



Death of value...ation

Alvia Asset Partners Investment Team Insights
Quarterly Update - June 2020



Introduction

I am sure we can all agree that 2020 has been truly unique and certainly not for the faint hearted! Investing is never easy and when your perception takes you to a place where you believe it is – it is probably a great time to reflect and take some profits as dismay is around the corner. Assume someone told you that the US unemployment rate would go from 3.5% in January to circa 14.5% in April and then they asked you to predict how the share market would look, what would you genuinely predict? Down 40 maybe 50%? I dare say your prediction would be much more dire than the resulting 0% outcome. As I said, truly unique.

With all being said, we remain very concerned about pockets of extreme market exuberance and we firmly believe in being very active in times like these – this is not the time in our opinion to own indices. The more we read about the '*death of old valuation methods*', i.e. using future cash flows to scrutinise an opportunity in the context of a margin of safety – we get nervous. In our opinion, all assets should be valued on the basis of their future streams of cash flow, discounted for the risk around those cash flows. We do not believe in valuing anything based on the strength of a narrative, revenue growth or a charismatic leader.

We simply try to value all things on the basis of future cash flows over 5 to 10 years and in doing this we avoid a lot of potential disasters. Good investing tends to flow over the long term to those that position themselves with a degree of margin in their favour to ensure with the benefit of time that good valuation work can be realised. Buying good assets at reasonable prices when the short-term emotions get the better of the masses enables patience to outdo IQ.



Buffett or the Fed

Whilst we hold some cash opportunistically, we will not broadly attempt to predict the behaviour of markets and many including us are somewhat astounded by the intensity of the recovery from the bottom of 23rd of March. It is a futile exercise to attempt to time exits and entries into the market. Cash only allows our opportunistic flexibility, which we are hopeful can be exercised in quality opportunities that Mr Market gets short-term anxiety with. This time around even Warren Buffett, who has taken advantage of every historical market crisis ignored his own advice and sat this one out and it's our guess that he didn't quite anticipate the breadth of the Fed 'at all cost' mentality.

Robinhood 'investors' lead the way

There are plenty of bearish arguments out there and we are certainly conscious and wary of them all (**Tesla pricing at \$1,700 without any real earnings is certainly one of them as it points to irrationality**) but I am going to try to be bullish to counter balance – we always try to remain somewhat neutral. We are at extreme levels of cash in the system with record cash level weightings across a number of institutional equity funds. Bonds as an asset class have seen huge inflows despite their dismal return propositions. The Fed is a very difficult counterpart to argue against and almost all bull markets have historically begun with the cutting of rates and almost every bear market has begun with the raising of rates. It is simply very difficult to contemplate interest rate increases in the current market with the extent of new debt in the system and the extent of COVID related uncertainty.

Main Street does not equal Wall Street and it never has

There has and always will be a disconnect between the actual economy and the share market.

The actual correlation coefficient between annual GDP growth and the share market from 1930 to 2019 is 0.09, meaning there is almost no correlation whatsoever. Therefore, the next time you read a fund manager quoting GDP growth as a reason to invest – you know what to say.



Investment learnings from this crisis

Every single time markets fall, people will bring up the 1930's and talk about 80% drawdowns (they will always use charts showing the current sell down against a chart from the 1930's).



Every bear market and every recession have unique aspects which make everyone think the current situation is much worse than ever before.

People will sell and look for bottoms that never materialise.

Most importantly, 'experts' will advise that you should wait for clarity - this will be the most expensive advice you will ever source.



Wirecard and another corporate governance failure

Here is our checklist internally that we use to avoid disasters – fingers crossed it has worked for us so far:

- A very salesy, media savvy CEO (we call them “glossy CEOs”) – actively seeks publicity and is always in the news. We love the CEOs that you never hear from, such as David Teoh of TPG, a portfolio company of ours. Simon M of Mayfair 101 is a good example of one to avoid.
- Senior exec compensation tied to actual earnings or return metrics and not tied to share price or sales – package well out of line with peers.
- Avoiding overly optimistic projections inside and outside the business.
- Question marks over product quality once you dig beneath the surface.
- Big build-up of (non-cash) receivables – when it does not make sense... this is a big one.
- Suppliers not being paid on time.
- Margin irregularities that do not make sense – i.e. S&G going down as business grows or interest expense remaining flat as debt builds. Similarly, interest revenue not aligning with cash reported.
- An overall appetite for aggressive debt profile.
- Turnover in legal, finance and HR or audit.
- Dismissive of ‘hedge funds’ or short theses.
- Messiah type CEOs that overuse Twitter to build a following.
- Continuous loss making or just borderline adjusted Non-GAAP profits. Eventual profits continually pushed out to the future.
- Non-GAAP use with addbacks that are real ongoing costs.
- Weak board makeup – or just CEO associates.

We can think of one large listed entity that ticks all these red flags which in our opinion makes it completely un-investable.



Be wary of headlines of over-valuation as beneath the surface it is different

At time of writing the S&P 500 is down only 4% year-to-date, which according to many investors is not reflecting the impact of the COVID-19 crisis.

However if you exclude Amazon (we don't own), Google (we don't own), **Facebook (we own)**, Microsoft (we don't own), **Apple (we own)**, **Berkshire Hathaway (we own)**, Johnson and Johnson (we don't own), Procter and Gamble (we don't own) and UnitedHealth (we don't own), the market would actually be down 10%.

<u>Company</u>	<u>YTD return</u>	<u>YTD impact on S&P 500</u>
Microsoft	30,79%	1,86%
Apple	23,99%	1,37%
Amazon.com	56,42%	2,64%
Google	9,75%	0,33%
Facebook	13,72%	0,30%
Johnson & Johnson	-3,36%	-0,05%
Berkshire	-21,21%	-0,28%
Visa	4,14%	0,05%
Procter & Gamble	-3,22%	-0,04%
UnitedHealth Group	1,46%	0,02%
		6,20%

Source: Robbe Delaet, Seeking Alpha



Further to this the high valuation is largely driven by the big 10

Interestingly, the high stock market **price to earnings ratio of 21.37x** is a lot lower if we exclude the biggest companies which on average are not impacted by the crisis.

The other 490 S&P 500 companies are valued at a **P/E ratio of 16.93x**, which is more in-line with historical averages.

This does provide us with some comfort that active management has a big piece to play over the coming years.

<u>Company</u>	<u>P/E ratio</u>
Microsoft	40.36
Apple	30.42
Amazon.com	138.03
Google	29.38
Facebook	31.76
Johnson & Johnson	21.66
Berkshire	43.56
Visa	35.19
Procter & Gamble	29.41
UnitedHealth Group	20.57
Other 490 companies	16.93

Source: Robbe Delaet, Seeking Alpha

Big 5 vs 495

Breaking it down even further, the 495 (i.e. 78% of the index) could not get anywhere near the big 5 – see below.

Big 5 vs. Other 495	Q2 performance	% of S&P 500
Microsoft	27.0%	6.0%
Apple	43.2%	5.8%
Amazon	40.4%	4.5%
Alphabet A&C	23.3%	3.3%
Facebook	36.8%	2.1%
Other 495	17%	78.3%

Source: Robbe Delaet, Seeking Alpha



Berkshire watch

Berkshire recently made its first big acquisition in a long while, spending circa \$10bn cash and debt on Dominion Energy's natural gas transmission assets. It is right out of the BRK play book – acquiring regulated, monopolistic type assets in a well out of favour segment of the market. Unappreciated, stable assets that Buffett and his investment confidants understand well. Buffett paid a touch more than we expected at 10x and only time will tell if this was a 'fair' or 'wonderful' price.

Q2 global craziness

There is a long list of craziness that we have witnessed this quarter but some of the best would be:

- Zoom, the new flavour of the month, trading at a \$72bn market cap with \$800m in revenue last year (no earnings);
- Shopify with \$1.7bn in revenue (no earnings) with a market value of \$107bn;
- Virgin Galactic with no revenue and some prototypes priced at \$3bn (was \$7bn); and the best of all time:
- Nikola (with nothing but a car concept on paper) trading at \$23bn – that is the size of Ford Motor Company.

Suffice to say we find it hard to see investors (aka gamblers) seeing returns on these price points.

Why sell side research is dangerous

*2nd July: Citibank release gushing report on **Afterpay** with massively upgraded price target (\$27.10 up to \$64.25!!!) & big EBITDA/margin growth.*

7th July: Citi on ticket to raise \$1bn in various ways (with a \$250m sell-down from the founders). Absolutely no connection whatsoever.



US election is coming even if we are distracted

What PredictIt is saying about the upcoming election:

- Joe Biden is **93% likely** to be the Democratic nominee and **61% likely** to be our next President
- Donald Trump is **91% likely** to be the Republican nominee and **41% likely** to be our next President
- Democrats are **62% likely** to retain control of the House *and* win control of the Senate

Why as investors it is important to track:

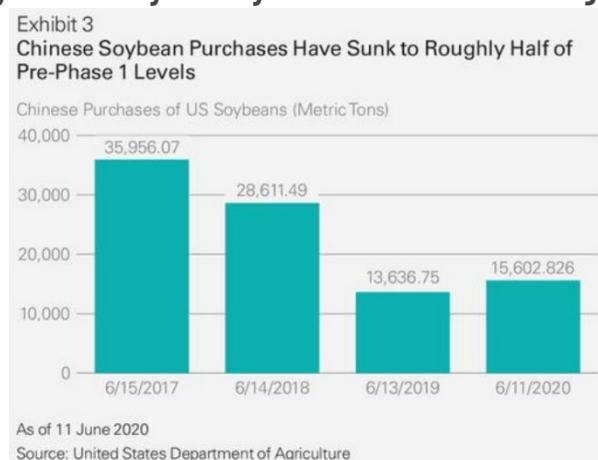
A Biden presidency will certainly mean a less business friendly environment with increased levels of corporate taxation, which is a clear negative for earnings.

After months of fixating on the pandemic, Wall Street has something new to worry about: a possible Biden presidency. The closer we get to a Biden victory the more investors will start fixating on the earnings downgrades.

Goldman Sachs have a Biden presidency at a 12% hit to earnings. However, this needs to be considered against the fact that he will likely be a steadier hand than Mr Trump, which would negate potential fears of increased US/Chinese tensions. Overall, we think we would take earnings hit to avert another round of tariff conversations.

"A Biden presidency would result in less trade tension with China, which would be a welcome relief for equity investors," economists at BCA Research wrote.

You can see from the below chart that despite a Phase 1 trade deal, the relationship between the US and China symbolised by the Soybean trade is not as strong as it once was.



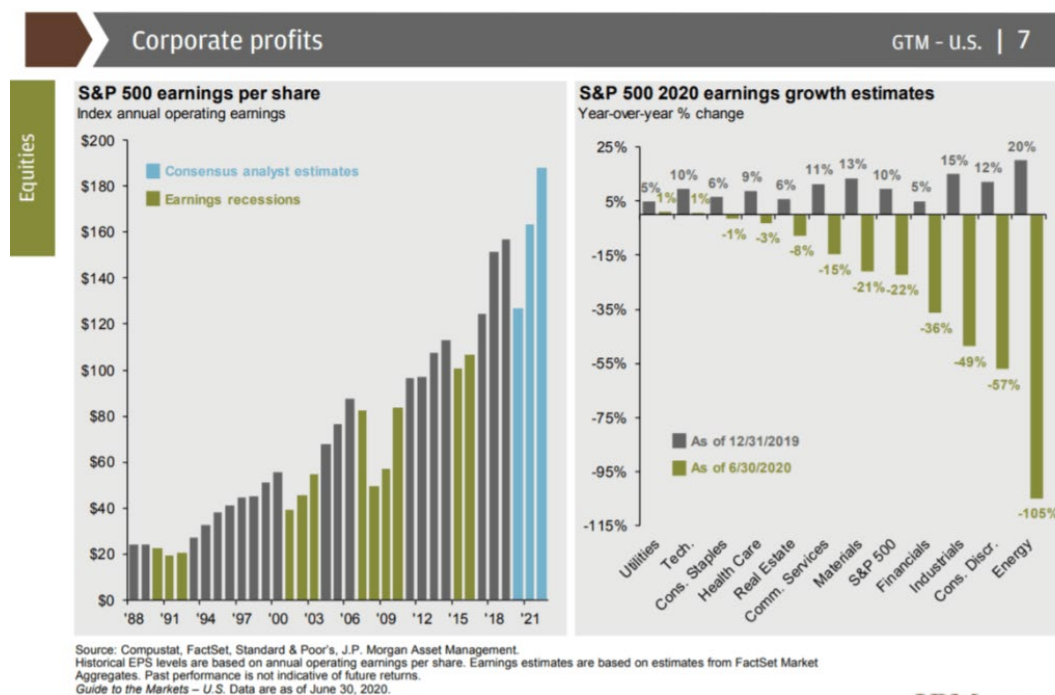


Let's talk about the 'E'

It's apparent that analysts have been forced to drastically shift their estimates for 2020 but it is really 2021 and beyond that matters. It is apparent that the market is prepared to now completely look through 2020.

It will be interesting to see if the retail investing community will be prepared to look through the nasty results to come through later this year without reacting and extrapolating.

We are looking at a number of strategic monopoly airports as we speak and reviewing revenue declines in excess of 80% and it is hard viewing.



Source: JP Morgan Asset Management



Technology at all costs

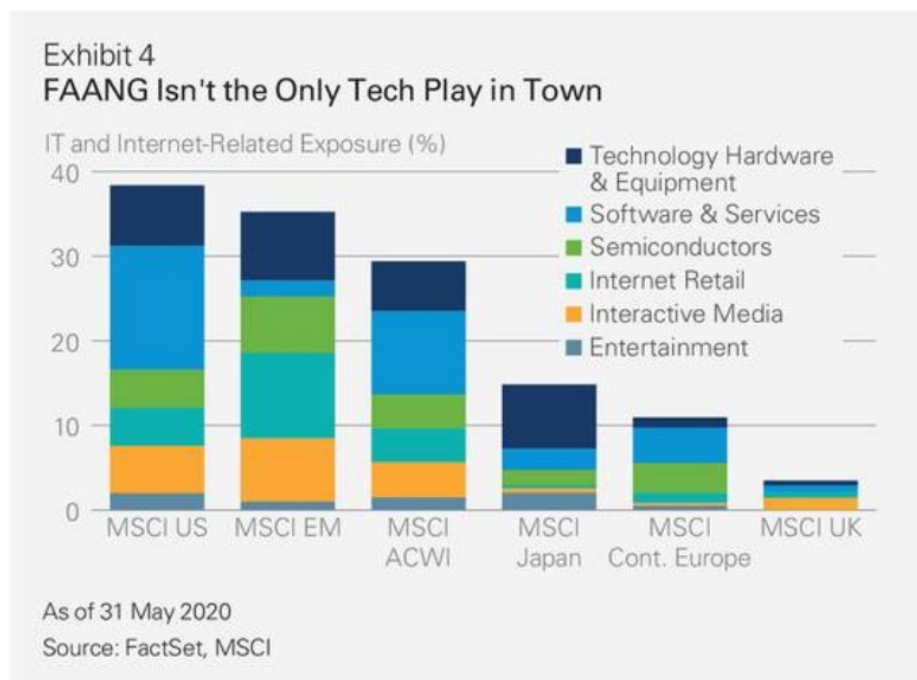
Its apparent that **FAANG** stocks aren't the only stocks driving the technology sector worldwide (see below). It is well and truly a loved thematic and whilst we love technology and the productivity it enables for all business, it is not the only game in town nor will it ever be.

If you only look back to the 1950s, chemicals were the only game in town. Every business requires an element of technology - **technology is not a synonym for a SaaS business**.

Facebook used technology to enable social interaction as does Apple use technology to enable efficient manufacturing. As does Barclays to effectively measure risk data about its loan book.

It is important sometimes to contemplate overall market trends. Phil Fisher, a brilliant investor says it beautifully. You will not believe it but chemicals were all the rage of the 50's – it is hard to find a big thematic support for chemicals today.

"There are fads and styles in the stock market just as there are in our clothes."



Source: FactSet



The Novel Coronavirus

Whilst we would like to avoid rewriting about COVID given it has all been written and argued about, it's impossible not to at the moment.

The below charts from the CDC and Deutsche bank are certainly interesting and likely point to the reasoning behind a reducing death rate as more youth flock to the streets and the elderly stay home. **More cases and less deaths.**

It is becoming more apparent that it clearly is very contagious and very much a threat to an older demographic and those with existing health conditions.

A comparison to the 1918 flu highlights this clearly and also shows why it is very important to protect our elderly.

Figure 1: Deaths from Covid-19 have seen a much larger skew by age compared to pneumonia and influenza deaths in 1918 at the time of the Spanish flu

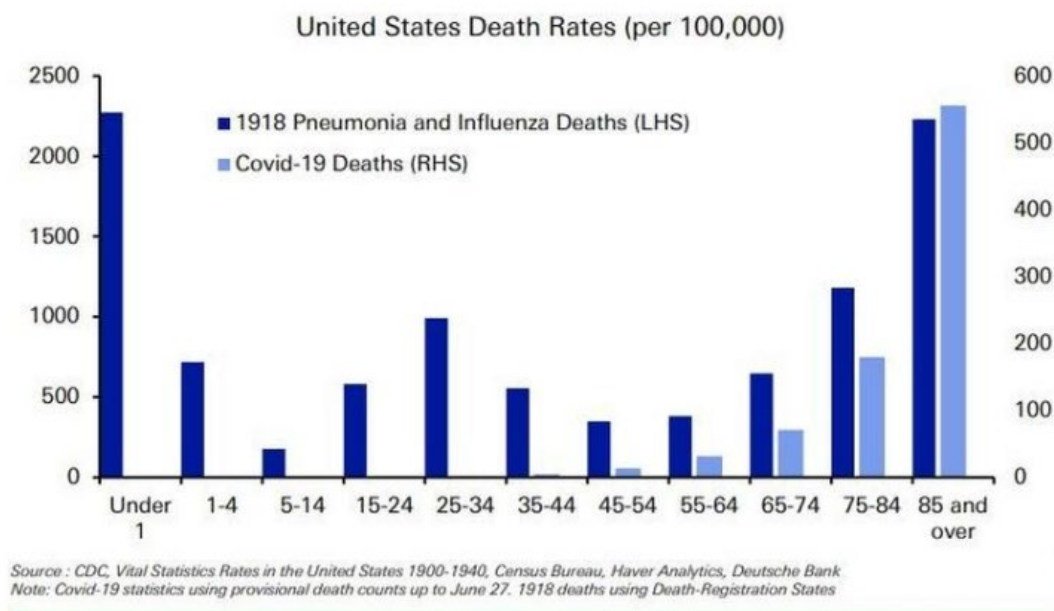
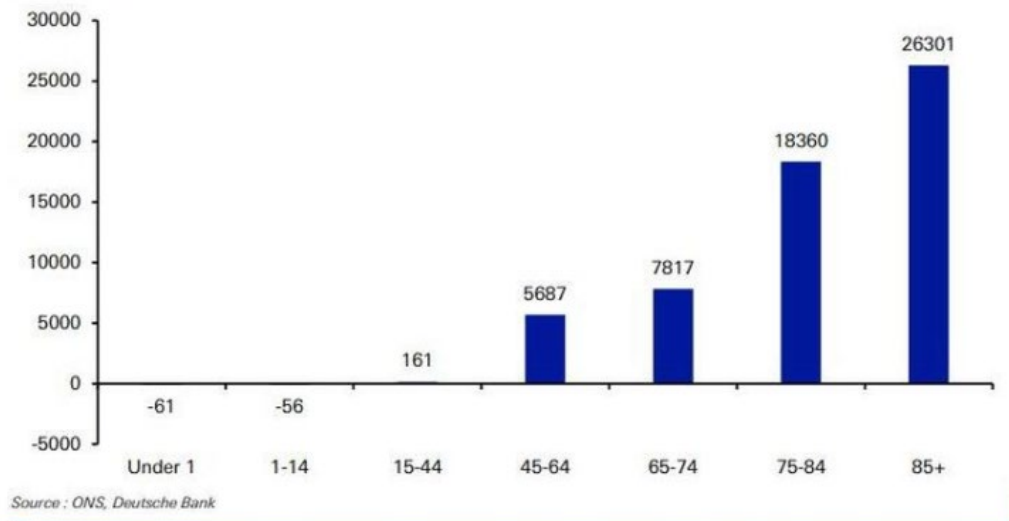




Figure 1: 2020 Excess Deaths in England and Wales during the pandemic compared to the prior 5-year average



Bonds helped but not enough in Q1

Historically bonds shelter an investment portfolio during a crisis, however we were surprised at the extent of some drawdowns in the bond market during February and March.

It is apparent that cash was the only point of stability during Q1.

See below US shares (on the left) and global investment debt declining down more than 10% and US high yield more than 20%.





Lessons from the Nifty 50 days

Given the strength of the big 5 and their respective quality we wanted to test the buy at any price philosophy.

Fun fact 1: If a stock is trading at 71x and it compounded earnings at 13% for the next ten years (something less than 1 in 1 million companies can actually achieve) it would only then trade at the market multiple of circa 21x in 2030.

Fun fact 2: Quality is super important but so is the price paid.

Fun fact 3: Stocks go up most of the time because the economy grows most of the time, about 70% for both time series. So, if you knew nothing else and someone asked what the chances were that stocks would be higher in any given year, the answer would be 70%+.

Digging deeper into Berkshire's purchase of energy assets

From time to time throughout market cycles segments get thrown in the bin in their entirety. When everyone runs across to one side of the boat, we all know what happens.

It is apparent that on the whole natural resources fit firmly in this category.

I challenge you to find a bull on oil – it is a hard slog, finding somebody to speak positively for energy.

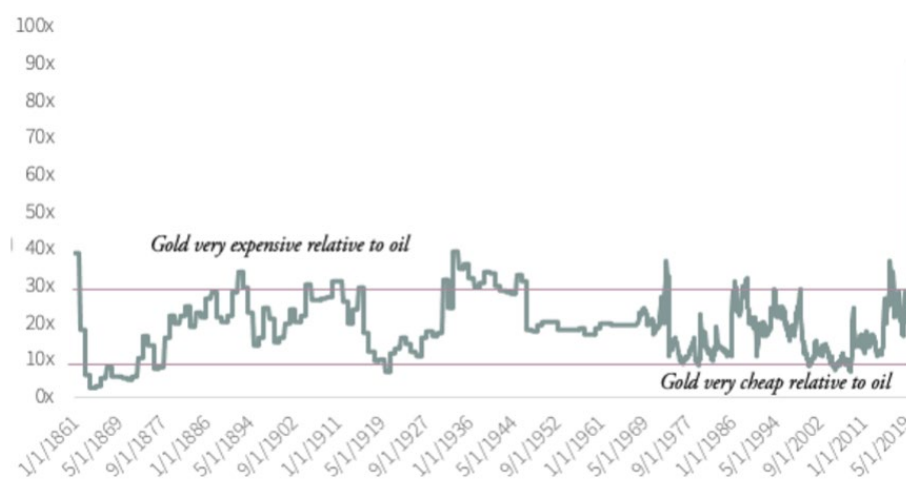
The charts below clearly articulate this imbalance – either gold is very expensive, or oil is very inexpensive.

This ratio is at unprecedented levels and either the gold falls or the oil price increases, or both.

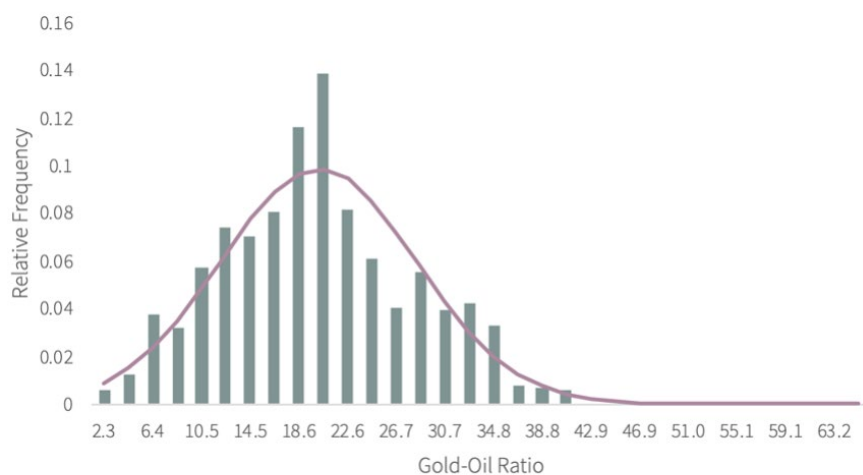
The below paints a clear picture around the logic behind Berkshire's acquisition of natural gas assets in Q2.



Gold-Oil Ratio 1860-2020



Distribution of Gold-Oil Ratio 1860-Present





Elon... enough said

If the below is not a bright red governance flag than I will eat my Tesla short shorts...

It is never wise to taunt your regulator – perhaps not so crudely either.

Add in a tripling of share price within a year, making it the most valuable automaker despite producing less than 5% of the cars that Toyota does.



Buffett v the Fed – think in cash flows

We certainly found it interesting that Berkshire did not deploy capital into this recent market sell-off – it is apparent that perhaps the velocity and the extent of the Fed's response this time distorted their normal approach.

We dug a bit deeper to review Berkshire's response in the eyes of such drawdown events and it is apparent that this is the first time Buffett was not active – which is somewhat strange. We are of the view given his recent share repurchases that it just reverted too quickly.

In the downturn of 1973, he raised debt at Berkshire to give him more fire power.

Several of his initial stock purchases continue to fall a further 50%, including his initial purchases of The Washington Post, as the market continued to crater.

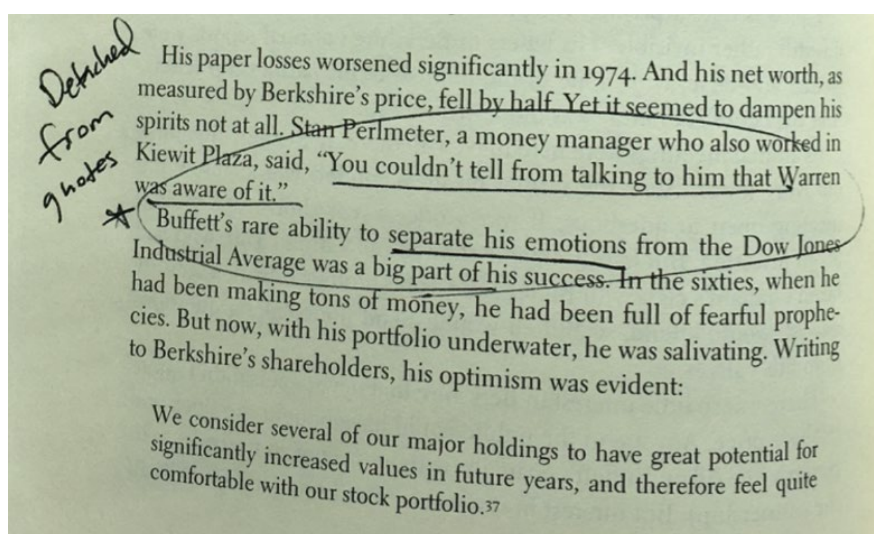
Berkshire Hathaway itself fell by more than half.

See below – he was not flustered at all, with a determination to think of cash flows beyond the crisis.



Buffett was simply buying stocks of businesses that he felt would be earning good money five years down the road. And when the market offered him cheaper prices, he was happy to take advantage.

This lesson remains to think of stocks as cash flow streams from businesses, and those cash flows come in over time.



Source: The Warren Buffett Way

Today is not different

Businesses will look horrible this earnings season but the intrinsic value of a business isn't measured on the cash flows generated this year, rather an aggregation of future year cash flows.

What is most important however is stress testing all businesses to ensure your businesses can survive long enough to realise your future cash flow assumptions.



Every Crisis Seems Unique

In **1973-74** it was an unprecedented spike in inflation combined with a brutal high unemployment rate. This so-called stagflation led people to become miserable.

In **1987** people thought the financial markets would crash the economy into a depression.

In **2008** it was a housing collapse and people thought the banking system would cause a depression.

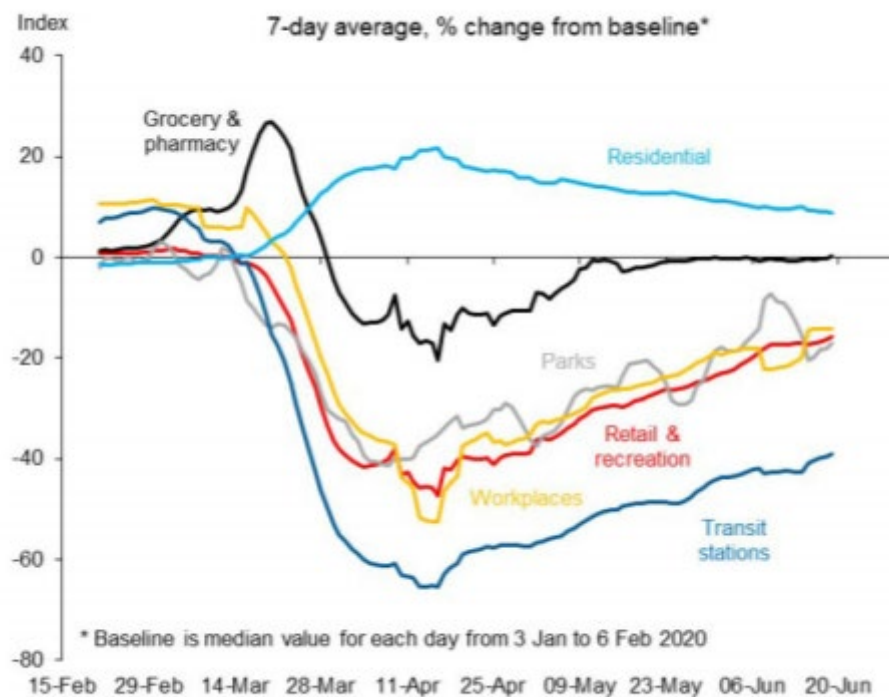
As referenced earlier – every single crisis seems like the end but do not let this take control of your investing (cash flow first) mindset.

Bull Vs Bear

Bull 1.

Despite the concerns around 2nd and 3rd waves the trend is upwards.

Google mobility trends - Australia



Source: Google, Macquarie Macro Strategy

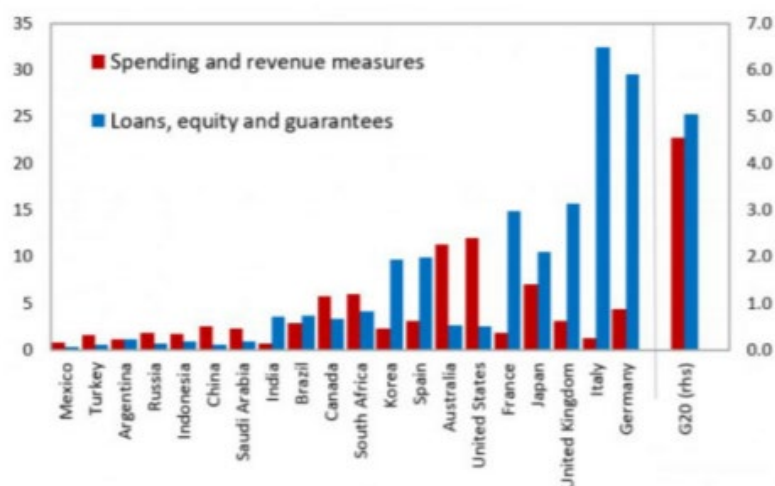


Bull 2.

The stimulus is significant and unprecedented in size.

Looking at the US in isolation, the stimulus is looking like 14% of GDP versus a potential negative 10% GDP outcome – that is an excess of 4% in the system in the US alone.

Announced fiscal measures in G20 economies, % of GDP



Source: National authorities; and IMF staff estimate as of May 13, 2020



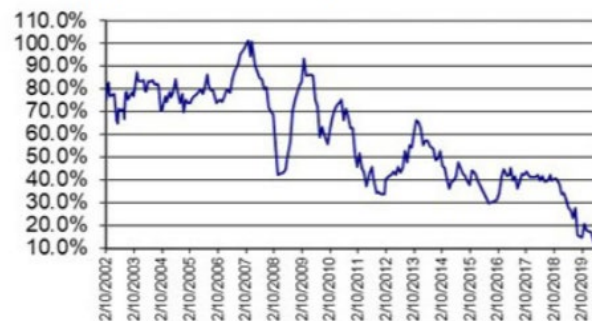
Bull 3.

Investors simply have no choice but to approach the equity market for yield.

All institutional investors worldwide have been forced to increase equity weightings to the detriment of fixed income (bonds).

See below from DNR Capital – earnings yields on shares versus bond yields are about as wide as we have seen in history.

Earnings yields versus bond yields



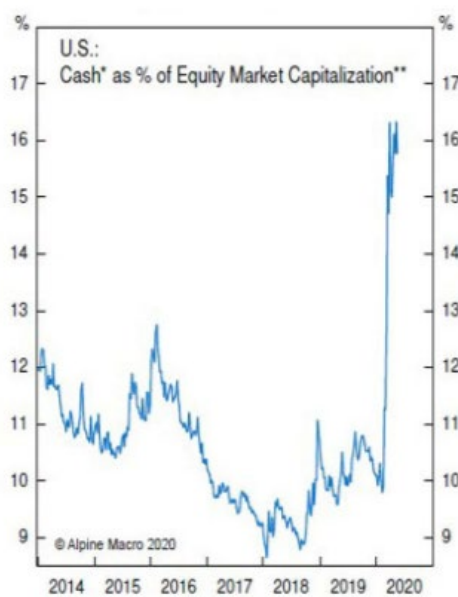
Source: DNR Capital

Bull 4.

Cash levels in the system are at unprecedented levels

Institutions are holding cash looking for another crash on Wave 2 or 3.

Cash as % of equity market capitalisation



*Institutional and retail money funds
**MSCI U.S. IMI Index

Source: Alpine Macro



Bear 1.

We are certainly going to need to deal with the prospect of a second wave and what it means for the world – many nations are still struggling to flatten their curves from round 1 and the US situation looks horrible.

Bear 2.

The US election which is pointing towards a Biden victory (however, polls are semi useless these days). This could result in a Democratic upper and lower house and likely corporate tax hikes as well as an increase to the highest marginal tax rate for individuals. A Trump victory, however, as mentioned, also poses a risk from the basis of an undermining of globalisation and a lack of sovereign diplomacy.

Bear 3.

Just overall geopolitical uncertainty – its without doubt that a number of geopolitical dashboards are blinking red. China's security law changes in Hong Kong will have significant flow on effects as will the weakening of Chinese-Indian relations over their borders...

Bear 4.

Social unrest relating to a wealth gap that continues to widen – record low interest rates equates to higher asset prices for the wealthy (continuing on from the 2010's). Add in a virus that has disproportionately impacted the less fortunate and it spells social unrest and increased pressure to tax aggressively.



Investment Update

The investment team used the market strength to reduce some Australian and international equities positions, which has increased our cash weights in both portfolios into the 10% to 15% range.

Alternatives

The investment team exited the portfolio's position in **BetaShares Agriculture ETF (ASX:QAG)**. The investment team is currently reviewing two investment opportunities in the alternatives space which we feel are more attractive from a risk-return perspective.

Alternatives typically have a low or negative correlation to equities and equity-like securities, reducing the volatility of an investment portfolio's returns. Over the long-term, this can be highly beneficial for a portfolio as it can reduce its exposure to large drawdowns.

Private investment opportunities

The investment team continues to review a number of potential private investment opportunities. One of these in particular is a supermarket and retail centre located in the north coast region of New South Wales. We will be sure to be in contact if we decide to proceed with this investment.

Sale of our Cardioscan investment

In June, the Alvia investment team decided to take the opportunity to realise one of its private investments, Cardioscan.

The sale price represented a net IRR (internal rate of return) to investors of **20.22% or a 1.44x MoM** (multiple of money).

Established in 1984, Cardioscan is Australia's longest-standing, continuously-operating cardiac monitoring and reporting service, providing state-of-the-art cardiovascular reporting services for the medical community. In 2018, Alvia provided Cardioscan with growth capital to facilitate the acquisition of a US based business called 'CMS' and establish the process of a global expansion. Since 2018, Cardioscan has significantly expanded its global footprint, entering the US, UK and Asia. Alvia oversaw a change in management and the building out of a global sales team.



Our decision to exit was not an easy one. Cardioscan is a great business with promising long-term prospects, however given the current environment and resulting economic uncertainty we felt it was prudent to exit and return funds to investors. In line with our investment philosophy, the valuation at our exit price left little room for further upside, without assuming significant additional risk of execution for the remaining 3 years of the investment term.

Investment	Cardioscan
Website	https://cardioscan.co/
Structure	Syndicated Unit Trust
Vintage	2018
Term	3-5 Years (exited after 2 years)
Net Return (IRR)	20.22%
Money Multiple (MoM)	1.44x

Thought of the quarter

This quarter's quote comes from the father of value investing, Benjamin Graham. Fundamental, valuation-based investing is key to delivering sustainable, long-term investment returns. The market has a multitude of moods, which can ebb and flow daily. The best investors ignore the market noise and focus on a company's fundamentals.

"Buy not on optimism, but on arithmetic."

- Benjamin Graham

As always, if you have any questions, or would like to speak to us with regards to anything in this update or anything going on in markets here or abroad, please don't hesitate to give us a call, or send us an email.

All the best from the Alvia investment team.

Josh, James, Chris and Dan

