Strategy Notes October 2017– Thinking About Rainy Days

Through a period where both portfolios have delivered strong performance, it may be of some surprise that the bulk of discussions around the portfolio management table this month have centred more on **risk identification** and how the portfolios are currently positioned should we see an unexpected shift in the current investment climate.

Professional money managers can, at times, be unfairly characterised as a relatively pessimistic group of individuals, primarily due to their continual pre-occupation with trying to evaluate risk and the possibility of negative or unexpected outcomes. Like a beachgoer in glorious summer weather continually checking weather forecasts for the chance of rain, this anxious behaviour has a tendency to accelerate through periods of better performance and we found ourselves with a similar disposition this month.

The affliction is perhaps somewhat more magnified given we retain fairly significant personal investments in the funds in our own right, in addition to our wider families and the broader Ophir staff. Hence while we're exceptionally happy to have delivered returns across both portfolios of +7-8% for the month, we have spent some considerable time also assessing how the portfolios are currently positioned should the current market outlook change.

Before going into an analysis of the key risks, it's worth providing a caveat that at the current juncture **we continue to remain very comfortable with the make-up of both portfolios at present** and the growth opportunities available to our portfolio companies over the coming years. While we feel we have assembled an excellent group of businesses that are well placed to take advantage of current and emerging structural growth opportunities both domestically and offshore, the portfolio will always be exposed to some degree of risk should the underlying macroeconomic environment change.

The Reflation Trade – Again.

The impact from **a sudden and unexpected earnings reflation period** in Australia would be one of the more obvious concerns near term, particularly given higher-quality/higher-growth businesses saw a preview of how the market could position for such a period through the 'false-start' reflation trade through the second half of 2016. A reflation environment is characterised by a period of rising prices and stronger economic growth, meaning businesses with earnings tied to the underlying economic cycle (i.e. cyclicals, financials and resource companies) begin to see an improvement in fortunes given the tailwinds of a better economic climate.

These types of businesses are generally not high quality and typically aren't overly expensive either. The ability for these companies to see a rapid improvement in earnings on the back of a more favourable operating environment can make them attractive investment propositions at the point when the underlying cycle immediately turns. Equally, the premium the market is willing to pay for higher-quality businesses that have...