Aurora Investment Trust – December 2022

Share Price: £1.95 Net Asset Value: £2.08 Discount: 6.3%

Market Cap: £149m

Data as of 31 December 2022

Holdings >3% on 31 December 2022	(%)
Frasers Group	23.4
Barratt Developments	15.0
Castelnau Group Ltd	10.5
Ryanair	6.5
easyJet	6.2
Lloyds Banking Group	5.7
Netflix	5.7
Hotel Chocolat	3.8
Bellway	3.8
RHI Magnesita	3.7
Others <3%	12.6
Cash	3.1

In December, the NAV was down 5.9% for the month, versus the FTSE All Share (incl. dividends), which fell 1.4%.

Shareholders will be aware of the unique fee structure in the Trust. Phoenix does not earn an annual management fee but earns a performance fee equal to one third of the outperformance versus the FTSE All Share Index.

That performance fee is paid by way of the issuance of Ordinary Shares, which are subject to a fixed three-year clawback period. If the outperformance versus the index reverses on the third-year anniversary, some or all the issued shares will be returned, and if outperformance fully reverses, Phoenix will receive nothing.

For the year ended 31st December 2019 the clawback test occurred at the end of December 2022 and due to underperformance, the clawback has been triggered in full. The shares awarded to Phoenix have been returned to the Trust and the NAV per share increased by 1.66p.

Following a review and dialogue with advisers, prompted by ourselves, we have agreed that accounting for the clawback in the daily NAVs better represents the economic impact of the clawback and is more informative to investors.

The impact of the fully clawed back 2019 fee and the 2020 & 2021 fees, which would be clawed back if present performance continued but which have yet to be subject to the final three year clawback test, has been to increase the NAV by 5.44p per share in total.

In individual share price terms, fallers of note during December included Frasers Group -21% & easyJet -17%. From a positive perspective, Hotel Chocolat rose 7.2%.

The following contains extracts from Gary Channon's year end thoughts to Phoenix investors:

Year Review

This has been a tough year in which to beat the UK indices. The main UK indices have unusually (from a global perspective) returned a positive performance in 2022, largely due to the weighting in energy and miners, whose prices jumped in response to the elevated profit opportunity that followed Russia's invasion of Ukraine. Between them, those sectors make up c. 25% of the market and they are up 42% and 23% respectively in 2022. We don't have any ownership in those areas.

The Mid Cap Index, which has a lower exposure to those sectors and is more domestically focused, fell 20% in the year.

The 17.4% decline in Aurora was after a positive 6.5% contribution from the inflation hedge in 2022. The biggest contributor to our decline was Barratt Developments where we re-invested the proceeds of that hedge, it was down 42% in 2022, which results in a -5.4% effect on the Fund. Castelnau Group contributed a -4.3% effect after it declined 35%. The other stocks to make contributions of over 2% was Randall & easyJet, which had -3% & -2.8% respectively.

Last year's biggest riser, Frasers, the Trust's biggest holding, fell 8% in 2022 (having risen 71% in 2021). When combined with its large weight this had a -1.5% effect on the Trust for the year.

The best performer in the portfolio in 2022 was Netflix, rising 50% from when we purchased it and making a +1.3% contribution to the overall performance.

Inflation

Given the significant contribution of the inflation hedge to our recent performance, it is worth commenting on our current thoughts and why we were happy to take it off and not extend it.

There seems to be some general misunderstanding as to whether inflation is controllable or not, which at times draws upon the 1970s as an example. However, it is important when considering that period to understand that the prevailing view of politicians and policy makers at the time was that inflation couldn't be controlled with interest rates or money supply. The way in which governments sought to control inflation was through government intervention in prices and wages.

In the UK we had the National Board for Prices and Incomes, which was set up in 1965 and through which the government attempted to impose controls on prices and wages through direct legal constraint and coercion. Periods of wage freezes were imposed, where no businesses could raise pay, followed by mandated pay rise levels set by the government. This even extended to dividends. All these measures seem unworkable today and they were even then. Much mental and legal resource was spent trying to operate around them and huge misallocations of capital were caused by those distortions, but their ultimate undoing was that they failed to work. Inflation took off and labour represented by unions went on strike bringing the UK to a standstill. (Plus ça change, plus c'est la même chose!)

Some lessons of history are learned because they result in a change that works, and so it was with inflation. We learned that inflation could be controlled by the setting of interest rates and paying attention to the money supply and that, even better, if you gave this as a mandate to an independent central bank, then it would gain real credibility in the pricing of long-term obligations from the government.

The lesson of history that you can't control inflation by imposing below market wage settlements looks like it is about to be relearned in the UK.

We were worried about inflation in 2021, because we saw the huge growth in money supply caused by the pandemic interventions, which were funded by effectively printing money. Because "quantitative easing", as it became known, worked so well in the Global Financial Crisis of 2008, it was assumed not to cause inflation. But the big difference then was that the money printing occurred as the banking system shrank and the overall effect on money supply was minimal. With COVID there was no offsetting shrinkage. To make matters worse, the interruption to the world trading system that COVID caused meant that supply could not respond to all the extra money in the system and so price rises were the inevitable outcome.

To throw fuel to the fire, the invasion of Ukraine, accompanied by a restriction on the supply of Russian energy, caused a surge in oil and gas prices which quickly feeds into all prices.

The key central banks all have a clear policy objective of controlling inflation, and this hiccup has undermined their credibility, which they are acting quickly to regain. They have the tools and there is no reason not to expect them to succeed. Money supply has already stopped rising and has even been declining in the US for the first time in decades. It's a reasonable assumption that long term inflation will be around the goals set for central banks (UK is 2.0%), and that in focusing on restoring their credibility they will tend towards undershooting that level.

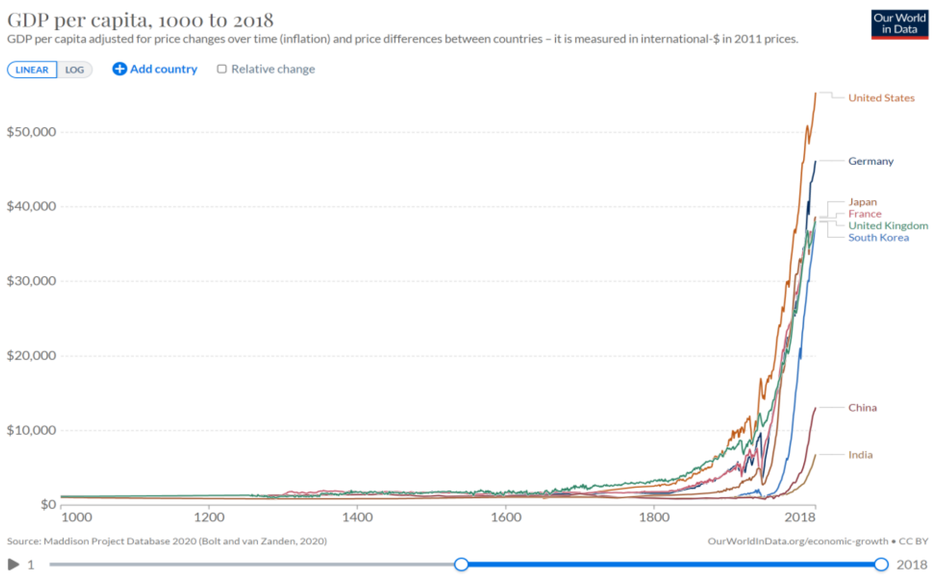
2023 will be the year of transition and given the unsustainably elevated level of energy prices (i.e. they are at such a high level that the excess profits incentivise increased supply, whereas elevated prices reduce demand and incentivise alternatives), it is highly possible that inflation could be negative before the year is out.

Once central banks can see the trajectory is on target, we will see where peak interest rates are and also whether a greater recession is needed, albeit that is the ultimate effect of raising rates to restrain inflationary pressures.

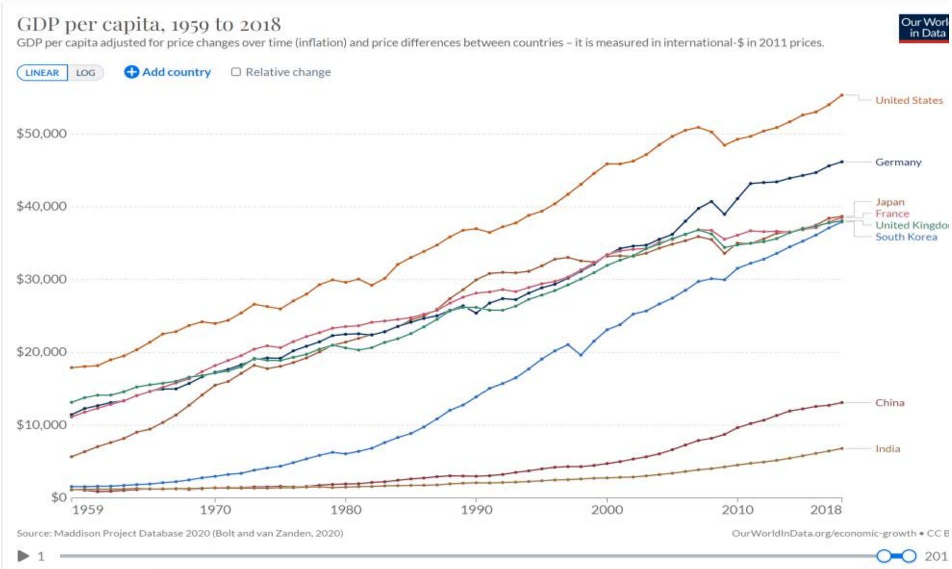
Outlook

You know us better than to expect a forecast for 2023, but we do want to share a thinking framework for someone with, or thinking of, making a long-term investment in equities and then in particular with our investment philosophy.

For all the talk about inflation, interest rates and wars, the most important factor for considering an investment in equities is the underlying economic miracle engine that has been running now for some 300 years. Whatever you call it, industrialisation or capitalism, starting in the UK a force has been at work that has raised the productive output of the world at a rate faster than population growth. In the previous 1000 years this did not happen.



The forces of that progress are identifiable and measurable. The number of people involved and the output per person are the two simple factors of the output result. Innovations in ways of working and innovation in the technologies involved, combined with trade, drove that output. But by far the biggest absolute driver has been the increase in the number of people joining the system. Even without any innovation, newly industrialising countries can just adopt methods and technologies already discovered.



The effects of this machine can be seen in the world GDP figures adjusted for inflation. The first column of GDP data in the table below shows the figures adjusted for inflation, but when we are thinking about where corporate profits come from, it is actual dollars which the next column shows. Corporate profits have averaged between 8% and 10% of GDP over that period and so the final column is an estimate of their size using a 9% estimate.

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The effects of this machine can be seen in the world GDP figures adjusted for inflation. The first column of GDP data in the table below shows the figures adjusted

	World (2015$)	chg	World (Current$)	chg	Profit Pool
1961	$11,316,399,618,088		$1,448,625,354,543		$130,376,281,909
1971	$18,866,906,740,753	67%	$3,310,780,486,001	129%	$297,970,243,740
1981	$26,824,107,597,640	42%	$11,727,633,651,775	254%	$1,055,487,028,660
1991	$36,481,847,683,018	36%	$23,763,555,781,581	103%	$2,138,720,020,342
2001	$49,318,791,162,402	35%	$33,623,959,264,594	41%	$3,026,156,333,813
2011	$67,008,015,715,948	36%	$73,857,648,457,527	120%	$6,647,188,361,177
2021	$86,852,662,217,901	30%	$96,513,077,364,368	31%	$8,686,176,962,793

Source: World Bank national accounts data, and OECD National Accounts data files, Phoenix

Throughout those decades interest rates went up and down, inflation came and went and so did wars, but none of it derailed this relentless machine.

Increasing output at a rate faster than population growth raises the standard of living and that has also happened at a relentless pace. The best way to show it is with the GDP per capita, see table below

World GDP per Capita

Year	Value	Change
1961	$3,683	
1971	$5,007	36%
1981	$5,933	18%
1991	$6,778	14%
2001	$7,921	17%
2011	$9,500	20%
2021	$11,010	16%

Source: World Bank national accounts data, and OECD National Accounts data files

As citizens get wealthier they consume differently, and the business opportunities to satisfy that consumption grows. This is the basis of the economic system in which we participate, from which our businesses derive their profits and therefore, ultimately where the returns and values of our businesses come from.

This is the strong and compelling case for equities over the long term, as a participator in that great wealth generating machine and as a protection against any inflation that accompanies that progress.

World GDP had just passed $30 trillion when we started Phoenix in 1998 and it most likely will have passed $100 trillion now. The pool of corporate profits has more than tripled in that period and a holder of one of the world indices would have achieved something similar to that on their investment.

The Case for the Value Investing Approach

If the index-based approach can give such good returns for the long-term investor, then why contemplate a value-based approach?

There are two key edges that a value-based approach has over a pure index tracking one, which should mean that all value managers can outperform the index, even after fees, if they do them.

1. *Avoid bubbles of over valuation*
2. *Take advantage of troughs of under valuation*

Both go against basic human instincts and are the primary reason why the average investor underperforms.

Avoiding bubbles. As we have discussed previously, markets have in the past few years become dominated by a euphoric interest in technology related businesses. Many of them look like great businesses and are highly profitable, but in a run reminiscent of the

Go-Go Years rally of the 1960s, which focused on the Nifty Fifty of forever stocks, the valuation put on businesses with great prospects reached highly elevated levels.

A value-based approach keeps you out of such manias and protects you from the fallout seen already in 2022. We had none of those in the portfolio.

Buying Value in a Trough. As we have discussed previously, the layers of negative forces prevailing in the stock market, especially in the UK, have created significant undervaluation opportunities. It has been our focus to make the most of this opportunity. Although straightforward in principle, buying cheap but declining and out of favour stocks is always uncomfortable when you are doing it, because they usually keep declining and looking like mistakes.

We save ourselves from the human side of that by sticking to our approach, making rational value-based judgements, in the knowledge that, in the long run, it is the underlying cash generation of a business that ends up determining its value and long-term investment returns. We pay no attention to timing but if we invest in undervalued securities, that are themselves making high returns on the capital retained within them, then time works for us. Value builds and, ultimately, returns follow.

The result of applying that edge, since we started in 1998, is that we had a 12-fold return whilst those world indices and profit pool tripled.

UK House Prices

Given our large exposure to UK housebuilding, and that this is again a much-discussed topic, we thought we should say something on house prices.

Those familiar with our investment rationale will know that the movement in house prices does not matter much for value and, counter-intuitively, the outcome that produces the most cash for shareholders is one of continual house price decline. The reason being that declining prices, in essence, release capital currently tied up in land, because the replacement cost of land falls as house prices fall. Because the cost of building houses doesn't decline, land prices always take a disproportionate hit which releases a lot of capital. (e.g. in 2009 a 9% fall in house prices was accompanied by a 40% fall in land prices).

We restate that reasoning so it is clear that we don't have an endowment bias (i.e. the cognitive bias you get when you already own something to favour thinking that supports that ownership) that leads us towards optimistic house price expectations.

Ultimately, we think house prices reflect the forces of supply and demand. Rising mortgage rates have an impact on the area of demand that comes from buyers of a house with a mortgage, but demand occupancy is a function of the supply of households and most households aren't formed with a mortgaged purchase; they start as a rental decision. A shortage of supply of housing means that occupancy of property is high and that landlords can expect a tenant. Higher rates mean that landlords will either have to raise rents or lower the price at which they are willing to buy properties. In 2022 private rents rose 11% in the UK and 15% in London. Like higher energy prices, they end up taking up a larger proportion of household budgets and for some it will mean that a household doesn't get formed, e.g. young people will continue to live at home longer.

The price at which landlords are willing to bid will be impacted by their cost of funds. Though the overall yield on UK residential property is still at or above the long-term risk-free rate. On top of that, rents rise with inflation and so, from a purely asset pricing point of view, the pricing still looks attractive.

House prices adjust very slowly in the UK. Many choose not to move when they don't get their desired price and so transaction volumes decline. In 1989 -1995, when the last period of overbuilding caused a bursting bubble in the UK, it took 5 years for prices to fall 9% and, with inflation included, that resulted in a fall of 23% in real terms. (1989 was the last year in which the UK built more houses than households formed!)

That bubble was accompanied by over building and lots of poor lending. Following the financial crisis in 2008, the UK mortgage market has changed considerably, and new regulations have restricted lending to those passing affordability tests, which include rises in interest rates. That's not to say that a rise in unemployment won't cause some to find their mortgage unaffordable, but the UK regulator has already guided the lenders to seek all possible ways to help burrowers, including pausing capital repayments rather than have someone lose their home. Repossessions have never been a significant factor in the UK house market, even in past bubbles, and that looks even likelier to be the case again.

More likely is a period of adjustment to new mortgage rates and rental prices, a decline in prices from lower expectations of value by agents, sellers and buyers, before the forces of supply and demand assert themselves to leave residential property in the UK still expensive.

We have used many methods to estimate the level of undersupply of housing in the UK and the best approximate figure we have is around 5% or 1.5 million homes, not evenly distributed and most extreme in London. The latest changes and government backdowns on planning policy show that there is no likely path in the medium term to fix this. Even the political will, that we have seen from both parties in the past 20 years to raise housing output, it has not overcome the underlying local resistance to new housing.

China

Given the way we view the world, the most significant recent news has been the re-opening of the Chinese economy from COVID. In the short run, it will help alleviate inflationary pressures, but in the long term, the forces we talked about earlier are what matters. China aspires to have an economy like the US, but even if it managed to raise its GDP per capita to the level of the UK, that alone would add $47 trillion to the $100 trillion world economy. However, China's relationship with the US and Europe (including the UK) has changed; there is a wariness about China's intentions, and this is causing restrictions to trade in crucial areas like semiconductors. Military and political rivalries are concerning, but a student of history can't help but notice how much innovation and economic progress has been made in the competition for power between nations (see Paul Kennedy's 1987 book *The Rise and Fall of Great Powers* for a great illustration of this over 500 years). There is no military victory route available and so the best way for China (and India) to build their power to match the size of their nations, is economic progress towards conversion with the West, and in doing so the standard of living of the whole world will rise substantially. And as previously said, the best way for a long-term saver to participate in that is by owning commercial enterprises.

Conclusion

All that grandiose macro context doesn't help you pick stocks. Companies succeed and fail in much more dramatic fashion than countries. We have a portfolio of strong businesses, and so in tough times they get relatively stronger and that shows when conditions improve. We see that happening across the portfolio, where strong managements are outcompeting their competitors and creating great long term future value. Unfortunately, our external scorecard is based upon the value that the market puts on those businesses, and currently that is low. We believe we have added more long-term value to the portfolio in this period than we have ever before and that will start showing up in returns in the coming years.

Aurora shares are eligible to be invested in an ISA or SIPP. Neither the Aurora Investment Trust nor Phoenix Asset Management Partners run such a scheme. You should consult a financial adviser regarding a suitable self-select ISA or SIPP provider.

Aurora Track Record

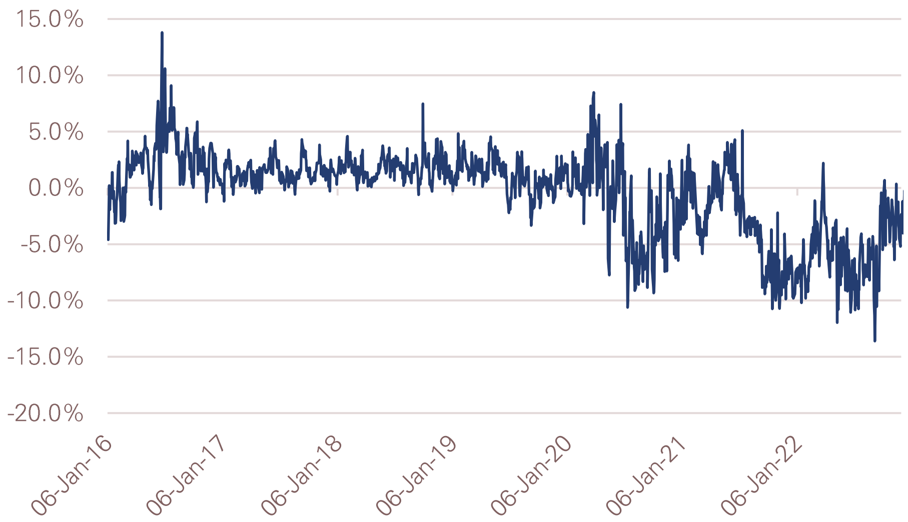
Performance	NAV Return %	Share Price Total Return** %	All-Share Index %**	Relative NAV to ASX %
2022 (to 31 December)	-17.4	-16.3	0.3	-17.7
2021	19.1	13.5	18.3	0.8
2020	-5.5	-10.0	-9.7	4.2
2019	29.7	31.9	19.1	10.6
2018	-10.3	-10.9	-9.5	-0.9
2017	20.4	21.2	13.1	7.3
Cumulative*	39.1	36.1	52.5	-13.4

* Since 1 January 2016
**Share price return with dividends reinvested; All Share Index returns with dividends reinvested.

Aurora Share Price & NAV per Share – 31 December2022

Past performance is not a reliable indicator of future performance.

Aurora Premium / (Discount) – 31 December 2022



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Investment Objective

We seek to achieve long-term returns by investing in UK-listed equities using a value-based philosophy inspired by the teachings of Warren Buffett, Charlie Munger, Benjamin Graham and Phillip Fisher. Our approach, combined with thorough research, invests in high quality businesses run by honest and competent management purchased at prices that, even with low expectations, will deliver excellent returns.

Contact

Phoenix Asset Management Partners Ltd
64 – 66 Glentham Road London SW13 9JJ
Tel: +44 (0) 208 600 0100
Fund Manager since 28 January 2016

Portfolio Manager: Gary Channon
Listing: London Stock Exchange
Inception Date: 13 March 1997
ISIN: GB0000633262
Bloomberg: ARR

Fees

Management: None
Performance: One third of returns in excess of the market

Regulatory Notice: