easily understandable.

Firstly, our Fund charges a flat, annual management fee of 1.43% per year, inclusive of GST. Other administrative costs are estimated to be around 0.22% per year, and include a reasonable estimate of certain costs of implementing the Fund's investment strategy, which include Responsible Entity fees, custody fees, audit fees, accounting fees, legal and regulatory fees and all other fund expenses. These fees are accrued on a pro-rated basis over every financial year.

Secondly, there is also a performance fee component, calculated as 10% (inclusive of GST) of any outperformance of our benchmark, which is the MSCI World Net Total Return Index measured in Australian dollars. This performance fee is subject to a high-water mark, meaning we must first recover any prior underperformance before we can charge a performance fee. Practically, this means we must both be above our previous high-water mark and outperforming our benchmark before we can charge you a performance fee.

Finally, any transaction costs incurred in the management of the portfolio is deducted from the performance of the Fund. Because we look to be long-term investors, we anticipate a low portfolio turnover. As such, we aim to minimise this component of the fee, because we know any excessive dealing cost is effectively a tax on the performance we deliver to you.



Our business

11

AIM was founded in 2015 as an independent investment manager.

The firm is structured to do one thing only: manage client investments. Activities not related to delivering this outcome are outsourced to leading asset management service providers to enable us to focus on conducting investment research, managing the portfolio, and engaging with our investors.

In 2019, the Fund was restructured from a currency hedged global long/short mandate to an unhedged global long-only equity mandate.

AIM is owned by its directors. We are not incentivised by any third party to sell or recommend any product or service beyond the capital we manage for our investors.

In addition to business ownership, all directors are also invested in the Fund; the same goes for members of the staff. We view a significant ownership interest in the Fund as a key component to creating alignment between ourselves and our investors. We believe in our process and portfolio of businesses, and do not try and do better than our clients by investing in businesses we would not own on your behalf. Equally, we would not own a business in the Fund that we would not own in our personal capacity. We believe this makes us aligned with our investors.