

# HARRINGTON PARTNERS

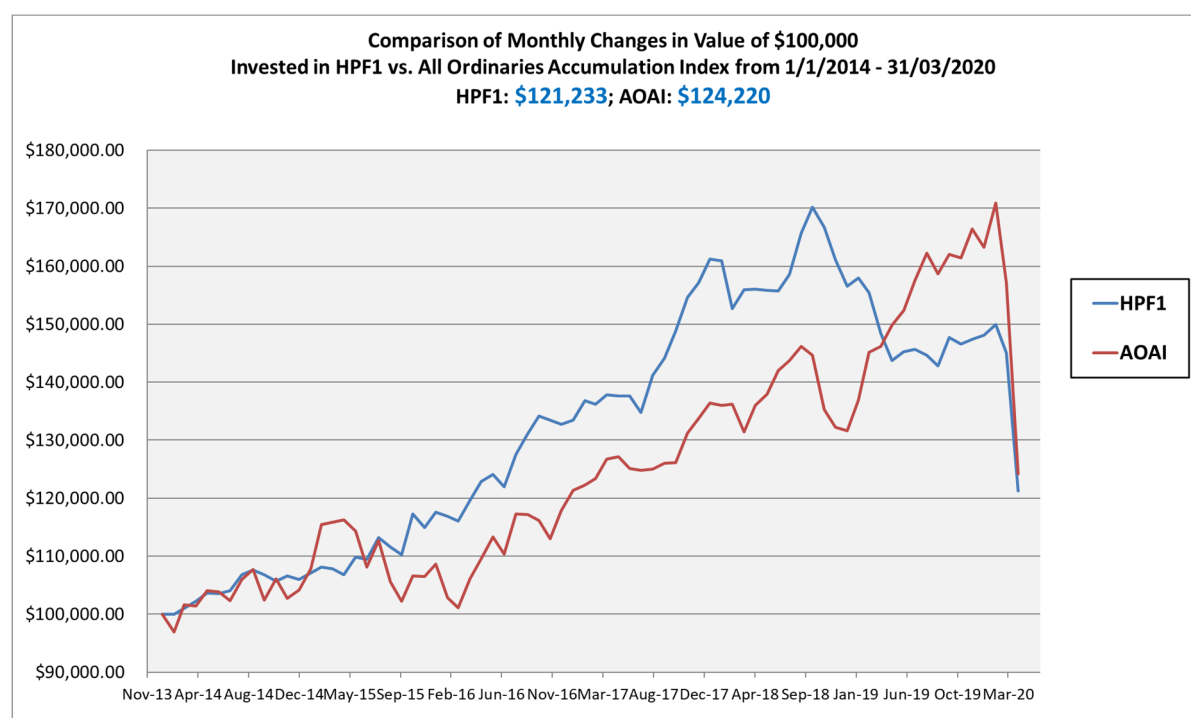
## Investment Management

### Harrington Partners Fund 1 (HPF1) – 31 March 2020

Harrington Partners primary goal is to protect investors capital and outperform the Australian All Ordinaries Accumulation Index (AOAI) by 3-5% annually as measured over rolling 5-year periods. The Fund managers have the majority of their investable assets in the Fund, this creates a very strong alignment of interests between the managers and investors with a concentration on achieving the highest possible risk adjusted returns.

	HPF1 Net Return*	AOAI Return <sup>#</sup>	Relative Performance
<b>6 Months to 30/06/2014</b>	<b>3.71%</b>	2.36%	1.35%
<b>30/06/2015</b>	<b>5.51%</b>	5.67%	-0.16%
<b>30/06/2016</b>	<b>11.50%</b>	2.01%	9.49%
<b>30/06/2017</b>	<b>10.48%</b>	13.12%	-2.64%
<b>30/06/2018</b>	<b>15.49%</b>	13.73%	1.76%
<b>30/06/2019</b>	<b>-6.45%</b>	11.04%	-17.49%
<b>9 Months to 31/03/2020</b>	<b>-16.76%</b>	-21.19%	4.43%
<b>Annualised Performance</b>	<b>3.13%</b>	3.53%	-0.40%
<b>Cumulative Performance</b>	<b>21.23%</b>	24.22%	-3.00%

#Data source for AOAI Returns: S & P Dow Jones Indices LLC. \*Net Return to investors which is less fees and charges but includes reinvested distributions. Past returns are not a good indication of future returns.



The Fund returned -16.76% net to investors during the first nine months of Financial Year 2020 (FY20), this compares to a return of -21.19% for the All Ordinaries Accumulation Index over the same period.

## Commentary on the first 3 months of 2020

The past three months have been some of the busiest we have experienced since starting Harrington Partners in 2014. In late February, the All Ordinaries Accumulation index was at the highest point it had ever been. This all changed very quickly with a one-two punch to equity markets from an escalating oil price war and the government measures implemented to slow down the spread of the Coronavirus. At its low point for the period the All Ordinaries Index had fallen almost 40% from its highs just a month earlier.

The drastic falls in markets can be hard to stomach, but they are a normal part of the cycle of investing in publicly listed businesses. These periods can create uncertainty and discomfort but also provide 'once in a decade' buying opportunities for long-term investors. As managers we remain fully invested in the Fund, we have been waiting for a period like this to materialise since the beginning of Harrington Partners and have already taken advantage of the pullback to purchase some new businesses that we are confident will compound our returns for many years to come.

These are unprecedented times and it is unknown how it will ultimately affect the world economy and life as we know it, we are confident however that just like all other crisis before this, we will collectively emerge and again continue to prosper. We hope that yourself and all your loved ones are healthy, happy, and optimistic about the future that lies beyond the current challenges.

## Portfolio

The top 10 holdings at March 31, 2020 were:

Rank	Holding	Total Equity Weighting	Total Portfolio Weighting
1	United Overseas Australia (ASX:UOS)	11.51%	6.29%
2	Ryman Healthcare (NSX:RYM)	11.26%	6.15%
3	Undisclosed	10.82%	5.92%
4	Enevis Limited (ASX:ENE)	8.92%	4.88%
5	Locailty Planning Energy (ASX:LPE)	5.89%	3.22%
6	Kangaroo Island Plantations (ASX:KPT)	5.67%	3.10%
7	Undisclosed	5.47%	2.99%
8	Undisclosed	5.34%	2.92%
9	Undisclosed	4.74%	2.59%
10	Undisclosed	4.34%	2.37%

The top ten holdings made up 40.5% of the total portfolio and cash allocation decreased from 48% to 39% at the end of the period.

The 9% drop in the cash weighting since December masks what has been one of the most active periods in terms of buying and selling since the Funds inception. During the period our cash weighting reached 65% and since then we have allocated approximately 31% of the portfolio into new businesses which resulted in 2 of our top 10 holdings being sold. Our positions in **FSA Group (ASX:FSA)** and **EVZ Limited (ASX:EVZ)** were sold and although listed above our position in **Enevis Limited (ASX:ENE)** was also sold in the first week of April. In the case of EVZ and ENE although we were happy with the

management teams we had partnered with, after owning the businesses over the past 2 years it became clear that our original hypothesis<sup>1</sup> for both companies was not playing out as predicted. Under normal market and economic conditions we may have held on to the positions, but with the risks posed from the onset of the Coronavirus and the subsequent economic slowdown the decision was made to liquidate these positions and allocate the capital to new opportunities.

The most noticeable change to the portfolio over the period was the inclusion of **Ryman Healthcare (NZX:RYM)** which is New Zealand based business that we now have as our second largest position. We originally became aware of Ryman through reading the investment letters from Rob Vinall from RV Capital ([www.rvcapital.ch/](http://www.rvcapital.ch/)). We have studied the business over the last 18 months and were ready to act when the market gave us the opportunity. Ryman operates and develops full-service nursing homes in New Zealand and Melbourne and possesses an extraordinarily strong culture that puts the care and wellbeing of its residents as their top priority. Ryman listed on the New Zealand stock exchange in 1999 raising \$25M to fund future growth. Since then Ryman has invested \$3.7Billion in new and existing villages, paid out over \$800M in dividends and compounded shareholders capital at about 20% per annum. This was achieved without raising a single extra dollar of capital since listing. Whilst the Coronavirus has brought its own unique set of temporary challenges for Ryman, this will have minimal impact on their substantial long-term growth potential which is set to be driven by the multi-decade wave of demand for quality aged care. You can expect a full writeup on why we have made the investment in the coming months.

### The Continual Evolution of an Investment Philosophy

*“Our first preference is to pay sensible prices for well managed businesses that have stable cash flows, conservative balance sheets, and the ability to grow their franchise.”*

We wrote this in our very first Harrington Partners letter to investors and it remains a cornerstone in our investment philosophy. However, how we go about identifying these businesses has changed meaningfully over the past eighteen months and we would like to take the chance to explain this dynamic in further detail.

We began our investing careers in the middle of the Global Financial Crisis (GFC) with our first foray into the field coming after reading a Warren Buffett biography<sup>1</sup> and the Ben Graham classics ‘The Intelligent Investor’ and ‘Security Analysis’. This led us on a journey of looking for ‘cigar butts’ which were cheap companies with one last puff left in them and special situations that possessed a margin of safety (i.e. price that is below intrinsic value). These companies were typically defined by lower quality operations and relatively low valuations. We would sell these positions once they had appreciated to our pre-determined level of intrinsic value and then look to re-allocate these funds into similar opportunities. To compound returns over time meant we would have to continue to find more and more investments like this to recycle our capital into. This proved to be very lucrative in the depth of the GFC and in the 2-3 years following, however over time it became more apparent that these companies did not possess strong competitive advantages and earnings were usually cyclical and not growing.

To sustain this investment style, we would need an ever-expanding list of lower quality yet ‘cheap’ businesses. This would have the double negative effect of having to do more work to find ever more opportunities, combined with the fact that we would be buying and selling at increasing intervals

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<sup>1</sup> Lowenstein, 1995, [Buffett: The Making of an American Capitalist](#)

which in turn increases trading costs and tax liabilities. This is an important note because although headline returns per year may seem comparable there is a very big difference between returns that are realised, and have a tax liability payable, compared to returns that are unrealised, and this becomes especially apparent over longer periods of time.

As an example, if the Fund earns a return of 15% for the year, with half coming from realised gains and half from un-realised gains, the realised portion of these gains will carry a tax liability for that year. Assuming an investor has a marginal tax rate of 30%, then the actual after-tax return for this investor for the year will be 12.75% or 2.25% lower than if the gains had all been unrealised. Our ultimate goal is to patiently compound capital over many years, therefore it makes much more sense for the Fund to try to make gains on what we already own and not have to give up part of this return to the tax office each year. The beauty of this deferred tax is that it acts as a non-redeemable, interest free 'loan' from the government and the longer we own the business the more our compounding is accelerated due to the compounding on the deferred tax. This meant that if we were to continue to be able to compound returns at the highest rate possible, we would need to find companies that themselves would be able to compound.

In going after these high-quality companies that can compound capital our experience has shown that we should focus more on qualitative measures which are not always easily discernible from the financials alone yet give these companies a competitive advantage.

The first of these qualitative measures that has become ever more important to us is insider ownership, by which we mean that the manager or board member/members who have oversight on capital allocation decisions also own a meaningful amount of equity in the business. This was one area we focussed on heavily through 2018 and 2019 and although meaningful ownership remains paramount to aligning management interests with shareholders, we started to see there was more needed than just the financial ownership incentive alone. What we are now focusing on going forward is management teams that have talent, integrity and passion with one of the biggest factors being whether they lead by example. Leading by example and setting the company culture so that employees inherently know how to act in certain situations without having to ask advice is paramount to a successful and efficient business. Combine this with a manager who sees the company as a defining element of their their life's work and there becomes the formidable force of an aligned manager as well as an engaged workforce whose aim is the betterment of the company as a whole. These types of managers are not easy to come by but when we have come across them, they almost always own a large proportion of the business.

Our second focus is the quality of present and future earnings of the business and whether we believe these earnings can continue to grow over time. For investments to compound over long periods of time the underlying business needs to be able to grow its intrinsic value on a per share basis. For this to be possible it is imperative that the company possess some sort of competitive advantage within its industry. More importantly though, the business must continue to invest and innovate so that it can increase or at a very minimum maintain this competitive advantage over time. This is another big shift in thinking for us as investors, we have always tried to look for businesses which possess a competitive advantage but have come to see through experience that this can quickly be competed away or become obsolete. Warren Buffett says that all he wants from his managers at Berkshire Hathaway is to continue working at '[widening the moat](#)'. The world continues to change at an ever-faster pace and just possessing a competitive advantage (or economic moat) is no longer enough, constantly protecting and growing this advantage is fundamental for long term compounding to be realised. For this reason, we now look for companies that are actively investing in maintaining and

growing their competitive advantage and we are happy to see depressed short-term profitability if their focus remains on creating higher longer-term value.

Another evolution in our philosophy is being more patient when first investing in a business by taking smaller positions in the beginning and only increasing our ownership if our thesis is generally playing out as expected over time, this is especially the case when it comes to businesses without long proven track records.

Our investment in **Enevis (ASX:ENE)** is a great example where it is now clear that we could have been more patient. We first purchased shares in ENE through participating in a capital raise and it immediately made up approx. 10% of the portfolio. At the time ENE was acquiring an energy efficient lighting business called Lumex. We had done extensive research on the company and were especially optimistic about the potential growth opportunity in their core audio visual division, but with the limited information available it was hard for us to get a good idea as to the potential of Lumex. However, we felt our risk of not understanding Lumex fully was reduced by the fact that the price and structure of the deal was very reasonable and came with some potentially valuable industry contacts.

It became apparent after about 12 months that although the audio visual division was performing as expected, Lumex was substantially underperforming and that ENE was not going to be able to grow fast enough to cover their cost base that had been implemented under the expectation of faster growth. Meanwhile, the company experienced some unexpected divisional management issues and several distracting operational setbacks which put further pressure on their financial position and ultimately made necessary the sale of their street lighting division.

Although ENE did not grow as expected our biggest lesson from the investment was making it too large of a position from the outset. The better approach would have been to make a much smaller initial investment and then to watch the business closely over twelve months to determine whether our hypothesis was sound. It is a lot clearer to us now that we need to be much more discerning when investing in companies that do not have long proven track records and it is our view that the best way to do this is to be patient and actually watch the business over 12-24 months before taking a large position.

Our intention going forward is to be more disciplined in following companies over time before concluding any concrete investment opinion. The experience of the past few years has shown us that despite how in depth our research process is, where we have gone wrong in our hypothesis has only become apparent over time. This level of patience will ultimately lead to some missed opportunities, especially in the short term, as the window for buying companies at depressed prices is usually short. However, as more time progresses, the list of our potential companies to invest in will grow and our knowledge and competence will continue to grow with it.

In the case of great companies that do have a proven track record this means researching them in normal times and patiently waiting until prices become depressed due to a misunderstanding by the broader market, at which point we will be ready to take action. When these opportunities do ultimately arrive, it will be paramount that we swing for the fences.

Our time and focus are now almost entirely allocated to finding these quality companies that can compound our capital for long periods. However, we will still take advantage of special situations if the payoff profile is well in our favour.

The above evolution of our focus has also led us to simplify our investment process with the intention of becoming more disciplined in where we allocate our time. Going forward we will now ask ourselves four overarching questions before we make any investment decision. We have a checklist we go

through with all our investments that have many more specific questions but if the following four cannot be answered in the affirmative then we will wait or simply move on. When discussing companies in future letters we also intend to report to why they meet these criteria. The 4 questions are as follows:

1. Will the company be thriving in ten years' time?
2. Does the company possess a competitive advantage and are they working to build this over time?
3. Does management have integrity, talent and are they setting an example?
4. Is the company selling for an attractive price?

### Outlook for the Coming Months

We expect markets to remain volatile over the coming months and that the share prices of the companies we currently own to be the same. Volatility in quoted prices should not worry the long-term investor and in the words of Ben Graham –

*“Price fluctuations have only one significant meaning for the true investor. They provide him with the opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At all other times he will do better if he forgets about the stock market and pays attention to the operating results of his companies”<sup>2</sup>.*

Most businesses will see a decrease in activity due to the impact of Coronavirus containment measures and our businesses are not immune. At present we are optimistic about the companies in the portfolio and their ability to not only weather this storm but come out the other side even stronger. We will continue to work diligently and look to take advantage of any sharp falls in prices that may eventuate.

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None of this would be possible if it were not for the patient capital that our investors have entrusted to us. Although we went into this period with a relatively high cash position, the fact that we have had no redemptions since the onset of the virus has made our job considerably easier in making capital allocation decisions, and we want to wholeheartedly thank you for your trust and patience through this period.

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<sup>2</sup> Graham, 2003, [The Intelligent Investor](#) – Revised Edition, Page 205.

We are privileged that you have chosen to partner with us on this journey. As always, we welcome any feedback and if you have any questions, comments or investment ideas please do not hesitate to contact us.

Yours Sincerely,

A handwritten signature in blue ink, appearing to read 'Cameron Harrington'.

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A handwritten signature in blue ink, appearing to read 'Brendan Harrington'.

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