LATITUDE
INVESTMENT MANAGEMENT

Dear Shareholder,

Technology shares are soaring, rebounding from a weak year in 2022. This renewed momentum follows an explosion of interest in artificial intelligence following the release of the consumer facing software ChatGPT.

We're underperforming the market this year given our limited exposure to this "theme". Our positioning isn't due to an overarching negative view on AI, quite the opposite. It's the result of a number of trading decisions over the past few years where we've found better *relative* opportunity elsewhere. Combined with a belief that profits from AI will take years to materialise.

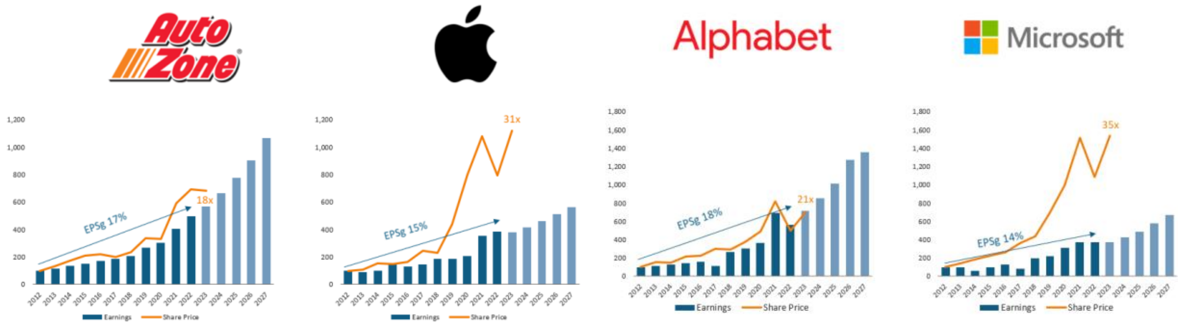
We hosted a webinar last month and, given that we don't do these very often, it might be of interest. We discussed how we've arrived at our current portfolio which, it turns out, is a dramatically different portfolio compared to many of our peers and the benchmark index.

Link: https://www.latitudeim.com/webinar
Password: webinar2023

To be overly reductive, our point is that the *relative* attractiveness of stocks is extraordinarily skewed in favour of not owning shares in the crowded, expensive, technology stocks. Yes, they are doing well this year, but 2022 was a warning shot for investors, showing the perils of concentrating too much capital in these well-owned businesses. Unless their earnings growth rates inflect meaningfully higher, there are far more attractive options for open-minded investors.

Here are some charts from the webinar:

Over time, share prices always follow fundamental business performance, approximated here by earnings per share. We are bullish on the prospects for all four of these businesses. AutoZone and Alphabet offer exposure to higher growth, at starkly lower valuations, hence why we still own these.[1]



We're very keen to emphasise that we're not particularly down on the tech stocks, including Apple and Microsoft. They are great businesses, achieving strong results, and we have owned them in the past when valuations and prospective returns were still attractive.

They have enjoyed a fantastic environment for growth in the past decade and, while things may get a little more challenging, we do expect strong momentum to continue.

However, there are some reasons for concern. For us, there is a general concern about high innovation industries like AI. The early stages of disruption within industries are incredibly exciting, generating huge opportunities to get carried away and lose a fortune.

[1] Bloomberg and LIM estimates

For example, the best time to buy into the mobile phone revolution was really buying Apple shares in 2007 when they released the iPhone. Any investment in other handset manufacturers in the decade prior to this was money sent to money heaven. Similarly with eCommerce, you could have tried to choose from a thousand choices in 1998 or waited a decade and bought Amazon in 2008 once the market had become more orderly.

It is with these examples in mind that we often employ greater patience when investing in industries subject to high levels of innovation and disruption. Approaching opportunities with this mindset allows us to prosper in a far lower risk manner while still benefitting from long-term disruptive trends.

Changing tide in capital investment

Elsewhere in the economy, capital spending is broadening out. Over the past 20 years, fixed capital investment in technology assets has been growing at around 6% per year, while investment in traditional fixed assets (like commercial, residential, industrial, transportation etc) has stalled, growing 0.5% per year.[2]

However, in the past 18 months, US construction spending on manufacturing – which has been flat for a decade – has just doubled.[3]

Commodities and energy will be required to satisfy the demands of governments seeking to renew their countries' fixed assets. Subsidies for environmental projects, including renewable energy capex are growing alongside those to encourage reshoring of sensitive industries like defence and semi-conductors.

A broadening of capital investment will be reflected through a broadening of financial investment over time. Those industries starved of capital investment over the past two decades are set to perform well as demand for their products and services returns, driving higher returns on capital.

2022 was just the start of a multi-year change in market leadership. Share prices follow business fundamentals over time, and it's clear already that earnings growth is coming from a broader set of industries and companies than the past ten years.

Portfolio trade in the quarter

So, in the context of the AI revolution going on elsewhere our short-term performance looks lacklustre, while earnings across our holdings continue to come through strongly, giving us confidence in performance over time.

We are very happy with the holdings and the overall construction of the portfolio as it is, although volatility always presents opportunity to improve our prospective returns.

In this past quarter we have made one portfolio trade, swapping **Equinor** for **Shell** which, on our estimates, enhances the portfolio's long-term earnings power significantly.

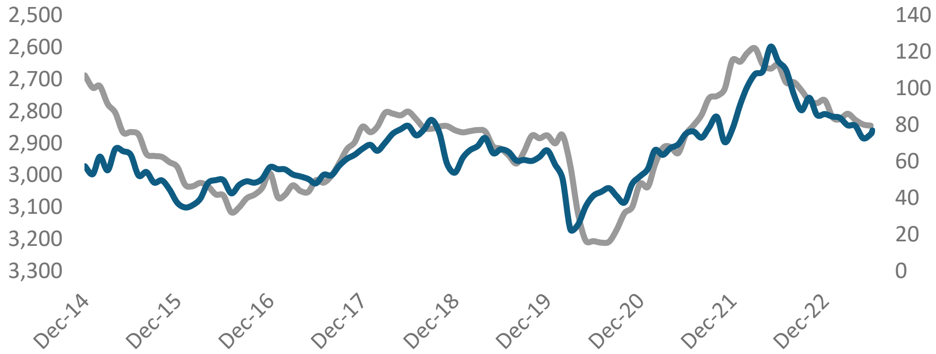
We currently have two stocks in the energy sector and, as explained in previous notes, our investment thesis is one rooted in the capital cycle. We continue to track the reinvestment rates of global energy

[2] Bureau of Economic Analysis, Structures (Commercial & Residential) & Equipment (Industrial, Transportation & Other Equipment) vs. Information Processing Equipment & Intellectual Property Products
[3] Census Bureau US Construction Spending Manufacturing

companies which, having fallen to a multi-decade low, are clearly not rising as they have in previous cycles.

Oil prices are set by the intersection of supply and demand and have been shown to have a very tight correlation to global commercial inventories. This chart shows that logical effect in action (note inventories are shown inverted on the y-axis – lower inventories driving higher prices). On this basis, the current $80 oil price is to be expected given the levels of inventories in the system.

Oil Prices and Oil Inventories

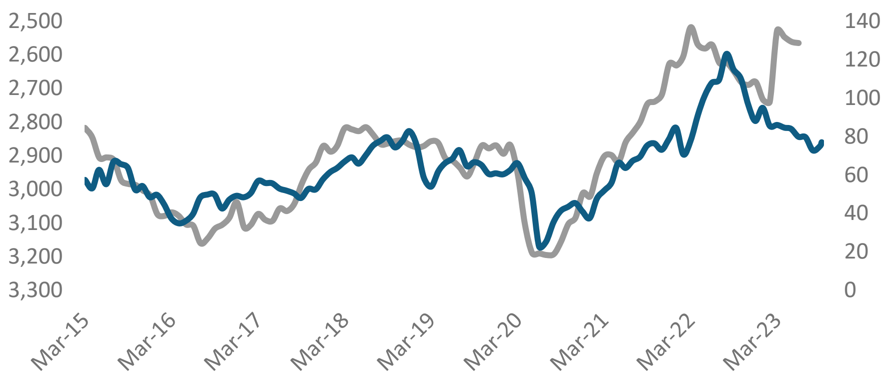


[4]

Whether it be declining US Shale, which historically accounted for 150% of production growth since 2008, sanctioned OPEC supply in Venezuela and Iran, or Russian embargoed oil, incremental supply is hard to come by. However, this year the supply side has been unnaturally supported by President Biden's unprecedented sale of over half of the country's strategic petroleum reserve, in order to keep a lid on inflation.

This chart shows an adjusted inventory figure, assuming the US administration needs to refill their reserves at some point in the future. Using this underlying inventory data suggests an oil price of $130 per barrel would be warranted today if the US administration hadn't sold their strategic reserves so aggressively.

Oil Prices and *adjusted* Oil Inventories



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[4] Bloomberg. Generic 1st Crude Oil, WTI & World Crude Oil & Liquid Fuels End of Period Inventory, OECD Commercial

[5] Bloomberg. Generic 1st Crude Oil, WTI & World Crude Oil & Liquid Fuels End of Period Inventory, OECD Commercial adj. for SPR refill

Predicting the oil price is notoriously difficult, although the above framework provides a sense of asymmetry to our oil price expectations.

With this macro context in mind, the portfolio trade this quarter was not a result of a bearish view on oil prices per se, but primarily a result of us not having a strong view on European gas prices returning to their 2022 highs (which drive Equinor's earnings significantly).

As a reminder, Equinor is a high-quality European gas producer generating 90% of its operating income from the Norwegian continental shelf (a high quality, geopolitically important energy source), with 50% of its production being gas. It has an incredible asset in Johan Sverdrup, and in May this year it was announced that production could increase to 755,000 b/d, which is about 7% of the total daily European oil consumption.[6] We do not doubt its asset quality.

European gas prices reached unprecedented levels in 2022 because of Putin's invasion. This was a result of a confluence of factors. Namely, the Nord Stream (Russian) gas pipeline being shut off, a lack of a reliable energy source to replace Russian gas (there has been a scramble to build LNG terminals) and low gas storage before what could have been a cold European winter. Equinor has profited handsomely from this, generating 40% of its market cap in free cashflow since 2022.[7]

On a prospective basis, European gas prices have less visible upside than oil prices, and no clear asymmetry.

Shell has been on our shelf of ideas for some time and is a large integrated European energy company with a greater liquids business than Equinor. Like BP, it remains diversified with an oil & gas, chemicals, and marketing business, and is also building out a renewables business, but at a pace which reflects the economic returns available across its assets.

Similarly to BP, Shell trades at almost a 50% discount to the US integrated oil companies due to its UK primary listing, despite their similar structures and exposures. Growth rates look comparable over the next five years, and we would rather a starting earnings yield of 15% to one of 9%, giving us a meaningful margin of safety as well as incrementally more upside should the shares rerate in line with global peers.

Our portfolio continues to trade on 12.5x earnings, and with forward growth of about 16% per year (marginally improved by this trade). Continually improving our portfolio's growth, while maintaining its quality and diversity, is how we believe we will deliver above average returns through-cycle for our shareholders.

As ever, please get in touch with anyone in the team if you have any questions.

Have a great summer,

Freddie Lait

[6] https://www.equinor.com/news/20230523-johan-sverdrup-increased-plateau
[7] LIM Estimates