Aurora Investment Trust – December 2018

Share Price: £1.83 | Net Asset Value: £1.82 | Premium: 0.5%

Market Cap: £102m

Data as at 31 December 2018

Holdings >3% at 31 December 2018	(%)
GlaxoSmithKline	9.5
Sports Direct	8.6
Lloyds Banking Group	8.4
Bellway	8.2
Dignity	8.1
Tesco	8.0
Randall & Quilter	7.7
Phoenix SG Ltd (Stanley Gibbons)	6.9
Vesuvius	5.7
Redrow	5.6
easyJet	5.5
Hornby	5.4
Morrisons	3.8
JD Wetherspoon	3.0
Others <3% (2)	3.2
Cash Position	2.4

Aurora shares are eligible to be invested in an ISA. 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 provider.

The NAV was down 5.6% with the FTSE All Share (incl. dividends) being down 3.7% for the month.

From an individual stock perspective, there were falls across most of the portfolio during the month, with Sports Direct being the largest at 18%, followed by Dignity down 13% and Morrisons down 10%. Redrow was a notable out-performer posting a positive return during the month of 5%.

From an activity perspective, there was a modest weight reduction in stocks with a lower upside to intrinsic value such as Tesco and Morrisons, as we further increased the holding in Dignity.

Whilst the Trust, along with the market, has seen share price falls in recent months, we have become increasingly excited at the attractive valuation levels we are seeing.

The following excerpt is taken from Gary Channon's Q4 report to investors in the Phoenix UK Fund. In it, Gary highlights that this is the first time in two and half years that we have an opinion about whether it's a good time to invest, and one of those rare moments in our 21-year history when we are happy to say that it is a great opportunity to invest in our portfolio. Historically, we have guided investors to our long-term track record.

In his report Gary highlights an upside to intrinsic value (our key measure of attractiveness) of 126% in the Phoenix UK Fund portfolio. The Aurora portfolio has a very similar composition and demonstrates a slightly higher upside.

Excerpt from the Phoenix UK Fund Q4 Report:

When the bearer of bad news tells you it's good news you are right to be wary. But that is essentially our message, that the decline in the Fund reflects a fall in the market that has created an opportunity for us to add value, which we expect to be reflected in future returns.

When climbing through a mountain range it is not possible to reach the next summit without going through the valley in between, and so it is with our approach to investing. For nine year-ends, we have been able to write without reporting a decline, but that wasn't because we didn't pass through valleys, it's just that we were out of them by each passing of the calendar year. In fact, we wrote this in last year's report:

"We have now had nine years of positive performances and the backdrop of a strong market. Nothing we have done with our approach has changed our expectation that progress will be choppy, and that means having down years. Please don't let the recent past obscure that."

Now there are different forms of choppiness in which some are bad. Declines that come from a fall in the underlying value of our businesses is "bad" choppiness, it's the loss of real value. However, price falls that don't reflect intrinsic value are not to be feared. The best kind of choppiness opens up opportunities to add value, usually this requires weakness in the whole market and that is what we have here. In the fourth quarter of 2018, world equity markets have fallen quite significantly, dragging down an already lagging UK market. Within that market, the shares of companies associated with the domestic economy have been further hit because of their perceived exposure to Brexit and all the uncertainties around that.

These opportunities present themselves because of an observed tendency of markets to overreact. At the heart of that overreaction, markets are overly sensitive to the near term and current news. To illustrate the point, if we took the typical UK stock at today's market level, we know that in theory their value is the present value of all the future free cash that the business will generate. So, today's depressed levels are telling us that either the future returns of the business are going to be lower or the returns to shareholders are going to be higher. However, when you play around with those models to try and figure out which it is, one thing that stands out is that no more than about 20% of the value today comes from the returns in the next three years. That leaves the bulk of the value accounted for by years 2022 and beyond, and yet there is very little discussion of expectations for those years.

It is inevitable therefore that judgements about value that are based upon information and forecasts currently available will end up placing too high a weight on the near term. At times when the current news is negative, and the near-term outlook is pessimistic, it is likely that what might be appropriate for the valuing of the 20% (Years 1- 3) is then applied to the whole and equities will trade at a discount to their intrinsic value.

The UK is a great case in point with a huge amount of focus on Brexit and its implications. Most of the focus is on what is happening right now and the near-term consequences. As the Bank of England has modelled in their work, if the UK leaves in March 2019 without a deal, they expect the pound to plunge and the UK economy to contract; for the worst cases they've modelled from disruptive to outright disorderly. The latter sees a drop in economic activity bigger than that seen in the credit crunch of 2008-9. And yet, even in their most pessimistic of forecasts, the economy is bigger in 2023 than it is today. In the more likely scenarios of some form of managed Brexit, the economy grows.

So, for investors in equities who need to consider the next 10 years to estimate the value of a business, Brexit is of course important, and coming in the early part of the 10 years gives it a higher present value than if it came at the end. Currently though, in our opinion, it is having a disproportionate impact on the value of UK focused businesses.

JP Morgan created a basket of UK stocks* focused on the UK economy to track the impact of Brexit and that basket has fallen 17% in 2018. That's more than the overall UK market, which has fallen 9.5% or the US market (S&P 500) which has fallen 4%. And this is where we have been investing. It's uncomfortable because we are buying the ugly and badly performing and we don't know when they will recover, and we also know there could be worse to come.

Although overreaction in stock prices has long been identified as a bias by many, including Nobel Prize winning Richard Thaler of Nudge fame, it's a hard bias to exploit because the disconnect can last longer than fund managers can keep their clients. It is an observed phenomenon that fired fund managers out-perform their peer group, which is cold comfort. So, before you start thinking of redeeming, let us make the case for the opposite, now is the time to be adding money, not taking it away.

Our best guide to the amount of value we have in the Fund is not the NAV which is based upon current share prices, but rather our estimate of the Intrinsic Value. After a very active quarter that figure is now £12,543 per share. Comparing that to the closing NAV of £5,559.20 gives an upside of 126%. There has been no better guide to our future medium to long term returns than that figure.

Whenever the upside has been above 120% in our past at a quarter end, then the average 3-year return has been 58% (16.4% per annum) and there have been no negative returns. We have had 33 quarter ends in our 21-year history where it has occurred, and we have the 3 years subsequent returns data. It also occurred right after the Brexit referendum vote in Q2 2016 and so far, the investment return, despite the latest dip, has been 29%.

Investing in or in front of a known storm is not without its risks, but the way to navigate those is to pick businesses which are not at risk of ruin or serious permanent capital damage from the storm. Businesses might be cyclical or economically sensitive, but unless that is combined with unsafe levels of leverage, they will be around on the other side of the storm.

As we said last quarter and previously, we have a portfolio of those types of businesses. We still expect the citizens of the UK to eat in (Tesco, Morrisons), eat out and drink (Wetherspoons), be clothed (Sports Direct), housed (Bellway, Redrow and Barratt), bank (Lloyds), play (Hornby, Stanley Gibbons), fly (easyJet) and die (Dignity), in the same way outside the EU, as they do now.

What makes a good business is the ability to persistently earn a high return on its capital and that is not dependent upon the country it's in, it is a function of the competitive dynamics in which it operates. To sell your product or service at a price that earns a high return you need something that protects you from competition and demand that doesn't disappear as you raise prices. That pricing power is the essence of a good business and all the companies we invest in have it in some form or other. It's what gives us the ability to estimate their future returns and value.

When we consider something like Brexit, we don't settle on a Phoenix view of a particular outcome, we model them all and try to estimate their probabilities. At the bottom of the fan of valuations we look at the worst case, and so if the UK's politicians are foolish enough to crash out of the EU in 3 months' time without having negotiated anything and the economy does plunge in the way the Bank of England has estimated, then our economically sensitive businesses will have some poorer years, but overall that knocks only about 10% from our estimate of the portfolio's intrinsic value. So, at the bottom of our range of outcomes we more than double our money, that's a nice starting point. Probability-wise that does seem unlikely. Although there doesn't seem to be a consensus in parliament for much on this issue, there does seem to be one for ensuring that this scenario doesn't happen.

Apart from the broad Brexit-related window of opportunity, there are two other idiosyncratic features of the portfolio. The first is retail, where a far greater destructive force than Brexit has been at work, that is the changing nature of shopping brought about by the internet. This is doing serious damage, wiping out whole businesses and depressing the values of those that remain. The businesses we own (Sports Direct, Tesco, Morrisons) are all positioned where they are the lowest cost operator in both stores and online. This should protect them from being undermined by an online competitor. We do assume in our modelling of the future that physical retailing will remain, but in a different form, as a showcase for products and as an experiential activity. Consumers, we believe the evidence shows, still like to go shopping, they do it today even when an online opportunity exists with more convenience and lower prices. The winners in this space, we expect, will be able to do both well and seamlessly. The best online only retailers are now beginning to open physical stores as they recognise that.

The other feature is our investment in the funeral business. This industry is now under competition authority scrutiny, but at the same time is suffering from a fall in prices due to an increase in competition. These two are incongruous, either there is a lack of competition and the authorities will seek ways to increase it, or there is competition driving down prices already and intervention is not needed. The truth is that for a long time the leaders in this field persistently raised prices ahead of costs, but in so doing they increased their vulnerability to competition, in Buffett's words, they reduced the moat that protected their pricing power. Over time, they paid the price in loss of share and declining volumes until ultimately, they are now lowering prices. We assume this is the world they will operate in, i.e. price competitive, where they will need to use their scale to be the low-cost operator and where future margins will not match the past. However, even on that assumption the shares are worth, in our estimate, three times where they trade today. The best investments we have found in the past are where you can buy the ugly duckling, of an ugly sector, in an ugly market…. Dignity fits the bill perfectly.

So, in summary, it's one of those rare moments in our 21-year history where it is worth banging on the table and saying this is a great opportunity to invest because we expect great long-term returns from these values. That doesn't mean this is the bottom, or that there aren't worse declines and news to follow. Our approach to investing requires us to have the ability to look foolish, to look early and to look wrong and to be able to do that for a long time. We've gotten good at that. The reward we expect, as it has been in the past, is the last laugh and great returns for our investors.

*JP Morgan Basket (UK Domestic Plays, Brexit Hedge Basket)
Bloomberg Code – JPDUKB16 Index

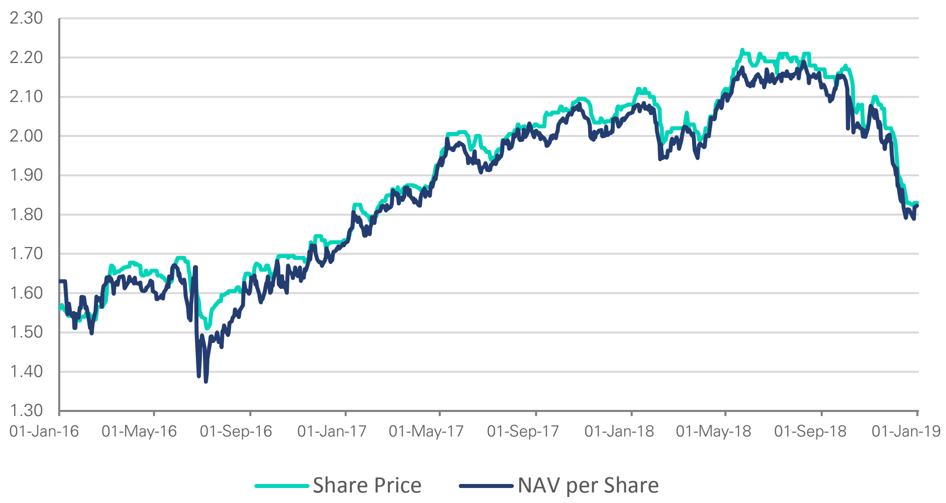
The appointment of Phoenix Asset Management Partners ("PAMP") as Aurora's investment manager came into effect in January 2016.

Aurora Track Record

Performance	NAV Return %	Share Price Total Return** %	All-Share Index %**	Relative NAV to ASX %
2018	-10.3	-10.9	-9.5	-0.9
2017	20.4	21.2	13.1	7.3
2016	6.6	12.0	16.8	-10.1
Cumulative*	15.1	20.8	19.5	-4.4
2015	-2.3	4.3	0.9	-3.2
2014	-11.3	-10.6	1.2	-12.5
2013	3.6	14.2	20.8	-17.2

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

Aurora Share Price & NAV per Share – 31 December 2018

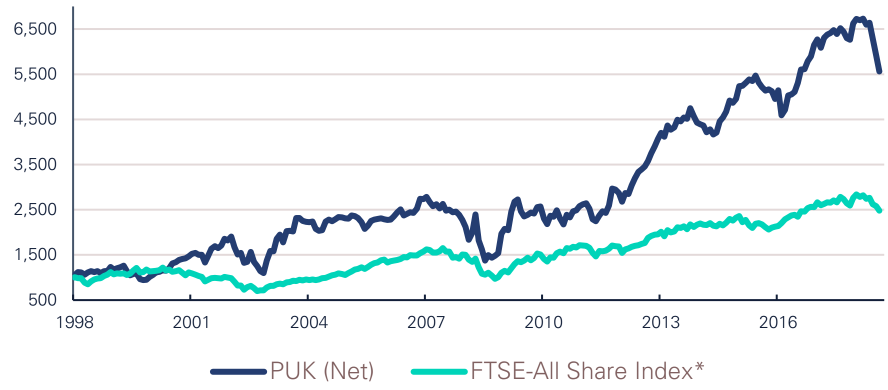


Phoenix UK Fund Track Record

Fund Performance (%)	Gross Return	Net Return	FTSE All-Share Index*	Relative NAV to ASX
Cumulative Since Inception*	830.2	455.9	161.5	294.4
Since Inception Annualised*	11.4	8.7	4.8	3.9

The investment strategy of the Aurora Investment Trust is the same as that of the Phoenix UK Fund.

Phoenix UK Fund
Value of £1,000 invested at launch to 31 December 2018



* Data from 30th April 1998, All-Share Index Returns with dividends reinvested

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

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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: