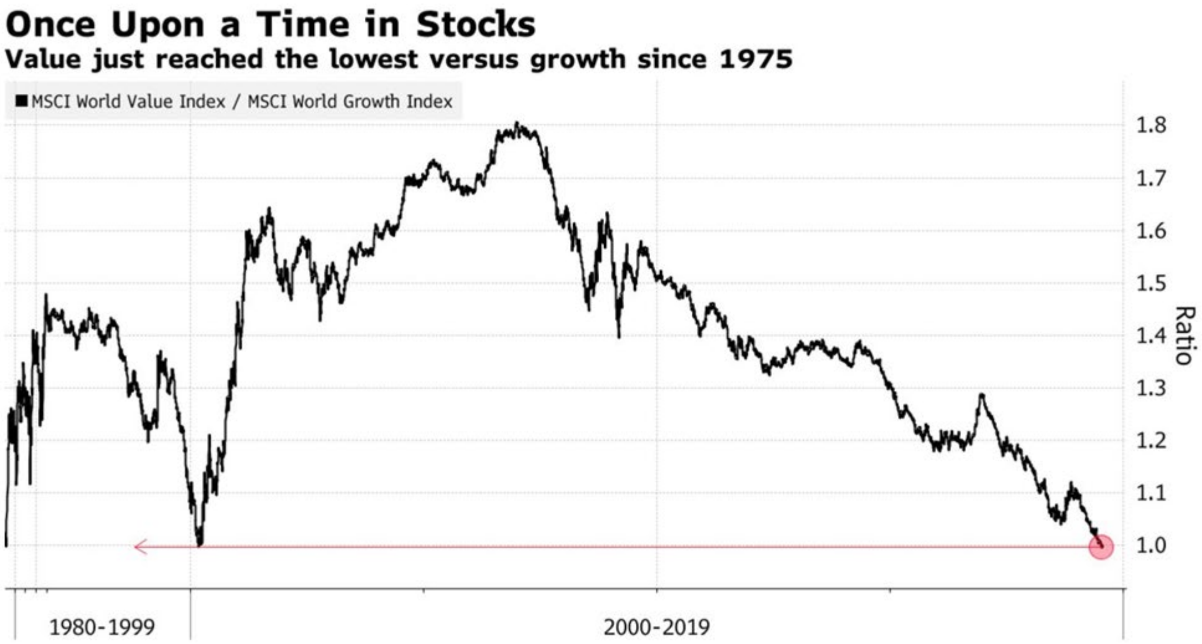
ALVIA

ASSET PARTNERS

Alvia Asset Partners Investment Team Insights

June 2019 Quarter

General Commentary



Source: Bloomberg

New norms?

William Bernstein said he'd been thinking about the question:

"What if the cost of capital never rises again?"

To ponder this is an interesting exercise but largely futile, there will always be a price for risk capital. However, it's a little terrifying to witness these conversations.

What's the real-world implication of this?

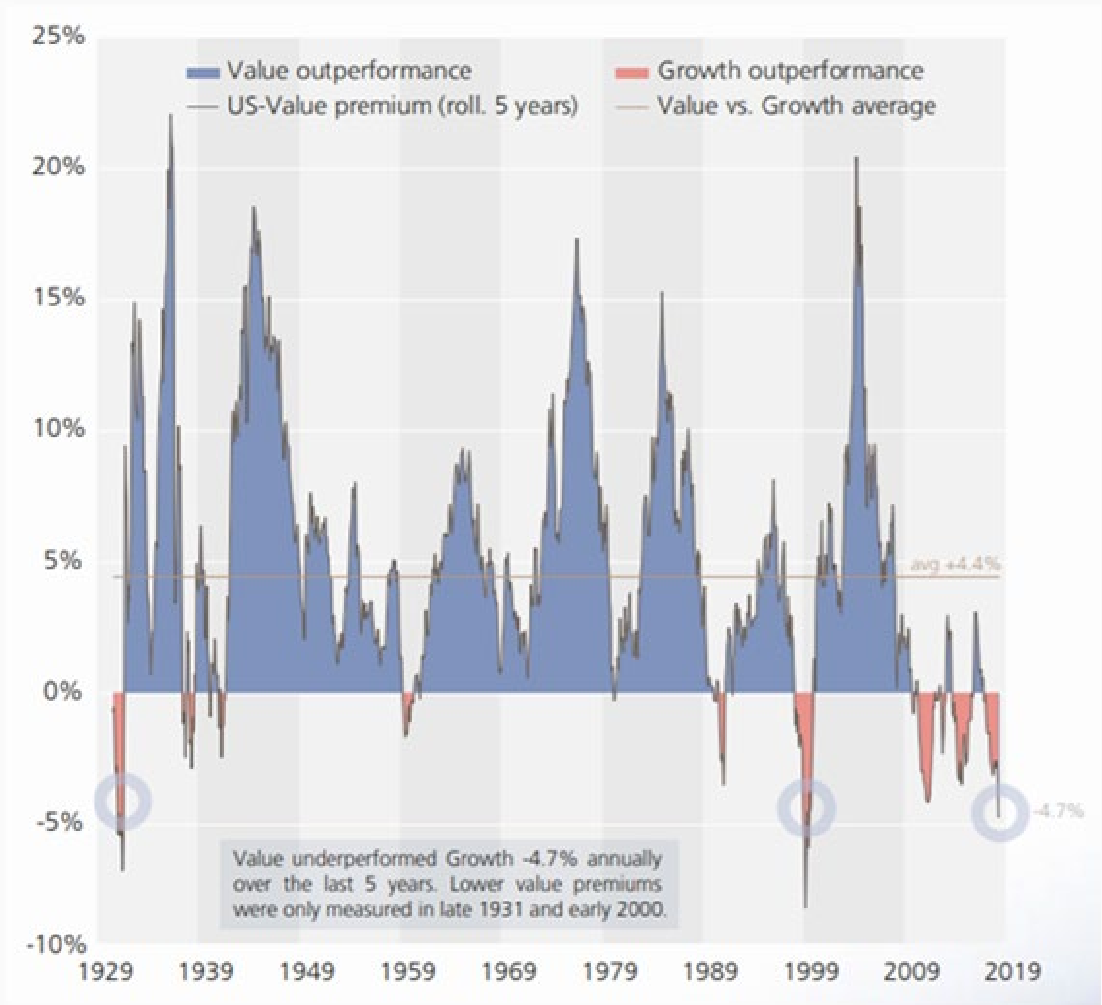
- Fundamentals start to be disregarded.
- Growth or "perceived" growth is bought indiscriminately.
- Asset values rise simply due to demand from capital.

What happens when this ease of capital stops...?

As you have seen above and below, the divergence between growth and value is at historical levels. We firmly believe this will not hold. In saying this, we don't have a crystal ball either.

Be aware of investors chasing returns. The below represents serious capital flows away from fundamental free cash flow assets to pitch deck story stocks (aka Beyond Meat – more about this later).

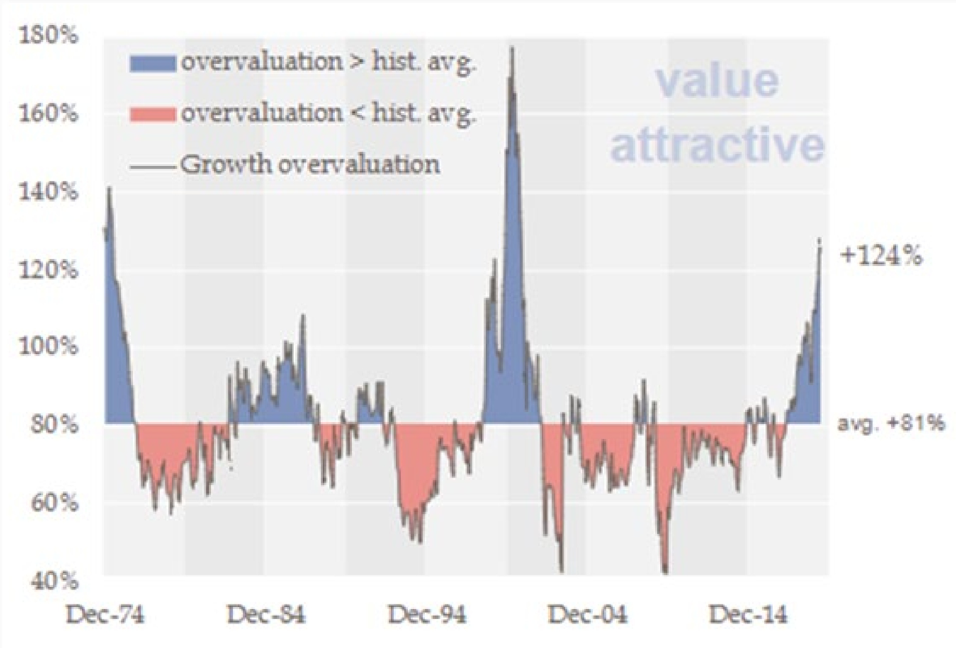
Figure 3: Rolling 5-Year Value vs. Growth Premium (HML) Since 1926



Source: StarCapital AG

This divergence is causing long-term focused funds to close and people to question the fundamentals of value investing. Does Warren Buffet know what he is doing? We have seen this before and hype is a nasty investing vice.

Figure 4: Growth vs. Value Valuation



Source: StarCapital AG

Aggressively challenge growth assumptions...

In summary, it's completely unrealistic to expect equity market growth in excess of economic growth into perpetuity... The above equates to a financial asset bubble and pockets of the market are beginning to appear bubbly.

Be brave: sack a growth manager and add an old boring value manager... you will thank us in 3-5 years.

Alvia's performance has suffered – still fine on an absolute basis but behind on a relative basis.

However, to be in front, our strategy would need to be the below:

We at Alvia Asset Partners buy the most expensive assets and add to them as they rise in price regardless of valuation...

Would you invest? Of course not.

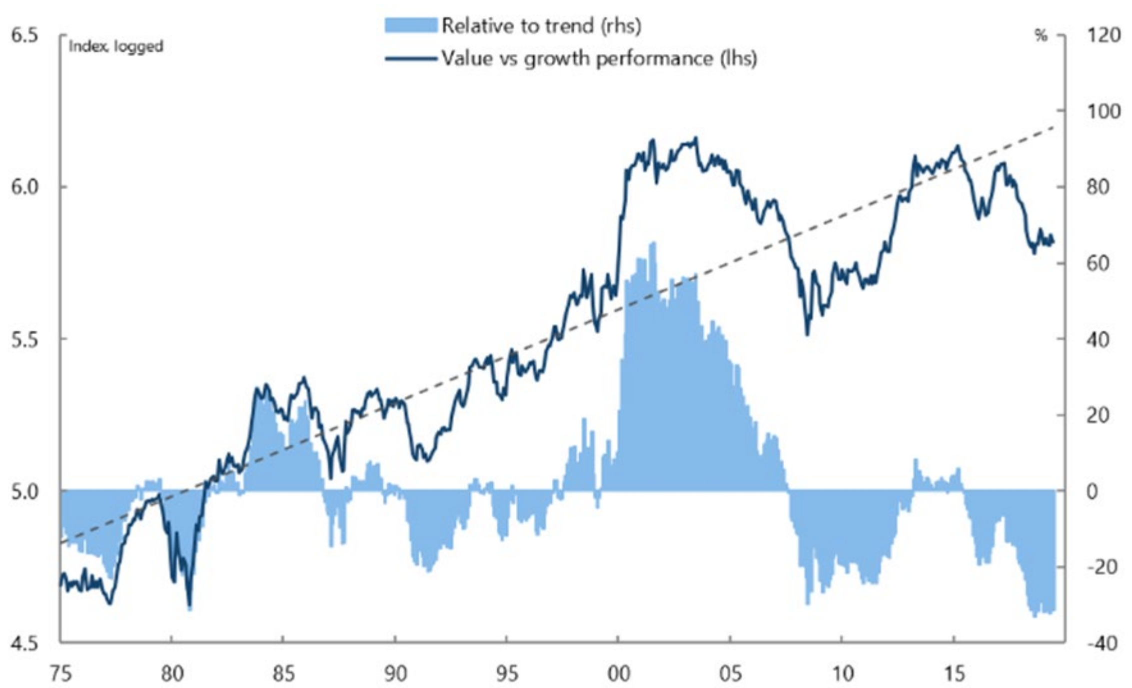
Ask yourself: why are we valuing businesses based on users and not free cash flow?

Do real assets not matter? Are intangibles worth multiples of 10 more than tangibles?

What we do know is that you can't eat relative returns and we are very comfortable holding real businesses/assets with real unsexy earnings that we can compound long into the future.

Fundamentals/valuation will matter at some point – we just can't tell you when.

Chart 1 MSCI Australia value relative to growth



Source: Deutsche Bank

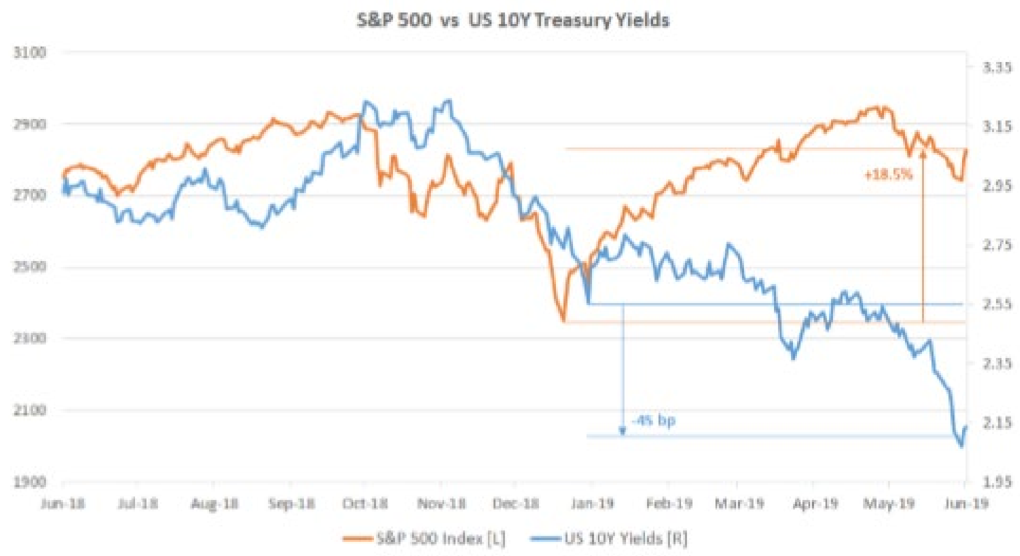
The Fed put (i.e. Fed floor) is real!

What's the big difference between the utter desperation of December 2019 and now?

It's the change in Fed tone and the market feeling like the Fed now has its back.
The market was simply worried about rate hikes increasing the base rate (discount rate) and now it's not. **That's it.**

See below the divergence between the 10-year rate and equities.

Thanks Mr Powell!



Source: EGMF, Bloomberg

Aussie backdrop – does it feel worthy of a 1.00% cash rate?

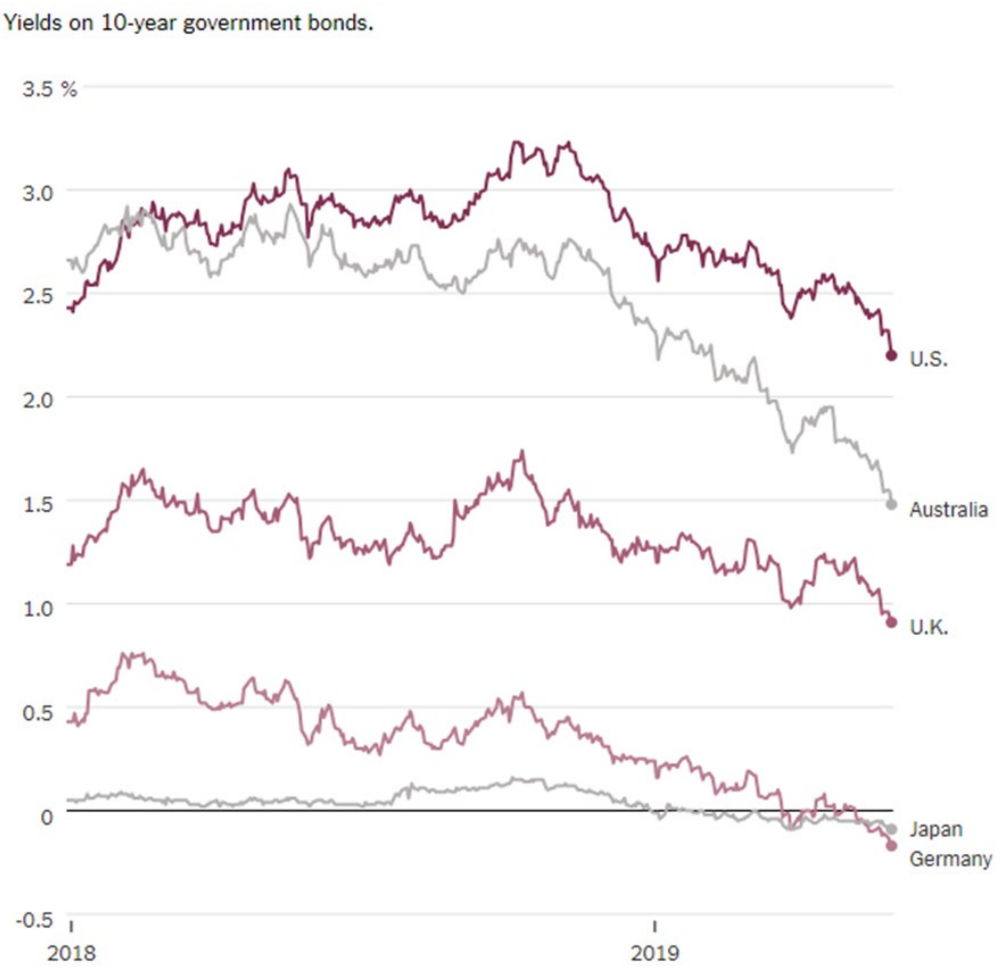
Quote from RBA minutes:

> *"more likely than not that a further easing in monetary policy would be appropriate in the period ahead".*

GDP growth did ease to 1.8% in Q1. However, we also saw a record trade surplus on the back of iron ore prices, and it's quite probable that we will see a fiscal surplus in 2019!

It's important to note that the RBA is playing a global relative game (see below) and simply cannot disregard the negative yields globally.

It's now being priced into bond yields that the US will be next to fall into the relative cycle.



Source: FactSet

Europe – Free money (good place to borrow)

- 10-year government bond yields in Italy have fallen to nearly 1.20% since mid-May. There is no way I would give the Italian government my money for 10 years at 1.20%.
- 10-year yields are now negative in Belgium, France, Austria, Finland and the Netherlands.
- Risk is not being priced effectively – with $13 Trillion (yes with a T) bonds with negative yields.
- **Greek 10-year bonds will pay you** 2%... in 2012 they were on **offer at 30%!**
- According to Bloomberg, in the global bond market, nearly 40% of all bonds are yielding less than 1%.

Value Managers

In good company

1. Geoff Wilson (Wilson Asset management)

- Blindsided by the Federal Reserve's U-turn on rates.
- His flagship $1.3 billion WAM Capital underperformed the S&P/ASX All Ordinaries Accumulation Index by 9 per cent in financial year 2019.
- It was only the third time in 20 years that WAM Capital had not beaten its benchmark.
- WAM Active, WAM Leaders and WAM Research also failed to beat their benchmarks for the year to June.
- Caught out by Fed U-turn
- Separate to the decline in the price of the Wilson LICs was the underperformance of several WAM investment portfolios.
- "Towards the latter part of last year, I was nervous about the quantitative tightening and its impact on the US economy and the flow on effect to price earnings ratios," he says.
- "The Fed was taking $US50 billion (A$71 billion) to $US60 billion (A$85 billion) a month out of the market through quantitative tightening and we have seen what happens to markets when liquidity is removed."

2. Hamish Douglas (Magellan)

- The Fed's abrupt U-turn six months ago turned night into day, down into up, bear into bull. As Magellan's Hamish Douglass put it in an interview:
- *"... the Fed completely changed the game and effectively says we're not going to have any more rate rises. I said to the team, it's like what Mike Tyson said: 'Everybody has a plan until you get punched in the mouth'."*
- *"...for businesses that are growing more strongly, we approach something that is known as a Petersburg paradox that as the growth rate starts approaching the discount rate, theoretically a business could be worth infinity on a net present value basis".*

- Well, it's a very important topic, where the level of long-term interest rates is a crucial element of judgement.
- Ultimately, as Warren Buffet describes, interest rates are the gravity of markets.
- The lower interest rates are, the higher valuations are; conversely, the higher interest rates, the lower valuations are.

A Brief History Lesson

Highest correlation to the 1930s (post-depression era)

1930s

- Post-depression
- High Indebtedness
- Interest rates cut to zero
- Gold rose as did commodities and stocks
- Wealth gap widened due to asset price inflation (faster than wages)
- Conflicts occurred as socialists and capitalists disputed 'trickle down' theory
- Populism grew as did trade barriers
- War occurred in 1939

Source: Ray Dalio

2010-Now = Reflation

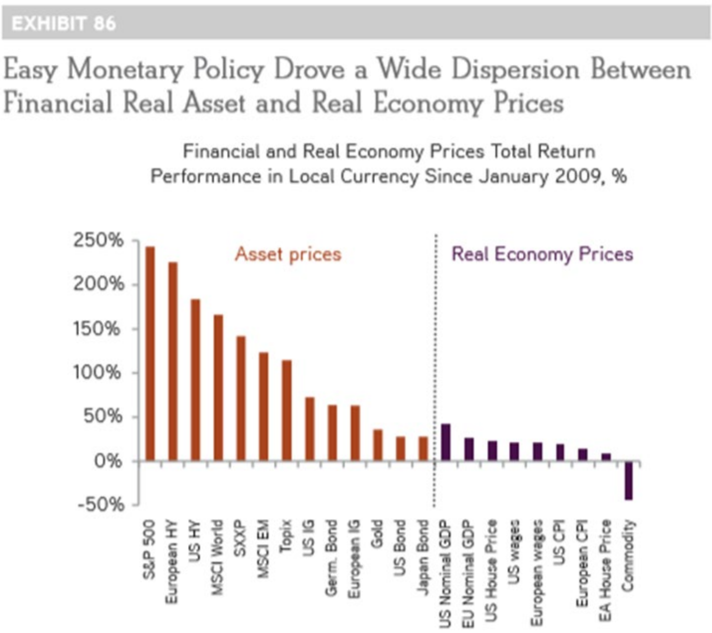
- Like the 1930s, with a close to zero interest rate environment causing very similar asset price inflation and social unrest.
- QE has taken it further making sovereign bonds largely un-investible
- This is creating a 'risk' curve movement – meaning the world is leveraged "long"
- Companies are flush with cash, gold and cash are portfolio underweights (as investors can't afford to hold them)
- The contrarian in us believes it's time to overweight value assets with real cash flows and alternatives (i.e. gold & commodities) with a healthy balance to cash

Income inequity is becoming an issue in the US & globally (see below)

Low interest rates benefit the rich exponentially more than the less fortunate and tensions will inevitably continue to rise as a result. The US election of 2020 **we believe** will be battled on these grounds.

Asset prices clearly outgrowing real economy = tension.

Source: Visual Capitalist



Source: Goldman Sachs

Hubris of the Quarter

Beyond (Meat) rationality

You may or may not have heard the story about Beyond Meat. It is effectively a vegan meat alternative company with first mover advantage. Now whether you believe in the story or not it's very difficult to ignore the fact that competition will intensify over time. First mover advantage does not equate to a moat. In fact, most of the time it puts a large target on one's head.

No rational investor can buy into the below, despite its top line growth

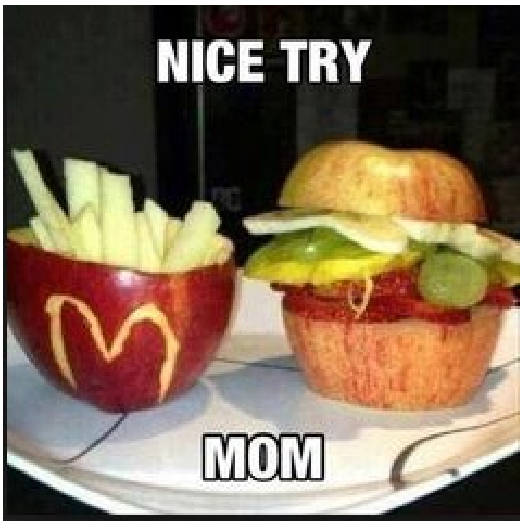
Current numbers:

- Revenues: $115m (growing strongly circa 50 %+)
- Operating margin: -21%
- Return on capital: -21.4%
- **Market cap: circa $10 Billion (yep)**

If we seriously stretch the assumptions

- Assume circa 60% top-line growth in years 1-5, 14% in years 6-10 and flatline at inflation beyond that.
- Assume operating margins improve to circa positive 13% (high by food manufacturing standards) by year 5.

The best case we come up with is an equity valuation of circa $3 Billion equating to a share price of circa $45. At the time of writing, Beyond Meat is trading for $202.92



Worry of The Quarter

Where is the greatest risk – in our humble opinion?

In similarity to 2000, it's the ability of venture capital to price risk.

> *'Today some tech investments have again produced great results, and the doubts seem to be gone. In investing, however, the truth usually lies somewhere between the extremes of infinite value and worthlessness.'*

Source: Howard Marks

Unlisted risk is starting to rear its head.

This is our number one risk (aside from unfunded pensions).

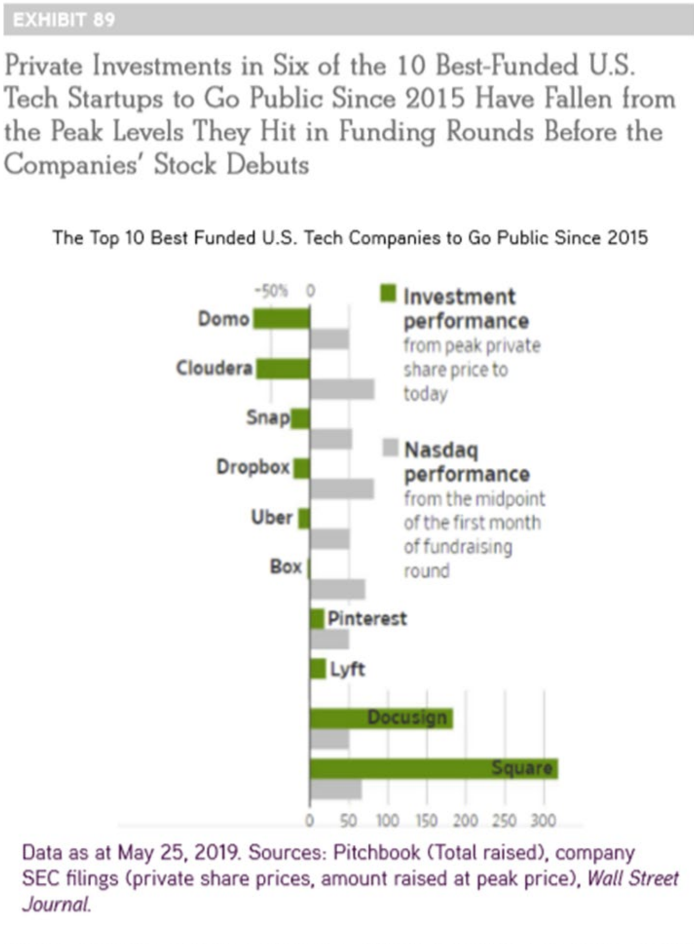
The extent of easy money that has poured into unproven ventures without any true rigour around valuation poses significant risk to all markets, in the event of a crisis of liquidity.

This lack of valuation rigor is beginning to translate to public markets as these ventures list.

See to the side, 6 of the 10 best funded US tech start-ups now trade below their last private funding round capitalisation.

Remember this is in a pretty buoyant market – imagine a fearful one.

Moral of the story – valuations and liquidity matters – it always will.



Source: KKR

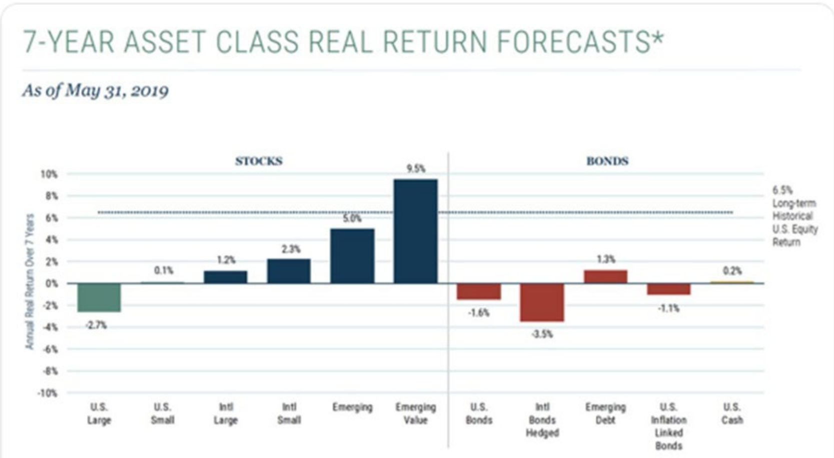
Asset Allocation

Time to be brave?

GMO and KKR continue to promote emerging market value and we tend to agree, despite it holding back our returns this year.

It's time to be brave and take some US profits and reallocate to emerging markets.

GMO's latest 7-year asset class real return forecasts:

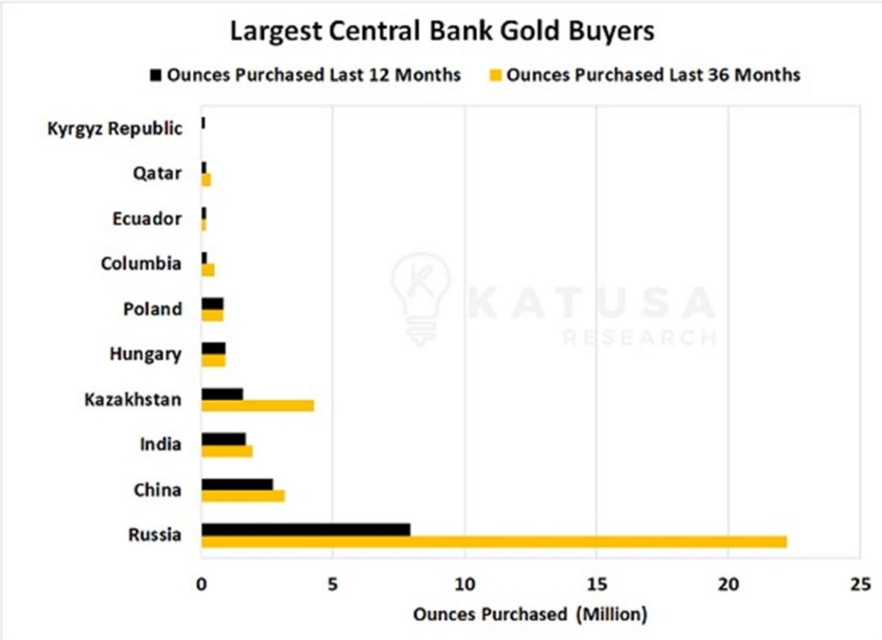


Source: GMO

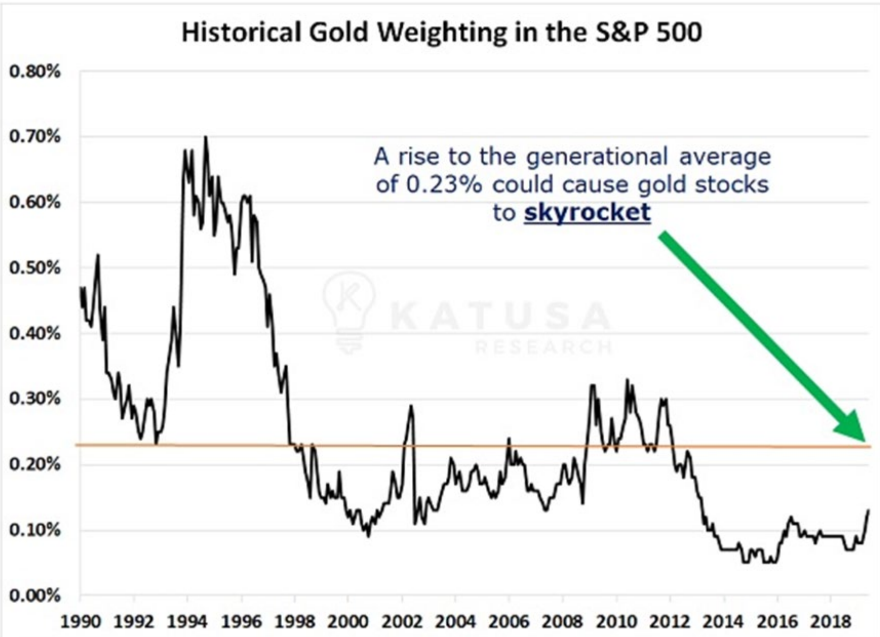
Source: MSCI, Bloomberg, FactSet, KKR Global Macro & Asset Allocation analysis

Gold worth an allocation?

Makes sense – it's been a long time coming and weightings are very low (shorts high but falling).
Central banks are looking for stores of value. Trust between governments (especially the US and China) is very low.



Source: Katusa Research



Source: Katusa Research

Behavioral Thoughts of the Quarter

Objective extrapolation risk

Jim Grant

"Eat, sleep, extrapolate"

It is much better to build a portfolio you can live with as opposed to ditching at the first sight of pain. Know your pain threshold and **don't extrapolate.**

I.e. Don't lift your investment objectives in the good times (reign them in) – something we see way too regularly.

All too often we see consultants lift their return expectations and risk weightings right at the worst possible time.

These same groups lower their expectations and therefore weighting at the bottom of the cycle.
Is it logical to expect higher returns from a higher base? **Absolutely not…**

We won't name the group but we recently read that a large investment consultant was expecting 8-10% from equity market returns over the next 5 years… This same group expected 5-7% from the market in 2010? **Completely illogical.**

Don't do the same with your portfolio – be sceptical and reign in your return objectives after a good season or 10 ;) – **do not get carried away by the excitement.**

Quotes of the Quarter

Charlie Munger

"I just think it was, to me, it was as natural as breathing, and of course I knew how compound interest worked! I knew when I saved $10 I was really saving $100 or $1,000 [because of the future growth of the $10], and it just took a little wait. And when I quit law practice, it was because I wanted to work for myself instead of my clients, because I knew I could do better than they did."

In the words of the great man… be extremely patient.

Warren Buffett

"I don't look to jump over 7-foot bars: I look around for 1-foot bars I can step over."

Money is cheap and easy.

Money is abundant…worldwide.

The talk about tariffs and trade wars have impacted some of the international flow of economic activity; but there is lots of money available.

Beware financial engineers whose sole purpose is to generate short term IRR's by pushing boundaries and allocating capital because they are forced to – shuffling of assets via leveraged buyouts actually increases the underlying economic fragility; it does not add economic value.

Mohnish Pabrai

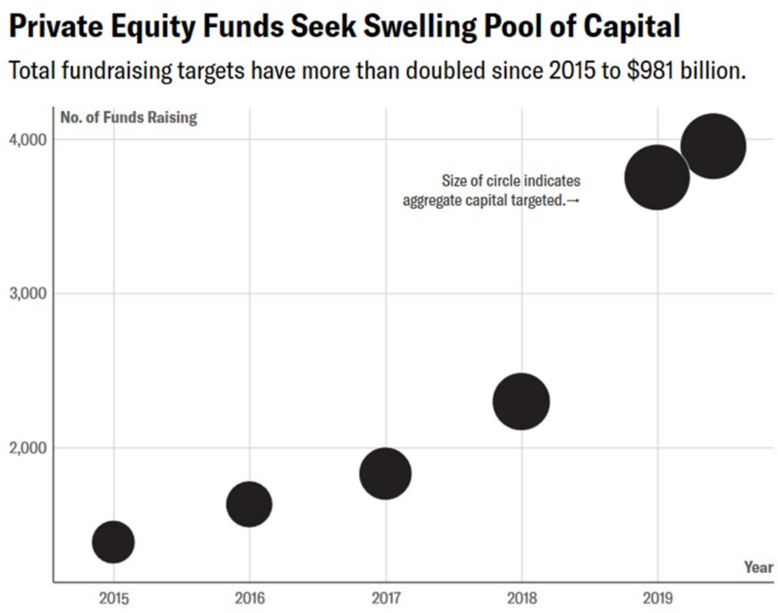
> *"Wall Street cannot distinguish between risk and uncertainty and gets confused between the two. Savvy investors like Buffett and Graham have been taking advantage of this handicap that Mr. Market possesses for decades with spectacular results."*

Trade hysteria has created a significant amount of uncertainty. Stocks with a Mr Market perceived higher exposure to trade related events have been heavily discounted. The last we checked, the entire global economy is reliant on trade (risk vs. uncertainty)…

Private equity firepower (long term risk?)

BlackRock forever fund… Love it conceptually but in practice everyone is long term until they aren't. BlackRock formed the LTPC fund to hold companies for "up to forever," structuring it with input from cornerstone investors to create a better alignment of interests than in traditional private equity.

$1.6 Trillion in Private Equity dry powder (all-time highs)



Source: Preqin

Australian Market

Pockets of exuberance

Buyer beware?

Multiples are starting to get very lofty, irrespective of the 'runway'.

A bipolar small cap & microcap market value world

5 Small Cap Tech Companies	Enterprise Value to revenue multiple*	Enterprise Value to EBITDA multiple*	1 Year Market Price Change
Wisetech Global	25.7	60	77%
Afterpay Touch	27	363	192%
Appen Limited	6.5	39	113%
Nearmap	21.1	101	229%
Pro Medicus	53.6	83	216%
Average	**26.8 times**	**129 times**	

Source: Microequities

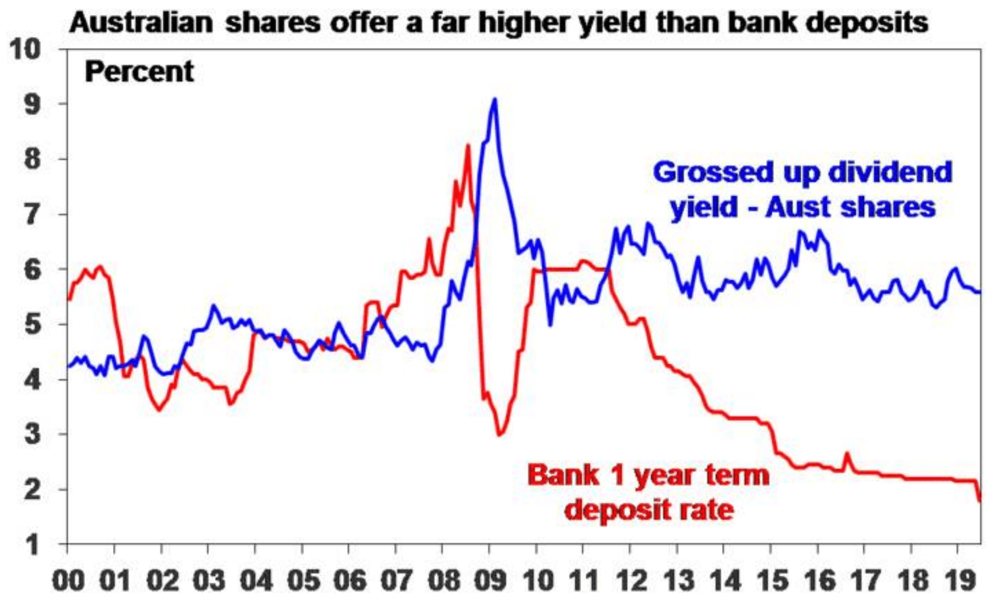
Bull Cases of the Quarter

Relative basis

It's hard to be bearish equities on a relative basis… in fact equities could even be quite cheap (see below).

When rates are low and maybe going lower, it makes equities look relatively cheap. Hence capital flows making their way into the market.

The problem with this however is we get stuck in a **"good news is bad news"** cycle whereby asset markets cheer bad news events which open the market to more rate cuts and it commiserates good news which signal higher interest rates.



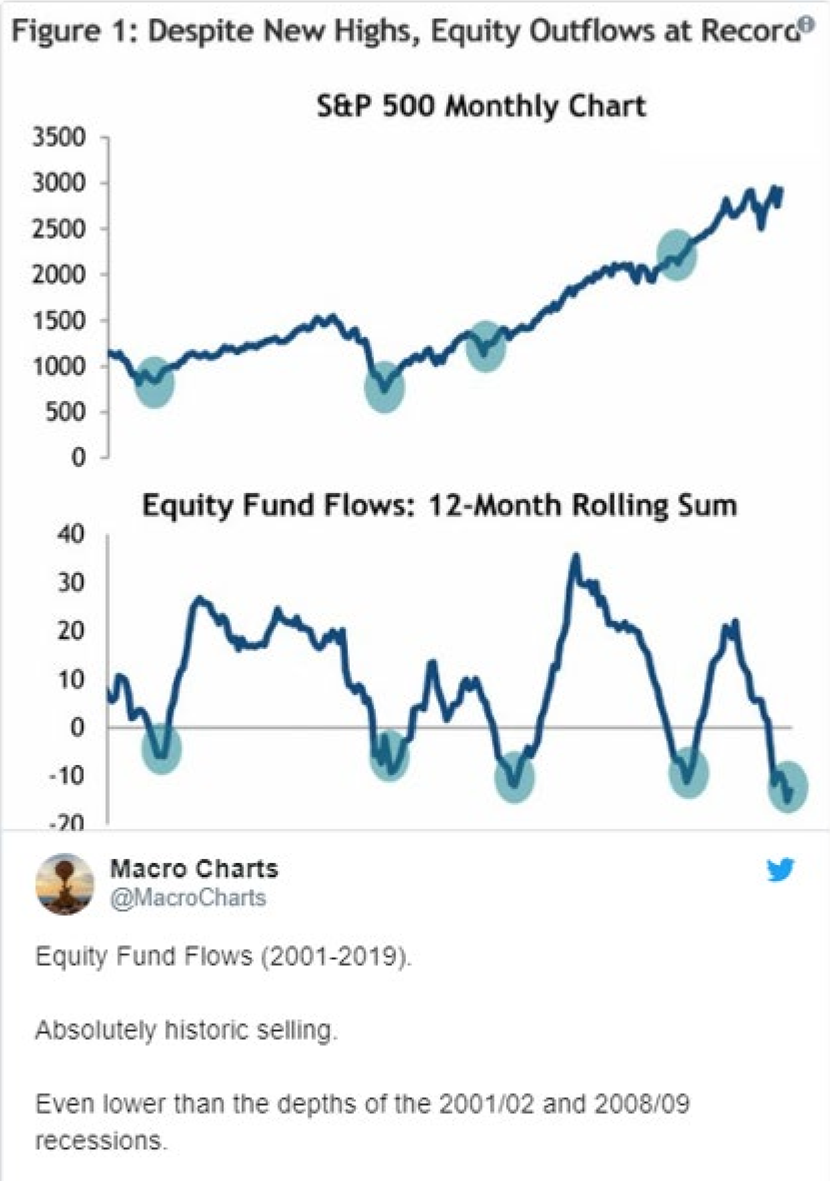
Source: AMP Capital

The great unloved bull market – fighting the last war (GFC still fresh?)

- Recency bias tends to suggest that we aggressively overweight the most recent events. As a result, things occur (as below), whereby we are actually seeing significant equity market outflows despite the most recent high returns. This is contrary to history, whereby you would expect significant inflows from retail investors chasing historically high returns (see below).
- Are we just too bearish? Is this because the GFC wasn't very long ago – did investors in the late 30's behave this way post the depression?
- The selling volumes are actually on par with Lehman Brothers selling.
- If the selling is predictive – this would be the first global recession perfectly predicted.

In the words of the great Peter Lynch:

"Far more money has been lost by investors preparing for corrections, than has been lost in corrections themselves."



Source: Macro Charts

Lessons in Family Investment Management

1. Disregard catalysts

What is the catalyst? (We hate when we catch ourselves saying this)

We were recently discussing a common stock we own with another investment manager friend and he said quite fairly: "what's the catalyst to move the stock higher?"

There is nothing wrong with this question but this highlights the inherent difference between institutional investing and family investing… well at least in theory.

Families, by nature, are true long-term investors (or at least they should be).

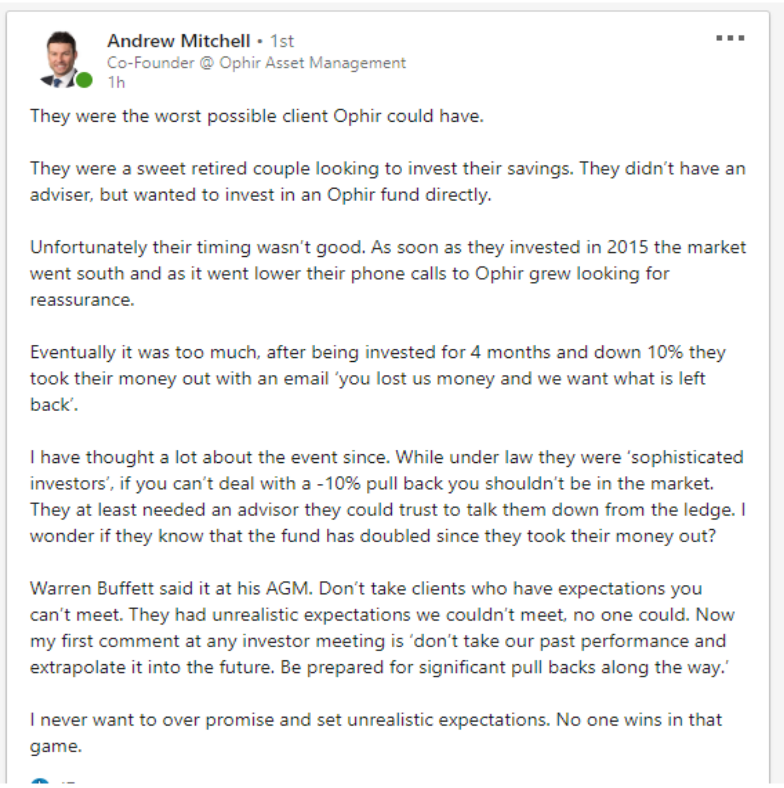
We are all prone to bouts of impatience, but really the value/price disconnect should be catalytic itself (as long as you hold your patience).

Families think in years/decades and institutions in months…
Families compound real absolute returns and institutions stress about relative returns and career risk…

The long and short – invest for quarter centuries not quarterly earnings (it's a mug's game).
Is this a great investment that is highly likely to significantly compounded upon itself a decade from now?

If you can't answer yes, move on.

Below is such a common story in retail short termism – play the long game.



Andrew Mitchell • 1st
Co-Founder @ Ophir Asset Management
1h

They were the worst possible client Ophir could have.

They were a sweet retired couple looking to invest their savings. They didn't have an adviser, but wanted to invest in an Ophir fund directly.

Unfortunately their timing wasn't good. As soon as they invested in 2015 the market went south and as it went lower their phone calls to Ophir grew looking for reassurance.

Eventually it was too much, after being invested for 4 months and down 10% they took their money out with an email 'you lost us money and we want what is left back'.

I have thought a lot about the event since. While under law they were 'sophisticated investors', if you can't deal with a -10% pull back you shouldn't be in the market. They at least needed an advisor they could trust to talk them down from the ledge. I wonder if they know that the fund has doubled since they took their money out?

Warren Buffett said it at his AGM. Don't take clients who have expectations you can't meet. They had unrealistic expectations we couldn't meet, no one could. Now my first comment at any investor meeting is 'don't take our past performance and extrapolate it into the future. Be prepared for significant pull backs along the way.'

I never want to over promise and set unrealistic expectations. No one wins in that game.

Source: LinkedIn

2. Control the Controllable (savings and ego)

Joe McLean is the premier wealth manager to the NBA's richest.

He has one client rule – put aside 80% of all earnings or find another manager – in our opinion this is the ultimate example of putting the client's interests first and we love it.

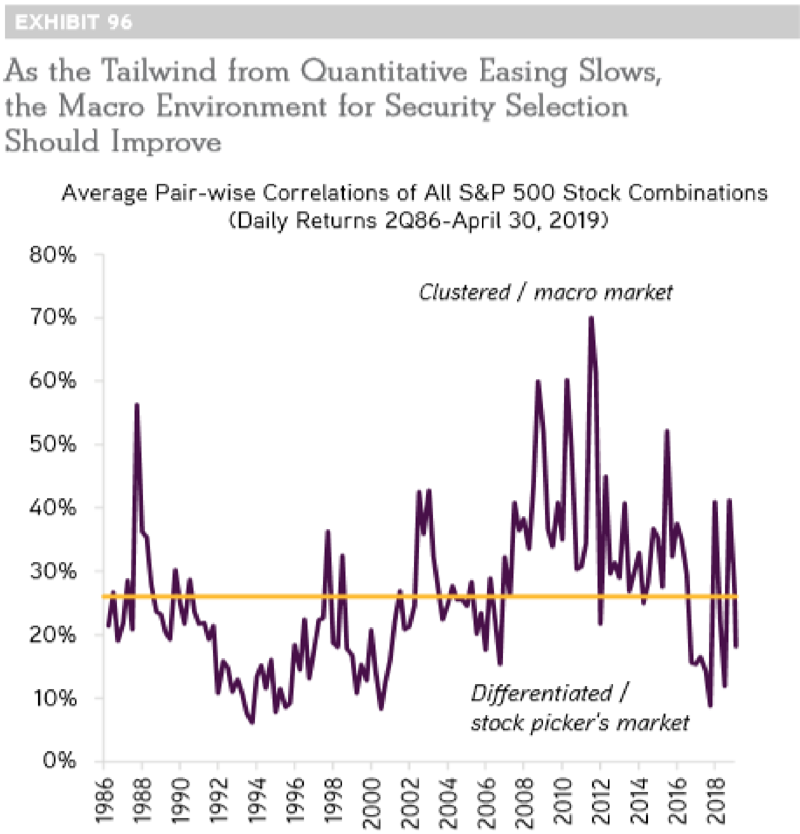
A basketball career is short and their earnings immense and Joe has likely seen the outcome of many failed saving regimes and has learnt from experience that his clients must buy in or he can't service them accordingly.

Tips of the Quarter

Tip 1 – *ignore the passive trade*

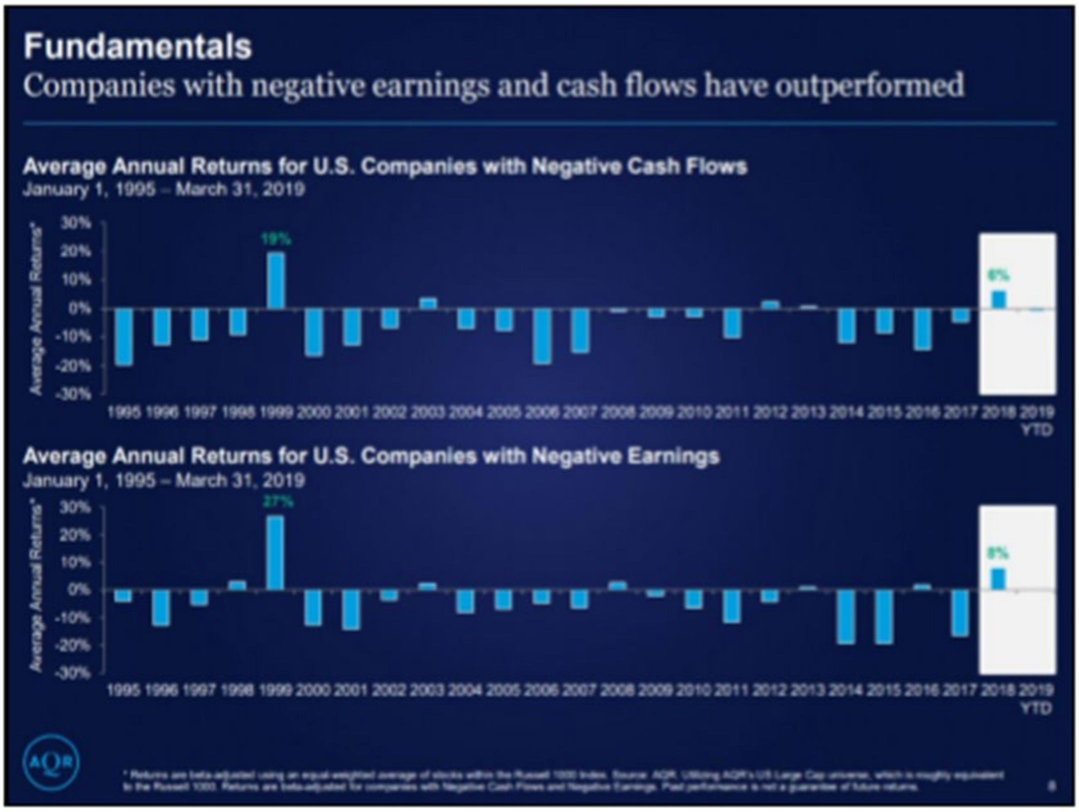
Trade the passive crowd hysteria for good active (preferably value biased) managers.
Active managers are closing in droves – especially value managers.

Thoughtless passive flows are at all-time highs. It's time to be different (see below).



Source: BofA Merrill Lynch US Equity & Quantitative Strategy (data as at 30 April 2019)

Tip 2 – *cash is king!*



Negative cash flow isn't cool!

Counterintuitively, companies with negative earnings and cash flows have seen their stock prices outperforming lately. The last time investors were this unconcerned with business fundamentals was 1999. Source: Farnham investments

Client Question of the Quarter

Your biggest holding is Berkshire Hathaway – how do you value it?

It's certainly complicated and getting more complicated by the day.

Here is our back of the envelope attempt:

1. Public holdings – circa $150k (per class A share)
2. Operating businesses – generating circa $15k cash flow on average. Apply a fair multiple of 10x - $150k (per class A share)
3. Cash 70k (per class A share)
4. Add them together and you get **<u>$370k per share</u>** without valuing the insurance float (likely worth a bit)

Currently trading at $312k.

We're comfortable with this risk adjusted valuation. ☺