GCQ FLAGSHIP FUND | P Class Units

GCQ
GLOBAL CONCENTRATED QUALITY

MONTHLY PERFORMANCE & PORTFOLIO UPDATE

February 2023

"The market is a pendulum that forever swings between unsustainable optimism (which makes stocks too expensive) and unjustified pessimism (which makes them too cheap). The Intelligent Investor is a realist who sells to optimists and buys from pessimists."

BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR

Returns	1 Month	3 Months	6 Months	Since Inception (1 July 2022)
GCQ P Class (AUD)[1]	**1.6%**	**5.5%**	**9.5%**	**14.4%**
MSCI World Index (AUD)	1.9%	-0.5%	5.7%	10.2%
Outperformance	**-0.3%**	**6.0%**	**3.8%**	**4.2%**

The portfolio's net return for the month of February 2023 was **+1.6%**[2].

Following the Fund's strong performance in January, it is pleasing to have followed up with a positive return in February - a month where the indices most relevant to the Fund (MSCI World, S&P 500 and NASDAQ 100) recorded negative performance in USD terms of up to -2.4%.

The market's negative performance was driven by increasing investor concerns over inflation and the outlook for official interest rates. A decline in the value of the Australian dollar contributed to the Fund's performance for the month.

On the following pages you will find a discussion of the opportunity we see to materially enhance returns, over time, by tilting the portfolio towards high-quality companies that are temporarily out of favour while reducing the Fund's exposure to companies that are more fully valued. We believe Alphabet, Google's parent company, currently presents such an opportunity as its investment merits are overlooked by a market that is chasing the hottest investment fad in Artificial Intelligence.

Portfolio Overview as at 28 February 2023

Company	Portfolio Weight
VISA	10%
Mastercard	7%
Global consumer payments	**17%**
Hemnet	9%
FICO	7%
Automated Banking Services	1%
Local monopolies	**16%**
RICHEMONT	6%
LVMH	5%
HERMÈS	4%
Super-luxury goods	**15%**
amazon.com	9%
Microsoft	5%
Global cloud computing	**14%**
Alphabet	9%
Meta	4%
Global online advertising	**14%**
S&P Global	6%
Moody's	4%
MSCI	3%
Credit rating agencies & investment index providers	**13%**
Other high-quality businesses	10%
Shorts	1%
Net exposure	**97%**
Cash	3%
TOTAL	**100%**

1. *Cumulative performance since inception, after all fees and expenses, and assumes reinvestment of distributions.*
2. *Net performance figures are shown after all fees and expenses and assumes reinvestment of distributions.*

Tilting the Portfolio

The GCQ team focuses its time on more than 15 industries with a structure and growth outlook supportive of sustainably strong shareholder returns. At any time, the Flagship Fund is invested in around 20 companies in at least six industries.

When we make an investment, we do it with a long time horizon, and we generally expect turnover of the portfolio to be only around 10% to 15% each year. While this means that the portfolio weights shown on the first page of our monthly updates may vary only slightly from month to month, we monitor all 200 companies on our watchlist very closely, and there will generally be a handful of times a year where we make a change to portfolio weights to take advantage of short-term market dynamics. Our goal is to use the pendulum of the market to our advantage, buying a company that is out of favour, while selling down those that are more fully valued.

It is often said that in the short run, the market is a voting machine, with the market willing to pay high multiples for the most popular businesses, and low multiples for businesses that are out of favour. In our experience, when a lower quality business in a highly competitive industry loses favour with investors, it is often for good reason, and the share price may never recover. However, when a high-quality business in an attractive industry sells off, it is often for only a short time – we have seen situations where the market has been spooked by a regulatory concern, or the impact of a poor strategic decision by management – before investor focus returns to the underlying quality of the business, and its ability to compound returns over the long-term.

Importantly, we only tilt the portfolio when we believe *sentiment* has changed (and never when quality has changed!).

It was one of these situations that saw us build a position in the super-luxury goods industry when the GCQ Flagship Fund was established in early 2022. At the time, multiples in the industry compressed primarily due to investor concerns of extended Covid-19 lockdowns in China. While we did not know *when* China's lockdowns would end, we knew that they *would*; the issues faced by these businesses were therefore temporary in nature; and we were being presented with an opportunity to buy wonderful businesses at attractive prices. We invested around 15% of the portfolio in the highest-quality super-luxury companies – Richemont, LVMH, and Hermès – to take advantage of this situation.

Just one year on, the pendulum has swung a long way back, and our super luxury company share prices are once again hitting record highs, up between 50% to 80% from their lows of 2022. By January 2023, the super-luxury companies had grown to represent 20% of the Flagship Fund portfolio, and with the companies closer to fully valued, we trimmed these holdings on several occasions in January and February.

Buying a company that is out of favour often requires a measure of courage and discipline to look through the near-term issues that are concerning the market. However, if we can identify these situations, and get the timing broadly correct, we believe tilting the portfolio can materially enhance Flagship Fund returns, thereby helping us to outperform the market over time.

We have set out below two situations that illustrate this opportunity. As we discuss, Meta's recent performance shows how quickly a high-quality company can recapture market support when sentiment shifts. While not quite as hated as Meta was in November 2022, we see a similar opportunity at Alphabet today, and we have been adding to the Flagship Fund's holding at what we believe to be very attractive prices.

Meta Platforms

"I want to discuss my management theme for 2023, which is the Year of Efficiency. We closed last year with some difficult layoffs and restructuring some teams. And when we did this, I said clearly that this was the beginning of our focus on efficiency, and not the end."

Mark Zuckerberg, Meta Platforms CEO, February 2023

As the dominant operator of social media platforms and owner of four of the most widely used mobile apps in the world (known as the "Family of Apps": Facebook, Instagram, Messenger, and WhatsApp), Meta Platforms scores highly on the Quality Checklists used by the GCQ investment team.

This collection of digital assets has allowed Meta to deliver phenomenal growth and returns on invested capital over the past decade.

However, after the share price peaked at US$382 in September 2021, a series of short-term challenges and company own-goals saw the Meta share price slide around 70% over the subsequent 14 months, making Meta one of the worst performing large-cap technology companies over this period.

Meta's market capitalisation declined by around US$700 billion as the company navigated challenging dynamics, including a volatile macro economy and weak advertising demand; increasing competition from TikTok; near-term revenue headwinds from growth in short-form videos (known as Reels), which do not yet monetise at the rate of Feed or Stories; and ad signal loss from Apple's App Tracking Transparency changes, which made cross-app user tracking on iOS devices more difficult for advertisers.

At the same time, CEO Mark Zuckerberg chose to double-down on the company's investment in loss making Reality Labs; Meta's effort to create an immersive world that can be accessed through virtual reality headsets. In 2022, Meta lost around US$14 billion in Reality Labs, with expenses expected to increase meaningfully in 2023. By early November, Meta was trading on terms that suggested the Reality Labs cash furnace would continue unabated for many years, without an adequate return ever being generated on the capital deployed.

At its November 2022 lows, Meta's share price implied a value for the core Family of Apps segment of just 3.5x EBITDA. Back in September 2021, these same assets had been valued by the market at around 17x EBITDA.

While the market was voting both that Meta's business was in decline and massive amounts of capital would be squandered, the GCQ investment team had a different view. Importantly, we were optimistic about the outlook for the Family of Apps. These assets benefit from very strong network effects, and have proven highly resilient against new competitors, like Google+, Snapchat, and increasingly, TikTok, where user growth is now beginning to stall, while Instagram Reels and YouTube Shorts are taking market share in short-form videos.

We were also hopeful that the serious question marks over CEO Mark Zuckerberg's capital allocation priorities would be addressed sooner rather than later. Looking to history, we saw clear evidence that Zuckerberg would not pursue a passion project if it jeopardised Meta's long-term success. Meta has shut down unsuccessful projects in the past – for example, Meta-backed cryptocurrency, Diem, which was subsequently sold for around US$200 million in February 2022.

We expected that the share price rout would provide the impetus needed for Meta to turn off the taps on the flood of capital that was being directed to these "investments".

True to form, Zuckerberg took the path that we anticipated, announcing in early February that 2023 will be "the year of efficiency" as he moved to realign the business and its strategic objectives.

This was exactly the signal the market needed, with Meta's stock up over 100% since its low in November 2022.

ALPHABET

"More than 6 years ago, I first spoke about Google being an AI-first company. Since then, we have been a leader in developing AI."

Sundar Pichai, Alphabet CEO, February 2023

Alphabet, the parent company of Google, needs no introductions. Google is the most visited website in the world, with more than 90% search engine market share.

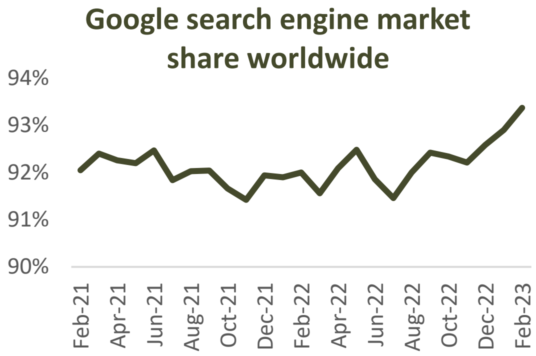
For most of the last decade, investors generally believed that Google's dominant position in search was at little risk of disruption.

Recently, investors have started to question whether advances in Artificial Intelligence (AI) might threaten Google's dominance, with the launch of ChatGPT by Microsoft-backed OpenAI in November 2022 providing a focus for these concerns.

Uncertainty about Google's positioning in a world where AI plays a greater role has contributed to a de-rating of Alphabet's share price over the last 12 months, declining by about 30% over this period. Along the way, there have been moments that could only be described as hysterical panic, such as the day in early February 2023 when Alphabet shares tumbled 8% after the media focused on inaccurate information in a promotional video for Google's Bard chatbot. It was less reported that Microsoft's Bing AI demonstration was also filled with errors!

While Google Advertising has grown revenues at 18% per annum over the past decade, the core Alphabet business (excluding "Other Bets" and the currently loss-making Google Cloud) is now trading on a post-tax earnings multiple of less than 10x. We believe that while "generative AI" has quickly emerged as a venture capital buzzword, the market has been spooked by an AI frenzy that has little actual bearing on Google's industry structure, competitive position or longer-term outlook.

Crucially, we believe Google has significant advantages in search, and despite the market reaction, we do not see any sign of the search business being structurally impaired. Google has around 93% market share in search, and – for all the sensationalist headlines – there is no sign of Bing/ChatGPT causing even a blip on the market share chart.



Source: Statcounter & GCQ Funds analysis

The forces that were responsible for Google establishing a dominant position in search remain unchanged. Google has significant distribution advantages with Apple's iOS, Android, and Google Chrome (the web browser on two-thirds of the world's PCs). We believe Google pays around US$15 to US$20 billion to Apple to be the default search engine on iOS (which is more than Bing's total revenue in 2022!). Google also has highly lucrative revenue share agreements with mobile OEMs, like Samsung, which pre-install Google applications on Android phones and tablets (with Android having over 70% market share in mobile operating systems).

Just as important is the degree to which consumer familiarity with the Google suite of products, like Gmail, YouTube, Maps, and Photos, creates user habits and stickiness. If you want to test your own propensity to shift away from Google, just try using Bing for a week!

While we see a host of use cases for generative AI – whether it be text summarization, content generation, or code debugging – we believe there is no clear opportunity for AI chatbots to disrupt commercial search in the highly profitable verticals, like finance, insurance, retail, and travel, that are central to Google's profitability.

Even if AI capability were to become a significant factor in shaping a consumer's choice of search engine, Google would be well-placed. It is often overlooked that CEO Sundar Pichai first spoke about Google being an AI-first company more than six years ago, and Google has been using AI to improve search since 2015. We expect that Alphabet will continue to integrate AI-based tools and applications into search over time.

On our assessment, the market's pendulum is currently viewing Alphabet with unjustified pessimism. The company is trading at its lowest EV/EBITDA multiple in over a decade (including during the height of COVID-19 uncertainty!), with opportunity for earnings growth through continued growth in digital ad penetration (digital represents only 60% of total ad spend in the U.S.); better monetization of the long-tail of search queries (where only 20% of searches currently carry ads); and a reduction in the company's bloated expense base. In its latest earnings release, Google suggested it is looking to make structural changes to its cost base, which we believe could potentially more than offset the higher compute costs incurred in providing AI tools and applications in search.

When we look back in five years, we expect that the noise around the AI threat to Google's dominance in search advertising will be long forgotten. Some time between now and then, we believe the quality of Google's business will once again be reflected in Alphabet's multiple. Value can be a catalyst in itself, and we have been very happy to add to our exposure at current levels as we know this opportunity may not last. As we saw recently with Meta, sentiment can change very quickly.

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