GCQ

GLOBAL
CONCENTRATED
QUALITY

30 January 2023

Investor Letter

"Buy businesses with pricing flexibility. For several years our investment philosophy has been based on the assumption that inflation over the next ten years will be the major enemy of capital. We assume that inflation may equal or exceed 7%. If this proves to be wrong, we will be delighted as the lower rate will lead to a much healthier stock market. If our assumption is borne out, the pricing flexibility of companies with dominant market positions will provide an important hedge against inflation."

- Bill Ruane, Chairman of the Sequoia Fund, 1980

Dear Fellow Investor,

We are pleased to be sending you this first annual letter following your investment in the GCQ Flagship Fund.

The P Class of the GCQ Flagship Fund was established on 1 July 2022 to facilitate investment in the Fund by investors who prefer to invest via a platform. Over the period from inception to 28 January 2023 the net return for investors in P Class units was **+13.1%**.[1]

We believe that investment performance should be measured over the course of a business cycle, and that the period covered by this letter is too short to make any meaningful assessment. However, for the purpose of putting our returns into context, the return for this period compares with equity market benchmarks as follows:

	Since July 2022
GCQ Flagship Fund (P Class)[1]	+13.1%
MSCI World (AUD)	+7.3%
S&P 500 Index (AUD)	+5.6%
Nasdaq 100 Index (AUD)	+3.4%

Index comparisons are useful for measuring performance provided a long enough time period is used. However, at GCQ, we do not refer to any benchmark when selecting investments, and our concentrated portfolio differs greatly from any stock market index. We have set our performance objectives in absolute terms and we will be pleased if we can achieve net compound returns of 8% to 12% per annum through the full investment cycle.

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We like to begin our investor letters with an instructive quote that reflects our thinking at the time of writing. We decided to begin this letter with an observation from Bill Ruane on the importance of investing in businesses with “pricing flexibility” in a period of higher inflation. Bill Ruane is the fund manager who Warren Buffett advised his clients to invest with when Buffett closed his own investment partnership in 1969.

Bill Ruane’s comments have been top of mind for us over the past twelve months. After many years of benign inflation conditions, the combination of supply chain issues, a tight labour market and excess consumer savings amassed during the pandemic provided both the necessity and opportunity for businesses to raise prices. Russia’s invasion of Ukraine then fuelled an energy and commodity price surge in 2022.

Headline CPI in the US, the measure of inflation that garners the most headlines, reached as high as 9.1% year-over-year in June 2022.

As a consequence, inflation and the resulting increases in interest rates have dominated market sentiment to a degree that had not been seen for decades. This prompted some commentators to delve into history as they expressed concerns we may see a repeat of the 1970s, when the US inflation rate averaged 7.1% per annum for the decade.

While short-term macroeconomic swings do not influence the type of businesses we aspire to own at GCQ, we agree with Ruane that inflation presents an enormous challenge for investors. The vast majority of businesses lack the ability to pass on inflation-related cost increases and struggle to maintain profitability in real terms when inflation is running higher than low-single-digit levels.

Even investors with the discipline to invest only in companies that can increase their profits ahead of inflation will inevitably record periods of negative returns in a rising interest rate environment as the “discount rate” applied to future cash flows increases. This was the case in 2022, with global equity investors almost certain to have experienced a drop in the market value of their investments (unless their holdings were confined to the energy sector).

The GCQ approach to investing in an inflationary environment

Our objective is for GCQ's investment strategy to outperform over the longer term and through various economic and market cycles.

At the heart of the strategy is a portfolio of approximately 20 investments in what we believe to be the highest-quality listed companies in the world.

How we define a "quality business" will be key to our success in navigating challenges such as inflation. Our focus is on businesses that:

- are positioned to predictably grow over many years;
- operate in an industry, and possess competitive advantages, which support high returns on incremental capital being sustained over long periods of time; and
- have a balance sheet, culture and management team supportive of long-term prosperity.

As we discuss later in this letter, every industry that we research and every company that we consider for investment passes through the GCQ Quality Checklists. Several Quality Checklist questions relate directly to a company's ability to navigate periods of heightened inflation.

One of these is a requirement that a business have high margins. Companies with high margins typically find it easier to increase profits in the face of across-the-board increases in costs. For instance, because Hermès has 65% gross margins, it can offset a 10% increase in raw material costs with only a 3.5% increase in its prices. The average company in the S&P 500 index, with only 38% gross margins, must raise prices by 6.2% to offset the same 10% cost increase.

Possibly the most important checklist requirement in a period of high inflation is that a company meet Ruane's requirement of having "pricing flexibility", otherwise known as "pricing power". Businesses with pricing power tend to sell highly valued products or services to customers who have little desire (or ability) to switch to a competitor or substitute product.

We have discussed pricing power in many of our investor updates in the past as it is central to our investment thesis in relation to almost every company in the Flagship Fund portfolio.

Our investment team is always hunting for situations where the value of a company's product is many multiples of the price that it currently charges. The Flagship Fund's investments in credit rating agencies are a great case in point. Having a corporate bond rated by S&P or Moody's costs around $2 in issuance and monitoring costs each year for every $10,000 of face value; if the same bond was issued without a rating, the additional interest cost would set the issuer back an extra $25 to $50. This simple comparison lies at the heart of S&P's ability to increase prices every year.

Pricing power varies between businesses and industries, as well as over time. At GCQ, we are constantly analysing the reason why a company has pricing power – and the extent to which it can raise prices without attracting competition or regulatory backlash.

Recent examples of pricing power from the Flagship Fund portfolio

"The ability to raise prices – the ability to differentiate yourself in a real way, and a real way means you can charge a different price – that makes a great business."

- Warren Buffett

In just the past few months, we have been encouraged by the decisions made by management teams at several of our portfolio companies to exercise some of their untapped pricing power.

Fair Isaac Corporation (FICO) is one such company. FICO has been one of the largest contributors to the Fund's performance since Class P was established in July, with the share price up around +65% over the ensuring period.

FICO is the owner of the intellectual property behind the FICO Score, which is the industry standard measure of consumer credit risk in the United States. Whenever a FICO Score is calculated by one of the three US consumer credit bureaus, FICO is paid a royalty for the use of its intellectual property. This places FICO at the centre of the consumer credit ecosystem, between lenders, investors, credit bureaus, regulators, and consumers.

When we discussed FICO in an earlier letter to investors, we highlighted our view that the company has a bright future as its core product is significantly under-priced relative to the value it delivers to the lending ecosystem. FICO generates an average of just three cents of revenue per FICO Score sold, and (until recently) the highest priced FICO Score was sold for only one dollar.

Confidence that FICO's value proposition is extremely attractive in the context of credit decisions that range in value from thousands to millions of dollars was central to our initial decision to include the company in the Flagship Fund portfolio.

In 2023, FICO is introducing a tiered pricing structure for mortgage lenders based on their size. Providing FICO Scores to mortgage lenders represents 7% of FICO's total Scores revenue. Previously, all mortgage lenders were charged a fee of around 60 cents per FICO Score. Following the royalty increase, the fee paid by smaller lenders will increase to as much as $2.75 – an increase of around 400%. We believe this demonstrates the power of owning a business with extreme levels of untapped pricing power, and continue to believe that FICO's products remain a bargain in the context of the value they deliver to customers.

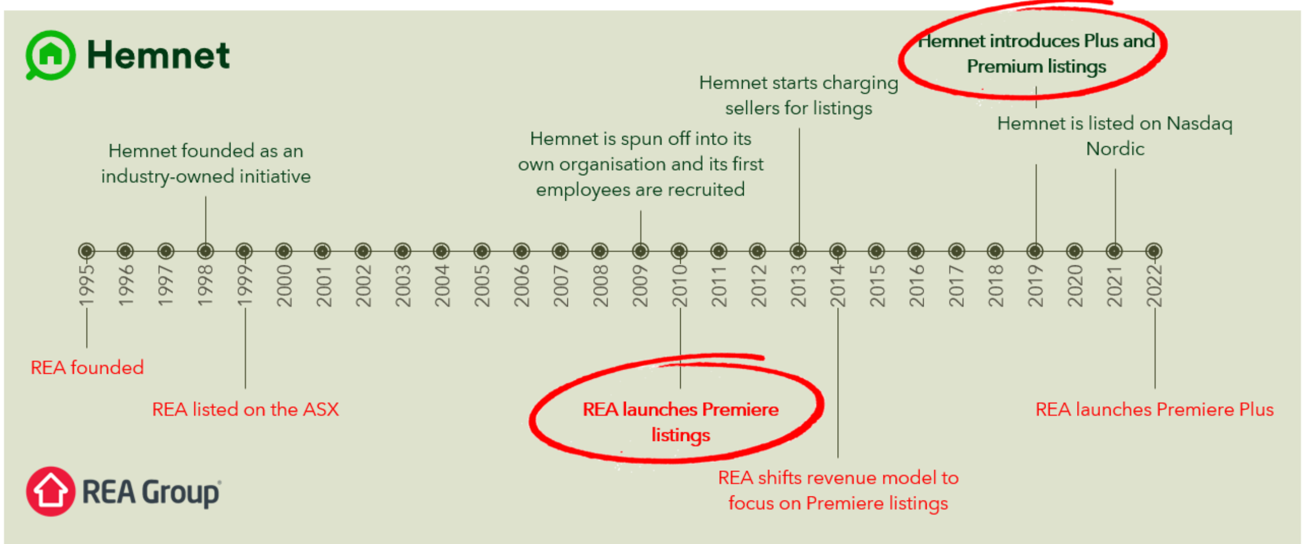
We are highly encouraged by the company's recent pricing initiatives, and believe that FICO will enjoy a long runway of pricing increases ahead!

GCQ

Hemnet, the monopoly real estate portal in Sweden, is another example of a company that is in the early stages of tapping its latent pricing power. Hemnet has been a meaningful contributor to Fund performance, with the share price up +12% since Class P's initial investment at the beginning of July 2022.

The average fee to list a home on Hemnet is equivalent to just 0.11% of the average Swedish home price. This is approximately one-third of the 0.30% that an Australian home seller would typically pay to list their property on realestate.com.au and domain.com.au. The reason for the difference is that Hemnet was much later than REA Group and Domain to start charging home sellers for listings and introduce premium listings.

Hemnet is 5+ years behind REA Group



Source: Hemnet & REA Group

Hemnet's opportunity to bridge this gap through a combination of price increases and product development is central to our investment thesis. We also believe that Hemnet has latent bargaining power in its relationship with real estate agents. For historical reasons, real estate agents (who were the owners of Hemnet until 2016) receive a fee rebate from Hemnet when their clients list a property on Hemnet. This fee rebate was originally 50% of the total amount paid by the vendor, but this has been reduced over time to now stand at between 20% to 40%. With agents receiving more than 90% of their buyer leads from the Hemnet audience, we believe that there is little reason for this rebate to be continued in the longer term.

The Hemnet management team is very aware of the central role that the business plays in the Swedish property market, and the opportunity this presents to increase pricing. The company's official guidance is for revenue growth of 15% to 20% per annum, but the recent cadence and trajectory of price increases suggests this may prove to be conservative. In 2022, price increases in Stockholm were between 22% and 46%. In the first weeks of January, prices were raised a further 7% to 16%, the first of several increases that we expect this year. In addition, we expect a continued trend towards Swedish home sellers purchasing premium home listings, providing further opportunities for Hemnet to grow its revenue and margins.

While FICO and Hemnet have spent decades consolidating their monopoly positions in niche industries before moving to exercise their pricing power, our Super Luxury goods investments have an even longer track record of consistent price increases. Here, pricing power is largely a function of brand desirability, created over decades (and sometimes centuries). Strong brand heritage enables decisions such as **Hermès'** move to increase prices by 8% to 10% across key leather goods franchises, like the Birkin and Kelly bags, in Europe and China during the early days of January 2023.

The outlook for inflation

Our work provides us with confidence that if elevated inflation does prove to be a longer-term feature of the economic landscape, companies in the Flagship Fund portfolio have the pricing flexibility required to provide a hedge.

However, at the time of writing, there is increasing reason to be hopeful that inflation will be largely brought under control in a relatively short timeframe.

We have already seen official measures of inflation fall sharply from their 2022 highs, as well as an easing of the underlying inflationary drivers. Through 2022, the companies we spoke to first-hand were telling us that COVID-related supply chain issues would be largely resolved in the second half of the year, and this is now coming through in the economic data. We are also seeing US households rapidly depleting the c.US$3 trillion in excess savings accumulated during the pandemic, which is likely to see consumers pull back on expenditure during the current year.

At the same time, energy prices have fallen sharply from their 2022 highs, wage growth is decelerating, and prices in some important goods categories (such as used cars) are declining.

Increasing signs that inflation is now trending in the right direction have underpinned equity market strength in the early weeks of 2023. The GCQ portfolio has benefitted from this and is up **+10.6%** in January month-to-date as at time of writing.

If current trends continue, there is every reason to think that Ruane's prediction of "a much healthier stock market" will play out.

The role of Quality Checklists in GCQ's research process

"Checklists seem able to defend anyone, even the experienced, against failure in many more tasks than we realised. They provide a kind of cognitive net. They catch mental flaws inherent in all of us – flaws of memory and attention and thoroughness. And because they do, they raise wide, unexpected possibilities."

- Atul Gawande, *The Checklist Manifesto*

We like to take the opportunity in our six-monthly letters to dig a little deeper into an element of the GCQ research process.

Before establishing GCQ, our investment team looked back over our collective investment successes and failures over the decades to see if we could identify any themes.

What stood out was that, almost without exception, our mistakes were made when we were seduced by company-specific factors while paying insufficient attention to the quality of the industry in which a company operated. We might have been attracted to a compelling valuation argument, a turnaround opportunity spearheaded by a talented CEO, or an attractive quirk to a business model. It was only with the benefit of hindsight that we realised issues in the broader industry – whether the rate of industry growth or the competitive landscape –meant the investment was destined to fall short of our expectations.

Learning from these mistakes, we made two important decisions for how we would structure the research process at GCQ. First, we decided to analyse the industry that a company operates within alongside progressing our work on a particular company. Secondly, learning from the disciplines of the aviation industry – where even the most experienced pilot performs an extensive standardised set of checks before starting the engines, taking off or landing – we committed to developing Quality Checklists for use at both an industry and company level to ensure consistency in our approach and continued discipline.

We only progress with developing a full financial model and forming a view on valuation of a potential investment once the Quality Checklists have been completed and peer reviewed within the GCQ investment team.

Our **Industry Quality Checklist** provides a snapshot of whether an industry has a structure and growth outlook supportive of sustainably strong shareholder returns:

- Will the industry benefit from secular growth (ahead of GDP growth and inflation) over the next five and ten years?
- Do competitors in the industry have high margins?
- Is the industry a monopoly / duopoly / oligopoly?
- Is the industry free from intense rivalry among existing competitors?
- Is it difficult for new entrants to enter the industry?

- Have no new entrants entered the industry in the last 20 years or half the time since the industry was established?
- Is the industry likely to be disrupted or supplanted by substitute products?
- Does the industry have bargaining power with its customers?
- Does the industry have strong negotiating power with suppliers?
- Is the industry structure stable or improving?
- Is the industry **not** undergoing technological change that could result in value destruction for existing participants?
- Is the industry free from regulation that restricts supernormal profits, or does it benefit from regulatory barriers to entry?

Ideally, every industry that we invest in would get a tick against all 12 questions. However, this is an unrealistic goal, and instead, the Industry Quality Checklist serves to focus internal discussion on whether any areas of potential weakness are of such significance that a business operating in the industry would struggle to meet our criteria for a quality investment.

Even an industry that we like very much – the Super Luxury Industry – falls short on two of the Industry Quality Checklist questions. First, the industry cannot claim to be a monopoly, duopoly, or oligopoly. Secondly, new brands are always trying to break into the category, and some do gain a foothold.

However, there are mitigating factors in both these areas. In terms of industry structure, the industry has become increasingly consolidated among the largest luxury brands. The market share of the top seven luxury brands has increased from 17% in 2000 to 33% today. As some companies (like LVMH and Richemont) own multiple leading brands, the consolidation is even greater at the corporate level.

When it comes to new entrants, most new brands have emerged in the ready-to-wear category, which is a part of the industry that is more fashion-driven and of less interest to us at GCQ. Very few companies have the heritage, craftsmanship and image to compete in the highly durable leather goods and jewellery categories which are our focus.

If we are satisfied that any areas of weakness on the industry checklist are adequately mitigated, we proceed to assess hand-selected companies from the industry using the GCQ Business Quality Checklist.

This is a separate set of 15 questions that seek to drill down on similar themes to the industry questions, but at a company level. In addition, the **GCQ Business Quality Checklist** includes questions around the balance sheet (we prefer to see minimal financial leverage), the capability of management, and whether corporate governance is friendly to minority shareholders. Importantly, we also assess whether the company is free from major Environmental, Social and Governance (ESG) issues that threaten the long-term sustainability of the business.

While the questions on the GCQ Business Quality Checklist apply equally to all companies that we consider for investment, for some industries, we have developed additional questions that we expect will help us identify the highest-quality companies.

Returning to the Super Luxury example, parts of the luxury industry can be fickle, particularly for brands that are exposed to fashion trends. To avoid the lower quality investment opportunities that dominate the industry, we have identified several characteristics – relating to brand heritage and custodianship, the durability and predictability of the business, and pricing power – that are common to the wonderful businesses that might meet our investment criteria. These characteristics form the basis of our 10 question **GCQ Super Luxury Industry Quality Checklist**. Some of the questions on our checklist include:

- Has the brand been around for c.100 years or more?
- Does the brand manufacture most of its high-value products in France, Italy, or Switzerland?
- Does the brand control its distribution through high-quality channels?
- Does the brand's strength allow it to sell Veblen goods[2]?
- Are the brand's key products similar to those sold 30 to 40 years ago?
- Does the brand increase prices regularly?
- Does the brand avoid displaying prices in store? (this knocks out a lot of companies)

At times, the use of checklists can seem like a burden. They can be a painstaking chore, particularly if you fall into the trap of thinking the outcome of the exercise is obvious from the outset. However, our investment team has come to embrace the discipline of the process, its central role in screening industries and companies, and providing a focus for our internal discussion of investment ideas. This is a discipline and process which you can be sure that we will never stop.

Portfolio Update

Our team focuses its time on around 15 industries that meet the requirements of our Quality Checklist. Within these industries, there are around 150 companies we research closely, and whose performance and valuation we monitor for potential inclusion in the portfolio.

We prefer investing in companies whose growth is not constrained by the boundaries of a single geographic market. Therefore, the vast majority of companies that we analyse operate, and are growing, globally. An exception to this is businesses that have a local monopoly in an industry with strong growth tailwinds.

When Class P was established on 1 July the portfolio replicated that of the pre-existing classes of the GCQ Flagship Fund.

While portfolio turnover is generally low and we intend to hold our investments for many years, we also constantly challenge ourselves to find opportunities to upgrade the portfolio.

This process has prompted some modest adjustments to the portfolio since Class P was established. Firstly, in July we exited the Flagship Fund's investments in CBOE and CME Group. These monopoly exchange businesses were relatively fully priced in the current environment, and we took the opportunity to redeploy capital into Hemnet and other more attractively priced local monopoly businesses.

More recently, we trimmed the Flagship Fund's position in FICO for risk-management reasons following its strong share price performance.

Figure One: Portfolio Overview as at 28 January 2023

Company	Portfolio Weight
RICHEMONT	7%
LVMH	6%
HERMÈS	5%
Super-luxury goods	**18%**
VISA	10%
	6%
Global consumer payments	**16%**
Hemnet	7%
FICO	6%
Automated Banking Services	1%
Local monopolies	**14%**
amazon.com	9%
Microsoft	5%
Global cloud computing	**14%**
S&P Global	6%
Moody's	4%
MSCI	3%
Credit rating agencies & investment index providers	**13%**
Other high-quality businesses	22%
Shorts	1%
Net exposure	**98%**
Cash	2%
TOTAL	**100%**

GCQ Team and Culture

Our introductory letter from December 2021 highlighted that maintaining a healthy internal culture was one of the factors we had identified as essential to GCQ's long-term success.

We started 2022 with a tight-knit team of four, and we have been focused on maintaining and reinforcing the positive elements of our culture as the team has grown.

We now have a team of eight across the investment team, operations and distribution.

Early in 2022 we welcomed **Chris Morris** as a Senior Investment Analyst. Chris had worked closely with Doug, David and Justin for several years in his prior role and has quickly established himself as an extremely valuable member of the GCQ team.

Also in the investment team, **Weipei Luo** joined us in May as an Associate Analyst while completing the final year of her Bachelor of Commerce and Applied Medical Science at the University of Sydney. With her studies now complete, we are very pleased that Weipei will be joining our investment team full time next week.

In July we welcomed **Nonie Veness** as our Operations Manager, supporting Kathy Wu and David Symons across all aspects of the firm's operations.

Most recently, **Stephen Higgins** joined GCQ in August as Head of Distribution. Stephen is off to a great start managing our relationships with wealth management groups while ensuring Doug and the rest of the team maintain a personal dialogue with our existing investors.

The growth of the team has happened a little quicker than we originally envisaged and has been driven by strong investor interest and our desire to ensure all elements of our investment team and business operations are fully resourced. In 2023 we look forward to adding – very selectively – to our investment team.

In Closing

Following a challenging year for investors globally, we believe the GCQ Flagship Fund is well-positioned to compound wealth at attractive rates over the long-term.

At GCQ, we do not try to time markets. Instead, the Flagship Fund is almost always near-fully invested in a portfolio of high-quality businesses. We have found that over time, we tend to get a much better outcome by being fully invested through market cycles.

We are confident that we own a portfolio of high-quality businesses that should continue to compound intrinsic value over the next 3-5-years, regardless of the broader market environment.

We thank you for investing with us at GCQ and look forward to a long-term partnership.

Yours faithfully,

GCQ Funds Management

"It makes no sense for individual investors to jump in and out of the market. People who trade in that way rarely grow rich, whereas the patient investor often does."

- Philip Carret

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GCQ Flagship Fund’s Target Market Determination is available here (https://www.eqt.com.au/corporates-and-fund-managers/fund-managers/institutional-funds/institutional). A Target Market Determination is a document which is required to be made available from 5 October 2021. It describes who this financial product is likely to be appropriate for (i.e. the target market), and any conditions around how the product can be distributed to investors. It also describes the events or circumstances where the Target Market Determination for this financial product may need to be reviewed.

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[1] Return for the period to 31 December 2022 as published by the Fund Administrator. Return for the period commencing 1 January 2023 is an estimate made by the Investment Manager.

[2] A Veblen good is a good for which demand increases as the price increases due to its exclusive nature and appeal as a status symbol. This runs counter to the usual situation of demand falling as prices rise. Thus, a Veblen good has an upward-sloping demand curve rather than the typical downward-sloping curve.