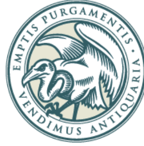


SAMUEL TERRY
ASSET MANAGEMENT

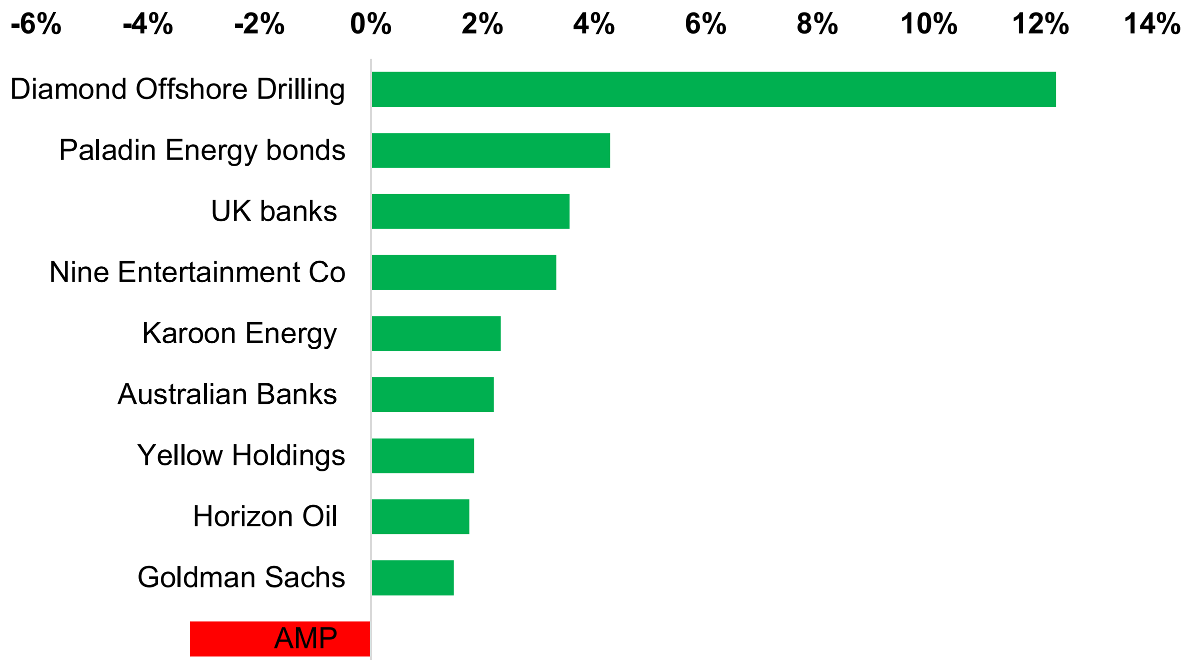
Dear Unitholders,

The Fund's results during the year are shown in the following table, which compares the Fund's return (pre-tax, net of fees[1]) to the Australian All Ords Index and the MSCI World Index:

To 30 June 2021	**STAR Founder Class**	**All Ords**	**MSCI ($A)**	**STAR A Class**
1 year	38.5%	30.2%	29.9%	34.2%
3 years (%p.a.)	21.0%	10.3%	13.6%	18.4%
5 years (%p.a.)	23.0%	11.5%	14.3%	
7 years (%p.a.)	26.0%	9.3%	13.2%	
10 years (%p.a.)	24.5%	9.4%	13.9%	
Since inception on 1 Nov 2003 (%p.a.)	17.0%	9.3%	8.6%	

The Fund generated good returns, both in absolute terms and relative to world markets.

Top contributors to 2021 return[2]



Our biggest loser during the year was Australian fund manager, **AMP**. We recognise that AMP has many problems but believe the share price provides ample compensation for them.

[1] Please note that the returns for A Class Units and the Founder units are different as the Founder units in STAR have a different hurdle rate than the A Class Units.
[2] STAM Internal estimate of contribution to NAV return before fees.

The returns made during the year were mostly due to large gains on securities purchased during the Covid-induced market collapse in early 2020. These purchases, since sold at large profits, included **Paladin Energy bonds, Westpac, National Australia Bank, Nine Entertainment, Goldman Sachs and Carnival Corp bonds**.

The largest single contributor to our returns was **Diamond Offshore Drilling**, an American company which provides offshore drilling services to the oil and gas industry. In April-June 2020, we bought 6.6% of Diamond's bonds at 12% of face value. At that time, the oil price was around $US 30 and Diamond had recently entered bankruptcy. As one of the largest bondholders, we joined the Steering Committee, which helped guide Diamond's debt restructure. This was time consuming but worthwhile.

Diamond emerged from bankruptcy on 23 April 2021. Our old bonds were converted into Diamond shares, and we invested in new Diamond bonds on attractive terms. The Diamond share price on 30 June 2021 values Diamond's equity at 2.5 times the value of the company implied by our bond purchases. As a result of the price rise and our investment in the new bonds, our weighting in Diamond shares and bonds rose to a total of 20% at year end.

Despite the increase in its price, we are at least as enthusiastic about our Diamond position as we were when we started buying it in April 2020. This is because industry conditions are much better than they were in 2020. The oil price is now over $US 80, which has prompted oil companies to increase their offshore oil development. As a result, some previously unused rigs now have contracts and the "day rate" (i.e. the price that oil companies pay to rent rigs) has risen about 50% in the last year, enabling Diamond to generate meaningful cash flow in 2022 and beyond.

Diamond was not the only offshore driller to experience bankruptcy in 2020. Several of its peers also declared bankruptcy. These companies have new owners with an unsentimental desire to maximise profits. The change of ownership is likely to accelerate mergers among drillers and the scrapping of older rigs, which in-turn could improve industry dynamics and returns.

The offshore oil industry has always been very cyclical and after the industry's worst slump in decades, the potential upside in earnings and share price is still substantial, as evidenced by these measures:

1) At the peak of the last cycle from 2006-2012, Diamond's operating profit *each year* was larger than its current enterprise value[3].
2) Diamond's enterprise value is less than a quarter of the book value[4] of its rigs.
3) Diamond's enterprise value is about one-third of the enterprise value it was in 2019, when oil prices were lower than they are now.

Although offshore drilling demand is in long-term decline, existing rigs could generate significant cash-flows over the next few years. Current prices assume extreme pessimism. At the price we paid, not a lot needs to go right.

Why we like the oil sector: investing in a declining industry

In addition to Diamond, we have over 10% of the fund in other oil companies, mostly in Horizon (8% of the Fund) and Karoon (3% of the Fund), two Australian-domiciled oil producers. The world has started the transition away from fossil fuels towards renewable energy. This has led many investors to avoid oil shares, either because they perceive the industry will soon become unviable or because of moral (aka ESG) reservations about investing in industries that cause

[3] Enterprise value is the valuation of a business reflected by its share price after adjusting for its cash or debt.
[4] Ignoring the adjustments to book value that resulted from Diamond's emergence from bankruptcy.

harm to the planet. The evaporation of capital willing to invest in the sector is creating opportunities; select companies offer attractive risk adjusted returns based on much lower oil prices.

We agree a transition to renewable energy is inevitable and desirable. The reality though is that, even under the most optimistic (from the planet's point of view) scenarios, oil consumption will only decline slowly over the foreseeable future, mainly because of demand from poorer economies. On the supply side, weak oil prices plus shareholder pressure on major oil companies has caused a sharp drop in spending on development and exploration of new oil reserves. As a result, oil reserves and productive capacity are falling at a faster pace than oil demand, which we expect will lead to higher oil prices for most of this decade. We expect that to lead to an increase in oil exploration and development, which will benefit Diamond.

None of that detracts from our view that the oil industry has a bleak long-term future. This does not mean there are not opportunities in the sector. One of our favourite assets is Yellow NZ, which owns the NZ Yellow Pages (2% of the Fund). Like other yellow pages businesses, it has been losing revenue at 20-25% pa for a long time and continues to do so. Everyone in the industry expects the yellow pages books will cease publication in a few years. Even so, we have made and continue to make good returns from investing in Yellow.

Successful investing in declining industries has three key requirements:

1) <u>A sufficiently low purchase price.</u>
2) A great management team who recognise the realities of their industry (Tracey Taylor and the team at Yellow NZ comfortably satisfy this requirement).
3) Discipline in paying cash flow to shareholders. Managers of declining businesses are often tempted to invest shareholders' money in new projects, however fanciful, in the hope of keeping their jobs going for a few more years.

Many people in the oil industry will not welcome their industry's outlook being compared to the yellow pages, but a change of mindset from expansion to managed decline is essential for the industry and its shareholders. We expect that the oil and gas industry will offer us more attractive opportunities and we will continue to encourage rational capital allocation among the companies in which we invest.

How we see our role

We want unitholders to understand how we manage your capital. When thinking about the assets we hold in the Fund, we do not think of our role as running a traditional fund.

Instead, we think of ourselves as running a family office with a long-term investment horizon. We think of our employer as highly averse to any risk that could severely reduce their net worth. They are rational risk takers, smart enough to accept moderate losses on individual trades, provided the odds on the trade are highly advantageous. Our employer is also willing to have a large proportion of their net worth in one security, provided the downside is small and the upside large. They will accept a bumpier ride, provided that, overall, it is likely to make them a lot richer.

We do not see ourselves as takeover raiders, but if the opportunity arises to buy control of a company on incredibly attractive terms, we are open to having a large proportion of the Fund in such an asset.

Our views on these matters are significantly influenced by the fact that we all continue to have a high proportion of our own net worth invested in the Fund. Unlike many fund managers, our interests are aligned with our unitholders.

Changes at Samuel Terry Asset Management

Ouafaa Karim joined the company as Chief Operating Officer in September 2020. Prior to her arrival, our business had outgrown its operational capacity. As well as improving our day-to-day activities, Ouafaa has enabled us to participate in more complex transactions, such as the Diamond Offshore recapitalisation, which we would have struggled to execute without her assistance.

In August 2021, **Mitch Taylor** became a shareholder in Samuel Terry Asset Management. This promotion is recognition of the great work he has done for our unitholders since he joined the firm in 2017. We look forward to him contributing good results for many more years.

In July 2021, we decided to soft-close the fund to new applications, including from existing investors. This decision does not affect the rights of unitholders to redeem part or all of their investment in the Fund. The reason we did this is that we do not want the Fund to grow beyond the optimal size for our capacity to run it well. We prefer to grow slowly, consistent with our increase in capacity.

Our Fund now has over A$400m of assets. That size precludes us from viably trading in some of the small, illiquid positions in which we have previously made money. On the other hand, our larger size opens new opportunities that were not previously accessible to us. These include:

- Buying distressed bank debt
- Taking control of companies, as we did with the NZ Yellow Pages
- Buying over-the-counter options and other similar instruments

We have a track record of making money in large companies as well as small ones. Furthermore, the increased size of our team enables us to manage more money than we did a few years ago.

Outlook

Most asset classes are expensive. Bonds, whether high quality government bonds, or junk bonds issued by highly-indebted companies, generally offer low returns that fail to compensate for the considerable risk to one's capital if interest rates rise or business conditions worsen.

Governments across most of the developed world run large deficits and have printed massive amounts of new money. Bondholders should be concerned that many countries, including Australia and the United States have lost any strong political constituency for sound government spending.

The combination of money printing and Covid-induced supply issues around the world is causing inflation to rise strongly for the first time in over two decades. Inflation expectations are rising quickly, yet bond yields remain remarkably low. Apart from Diamond, we own almost no bonds.

Most types of real estate in the English-speaking world are booming, spurred on by low interest rates, massive money-printing and fear of missing out. In Australia and globally, share prices are generally at close to record levels. The public seems to be extrapolating the tremendous gains of the recent past into the future, We see many signs of speculative enthusiasm in parts of the equity and real estate markets, as well as crypto assets.

We currently have 21% of the Fund in cash. With inflation looming and all these “easy profits” being made, you may wonder why we hold so much cash. The main reason is we want to be prepared to “go shopping” when markets are next “on sale”. As interest rates on cash are close to zero, a large cash weighting will continue to harm our short-term returns. We regard this as a price worth paying to have the ability to “go shopping” when no one else is willing or able to do so. Apart from inflation, cash has no downside risk, but large upside potential when tough times return.

We are comfortable with the current portfolio and optimistic about our continued ability to generate attractive returns.

We thank you for your continuing support.

Fred Woollard, Nigel Burgess and Mitch Taylor.

29 October 2021