

Dear Lakehouse Investor,

October was a tough month for investors in just about every developed market. Investors grew skittish over rising interest rates and the ongoing escalation of a trade war between US and China, sending our benchmark to levels it last sat at around one year ago. For our part, the Fund was a net buyer of shares for 16 consecutive trading days later in the month, which is a pretty active burst by our low-turnover standards.

The small end of the ASX felt the brunt of the market's volatility. 90% of the companies in the Fund's benchmark fell during October and the end result was a return of -9.6% -- the benchmark's worst month in more than six years. Not surprisingly, the Fund struggled as well and returned -11.2% net of fees and expenses. Thus far this fiscal year, the Fund has returned -0.6% compared to -8.6% for the benchmark.

Zooming out further, and much closer to our multi-year time horizon, the Fund has returned 47.3% since inception in mid-November 2016 compared to 19.6% for the benchmark. As ever, rain or shine, our team does not judge itself based on short-term results and neither should investors who embrace our long-term, high-conviction strategy.

The Fund's most significant contributor during October was **Citadel Group** (+5.1%). Alas, it was overshadowed by 13 more impactful detractors, which speaks to how broad the sell off was in October. The most significant detractor was **Afterpay Touch** (-30.4%), which we'll discuss in greater depth shortly.

More positively, the Fund was able to pick up more shares of some of our portfolio companies at lower prices -- the Fund's five largest holdings ended October at an average price about 25% below their highs -- and the Fund is well positioned to be opportunistic given its 15.2% cash position.

The Fund's five largest holdings as of the end of October accounted for 32.0% of the portfolio and are named in order of the Fund's allocation: **Afterpay Touch**, **Altium**, **Gentrack**, **Bapcor**, and **Pro Medicus**. Longtime investors should recognise each of these names as they've been Fund holdings for some time.

Companies Held:	22
Cash Allocation:	15.2%
Top 5 Portfolio Holdings:	32.0%
Net Asset Value per Unit:	\$1.4062
Fund Net Asset Value:	\$162.5 million
Benchmark:	S&P/ASX Small Ordinaries Accumulation Index

The Fund's largest sector allocations as of the end of the month were to information technology (67.9% of total capital), health care (9.2%), and consumer discretionary (5.9%), which is quite different to the benchmark's largest allocations: materials (18.0%), consumer discretionary (13.1%), and real estate (10.9%).

Our typical strong tilt towards information technology companies, and particularly enterprise software companies with their capital-light, recurring-revenue-centric business models, explains much of the Fund's pain during the month as it was the worst-performing sector in the benchmark. While unpleasant, our long-term enthusiasm for the sector has not waned.

Ironically, the best-performing sectors in the Fund's benchmark during the month, real estate and materials, are among our least favourite in terms of long-term prospects. Materials companies are typically cyclical, capital-hungry, price-takers. Listed companies in the real estate space, meanwhile, are particularly sensitive to changes in interest rates and typically require a good deal of leverage in order to earn attractive returns on their characteristically lower-returning assets.

Speaking of leverage, we also have mounting concerns over the fragility of Australian household finances and the state of the Australian property market, both of which we first flagged as a watchpoint in our [2017 annual letter](#). The confluence of high prices, tightening lending standards, off-cycle rate increases, higher stamp duties on some foreign buyers, and tighter capital controls in China have led to a 4.5% fall over the past year in the value of homes across Australian capital cities, according to CoreLogic.

We are not predicting a property crash, however, it seems clear to us that the odds of severe distress are higher than in the past. None of the above factors have dissipated, household savings rates have already shrivelled to levels last seen just prior to the GFC, many takers of interest-only loans may be forced to step up into loans requiring interest plus principal, and household debt as a proportion of income is far higher today than the last time Australian property cooled.

All that said, we are not without options in navigating such an environment or mitigating our exposure. For starters, the Fund is underweight consumer discretionary (5.9% vs. 13.1% for the benchmark) and has no holdings in listed real estate (which makes up 10.9% of the benchmark). The Fund also has no holdings in the bank-heavy financials sector which makes up 8.4% of the benchmark and a whopping 32.4% of the S&P/ASX 200.

Levers can also be pulled in terms of geographic and business model exposure. For example, 19 of the Fund's 22 portfolio companies have business models powered by recurring revenue streams such as subscriptions, maintenance, or licensing agreements. Further, 20 of the Fund's 22 holdings generate revenue from outside of Australia, which helps both in terms of diluting exposure to Australian softness but also adds a touch of a tailwind should the Aussie dollar

continue to weaken. That's not to say that our portfolio companies wouldn't encounter tougher sailing during an Australian recession but neither are we sailing while blindfolded.

Afterpay Touch

Let's get back to talking about companies. Namely, Afterpay Touch, which is the Fund's largest position and whose shares were roughed up during the month. Following on the heels of the royal commission into financial services, the Senate will be leading an inquiry into financial services that are either unregulated or lightly regulated. Targets will include payday lenders, debt management firms, and, yes, 'buy now, pay later' players, including Afterpay. Meanwhile, the press reports that ASIC expects to release a deep dive into the 'buy now, pay later' sector later this year.

The above sounds spooky, particularly in light of the dramatic headlines coming from the ongoing royal commission, but the spotlight may not prove unflattering. After all, Afterpay users who pay on time pay no fees or interest, 93% of Afterpay orders do not incur late fees, and 85% of transactions are linked to bank-issued debit cards. The company also noted in February that it had only been served with 14 notices by the Financial Ombudsman -- a drop in the ocean compared to the user base of 1.5 million at the time -- and that none of the decisions had gone against Afterpay.

We don't take the headline or regulatory risks lightly, however, it's important to keep a few layers of context. Afterpay has already been engaging with ASIC, for starters, and has introduced identity checks for users as well as caps to late fees. Also, even if Afterpay is forced to run credit checks on users, we think doing so would not be financially or operationally onerous, and for that matter may even reduce fraud and late payments. All that is to say that, even if Afterpay becomes more tightly regulated, that does not necessarily mean that it will hinder the economic model in Australia, and any hindrance may prove only marginal.

It is also worth remembering that Afterpay is not the only disruptive business to find itself navigating uncertain legal and regulatory frameworks that did not foresee their existence. Name just about any major disruptor of the past two decades -- Amazon, Facebook, YouTube, Uber, Airbnb, etc. -- and you'll find those companies lurched through similar trials and still do today. That's not to say that we or the company should take such matters lightly, however, uncertainty and heavy scrutiny come with the territory of being an impactful, disruptive business.

Meanwhile, a significant portion of Afterpay Touch's value is found in ventures outside of the Australian 'buy now, pay later' business. The US business already has more than 1,000 merchants live including the likes of Urban Outfitters, Revolve, and Kylie Jenner and reached A\$20 million in underlying sales in just its second full month of operations (July). We're also impressed that, according to SimilarWeb, Afterpay's websites are receiving about 30% of the traffic that flows to

large and well-known rival PayPal via urbanoutfitters.com, suggesting Afterpay is capturing a material chunk of volumes.

It is still very early days in the US, the business will take time to reach profitable scale, and we've little doubt that Afterpay will face similar regulatory scrutiny in the US as it does in Australia should it reach comparable success. Still, it was a shot on goal worth taking and the initial start is going as well as could reasonably be expected, even for early stages. It's also worth remembering that the US isn't Afterpay's only international market: the business launched into New Zealand last year and expects to launch in the UK by early next year.

But wait: aren't we concerned about Australian credit, and wouldn't an Australian recession be bad news for Afterpay? Yes, and it's fair to say that an Australian recession would temper consumer spending and increase the number of users who fail to pay Afterpay back. That said, as mentioned, it is worth remembering that the business is not a pure-Australian story. Also, because Afterpay recycles its capital so quickly and reviews each transaction individually -- it actually rejects about 30% on the spot -- Afterpay should be well placed to quickly identify disconcerting trends in repayments and adapt its risk and approval frameworks by tightening standards for certain user cohorts, items, geographies, and merchants. Lastly, we suspect a business that grew its user base by 138% last fiscal year may still be able to find avenues for growth even if the economy does briefly backslide.

Afterpay Touch has always been a business with a wide range of outcomes, which is why we've taken profits along the way for what has been a very successful investment thus far, even despite the recent pullback. Still, given the continued traction both online and in-store in Australia, promising early start in the US, potential in the UK, diversifying base of merchants and capital sources, optionality around new services for both users and merchants, and the shares sitting at roughly 46% off their highs, we're comfortable hanging in there to see what the future holds.

Looking Ahead

Corrections happen and we cannot control what the market will do. We can, though, control our mindset, process, and strategy, and nothing about our long-term, business-focused, growth-oriented approach has changed.

We continue to hunt for hidden gems -- our team has held around 300 company meetings since the Fund launched just under two years ago -- and have been steady buyers over the past couple of weeks. Here's hoping the market keeps presenting more opportunities.

As always, thanks to all our investors for your time and trust. It means a great deal to us and we were pleased and humbled that the Fund's investors collectively invested more into the Fund than they redeemed during what was the toughest month since its launch. We are fortunate to have such an aligned group of investors.

And one last thing. Speaking of the long-term and investments, we're pleased to share that Lakehouse Capital has added a fifth investor to the team, Nicholas Thomson. Nick is fresh off doing some globetrotting following nearly six years serving as an analyst at Dakota Capital in Sydney and New York. He's a great fit and we're thrilled to have him join the team.

Best Regards,



Joe Magyer, CFA
Chief Investment Officer

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