

# Quarterly Review

Q4 2020

## Wenlock Global Fund

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# Wenlock Global

## Fund - December 2020

Net Performance	3m	1yr	SI
Wenlock Global Fund	-2.5%	-28.7%	-7.4%
MSCI World Net Total Return (AUD)	+5.9%	+5.6%	+48.7%

Source: Mainstream Fund Services, Thomson Reuters. ^Calculations are based on total returns and net of all fees but before tax or the buy/sell spread. Performance figures are based in AUD.

SI = Since Inception 9 August 2017.

**Past performance is not a reliable indicator of future performance.**

Dear Investors,

The US elections were front and centre for investors during the quarter. As usual, investors reduced risk going into the election and by the time it was clear that Joe Biden was the winner, they were relieved that the volatile nature of Trump's policies was over. The relief rally that ensued was a welcome relief after a volatile period. Investors were happy that there was not a blue sweep and balance was restored between the two parties, albeit by a slender margin.

To reflect the change in our economic outlook for the next 24 months, during the quarter, the fund underwent a broad change in its sector and specific exposures to certain risk factors. Those changes pertained to the view that a vaccine was highly likely in shifting the direction of the global economy from one of weak fundamentals to that of accelerating growth, especially in the services economy. This, in the face of record high levels in stock prices, driven in the most part by the largest companies, our concern is that valuations of the technology sector looked somewhat rich. Understanding that periods of stretched valuations can last for some time, we took the view that it was prudent to avoid those names in the next phase of the recovery.

Having established that economies will open over the ensuing 12 months, the key consideration of us has been which companies and sectors will benefit from the reopening. Using our investment process as a guide, companies that had been shut down by the

COVID crisis and presented the following characteristics were ripe for investing.

- High returns on invested capital
- High free cash flow potential
- Secular industry tailwinds
- Recovery to normal business operations

During the crisis, many companies we would typically hold are now exhibiting valuations that we find uncomfortable, but more importantly their ability to grow their free cash flows to the level that their share prices are reflecting, in our view is difficult. At the same time, the likelihood that many of those companies beating investor expectations diminishes as the global economy recovers.

Admittedly, many companies that outperformed during the crisis will continue to deliver decent cash flow growth, but the level of outperformance is limited in our opinion. That is because their share prices are reflecting the same level of free cash flow growth despite a relative slowing in the demand for their products. For example, the likes of Netflix, Spotify, Apple, Facebook, Amazon and AMD will see slowing demand (albeit from a high level) as people go about their normal day to day duties. During the pandemic, most of us became used to ordering items online and we will probably continue to do so forever, but as shops and offices open up, we are likely to spend money in other areas that were neglected. What we would have spent on a nice holiday with the kids was spent on building a new garden deck or buying household goods.

The reopening of the economy presents opportunities for investors to select companies that were temporarily halted by the pandemic. Prior to the pandemic, those same companies were experiencing secular tailwinds that drove higher returns in invested capital and free cash flows.

It seems pretty obvious that such sectors as airline, hotel and entertainment should experience extended periods of growth as people resume their usual activities.

The risks, however, shouldn't be underestimated. There are many unknowns that investors will be concerned about, such as:

- Virus variants – leading potentially to another series of lockdowns
- Bubbles in alternative asset prices – Bitcoin

and NFT's (non-fungible tokens) are seeing a high level of speculative investments which could reverse

- Inflation (Higher Interest Rates) – Pent-up demand and a strong consumer balance sheet portend for higher prices
- Valuations – A rerating of the market has meant valuations in some respects are elevated in areas such as IPO's and SPAC's
- Geopolitical – Uncertainties regarding domestic and foreign policies

The pressing risk today is that higher rates will crimp future growth and as a result long duration investments will be impacted by higher interest rates. The US Fed has made it abundantly clear that rates will not increase for a while despite the markets pricing in higher rates. Commodity prices are moving higher, in particular oil and industrial metals, which play a large role in input prices. We will no doubt see inflation creep into prices reflecting both higher input prices and demand. To what extent this effect is temporary in nature due to supply and demand imbalance is yet to be understood. Theories that offer some insight range from:

- Supply side shocks given many parts of the global economy were shut for large periods of time and getting back to normal rates of production will take time and the backlog is overwhelming. This will persist and impact inflation and interest rates.
- Demand side inflation from the sheer level of consumer savings and the appetite from consumers to return to previous habits.
- Innovation-led deflation will keep a lid on inflationary pressures especially during the lockdowns as the whole world moved to adopt technology to continue with many of their tasks. This shift will continue and be a headwind for future inflation.
- Lower absolute interest rates for longer. With lower interest rates globally, the cost of servicing debt has been reduced dramatically and thus reducing any inflationary pressure.
- Money supply has seen its largest increase in the history of money creation and the high levels of liquidity will need to find a place to reside, resulting in broader inflation of asset prices.

Inflation protagonists argue that it is inevitable prices will rise and stay elevated for some time and result in a

heap of trouble for certain assets such as high growth technology companies. These companies represent a very large portion of the global stock markets and portfolios. On the other hand, deflationary forces have kept inflation lower despite massive amounts of liquidity injected into the global economy after both the technology bubble and the GFC. To put this into context, the US Fed increased its balance sheet approximately 5x from 2008 to 2015 and the current expansion is 2x. Although the absolute dollar value expansion is similar at c.\$3.7Trn. We believe a large part of the deflationary force after the GFC was driven by innovation. Measuring this data point is very difficult but anecdotally we are all aware that the cost of buying goods and services online is lower and the operating cost for businesses has reduced. For example, using an Uber versus a regular taxi is cheaper, buying something on Amazon or eBay is cheaper than buying from a shop. Businesses that need to keep records are now storing data on the cloud at a fraction of the costs of a server. Efficiencies are also being created which cannot be measured in any inflationary data, such as Zoom meetings that provide faster decision-making processes.

In reality we should expect to see inflationary pressures in the near term (6 to 12 months) as economies relax restrictions and people resume their daily activities. Take the UK as an example, where restrictions are being relaxed earlier than many Western countries. The UK will experience outsized demand for:

- Dining and drinking
- Holiday travel
- Entertainment breaks
- Social gatherings

The depressive nature of the pandemic will lead to an outburst of emotions and expressions of freedom throughout the remainder of the year. We wouldn't be surprised to see celebratory parties involving the wider community continue throughout the summer period. Usually coming out of a recession we would witness a slow and gradual repair of the economy as consumer finances begin to repair. However, this recession is unlike any other seen in modern times as consumers are likely to be in a much stronger financial positions than previous recessions. This, a result of fiscal stimulus during the lockdowns. Savings rates across many parts of the western economies have strengthened and thus place consumers in good stead once normalcy resumes and this is inflationary.

In fact, we would expect further fiscal stimulus as economies open as governments provide the impetus to drive demand from a hibernated consumer. In this regard, programs such as 'Eat out to help out' in the UK could be instigated across many economies and governments could save money by using digital payments to drive consumer spending. Australia too is adopting this model to drive demand and get people out to support local businesses. Businesses themselves will use innovative means to drive demand by offering incentives for products and services.

### **Bubbles**

During the pandemic we raised concerns that we were seeing behaviours like that witnessed during the technology bubble. At that time, it was early in the trend and since then it has increased. However, unlike the technology bubble of the early 2000's, some of the recent IPO's and SPAC's have a solid business behind them. Comparing this to the early 2000's is chalk and cheese, where companies were listing on stock markets with just an idea and no real business model with management that had little experience. The only similarity is that valuations do seem rich in today's new listings. Virtually all IPO's and SPAC's have an operating business that has been in operation for several years before they went public. Some investors have commented valuations in SPAC's that have not announced a merger target are highly speculative and dangerous. However, where the parallels end is after the merger of a SPAC. Here the SPAC will be consumed by the operating business, which will absorb the assets of the SPAC (usually the cash). Much like an IPO but without all the fanfare and costs. The downside many point to is that SPAC's can provide forecasts whereas recently IPO'ed companies aren't allowed to until much later on. We view the ability to provide forecasts as providing investors with clarity and a yardstick to measure management performance. Admittedly there will be SPAC's that implode as is always the case when there are lots of liquidity. But there will be many that will go on to become successful. Unfortunately, the ones that implode will grab all the headlines as SPAC's disrupt the traditional investment banking model.

## **Portfolio Review**

The fund continued to undergo the transition from its defensive stance to that of growth.

With the first of the vaccines approved in the US and the UK the transition of the portfolio began to take place. In last quarter's newsletter we wrote about the vaccine approval and the impact that could have on company profits. This suggested profit estimates will start to move higher for 2021. What we hadn't anticipated was the second lockdowns in Europe to be sudden and severe. As covid case counts increased across Europe and the US, mainly due to the early relaxing of the restrictions in the summer months, the resurgence of infections stalled any economic improvement. The second lockdown meant that investors held onto or increased their holdings in the covid beneficiaries, such as Amazon, Netflix and other FANG stocks. This has delayed the inevitable rotation into the reopening investments.

The political climate in the US heated up as Donald Trump lost the presidential election to Joe Biden. Investors cheered the news and drove the markets to historic highs. Biden's clear policy divergence in terms of the covid pandemic was one reason for Trump's loss.

### **Why greater US exposure?**

A larger exposure to the US is driven by the fact the country will likely exit the pandemic faster than many. Also, the liberties attributed to their citizens will mean that they will demand freedoms sooner than others. The vaccines themselves have been developed by US companies (with the exception of the Oxford/Astra vaccine) and their early securing of supplies will play a large part in its recovery.

With that thesis, we have placed a greater emphasis on the US domestic recovery. Many holdings have US centric revenue generating businesses, such as Square, Lightspeed, Abiomed, Acutus and Insulet.

The Fund has little exposure to Europe or other developed nations. We will continue to monitor this dynamic and as Europe begins to recover, we expect to see a balance between the US and Europe.

### **Healthcare reduced**

Healthcare exposure within the Fund was reduced during the quarter as the vaccine news was much better than expected and that the economy was likely to be in a significantly better position as each month passed. As we had increased the Fund's exposure to the Healthcare sector during the pandemic the opposite would be the case as we exited the crisis. To that end, we increased exposure to the companies that

would benefit from the reopening of the economy but ensured that any investment conformed to our investment process. This meant returning to some investments that we exited as the pandemic hit and identifying new investments that have secular tailwinds with strong growth prospects in revenues and cash flows.

Healthcare exposure fell from above 40% to just under 20%. The funds were redeployed in the Industrial, Technology and Communication Services sectors. Although on the face of it, this may sound peculiar given that these are not obvious reopening themes, the underlying companies are not necessarily reflective of the sectors. For example, Disney falls in the Communication Services sector.

The Industrial sector includes portfolio holdings in both Array Technologies and Lyft. Array provides tracking platforms for the solar power generation industry. Lyft on the other hand is a ride sharing company based in the US. Sector exposures used by industry standards (GICS) can provide a somewhat abstruse.

As we transition to the secular reopening investments, we also find exposure to the mega capitalised companies reduced. Many of these mega caps have performed very well over the past 12 months as they have been beneficiaries of the lockdowns. As we exit these lockdowns the companies that underperformed generally have smaller capitalisations. We also view valuation in the mega caps as rich given their profit outlooks and thus we prefer those smaller but still very large capitalised companies. The average capitalisation is closer to \$80bn at the end of December 2020. As we look forward, we expect that to further reduce to closer to \$50bn. Although smaller in size, there is plenty of liquidity in those large capitalised companies to service the Fund's needs.

The opportunities in the large cap space are a function of where they are in the recovery. It is an output of our investment process which is focused on cash flow generation, return on invested capital and secular growth. In the current market environment, we view that it just so happens that many companies in the large cap space present these qualities.

## Outlook

The outlook has not changed too much from our previous comments. We continue to expect the next 12-24 months to deliver strong profit growth for the wider economy but specifically for the investments in

the Fund. Those investments should deliver stronger profit growth than the overall market.

This optimism is driven by a multiple of factors:

- Faster than expected vaccine rollout. We envisage a much faster pace of vaccine rollout across the world, particularly in the US, which has very early on secured its supply. The distribution channels in the US have less friction than other parts of the world and so the US will lead many countries out of the pandemic and thus to a faster recovery.
- Fiscal Stimulus. Many parts of the world have effectively made whole afflicted businesses and consumers during the pandemic and thus exiting the recession will be a much smoother and faster process. Unlike previous recessions, consumers and businesses haven't had to deal with many of the challenges typically faced. The faster recovery will be evident in company preannouncements, which we expect over the next 6 months. As we exit the lockdowns, we expect further fiscal support in the form of cash handouts to induce consumer spending to pump economies.
- Digital adoption. The pandemic has meant many businesses and consumers have lent on technologies to fulfil their tasks were activities. This has meant that companies are able to engage with their consumers in a more productive fashion. The outcome of which should be exhibited in increase business interactions and lower customer acquisition costs. This will have the impact of higher overall operating margins.
- Pent-up Demand. With so many consumers stuck at home and swelling bank balances, the appetite for once common activities will take centre stage. Holidays, concerts, dining etc will probably roar back. Other areas that we expect to increase are basic social interactions and elective surgeries.

As we traverse 2021, earnings expectations will increase and later on in the year they might extend too far, thus artificially reducing valuations. This could be a risk event and we will be monitoring this situation to ensure we are not overly optimistic in the recovery of corporate profits.

A risk that has become a worry for many investors is the view that interest rates will have to increase as the

global economy recovers. This to subdue inflation. As mentioned earlier, we see inflation at this current point in time as being transitional and not structural in nature. As we recover from supply shocks across the world the balance in supply and demand will find its equilibrium and result in normalised prices. However, in the short term we expect to see prices increase where there is shortage in supply. For example, airline and hotel prices will no doubt see an increase as people rush out of lockdowns. Oil prices, despite seeing a recent rise, should normalise as supply is brought on and the US resumes production. Day to day goods like groceries should see a return to normal levels as supplies come back onboard.

### **Protection**

The Fund reduced its protection as the recovery took hold and the need for protection was provided in the form of cash. We expect as asset prices increase that protection to be increased but at a moderated pace.

## COVID is a Profitability Boost

First discovered in 2019, COVID-19 is the deadliest pandemic in half a century. Nearly 100 million have been infected from all around the globe. Over 2 million have died from the coronavirus pandemic.

### Virus Outbreaks in the Past 50 Years

Virus (year identified)	Infections	Deaths
Marburg (1967)	466	373
Ebola* (1976)	33,577	13,562
Hendra (1994)	7	4
H5N1 Bird Flu (1997)	861	455
Nipah (1998)	513	398
SARS (2002)	8,096	774
H1N1** (2009)	762,630,000	284,500
MERS*** (2012)	2,494	858
H7N9 Bird Flu (2013)	1,568	616
2019-nCoV* (2020)	11,871	259

Source: Statista

The outbreak has also led to the demise of many companies, a lot of which sizeable and with long history, such as car rental company Hertz and department store operator J.C. Penney.

### Creative Destruction

By destroying legacy businesses, however, COVID has accelerated the creation of a new era, one that is more digitised, efficient and profitable. Instead of flying 18 hours to New York, executives now Zoom. And instead of relying on paper and pens, companies now use eSignatures. With COVID, people are shopping from home and working from anywhere. Meanwhile, companies are moving data to cloud platforms and retailers are strengthening their omnichannel abilities.

Through cloud migration, companies eliminate often-large initial capital outlays on infrastructure, which typically make up over 30% of IT budgets according to [KPMG](#). This can lead to higher returns on invested capital (ROICs).

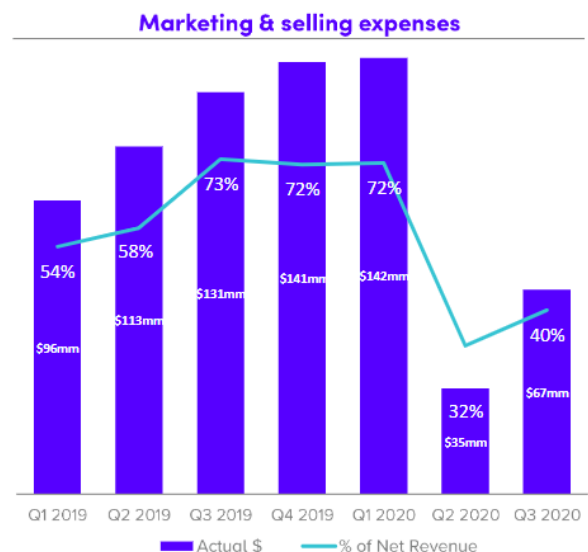
### SmileDirectClub

During COVID, negative revenue growth has forced companies into structural cost cutting. SmileDirectClub (SDC), for instance, has seen revenue plummet 45% y/y in 2Q20 as virtually all the SmileShops, in the U.S and internationally, were closed.

Store closure has given the teledentistry company a valuable opportunity to review its store footprint. Before the pandemic, SmileShops were only 25% utilized. While the CEO admitted in February 2020 there was “too much excess capacity” and had commissioned Buxton to test how many shops SDC really needed, however, the company kept opening new stores in 1Q20. This all changed as COVID hit. The Tennessee-based company became more strategic with the store count and locations, closing c.90% of its SmileShops and beginning to make use of pop-up stores. These pop-up stores provide a cost-effective way to help SDC understand the local market before committing to a regular SmileShop.

### SmileDirectClub Financials

Quarter	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020
Referrals as a % of Aligner Orders	20%	20%	20%	20%	20%	21%	23%
SmileShop Count	223	310	366	391	418	42	92



Source: SmileDirectClub Investor Presentation

Reducing store count could bring massive cost savings. Based on our estimation, a store could cost upwards of \$150,000 a year. According to SDC, there were 319 SmileShops and 1,700 SmileShop employees across 8 countries as of 31 December 2019, or 5 workers per store on average. The [federal minimum wage is currently \\$7.25](#) while the [effective nationwide minimum wage is \\$11.8 as of May 2019](#). If each store is open 5 days a week and 8 hours a day, workers alone would cost \$123,000 a year if SDC is paying only the

bare minimum of \$11.8/hour. The rest are rent, utilities, depreciation and sundry items like insurance. The store expense would be lower if not all employees work full-time and if SDC pays its international staff less generously.

COVID has also made SDC realise how inefficient it had been with marketing spend. According to Pathmatics, SmileDirectClub used to be one of the top 10 spenders on FB ads in the U.S. The company managed to reduce advertising spending by leveraging on the 50% brand awareness that it has built over the years and by doubling down on referral sales, which likely require lower customer acquisition costs.

As a result of these initiatives, SDC successfully reduced sales and marketing (S&M) expense as a percentage of revenue in 2Q20 to 32%. This has helped SDC deliver adjusted EBITDA profitability a quarter earlier than expected. In the long-term, the company is targeting a healthier range of 40-45%, compared with c.72% in the nine months before COVID.

In its prospectus, SmileDirectClub says it is “revolutionizing the oral care industry” through its “cutting-edge teledentistry technology”. Its SmileCheck platform allows dentists to review, approve and monitor members’ treatments. However, SDC was not as “tele” as some would like to think. 85-90% of customers started their journey physically at a SmileShop since the company went public in 2019. Only 10-15% chose to use impression kits. SDC only became more “tele” during COVID, with 55-60% volume coming from impression kits, giving SDC the opportunity to go even leaner with store footprint in the future.

In conclusion, SDC expects its operating expenses will fall and the hope is there margins increase over time.

## Lyft

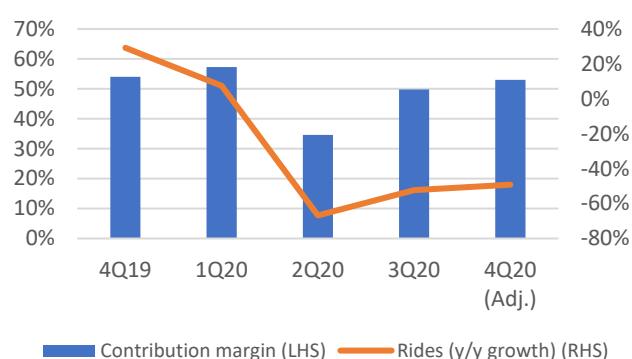
Lyft is another profitability story. The company operates a peer-to-peer marketplace for on-demand ridesharing across the U.S. and in select cities in Canada.

Lyft was adversely affected by stay-at-home orders and other restrictions, including those limiting gathering size, discouraging air travel and forcing Disneyland California to close. Rides were down as much as 75% in April compared with 2019, followed by a gradual

recovery from May through October, before getting worse in November due to the resurgence of COVID.

A key business metric that Lyft looks at is the contribution margin. Given the company’s cost structure, higher ride volumes usually translate into higher contribution margins, with contribution being defined as revenue less cost of services, amortization, share-based compensation and changes to insurance liabilities. Lyft’s contribution margin was 55.5% in 4Q20. The contribution margin fell to 53% after adjusting for two one-off items, namely a reduction of \$15 million driver acquisition and engagement spend in December 2020 in response to a weak rideshare demand and a \$6.7 million net contribution from remarketing older Flexdrive vehicles in a strong used car market. What that means is that, Lyft managed to achieve essentially the same contribution margin versus a year ago even when rideshare volume halved. This is a significant improvement from 49.8% in the preceding quarter and the trough of 34.6% in 2Q20. More importantly, the improvement is a structural one that is going to stay, with Lyft expecting contribution margin to reach record high of over 57% later this year.

### Lyft’s Structural Cost Reduction in 4Q20



Source: Company data

Lyft has removed \$90 million in fixed costs in 4Q20 and is anticipated to remove a further \$35 million in 1Q21, even as it plans to increase research and development (R&D) investments. Cost savings will come primarily from the reduction in general and administrative (G&A) expense.

Assuming ride volume begins to increase by high-single-digit on a month on month basis at the beginning of 2Q21, Lyft could be adjusted EBITDA profitable as early as 3Q21. This also means Lyft can become adjusted EBITDA positive by 4Q21 with 15-20% fewer rides than originally thought.

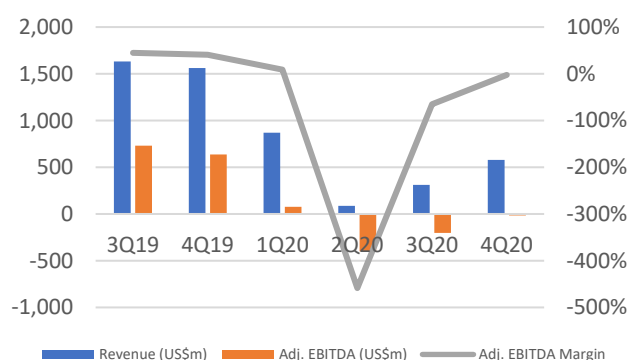
## Theme Parks

Restrictions on people movements have also undermined theme parks' top and bottom lines. Take Disney as an example. Revenue from Parks, Experience and Products (DPEP) collapsed 85% in the June quarter compared with the same quarter in 2019 while operating income fell to a negative 1.96 billion from a positive 1.72 billion a year ago.

Disney estimated the pandemic has reduced DPEP operating income by c.\$2.6 billion in the December quarter as a result of closures and reduced operating capacities. Nevertheless, DPEP managed to reduce operating loss significantly to \$119 million due to effective cost management. According to the company, engineers have figured out ways to increase capacity with the same safety measures at Walt Disney World and in Shanghai Disneyland Park, allowing Disney to right size not only its fixed cost base but also its variable cost base.

Similarly, Comcast saw its parks revenue plummeted c.90% q/q in 2Q20 to \$87 million. Although revenue was still down 63% y/y in the latest quarter, the segment became adjusted EBITDA breakeven, at a time when Universal Studios Hollywood was closed while parks in Orlando and Osaka operated at limited capacity.

### Comcast Theme Parks Revenue and Adj. EBITDA



Source: Company data

As COVID restrictions ease in the future, these companies will likely witness a double compounding. Extraordinary revenue growth, together with significant margin accretions, will turbocharge profits.

The question is how much of this has already been discounted in the stock price. Before the pandemic, Lyft was trading at 3.4 times forward sales. After releasing its 4Q20 numbers and discussing the

possibility of being adjusted EBITDA profitable by 3Q21, the company traded at 5.6 times FY21 sales and 4.3 times FY22 sales (discounted at 9.1%, based on FactSet). It would seem that investors are willing to overlook 2021, with 1Q21 rideshare volume guided to be down 45% y/y, and focus instead on 2022.

Likewise, SmileDirectClub was trading at 4.9 times forward sales immediately before COVID hit. The teledentistry company was then rerated to trade at 5.9 times FY21 sales and 5.1 times FY22 sales (discounted at 8.9%, based on FactSet) on the last trading day of January 2021.

# Wenlock Global Fund

## Fund Statistics - December 2020

Source: Mainstream Fund Services, Thomson Reuters, Wenlock Capital

Numbers rounded and may not sum to 100%

Sector Allocation (ex cash/options)	% of NAV
Communication Services	29%
Technology	21%
Healthcare	18%
Industrials	11%
Consumer Staples	1%
Consumer Discretionary	1%

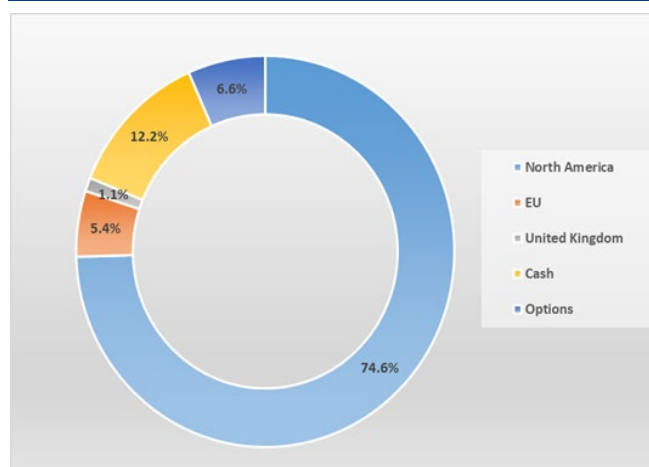
Currency Exposure	% of NAV
US Dollar	93%
UK Pound	1%
Euro	5%
Australian Dollar	1%

Source: Mainstream Fund Services, Thomson Reuters.

^Calculations are based on total returns with distributions reinvested and net of all fees but before tax or the buy/sell spread. Performance figures are based in AUD.

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### Performance of \$10,000 invested since inception



Top 10 Holdings	Sector
Amadeus IT Group	Technology
BioLife Solutions	Healthcare
Eventbrite	Communication Services
Facebook	Communication Services
Insulet	Healthcare
Lightspeed POS	Technology
Lyft	Industrial
Pinterest	Communication Services
The Walt Disney Company	Communication Services
Twitter	Communication Services

Net Performance	Fund	Index*	Relative
1 Month	+0.4%	-0.5%	+0.9%
3 Month	-2.5%	+5.9%	-8.4%
1 Year	-28.7%	+5.6%	-34.3%
Since Inception**	-7.4%	+48.7%	-56.1%

\*MSCI Daily World Total Return Net Index AUD \*\*Inception 9 Aug 2017

Source: Mainstream Fund Services, Thomson Reuters, Wenlock Capital.

^Calculations are based on total returns with distributions reinvested and net of all fees but before tax or the buy/sell spread. Performance figures are based in AUD.

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# Wenlock Global Fund

- ❖ The Wenlock Global Fund targets long-term capital growth whilst ensuring capital preservation. The Fund invests in 20-40 superlative businesses across the world that are exhibiting strong long-term secular trends. At times, the fund employs protection to protect against large falls in asset prices.
- ❖ These superlative businesses are selected after rigorous fundamental bottom-up research which provides the Fund potential long-term capital returns.

Investment Style		Bottom-up Fundamental Research based on Cash Flow Returns
Number of Holdings		15-20
Inception Date		9 August 2017
Currency		AUD
Minimum Investment		\$10,000

## IMPORTANT INFORMATION

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