Aurora Investment Trust – June 2024

Share Price: £2.48 Net Asset Value: £2.70 Discount: 8.1%

Market Cap: £189m

Data as of 30 June 2024

Holdings >3% on 30 June 2024	(%)
Frasers Group	21.3
Barratt Developments	13.5
Castelnau Group Ltd	13.5
Netflix	8.7
Lloyds Banking Group	8.4
Ryanair	5.4
RHI Magnesita	4.4
Bellway	3.8
easyJet	3.7
AO World	3.5
Hargreaves Lansdown	3.0
Others <3%	7.2
Cash & Cash Equivalents	3.6

In June, the NAV was down 2.1% for the month, versus the FTSE All Share (incl. dividends), which was down 1.2%.

There were no individual share price moves of note during the month.

We report on holdings above 3% and shareholders will see that Hargreaves Lansdown has appeared in the holdings table at a 3% weight.

We started buying the stock on the 19th of December 2023, just after it got ejected from the FTSE 100 Index. We set about buying a 2% position and it took until the 20th of March 2024. This wasn't a liquidity issue; Hargreaves is a big stock in comparison to how much we wanted to buy, it is because we stick to our limits and don't chase, and there were only 10 trading days (out of 63) in the period when it traded within our limits. In the end, we paid just under £7.10 for the holding including commission and stamp duty. If the bid does go ahead at the Board agreed price, then including dividends we will have made a return of around 64%, which looks good over such a short period but in reality, is a frustrating disappointment because it comes from years of work and patience.

In his second quarter report to Phoenix investors published today, Gary Channon, Phoenix CIO, outlined some thoughts on how we approach position sizing. He also commented on developments at Dignity, which is the largest holding in Castelnau Group, which in turn is a significant weight in Aurora. Finally, he outlined thoughts on the attractiveness of the UK market and the impact of a potential Labour victory in the election. Gary's comments are outlined below.

Position Sizing

One of the things we get most asked about in a way that suggests what we do is strange, or at least unconventional, is position sizing. When something like the Hargreaves Lansdown situation happens, it invites the question of why put so little into something that seems to fit all your criteria and offers more than 100% of upside and little or no downside. By little, we mean in relation to how much we are willing to hold in a single investment.

Our portfolio has always been less than 20 holdings, but the top 5 are usually over 50% of the portfolio and often more. That leaves the tail of the portfolio with holdings of 2% to 3%. This c.10 to 1 ratio may seem unusual but it is rooted in the Kelly Criterion approach that we have previously mentioned.

The Kelly Criterion, or Kelly Ratio, is a formula that tells you how much of your capital (or investment pot) you should allocate to a bet if your objective is to maximise the long-term size of that pot without going bust in between. It requires just 3 inputs: how much money you have to start, the probability of success, and the win:loss odds.

It works (in other words it is mathematically provable) for something like an endless series of coin flips, or simple payoff bets. As we know, investments don't look like coin flips (or shouldn't!). Investments don't have discreet timeframes for payoffs, they don't have clear win loss payoffs, and probability of success is hard to determine and is dynamic. We also don't make one investment at a time, we run them concurrently in a portfolio. Many brilliant people have worked to modify Kelly in order to apply it to investing and none more so than the great Edward O. Thorp, whose highly readable 2017 autobiography sums him up in the title! (A Man for All Markets: Beating the Odds, from Las Vegas to Wall Street). He has written many academic papers on how to apply and modify Kelly to different investment or betting strategies and has used it.

What we have done at Phoenix is take the core principles of what the optimisation is trying to do and develop a position sizing approach based upon it. Kelly is essentially "edge over odds"; how probable do we think it is that we will succeed and what is the ratio between upside and downside.

What we have learned in our history is just how important the probability part is. Almost all investment talk is in terms of returns and upside, but that upside is not expressed in terms of probabilities. The lesson we learned in the first decade of investing was that we placed too much into new ideas in proportion to how well we understood them. There is such a different probability of our assessment of the value horizon being approximately correct in an industry that we have been running a monitoring programme on for years and thereby testing expectations versus reality in a learning feedback loop, compared to an industry that we have just made our first investment in. That's why we would rather have 10 times as much in Barratt than we would a first investment in Hargreaves Lansdown. We are much less likely to make a mistake in the former and have a much better appreciation of the risks. Every new extension of our circle of competence starts like this and we hope through time, to develop the expertise to increase our understanding and thereby our probabilities of forecasting the future.

The essence of our position sizing philosophy, a desire to make high returns with minimal risk, is that we bet big where we believe we have a deep edge.

As an aside, if you applied our historic record in the Phoenix UK Fund blindly to Kelly and used it to work out how much we should allocate to an average investment, you get some big numbers! The probability of one of our investments at closure being profitable (by number) has been c.80%. Even if the payoff was 100% upside or downside, then Kelly gives a position size of 60%! That would have been a bumpy ride. Another way to look at it is that our monetary win: loss ratio over the life of Phoenix is about 19:1, which even if the probability of success was 50%, gives a Kelly position size of 47%! So, as you can see we don't use a strict Kelly calculation, or modified Kelly, we use the underlying principles. You also learn another element of position sizing; it needs to be constrained to a size you can tolerate in loss scenarios.

Dignity Update

During the quarter we formally appointed Zillah Byng-Thorne as the new Dignity CEO who we wrote about in the Castelnau Group Q1 Report, for those who don't have the Castelnau reports they are available on the Castelnau Group website. As the capital structure work is so material to the future, Zillah has been engaged on that in advance of her appointment.

To recap where we were, based upon the level of rollover of Dignity shareholders who stayed in after the takeover and the amount of equity we raised for Dignity after the take private, we still had a capital structure that was more geared than we wanted it to be.

Therefore, we had embarked on a process to seek an investor buyer for the crematoria business who would partner with us. That process was run, and we had 4 funded buyers at the end, but working with SPWOne and Zillah we also looked at alternatives because of the amount of long-term upside we would be losing if we sell what we all know to be highly attractive assets. The value today would not reflect any of the uplift we expect if that business stays in the Group and remains part of the original strategy of building a truly great and unique vertically-integrated end of life business.

An alternative way of deleveraging the Group has been found. With surplus released from the funeral plan trusts, the business has enough liquidity to repay £100m of its debt. Those releases have happened, and that process is underway as announced by Dignity today. The Phoenix facility is being repaid by using a portfolio of unencumbered freeholds. That process launches this month, and the proceeds are expected in the coming months.

Because of the way that the Dignity debt is structured, this repayment has a much bigger impact on debt service obligation than if it was a normal loan. The £34m of current annual debt service cost will fall to £23m, so the covenant hurdle which is for EBITDA to be greater than 1.5x the debt service cost, will drop from £51m to £34m, a level we are already trading over.

£540m of securitisation debt when we became involved in the company will be c.£400m following this repayment. The agreement we have to repay the B's early at a discount of c.£50m is still in place until the end of this year and we are still looking to utilise that.

The steps so far have already necessitated a change in the valuation of the Dignity holding in Castelnau. This is reflected in the Castelnau NAV that has just been released, which has risen by c.35%. This is just an initial first step in value creation at Dignity. The valuation does reflect that even with a lower death rate, we are on course for rising profitability this year but it gives little to no recognition to the value of a successful execution of the strategy, which our intrinsic value does.

Dignity is a sprawling and complicated challenge, but a lot has already been achieved. We have been really impressed with Zillah, not because she already has all the answers but because of how she goes about getting them and how she gets things done. Our confidence in the probability of the potential value in the business being unlocked has risen materially.

It's 85km to get to the summit of Mount Everest on foot. After trekking the first 65km you reach Base Camp! That feels like where we are with Dignity.

Outlook

When a pendulum reaches the extreme point of its swing and changes direction, it isn't because the forces acting on it change at that time, it is because the forces pushing it in one direction are diminishing and those forces pulling it in the other direction are growing, it changes direction when those forces cross over. Although reluctant to proffer anything that might look like a forecast, we feel we must share, even at the risk of future ridicule, our growing impression that the perennial underperformance of the UK market is turning or has turned.

The major macro forces that have been pushing it down are:

a.) The long disinvestment of UK equities by domestic pension schemes. This has now happened and there isn't much left to divest.
b.) The negative political developments that undermined the external attractiveness of the UK for investment. The government of Rishi Sunak and Jeremy Hunt has returned the UK to sensible economic governance.
c.) The Brexit effect, which includes the referendum result, the period of negotiation and then the negative impact of implementation have now largely happened.

Countering that are:

i.) Pragmatic decisions are beginning to be made, undoing some of the negative impacts of the way Brexit was implemented. Some of these are technical agreements that impact trade but also include collaborative programmes like Horizon for scientists that the UK has rejoined.
ii.) The cheapness of equities, even though bidders must pay significant premiums to prevailing share prices, has caused a surge in the number of acquisitions of UK businesses. Even our narrow portfolio has experienced two takeouts (Hotel Chocolat and Hargreaves Lansdown).
iii.) UK companies are buying back their shares like never before. It has long been a frustration of ours that there was a negative perception in the UK about buybacks and a pressure from income funds to pay dividends over buybacks. When your equity is cheap it is very value enhancing for remaining shareholders to buy back your equity. What was a trickle 5 years ago, by last year had risen to 40% of the FTSE100 buying back their shares and that has increased and extended into the FTSE250 in 2024.

The UK economy, which has lagged since Brexit, is finally showing signs of performing better relative to its peers and not long after you receive this report, we are likely to have a new UK Government.

We believe an incoming Labour Government with a big enough majority not to be hijacked by the extremes of its party, and that has spent so long in opposition that it is hungry to prove its credentials is likely to be a positive political force. Knowing they need economic growth to deliver their plan, they have and need to maintain, a pro-business approach. Not being the party that delivered Brexit, they (as did the Conservative party at the time) campaigned for the UK to remain in the EU, however, no one is contemplating a reversal but what we should expect is pragmatic solutions that reduce the negative impact, which is also beneficial to the EU.

When a pendulum does reverse, it is very slow to begin with and then builds momentum. The end of 2023 and 2024, so far, feels like that point where backwards started to become forwards. The only other thing to say on the matter is that a reversal in underperformance can happen through a rise in performance or as relative resilience as others fall further. If the AI inflated US market crashes, then the UK could be a safe port in the storm.

We have a very UK focused portfolio, which is priced attractively, generating profits, and buying back shares. If the UK economy continues to pick up momentum as it has done this year, then they will benefit from that. Housebuilding is the only part of the portfolio directly impacted by policy goals of an incoming Labour Government, and so far, the signs are positive. The executives we speak to in the industry who have been engaging with Labour are of the view that their plans are likely to be positive for the sector. We have watched many manifestos arrive post elections and have seen how they survive exposure to the civil service and then local government, however, if the goal is more houses, then you need housebuilders to build them, and they need a planning system that makes that achievable where the demand exists. That seems to be accepted. Our housebuilding investments are screamingly cheap without a scintilla of optimism about whether the new Government will succeed, but if they do, then we are very well placed, the new Barratt Redrow will be the UK's largest and we believe, best (on many criteria) housebuilder, and it still trades below liquidation value.

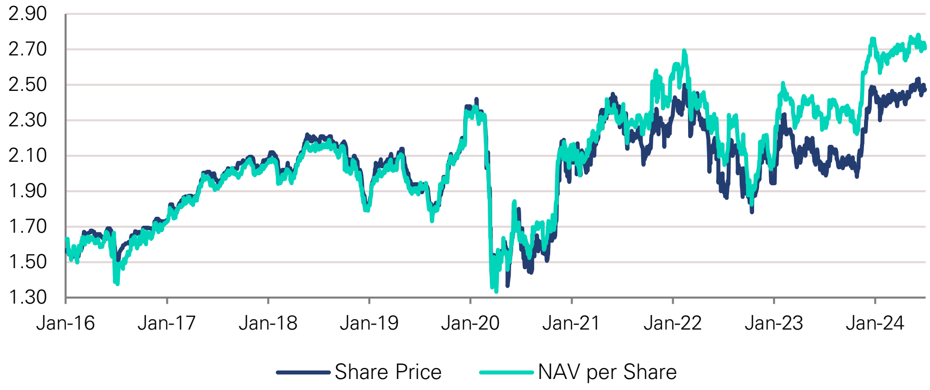
As always, Intrinsic Value is our North Star, and right now it sits high and shines brightly.

Aurora Track Record

Performance	NAV Return %	Share Price Total Return** %	FTSE All-Share Total Return Index %**	Relative NAV to ASX %
2024 (to 30 June)	0.3	1.6	7.4	-7.1
2023	33.2	28.8	7.9	25.3
2022	-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
Cumulative*	93.7	81.6	85.2	8.5

* Since 1 January 2016
**Share price return with dividends reinvested; FTSE All Share Total Return Index with dividends reinvested.
Past performance is not a reliable indicator of future performance.

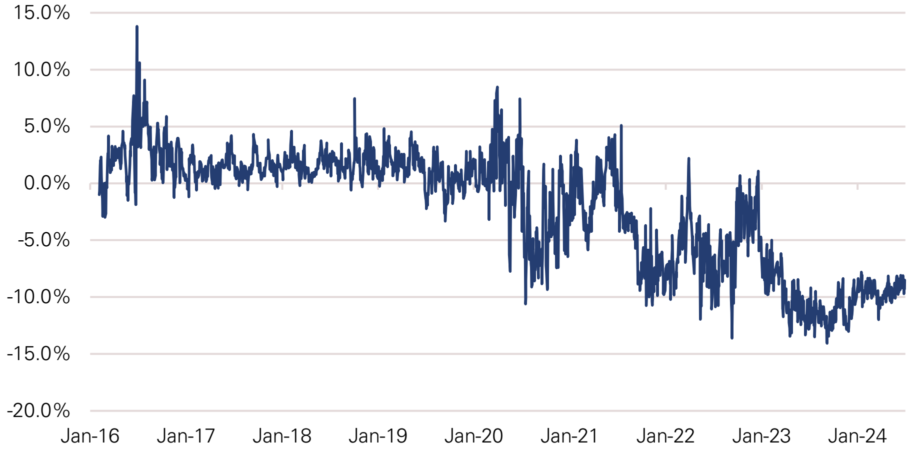
Aurora Share Price & NAV per Share – 30 June 2024



Past performance is not a reliable indicator of future performance.

Aurora INVESTMENT TRUST

Aurora Premium / (Discount) – 30 June 2024



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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.

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.

Target Market

The Aurora Investment Trust is a long-term investment vehicle, appropriate for those making investments with at least a three year time horizon. It is aimed at investors looking for a manager with a business and value orientated approach, achieved through investments in predominantly UK companies demonstrating a high return on capital and control over their profitability through the strength of their business franchise. Aurora's portfolio is typically concentrated in a small number of deeply researched stocks, which can result in above average volatility. An investment in Aurora may be best suited to investors with at least an underlying knowledge of equity investments. The Trust is measured against a benchmark but does not follow the benchmark in its portfolio construction. It is intended for investors looking for capital appreciation rather than income, and while it does distribute a dividend, this is not the strategic aim of its investment approach.

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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

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