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29 July 2022

Investor Letter

"In my whole adult life I've never hoarded cash waiting for better conditions. I've just invested in the best thing I could find. And I don't think I'm going to change now."

- Charlie Munger, February 2022

Dear fellow investors,

We are pleased to be sending you this first semi-annual letter following your investment in the GCQ Flagship Fund in February 2022. We have presented two sets of performance figures in this letter – the performance of the GCQ Strategy from inception in January 2021, and the performance of the Flagship Fund A Class units from February 2022 (when the Fund was first open to external investors) through until 28 July 2022.

We believe that investment performance should be measured over the course of a business cycle, and that it is too early to make any meaningful assessment of our performance. However, for the purpose of putting our returns into context we provide a comparison of GCQ Strategy performance with some relevant equity market benchmarks in our monthly updates and in our letters.

The GCQ Strategy net return compares with some relevant benchmarks as follows:

	Since Inception	Since February 2022
GCQ Strategy [1]	+39.9%	-9.6%
MSCI World Index	+3.1%	-10.6%
S&P 500 Index	+10.9%	-9.1%
Nasdaq 100 Index	-0.2%	-14.5%

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Index comparisons are useful for measuring performance provided a long enough time period is used. However, at GCQ Funds Management we do not refer to any benchmark when selecting investments, and our concentrated portfolio does not closely reflect any 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. We will discuss our approach to portfolio construction a little later in this letter.

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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 a response Charlie Munger gave at the Daily Journal annual meeting, held in February this year, when asked whether he would be inclined to increase his cash holdings due to uncertainties in the market environment: *"In my whole adult life I've never hoarded cash waiting for better conditions. I've just invested in the best thing I could find. And I don't think I'm going to change now."*

Charlie Munger's remark is top of mind as the first half of 2022 has delivered the worst first half performance for the equity market of any year since 1970.

We understand the mindset of anyone who wishes that they had reduced their exposure to equities in the more buoyant market of late-2021, but history shows that successfully timing the market is no easy task. Predicting future events – such as the outcome of an election, future interest rate movements or the severity of an unfolding pandemic – is fraught with difficulty. Even more difficult is assessing the market's ultimate response to these events.

Just think for a moment about what you would have done if you had perfect foresight in relation to President Trump's election win in 2016 or the economic impact of the Covid-19 pandemic in 2020. Most investors would have been tempted to sell every share they owned, and very few would have predicted that these events would ultimately be a key catalyst for the market to soar.

From our own observation over the years, most people who try to time the market actually take their money out after the fall and then face the challenge of timing their re-entry.

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This is why UK fund manager Terry Smith has observed: "When it comes to market timing there are only two sorts of people: those that can't do it, and those who know they can't do it."

We are firmly in the latter camp at GCQ, which is one of the reasons why our introductory letter late last year included a commitment that "we will not try to time the market, and we believe it is a mistake to manage your cash balance. You should think of the GCQ Flagship Fund as part of your high-quality equity portfolio and expect us to be fully invested most of the time." Consistent with this philosophy, after launching in February 2022 the GCQ Flagship Fund has had a cash weight of below 10% since early April 2022.

While being close to fully invested in a falling market is invariably a painful experience in the short term, our approach is to focus on the highest quality businesses and to analyse all potential investments with a long-term time horizon.

History shows that short-term equity market prices are driven by unpredictable news events and changes in market sentiment, while long-term investment returns are driven by the fundamental performance of the underlying businesses in a portfolio. Our strategy is to build enduring wealth over the long-term by focusing our efforts on businesses that we expect to deliver predictable and persistent fundamental outperformance. By staying invested in these high-quality businesses at all times, and not seeking to time the market, we will be beneficiaries of their growth in profitability, and well-placed to generate superior risk-adjusted returns over the long-term and through investment cycles. **Of course, we can also be certain that there is no surer path to the erosion of wealth than holding large cash balances through a sustained period of high inflation.**

We like to think that Mr Munger would approve of our approach!

The Flagship Fund Portfolio

At any time, the GCQ Flagship Fund portfolio includes approximately 20 of what we believe to be the highest quality listed companies in the world.

Hand selecting companies for inclusion in the GCQ Flagship Fund portfolio starts with a review of industries that have a structure and growth outlook supportive of sustainably strong shareholder returns. Our focus is on industries that display monopoly, duopoly, or oligopoly characteristics, and firms that own highly valuable brands with pricing power.

Our team focuses its time on around 15 industries that meet our requirements. 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. These investments in local monopolies are growing as a share of the overall portfolio and we have chosen to break them out for the first time in the table on the following page.

More often than not, monopolies in industries without excessive regulatory risk make wonderful investments. Rupert Murdoch possibly expressed it best many years ago when he observed: *"A monopoly is an absolutely terrible thing… Unless of course you own one!"*

Figure One: Portfolio Overview as at 28 July 2022

Company	Portfolio Weight
VISA	10%
MasterCard	6%
Global consumer payments	**16%**
Richemont	6%
Hermès	4%
LVMH	6%
Super-luxury goods	**16%**
amazon.com	10%
Microsoft	6%
Global cloud computing	**16%**
S&P Global	7%
Moody's	4%
MSCI	4%
Credit rating agencies & investment indices	**15%**
Alphabet	9%
Meta	4%
Global online advertising	**13%**
FICO	7%
Hemnet	4%
rightmove	1%
Automated Banking Services	1%
Local monopolies	**13%**
Other high-quality businesses	7%
Shorts	-1%
Net exposure	**95%**
Cash	5%
TOTAL	**100%**

By focusing on excellent businesses that we expect to deliver persistent fundamental outperformance, we can almost always find attractive opportunities to deploy capital. However, every now and then, we are spoilt for choice as a period of market uncertainty results in the indiscriminate selling of companies across countries, industries and the quality spectrum. The trigger for these selloffs can vary, from geopolitical conflict, to a global pandemic, to concerns about the economic outlook.

We have experienced one of these periods of indiscriminate selling in the first half of 2022.

The market downturn was led by unprofitable and hyper-growth technology companies. While we do not invest in this part of the market *(. . .and never will)*, high-quality businesses with high returns on equity and strong growth have also been weak. The GCQ Flagship Fund portfolio is filled with businesses of this type, which we can value on current year cashflows and with expectations of strong growth for many years to come.

The primary cause of the downturn in equity markets is clear – the discount rates that investors use to value future cashflows has increased materially, driven by increased expectations for long-term interest rates as central banks are forced to respond to resurgent inflation. At the same time, concern that increased interest rates will lead to a recession has investors revising earnings expectations downwards.

Positioning of the Portfolio

At the time of writing, we are approaching the end of the US company reporting season.

While the medium-term economic outlook remains far from clear, we believe there are two causes for optimism emerging for GCQ investors. First, earlier in the reporting season the CEOs of the major banks (who have possibly the best vantage point for viewing the macroeconomy) each commented positively on the health of business and consumer balance sheets, and continuing robust demand.

Citigroup CEO Jane Fraser summarised the situation (on 15 July) by observing: *"While sentiment has shifted, little of the data I see tells me the U.S. is on the cusp of a recession. Consumer spending remains well above pre-Covid levels, with household savings providing a cushion for future stress, and as any employer will tell you, the job market remains very tight. Similarly, our corporate clients see robust demand and healthy balance sheets…So, while a recession could indeed take place over the next two years in the U.S., it's highly unlikely to be as sharp a downturn as others in recent memory."*

Secondly, we have noted with great interest an emerging bifurcation between the performance of high-quality established companies with pricing power – which are reporting strong results - and lower-quality commoditised businesses that are struggling to maintain earnings in the face of inflation and broader challenges stemming from the macro environment.

We had expected this, and we were mindful of the backdrop of high inflation when constructing the portfolio. Therefore, we have stuck to businesses with durable demand and significant pricing power.

Visa and Mastercard exemplify our approach to investment as they benefit from inflation; their revenue is driven by nominal consumer spending via debit and credit cards. Most other companies in the portfolio have the ability to pass on increased costs. A good example is our super-luxury investments; Richemont, LVMH and Hermes have intentionally under-supplied the market for many years and the brands they own are so desirable that they should have no trouble increasing prices at a rate that comfortably exceeds inflation.

A third interesting example is global cloud computing, where Microsoft and Amazon.com are the leaders of an increasingly concentrated industry. The trend towards increased use of the cloud, as opposed to on-premise server farms, has fuelled the growth of Microsoft and Amazon.com for several years now. Now that we are in a tough economic environment, where most companies are trying to do more with less, the deflationary benefits of using the cloud appear to be pushing customers to accelerate migration to the cloud.

Our portfolio companies have reported generally excellent in the last few weeks, with strong underlying performance and forward guidance that reflects management's confidence in continued growth in profits through a period of high inflation.

These strong results have been reported at a time when valuations across the portfolio are undemanding. In early July, our portfolio companies were, on average, trading on a forward free cash flow yield of 5.1% while growing profits at around 15% per annum. In the past when we have seen high-quality companies trade on such terms it has been only a short time before prices rebound. It may be this time is no different; the GCQ Flagship Fund has achieved a net return of around 10% for July to date.[1]

Select Portfolio Positions

Our Monthly Performance & Portfolio Updates generally include a discussion of one of the industries from our Portfolio Overview and why we are invested in the industry.

For this letter, we thought we would discuss one local monopoly and one of the "other high-quality companies" in which we are invested. These are two companies that are possibly not as well known to investors as some other companies in the portfolio.

Fair Isaac Corporation (NYSE: FICO)

At GCQ, we like to invest in businesses that have become so essential to the operation of an industry that they have become an industry standard. That is why our portfolio includes S&P Global and Moody's. The credit ratings issued by these companies support bond issuance all over the world. Similarly, the market indices calculated by S&P Global and MSCI are essential to the rise in passive investing and near-impossible to displace.

Fair Isaac Corporation (FICO) is a smaller business, but one whose key product is an equally powerful "industry standard." FICO owns the intellectual property behind the FICO Score, which is the key measure of consumer credit risk in the United States.

FICO sits at the centre of the consumer credit ecosystem between lenders, investors, regulators, and consumers. FICO's high returns on capital are protected by powerful network effects between these industry participants, which each rely on the FICO Score as the "language" for assessing and communicating consumer credit risk.

As a simple example, a bank will use the FICO Score as a key input to determine whether to provide a mortgage to a consumer. US banks have been lending based on FICO Scores for decades, and the FICO Score is tightly integrated into internal loan origination processes. Today, 90% of consumer lending decisions in the US rely on FICO Scores in this way. Once a loan has been made, the FICO Score is demanded by credit rating agencies and investors to assess risk when the loan is packaged into a mortgage-backed security. In the US, 97% of asset-backed securities rely on FICO Scores to measure risk. Regulators will similarly assess risk by referencing FICO Scores.

FICO is a capital-light, monopoly business with significant pricing power – exactly the type of high-quality business that GCQ likes to own.

While FICO is a local monopoly rather than a business with global growth, we believe the company has a bright future as its core product is currently significantly under-priced relative to the value it brings to the lending ecosystem. FICO generates an average of just three cents of revenue per FICO Score sold, with the highest priced FICO Score selling for only one dollar. This value proposition is extremely attractive in the context of credit decisions that range in value from thousands to millions of dollars. Credit providers, such as banks, buy FICO Scores through the credit bureaus (Equifax, Experian, and TransUnion), which aggregate data on historical consumer credit performance. The very low prices FICO currently charges can be explained by historical agreements with the credit bureaus, which kept prices flat for decades. In 2018, by positioning itself to go around the credit bureaus, FICO reclaimed its ability to control prices. Since then, FICO has embarked on a programme of double-digit percentage annual price rises.

The extent to which the FICO score is integrated into both the loan origination process and the securitization of loans gives the business an incredibly strong market position. We see a long runway for the company to continue to raise prices over time, and we look forward to being long-term owners.

Zoetis (NYSE: ZTS)

The trend towards increased expenditure on pet care led us to initiate a small position in Zoetis, the world's leading animal health company, and the #1 player globally in health products for dogs and cats.

Zoetis provides medicines, vaccines, and diagnostics to veterinarians and livestock farmers for animal care needs, with a diverse portfolio of 300 products across eight species.

Over the past 30 years, pet spending has outstripped U.S. personal consumption expenditure growth by 3% p.a. Spending on pet care has increased due to the "humanisation" of pets in the mind of increasingly affluent pet owners, while the aging of pets has led to more complex healthcare needs.

We expect these trends to continue, particularly as younger generations spend more on pets than their parents and grandparents. Pet owners also tend to be wealthier than the average consumer, typically in the top-third of the U.S. population, while increases in disposable income are driving increased pet ownership in emerging markets.

Over the past 20 years, the average life expectancy of a dog has increased from 10 years to 13-14 years. After 10 years, the annual cost of health care is double the first year's spend. No wonder so many pet insurance schemes withdraw cover when a dog turns 10!

Zoetis' scale and direct distribution infrastructure is a key competitive advantage that is hard for smaller businesses with less comprehensive product portfolios to replicate. To operate efficiently a business requires a global regulatory presence across 25+ markets as well as the ability to educate vets and livestock producers and deal directly with this customer base. As a result, the industry has consolidated over time and is now dominated by four large providers, with Zoetis the largest player. Each of these operators is strong in different categories, and market shares tend to be stable over time.

Zoetis has considerable pricing power and has demonstrated this by consistently raising prices at or above inflation across its portfolio over time.

Before being spun out as a separately listed company in February 2013, Zoetis was the animal health division of Pfizer. At the time of the initial public offering, Zoetis was predominantly a livestock health business. However, over the past decade, the balance has shifted towards pet health, which now constitutes c.65% of revenue, and c.75% of earnings.

We expect this business mix shift to continue, and we believe the longer-term implications of it are underappreciated by investors. In addition to pricing and operating leverage, we expect this mix shift to deliver sustainable margin expansion. We believe Zoetis is well-positioned relative to animal health peers, with a clear scale advantage in the largest, most profitable markets; a diverse and innovative product portfolio; durable secular tailwinds from increasing spend per pet; and favourable industry dynamics supportive of high returns on capital.

Currency

GCQ has discretion in relation to managing currency exposure for the A Class of the Flagship Fund. While we intend that A Class units will generally be unhedged, we took the decision to hedge the majority of our currency exposure in March, and have remained largely hedged in the subsequent period.

We made the decision to hedge as we felt the ongoing rally in Australia's key commodity exposures was likely to provide a greater tailwind for the Australian dollar than the headwind of global geopolitical tensions and concerns over the economic outlook.

The historical correlation between commodity prices and the Australian dollar has been very strong, and we did not want to see stock returns eroded by currency movements.

The Australian dollar has devalued in the period since the hedge was put in place, but commodity prices and long-term interest rate differentials remain supportive of a stronger Australian currency. We intend to remove the hedge immediately when we think the facts have changed.

GCQ Team and Culture

Our introductory letter 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 the year with a tight-knit team of four, and have been mindful of maintaining and reinforcing the positive elements of our culture as the team has grown.

In early February, 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 so it is no surprise to us that Chris has become an extremely valuable member of the GCQ team.

Further, we have broadened our capability with three additional new hires.

Weipei Luo is working closely with Justin and Chris as an Associate Analyst while completing the final year of her Bachelor of Commerce and Applied Medical Science at the University of Sydney.

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

Early next month Stephen Higgins will be joining us as Head of Distribution. Stephen will manage GCQ's relationships with wealth management groups while Doug and the rest of the team maintain a personal dialogue with our existing investors.

You would recall that when we opened the Flagship Fund to external investors, we purposely set the minimum investment at a relatively high level as we wanted each of you to have a direct relationship with our Chief Investment Officer. We believe this approach is working well. Doug is enjoying engaging with each of you and expects to be able to maintain a personal dialogue with up to around 100 Flagship Fund investors.

The growth of the team has happened a little quicker than we had envisaged and has been driven by strong investor interest and our desire to ensure all elements of our business operations are fully resourced.

In Closing

The first half of 2022 has been a relatively challenging period for investors the world over. We have stayed true to our strategy at GCQ and believe that our portfolio is well-positioned to compound wealth at attractive rates over the long-term. We are excited by the opportunities that we have in front of us.

We thank you for investing with us at GCQ and look forward to a long-term relationship as we work to deliver on our goals for the GCQ Flagship Fund.

Yours faithfully,

GCQ Funds Management

"I always remind myself, the economy will be a whole lot bigger in 10 years."

- Jamie Dimon, Chief Executive Officer of JPMorgan Chase, July 2022

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[1] Table shows performance of the GCQ Strategy from inception in January 2021 through to 28 July 2022. For the period from inception through to 31 January 2022, Strategy Performance refers to the performance of a private investment partnership run by the founders of GCQ. From 1 February 2022, Strategy Performance refers to the performance of GCQ Flagship Fund A Class units, net of fees and expenses. Past performance is not a reliable indicator of future performance.