LAKEHOUSE SMALL COMPANIES FUND

MONTHLY LETTER

31 July 2022

Dear Lakehouse Investor,

July was a reminder that a month can be a long time in markets. The US economy reported its second consecutive quarter of negative economic growth during July, triggering a significant shift in sentiment, as the US Federal Reserve softened its stance on interest rates. The yield on US 10-year treasury bonds fell from a high of 3.5% in June to 2.65% at month end, and global equity markets rallied in response.

Domestically, it's a similar story. Although the RBA raised rates by 0.50% in June, July, and again at the start of August, it downgraded its growth forecasts due to global uncertainties. The RBA has made it very clear that rates are not on a pre-set path. Local bond yields fell from a high of 4.1% in June to 3.1% at month end with the yield curve flattening and equity markets rallied in response.

Fund Metrics	
Companies Held	20
Cash Allocation	4.6%
Top 5 Portfolio Holdings	41.4%
Net Asset Value per Unit (mid)	$1.2482
Fund Net Asset Value	$227.6 million
Benchmark	S&P/ASX Small Ordinaries Accumulation Index

Turning to performance, the Fund returned 18.9% net of fees and expenses during the month compared to 11.4% return for the benchmark. Over the last 12 months, the Fund has returned -36.2% compared to -10.9% for its benchmark. Since inception in mid-November 2016, the Fund has produced a net total return of 79.1% compared to 50.3% for the benchmark. In annualised terms, the Fund has returned 10.8% per year since inception compared to 7.4% per year for the benchmark.

We received a number of updates from portfolio companies during July, which highlighted solid fundamental performance of the businesses that we discuss below.

	1 Month	3 Month	1 Year	3 Year (p.a.)	5 Year (p.a)	Inception (p.a.)
Lakehouse Small Companies Fund	18.9%	-4.7%	-36.2%	-2.9%	10.7%	10.8%
Benchmark	11.4%	-9.9%	-10.9%	2.5%	7.3%	7.4%
Excess Return	7.5%	5.2%	-25.3%	-5.4%	3.4%	3.4%

*** Performance calculations are based on exit price with distributions reinvested, after fees and expenses, since inception in mid-November 2016. * Benchmark: S&P/ASX Small Ordinaries Accumulation Index. Past performance is not indicative of future returns.*

The Fund's largest sector allocations are to information technology (43.6% of total capital), financials (19.3%), and healthcare (14.9%) while the benchmark's largest allocations are to materials (22.2%), real estate (15.2%), and consumer discretionary (13.1%).

As we frequently remind investors, our investment process seeks out and emphasises *Investment Fascinations*, that is businesses with extremely loyal customers, network effects, and unique and enduring intellectual property. Most of those businesses tend to be more concentrated in specific sectors (e.g. technology, financials, healthcare) while are rarely found in others (e.g. commodities).

On the topic of commodities, we'll quickly re-share a chart covered in our recent webinar outlining returns of different sectors in the 15 years from 2007 to 2021:

Abbr.	Sector Index	Annual*	FY21/22^	Best	Worst
INFT	S&P 500 Information Technology Index	16.9%	-20.5%	61.7%	-43.1%
COND	S&P 500 Consumer Discretionary Index	13.4%	-29.5%	43.1%	-33.5%
HLTH	S&P 500 Health Care Index	12.2%	-4.1%	41.5%	-22.8%
CONS	S&P 500 Consumer Staples Index	10.7%	-4.0%	27.6%	-15.4%
S&P	S&P 500 Index	10.7%	-15.6%	32.4%	-37.0%
INDU	S&P 500 Industrials Index	9.4%	-18.3%	40.7%	-39.9%
MATR	S&P 500 Materials Index	9.0%	-15.2%	48.6%	-45.7%
UTIL	S&P 500 Utilities Index	8.6%	4.0%	29.0%	-29.0%
TELS	S&P 500 Communications Services Index	8.1%	-29.9%	32.7%	-30.5%
REAL	S&P 500 Real Estate Index	7.7%	-12.5%	46.2%	-42.3%
FINL	S&P 500 Financials Index	4.0%	-11.2%	35.6%	-55.3%
ENRS	S&P 500 Energy Index	2.4%	24.9%	54.0%	-34.9%

**Source S&P, Factset, novelinvestor.com. Annual sector returns annualised from 2007 to 2021 in US$. The historical returns are provided as an illustration of sector returns over time. Returns represent total annual returns (dividends reinvested) and does not include fees and expense. Past performance does not guarantee future returns. ^ Utilising MSCI sector data.*

Despite its stellar run through 2021 and 2022, it is worth noting in the US that the S&P Energy Index has still only delivered investors a 2.4% compound annual return over the past decade and a half. For anyone regretting the absence of energy stocks from our portfolio, these increases have only taken the S&P Energy Index back to a level first reached in 2008.

While short commodity traders may have printed some quick paper profits at the start of the year, it's worth noting that oil is now 25% off its highs, the wheat price is close to 40% off its highs and now priced lower than before Russia invaded Ukraine. It is hard to know where the macro and geopolitical winds will blow market sentiment. For all we know, Nancy Pelosi's visit to Taiwan could yet turn into a significant event for the world stage, or it may fade into nothingness. Whatever is thrown our way, we would prefer to be invested in businesses with market leadership in growing markets where they have secular growth tailwinds at their back.

Company News

Turning to specific companies, the Fund's most significant contributor to performance during the month was Nanosonics (+40.2%), in part due to a positive trading update. The biggest detractor was EML Payments (-14.6%), which fell after the company CEO announced his resignation.

The Fund's five largest holdings as of the end of the month accounted for 41.4% of the portfolio and are named in order of the Fund's allocation: Netwealth, Nanosonics, Pinnacle Investment Management, Xero, and Nearmap.

Turning to Nanosonics which provided a further trading update following one in May. Full year revenue exceeded previous guidance of 12%, coming in at 17% and ahead of consensus expectations. The company's transition away from GE Health in North America to a direct sales model appears to have progressed well. Although we won't be fully updated on the exact near-term implications of the change until the company reports on 23 August, we accept this transition will create some short-term financial pain in terms of increased costs and reduced revenue as GE runs down its inventory and moves to a drop-shipping model, but we have not lost sight of the long-term gain of higher margins and increased control over the Trophon upgrade cycles.

Netwealth updated on its financial year Funds Under Administration (FUA) during the month, showing \$13.0bn of inflows during financial 2022, up 32% on the prior year. Adjusting for negative market movements, FUA ended the year 18.1% higher than 2021, and market share to over 6.0%. Four consecutive interest rate rises by the RBA has set a new, higher baseline for earnings for the 2023 financial year, with further rate rises in store. Casting the benefits of interest rate rises for Netwealth aside, this is a business with a demonstrated track record of generating organic growth that we see continuing for some time. We look forward to a comprehensive update on the business when the company reports its full year results on 24 August.

Pinnacle was quick out of the gates reporting their full year results after market on 2 August. While we'd typically wait until next month to update on the results, we'll go slightly out of cycle given a preview was provided in last week's webinar and next month's letter will be jam-packed. Pinnacle posted a strong result in the face of a challenging environment, with net profit up 14% despite investing heavily for future growth. As we've noted in previous letters, the business continues to benefit from diversification across asset classes, client type and geography, and remains well placed to continue growing from its profitable base using the \$120 million of liquidity at its disposal.

Nearmap announced in April that it commenced commercial production of its next generation camera technology, HyperCamera3, and in early August our team headed out to Bankstown airport to see the product in the flesh. We met with the Nearmap management team and the engineers behind HyperCamera3 to better understand the new capabilities and benefits of the upgraded technology. Some of the key takeaways include: how this new generation has been developed as an upgradable platform which can have components upgraded over time (e.g. lenses, stabilisers etc.), it includes near-infrared which adds an additional dataset, incrementally expands the use cases, and may improve Nearmap's win rates with US counties. In May, Nearmap upgraded full year ACV to the top end of its \$155 million to \$160 million guidance, implying full year ACV growth in excess of 20%. We look forward to digging into the full company results on 17 August.

Moving on to **EML Payments** which was the Fund's only detractor for the month. July was another disappointing month for EML shareholders on the back of the CEO and de facto founder resigning, along with continuing issues with the Central Bank of Ireland. The recent announcement suggests that the remediation program will likely take longer than expected. We have continued to lower our stake in the company and EML is now out of our top 10 positions.

Looking Ahead

Thanks to the hundreds of you who were able to join us for our recent webinar and question and answer session. Our team enjoys the opportunity to engage with you all and hope that those who weren't able to attend enjoy the recording.

As we head into August, the full year reporting season commences in earnest for most of our holding companies, and this will present an opportunity to sit down with management teams of the businesses we own to understand their plans for the year – and years – ahead.

And, as always, thank you to all our investors for continued support and trust.

Best Regards,

Lakehouse Capital

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