

Dear Lakehouse Investor,

2019 was a pleasing year for the Lakehouse Global Growth Fund. The Fund returned 23.6% net of fees and expenses in fiscal 2019 compared to 11.3% for its benchmark. For context, this was a solid enough result such that the Fund ranked number one out of 84 peers in the *Morningstar Equity World Large Growth category. Since inception at the start of December 2017, the Fund has returned 34.0% compared to 15.7% for its benchmark.

We are pleased with the Fund's progress towards its goal of long-term outperformance, however, we're eyes-wide-open that our growth focused, high conviction, high active share approach means the Fund will experience periodic bouts of underperformance. We do not get fussed over short-term zigs and zags, though, as evidenced by the Fund still owning 17 out of the 18 companies it owned twelve months ago.

Worries over trade wars and slowing global growth have been the dominant macroeconomic themes over the course of the Fund's young life. We appreciate the risks to both, particularly regarding the risk of a Chinese recession given its longtime reliance on credit expansion to power growth. That said, our passion and strength lies in analysing businesses, not predicting economic gyrations, and thus we mostly stay in our lane and stick to seeking businesses that should thrive over the long-term regardless of whether, say, the Federal Reserve cuts in August.

We are seeking businesses with strong positions in growing markets, pricing power, durable competitive advantages, aligned and experienced management teams, conservative balance sheets, and attractive valuations. Doing so puts us in situations which we think gives us multiple ways to win and fewer ways to lose, making for an asymmetric range of outcomes. Judging by our progress to date, as we'll discuss later, we think that mindset and approach have served the Fund well.

Our philosophy has not changed and neither has our underlying process for vetting potential investments. What has changed, though, is that we added two new Investment Analysts this year, Erwin Tan and Nick Thomson, who spend most of their time focusing on this Fund. Expanding the team has allowed us to optimise around new idea generation and coverage into a 'Fascinations' based approach.

Companies Held:	21
Cash Allocation:	11.9%
Top 5 Portfolio Holdings:	34.9%
Net Asset Value per Unit:	\$1.3239 (ex 1.78 cent distribution)
Fund Net Asset Value:	\$125.8 million (ex \$1.7 million distribution)
Benchmark:	MSCI All Country World Index Net Total Returns (AUD)

The classic way that most global investment teams are structured is around either geography (e.g. US, emerging markets, etc.) or sector (e.g. materials, IT, and so on). The problem with these approaches is that they are more concerned with covering the waterfront than finding where the fish are biting. For a fundamental, long-term-driven investment process aiming to identify outstanding businesses, a forced choice between focusing efforts along the lines of sectors or geographies is a false dichotomy.

Worse still is that not all sectors or geographies are created equal. For example, some countries have more robust economies and governance than others. On the business side, as a [study](#) by McKinsey emphasised, industries with sustainable barriers (e.g. software and household products) tend to have high and persistent returns on invested capital, while industries that are capital intensive (e.g. materials and energy) and highly competitive (e.g. retail and transportation) tend to have persistently low returns on invested capital.

Rather than fall back into using one of these traditional but flawed frameworks at Lakehouse, we inverted the process and asked a very basic question: what is the best way to identify outstanding businesses to buy and hold for the long-term?

Starting with that fresh sheet of paper, we focused on the backbone of our investment philosophy: well-run, competitively-advantaged businesses that can reinvest capital at attractive rates for a very long time offer the most compelling potential for the long-term investor. That clarity led us to focus on our core fascinations when it comes to stock selection:

Loyalty: Think enterprise software, payment processors, subscriptions, or any other form of business with an intense focus on customer loyalty and retention. Importantly, we view loyalty as not just switching costs, which make it difficult for customers to move on, but also the delivery of value and delight to customers that makes them want to stay.

Businesses with extremely loyal customers are often underestimated by the market because of their staying power, pricing power and ability to cross- and up-sell. In our experience, many investors lump recurring revenue businesses into one big pile, which creates an opportunity for discerning buyers to separate the coal from the gems.

Networks: Think marketplaces, exchanges, payment networks, social networks, or any other form of business exhibiting network effects. We're passionate about businesses with network effects because many of them scale quickly and capital-efficiently, creating a significant amount of value in short order. Markets tend to underestimate the staying power of a leading, well-established network.

IP: Think brands, data, patents, or even corporate cultures that are difficult to replicate. Businesses with strong IP have enduring pricing power and, often, an innovative culture and strong distribution network that creates and scales new and valuable IP.

The net effect of our focus on these fascinations is that the Fund tends to own faster growing businesses (revenue growth at the portfolio level clocked in at 22% over the past year) with high and healthy margins (average operating margin of 25%) and strong balance sheets (the average portfolio company has a net cash position).

The Fund held 21 positions as of the end of June, the top 10 of which are listed in order as follows:

Company	Allocation	Industry
Facebook	9.3%	Interactive Media and Services
PayPal	7.2%	Data Processing and Outsourced Services
Alphabet	6.6%	Interactive Media and Services
Visa	6.1%	Data Processing and Outsourced Services
Amazon	5.7%	Internet and Direct Marketing Retail
Monster Beverage	4.8%	Soft Drinks
Interactive Brokers	4.5%	Investment Banking and Brokerage
Booking Holdings	4.3%	Internet and Direct Marketing Retail
LVMH	4.2%	Apparel, Accessories and Luxury Goods
Adyen	4.1%	Data Processing and Outsourced Services
	56.8%	

We have discussed each of the above positions in our [monthly letters](#) and so will not rehash all their investment cases here. That said, we take care to note that three of the Fund's five largest positions -- Facebook, Alphabet, and Amazon -- are all targets to varying degrees in investigations by politicians and regulators into anti-competitive behavior.

We are watching the situation closely, however, we are not panicking. It is worth remembering that the mere fact that these companies are facing such intense scrutiny speaks to their strong competitive positions and, in turn, enviable economics. All things equal, we much prefer investing in dynamic leaders whose strength attracts attention rather than businesses with such weak hands and unimpressive economics that no one pays them any mind.

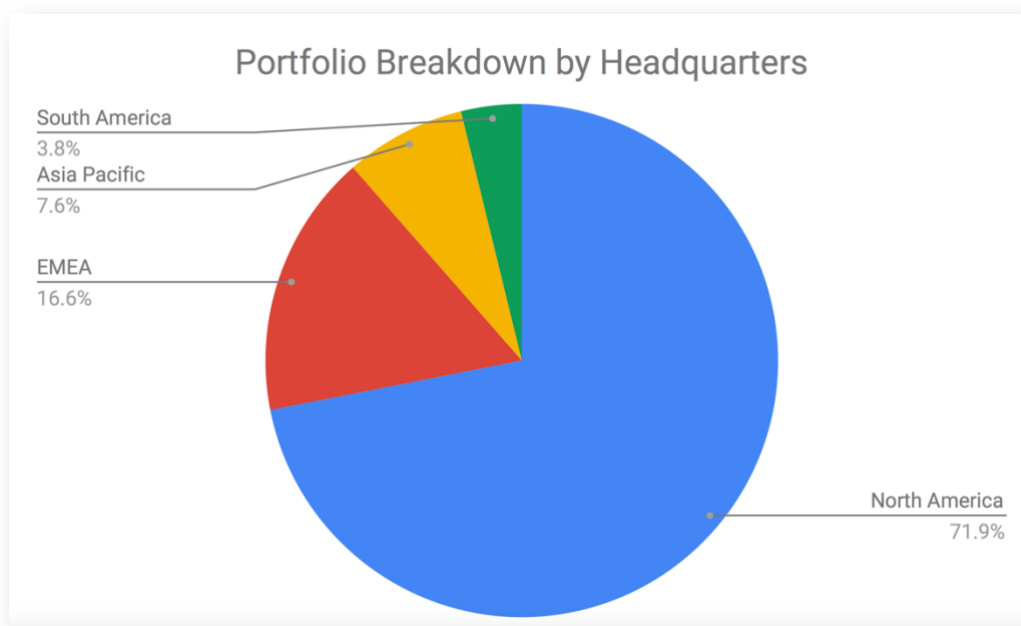
It will take much more than just talk to fracture these companies, though, and it is worth noting that the gravity for US antitrust law centres around consumer harm. We think proving such a case would be a steep hill to climb as Amazon rates among America's most loved consumer brands and the huge majority of Facebook and Alphabet's services are free and highly valued by consumers. Indeed, a recent study of just over 1,300 Facebook users in the US revealed that the average one would have to be paid more than US\$1,800 to give up Facebook for a year, which is almost 17 times the ad revenue Facebook generated per monthly active user in North America last year.

We also aren't sure that breaking these businesses up would change very much -- most of the pieces would still have their own natural self-reinforcing advantages via scale or network effects

-- or that the net outcome would be negative for shareholders. For example, while Alphabet's owning and supporting YouTube over the years undoubtedly enhanced YouTube's value, it is possible that Alphabet's ownership of the platform is now holding YouTube back because current and potential YouTube partners rightly do not view YouTube as being platform agnostic. The same could be said of Amazon Web Services.

It is also possible that, should these units be broken apart from their parents, the market might actually value them higher in their independent form than they are currently lumped in with one another. In any case, while we think the odds and impacts of breaking up these businesses are overblown, we will continue to watch the space and situation closely.

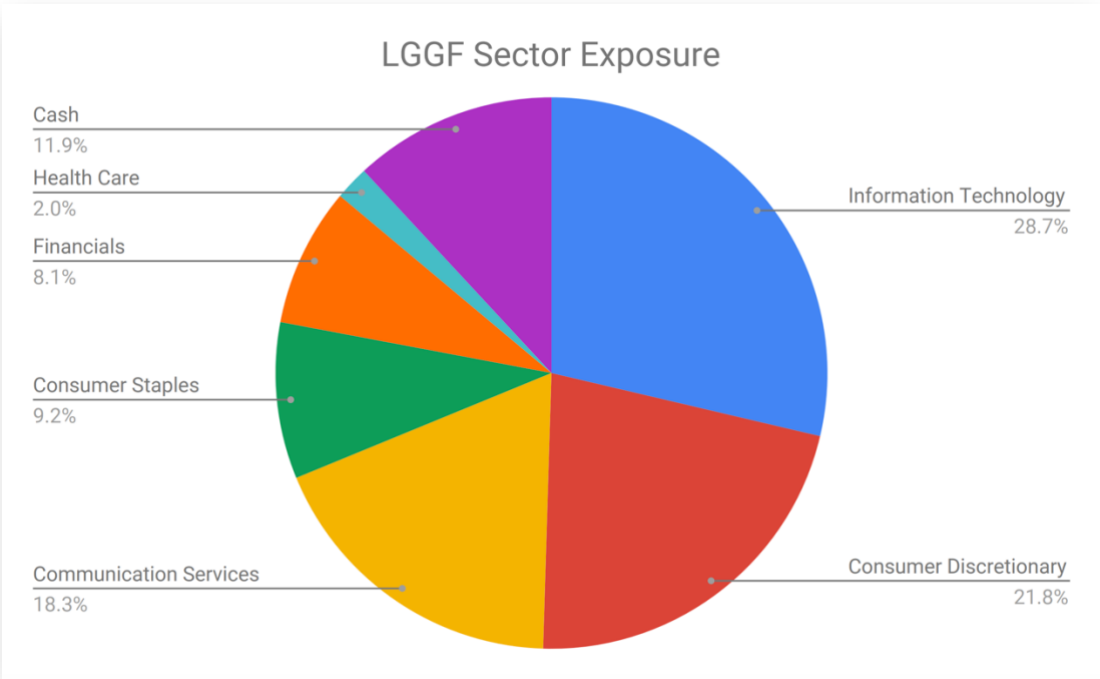
We spend a fair bit of time following what happens in the US because the bulk of the Fund's investments (71.9%) are headquartered in North America with the supermajority (67.9% of total invested capital) in the United States. We expect investors are unsurprised by that strong U.S. orientation given that it is home to the greatest number of great global growth companies, plays to my strengths and background, and that the U.S. is almost eight times as large within the benchmark as the second biggest market (Japan).



All that said, the Fund is less U.S.-centric than it appears at first glance as most of its portfolio companies are regionally or globally diverse. For example, each of Facebook, Alphabet, and Visa generate most of their revenues from outside the U.S. We estimate that around 51% of the revenue generated by Fund's portfolio companies comes from outside the U.S.

Zooming out to the sector-level, the Fund's largest allocations at year-end were to information technology (28.7%), consumer discretionary (21.8%) and communication services (18.3%). We

are larger than the benchmark in all three sectors and expect that will consistently be the case over time as we view these sectors, or at least subsets of them, as having superior economics and long-term prospects. Again, we do not feel a great compulsion to allocate capital to sectors that are notoriously cyclical, competitive, or capital-hungry, and thus we expect to remain underweight the likes of materials, energy, and utilities.



The Fund closed out the year with a cash allocation of 11.9%, down from 21.4% at the start of the year. The bulk of the Fund’s cash is parked in Australian dollars (the Fund’s base currency) and U.S. dollars (the currency in which most of the Fund’s investments are priced). It is fair to question, given the Fund’s strong performance, whether the Fund should run with a smaller cash position. As a reminder, we typically operate in a band of 5% to 15% with a cap of 25%. Our preference is that our active investment decisions drive the Fund’s returns, not decisions on cash allocations. That said, we sleep well with what strikes us as a prudent cash balance, particularly given how hard many growth stocks have run recently.

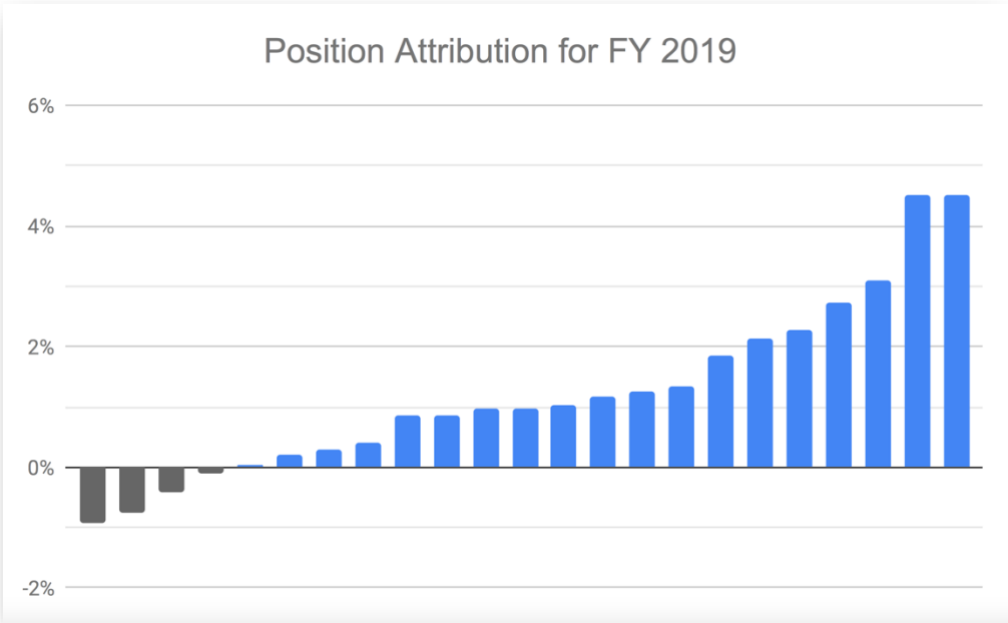
We’re still finding opportunities to deploy new capital -- having a global mandate makes for a tectonic sandbox -- but we’ve had to take a pass on many otherwise promising opportunities lately simply because we did not think the valuations skewed the investment outcomes in our favour.

Portfolio Company Activity

2019 was a year where we felt like we executed well against our process and, while it's hard to judge a long-term process based on just a year's worth of results, we think the performance data bears that view out.

The Fund's gains during the year were broad-based as 82% of the investments the Fund held at some point during the year were positive contributors. Also, while the Fund's tilt towards the information technology sector was a performance booster -- it was the second-best performing sector during the year -- about 92% of the Fund's outperformance during the year came not via sector selection but stock selection. To that end, we were also pleased that the Fund's five most significant contributors to performance outweighed the five most significant detractors by a ratio of about 8:1.

Granted, all this was buoyed by a roughly 5% depreciation in the Australian dollar during the year, which boosts the value of overseas investments in Aussie dollar terms, but the broader point that we struck the ball well remains.



The most significant contributor to performance during the year was Paycom Software, which increased by 141.4% (129.4% local currency). The provider of HR and payroll software solutions had a strong year with a successful move up market driving strong operational results. Traditionally, Paycom has focused on the mid-market (i.e. enterprises with 100 to 2,000 employees) however management recently made a bold move and decided to broaden Paycom's

target market. In effect, they gave their sales force the green light to target enterprises with up to 5,000 employees -- typically a more complicated and difficult sale.

Any initial investor skepticism over the change in strategy was quickly abated as the company managed to not only maintain 30%-plus top-line growth but also consistently beat earnings expectations and subsequently raise guidance. The company's focus on driving employee engagement within their human capital management system also appears to be paying dividends as the company's customer retention rate increased to 92% after several years of sitting at 91%.

The second largest contributor to performance was Atlassian, which increased by 120.2% (109.3% local). The company had a very eventful year with revenues crossing the US\$1 billion mark, an impressive feat for a company that was only generating US\$200 million per year as recently as five years ago. While the company's flagship collaboration tools, Jira and Confluence, continue to be tremendously successful, the company is by no means resting on its laurels. Atlassian recently completed two acquisitions, firstly with OpsGenie (a leading IT incident reporting platform) and then with AgileCraft (a provider of enterprise agile planning software). Long term, we continue to be bullish on the company's ability to expand its addressable market with the build out of its product suite and are particularly enthused by their push into the IT segment at-large.

We are still big fans of Paycom and Atlassian as both companies possess a number of traits we love to see, including; exceptional unit economics, very sticky customer bases, solid balance sheets, strong competitive positions and long runways for growth. That being said, we did take the opportunity to trim our position in both companies during the year as valuation multiples swelled to levels that we thought justified taking some chips off the table.

The third most significant contributor to performance was PayPal, which increased by 44.6% (37.5% local). PayPal has an impressive history of beating expectations -- gaining share of a growing market combined with significant operating leverage oftentimes has that effect -- and the company had a great year despite concerns on eBay's transition off from PayPal. Total payment volume (TPV) has grown by 26% in constant currency terms over the past year and repositioning the company from a checkout button to an open platform has helped forge partnerships with different online marketplaces and other financial institutions. Opening the platform has also helped re-accelerate the growth in active PayPal accounts. Meanwhile, Venmo ended the latest quarter with more than 40 million active accounts and TPVs higher than eBay. With the recent regulatory approval of the iZettle acquisition, we look forward to the following year, as PayPal moves towards offering both online and in-store payment solutions.

And now let's turn to the Fund's biggest detractors. The most significant detractor to performance during the year was FeverTree Drinks, which fell 30.8% during the year (-31.6% local). Investors, including ourselves, have been concerned about slowing growth in FeverTree's largest market (the UK), as the brand fast approaches maturity after growing sales at an average pace of 80%+ during the last five years. These concerns are not entirely misplaced -- FeverTree's

UK sales grew a pedestrian 5% during the first half of calendar 2019, albeit after a monster 1H18 which contained more than a few “one-offs” (the Royal Wedding, the football World Cup and an unusually hot summer).

Whilst we do not want to get complacent about our thesis, we think some sales deceleration is natural as FeverTree now has ~40%+ market share in the UK, and from this point on, share gains are likely to be incremental. In our experience analysing brands, this usually tends to be the point where reinvesting in portfolio innovation, marketing and distribution is helpful to sales. Encouragingly, though, FeverTree is growing rapidly in the US where it has taken greater control of its operations only recently, and in other parts of the world (including Australia) as it builds and invests in distribution.

We feel good about FeverTree’s ability to gain share of a growing market with structural tailwinds to consumption, and continue beating its (formidably larger) competition. Also, the stock price has come off roughly a third during the last year, which gives us further comfort around valuation, and we would not be surprised to see a suitor emerge given the share’s pullback and the brand’s strength.

The second biggest detractor was Interactive Brokers, which fell 11.5% (-15.9% local). Whilst the share price performance was disappointing, we felt that the company had a fairly positive year from an operational perspective. Despite the US-China trade war creating a tough macro environment, the company continued to grow its client accounts by 19% over the year. We believe that the ‘China risk’ is overstated. Speaking with the company recently, we noted that whilst mainland China represents around 20% of total accounts, it only makes up less than 2% of revenue. We continue to be patient holders of the stock and take comfort in the company’s consistent market share gains, strong balance sheet, aligned leadership team, and a valuation that strikes us as undemanding.

The third largest detractor was iQiyi, which fell by 10.9% (14.2% local) between the start of the year and when the Fund exited the position in February. While iQiyi’s growth remains impressive we became more wary of the potential risks. Namely, the continued deterioration in the outlook for the Chinese domestic economy and the company’s escalating cash burn. At the time of our exit, the company’s quarterly operating loss had more than quadrupled year-on-year as the company invests heavily for growth.

We always acknowledged that iQiyi was one of our higher-risk positions with a wide range of possible outcomes, and as such, we felt it was prudent to exit upon seeing smoke rather than waiting to see a fire. We aren’t fussed about realising a 36.9% gain on an investment where the thesis was drifting, though, and we’ll continue to watch the business for a possible re-entry should cash burn trends change or the company demonstrates it has the latent pricing power that we think it does.

Looking Ahead

Thanks to all our investors for your time and trust. It's still early days for the Fund but we're pleased with our progress towards our goal of long-term outperformance and feel good about the long-term prospects of the portfolio of companies we've assembled.

We're backing that conviction up by reinvesting in our own business. For example, we're in the process of upgrading to more robust order and portfolio management systems. Also, not only did we bring on two new Investment Analysts this year, we've also recently brought on an Operations Manager, Dennis Lee, who will allow the rest of us to focus on what we do best, and a Business Development Manager, Mark Fenech, to help us better serve our growing investor base and to connect with the advisor and institutional community.

Again, thank you. We can't promise that next year or years will look like this past one but, regardless, we'll stick to our playbook and keep doing our best for you.

Best Regards,



Joe Magyer, CFA

Portfolio Manager, Lakehouse Global Growth Fund
Chief Investment Officer, Lakehouse Capital

**Data source: Lakehouse Global Growth Fund: <https://www.morningstar.com.au/Funds/FundReport/42097>*

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