



**Alvia Asset Partners Investment Team Insights**  
**September 2019 Quarter**



## General Commentary



Source: Broyhill Asset Management.

### **Alvia goes Unicorn hunting.**

For a fundamental (valuation disciplined) investor, it's akin to suffering from leprosy when momentum is running hot. Nobody wants to know you – especially when sexiness is plentiful in unicorn SaaS land.

However, we are finally beginning to see sprinklings of hope despite the deep internal anguish. Unicorn fatigue is kicking in amongst sprinklings of light as momentum unwinds and rotates to value.

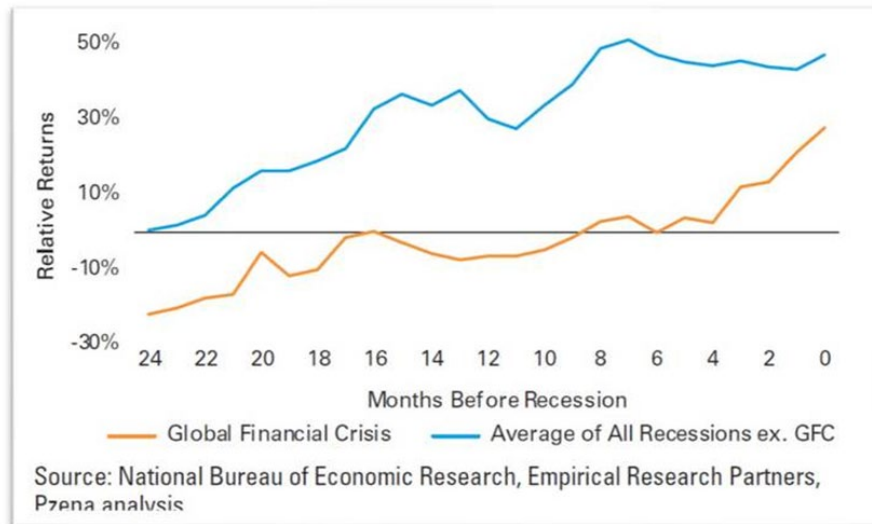
To this point, momentum has lulled investors into a false sense of 'safety' with top-line growth at any cost becoming the mantra as the low cost of capital equated to unrealistic discount rates.

### **What's left behind?**

Hard asset propositions, businesses with economic cycle exposure, steady compounders growing earnings but with semi-stagnant topline and some quality businesses that for whatever reason aren't sexy enough or have had a short-term mishap. We believe you are being offered risk adjusted opportunities to invest in the above irrespective of your views on potential recession risk. Why? Because these pockets of the market actually perform through recessions. Why? Because investors throw them out well in advance of any economic weakness and provide excellent entry points for astute valuers of businesses through the cycle.



### CYCLICALS OUTPERFORM THROUGH RECESSIONS



Source: Pzene Asset Management

This has benefited our portfolios with highlights such as:

- Adairs Limited (ASX.ADH)
- Blackmores Limited (ASX.BKL)
- Pacific Group Limited (ASX.PAC)
- Micron Technology (MU.NAS)
- Gentex Corp. (GNTX.NAS)

In addition to decent equity market returns for Q3, our bond portfolios have continued to perform well. Although, it's hard to claim skill with respect to bonds as our returns are mainly attributable to capital flows back into the bond market (chasing performance) given the interest rate cuts brought about by the Fed's capitulation on hiking.

We don't own bonds for capital returns – we own them to provide income and balance the volatility of the equity market. The capital returns are merely a short-term bonus. It's hard to fight the trend below over 30 years and with record government debt to fund.

It's in the global sovereign interest, to keep rates low.





The most interesting thing about the bond market is its interconnectivity with equity markets; i.e. what does the above interest rate global capitulation mean for equity markets?

In our opinion, it means a forced increase in institutional allocations to riskier asset classes, including equities (listed and unlisted). Just look at your average balanced fund – you will notice a steady increase in allocation to riskier asset classes.

What's the global average pension fund return promise, 7%?

We would think this is a semi difficult proposition from an average 30% fixed income (bond) allocation when sovereign debt is offering essentially 0% or in most cases negative rates.

**What does a Japanese bond investor get on US 10-year treasuries after paying to hedge out the currency volatility?**

**Answer: circa -1.5% and this isn't even included in the negative yielding bonds currently offered in domestic currency.**



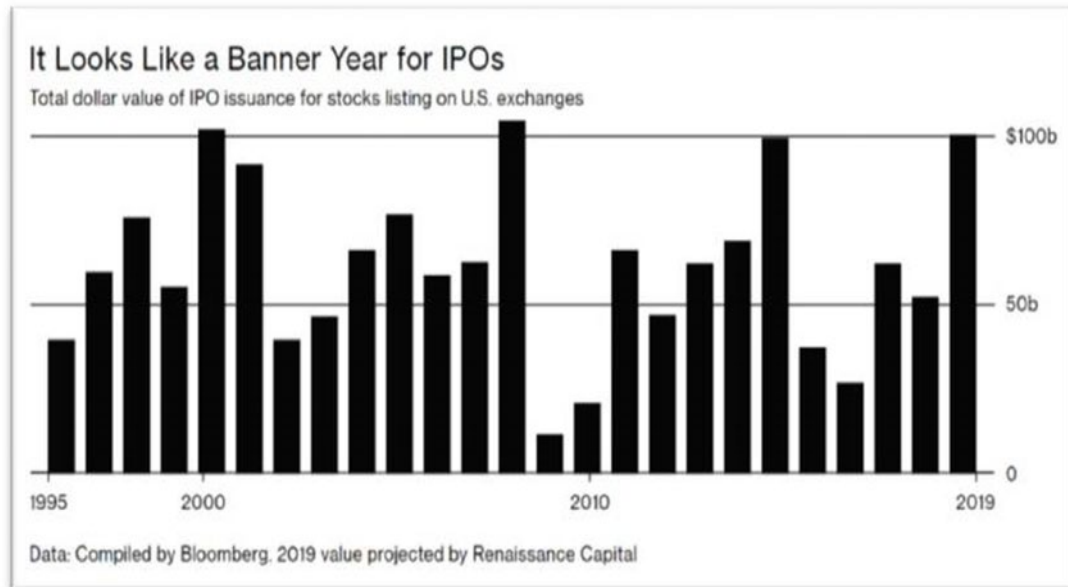
## Valuation Watch

Valuations, Revenues And Losses For Tech IPOs On U.S. Exchanges Over The Past Three Quarters				
Company	Business	Valuation	2018 Revenue	2018 Losses
Uber*	Ride-hailing app	\$64.4B	\$11.3B	\$3B
Tencent Music	Online music platform	\$26B	\$19B	Profit: \$1.8B
Pinterest	Social network	\$15.1B	\$756M	\$63M
Zoom**	Video conferencing	\$18.6B	\$331M	Profit: \$7.5M
Lyft	Ride-hailing app	\$14.4B	\$2.16B	\$911M
Farfetch	Online retail	\$7B	\$602M	\$155M
Elastic***	Enterprise software	\$6.3B	\$160M	\$53M
SolarWinds	Enterprise software	\$5.9B	\$833M	\$102M
Anaplan****	Enterprise software	\$4.8B	\$241M	\$131M
Beyond Meat	Meatless protein	\$4.6B	\$88M	\$30M
PagerDuty*****	Enterprise software	\$3.9B	\$118M	\$41M
SurveyMonkey	Survey platform	\$2.1B	\$254M	\$155M
Jumia	African e-commerce	\$2B	\$150M	\$195M
Upwork	Freelance hiring platform	\$1.8B	\$253M	\$20M
Eventbrite	Event ticketing	\$1.4B	\$292M	\$64M

\*Uber's loss is operating loss, not net loss.  
\*\*Zoom's fiscal year ends Jan. 31, 2020.  
\*\*\*Elastic's fiscal year ended April 30, 2018.  
\*\*\*\*Anaplan's fiscal year ended Jan. 31, 2019.  
\*\*\*\*\*PagerDuty's fiscal year ended Jan. 31, 2019.

crunchbase news

The return to astute valuation-based investing coincided with the bursting of the dot com boom and we think we will see this again. The unicorns are looking scruffy, weary and clinging to their shiny pitch decks. **They are also selling where they can at record quantum (IPO parties a plenty).**



Source: Renaissance Capital

### What's does this all mean?

- The trade war is a real problem – watch closely;
- Interest rates are the cornerstone of all asset classes – bonds and equities are priced on interest rates; and
- The hangover in unicorn companies is real and whilst a risk to markets, there will be a rotation from these names into businesses that are real and generating real profits and cash flows which thankfully have been left for dead.

It pays long term to be patient – it does not being short term oriented and fearful of your next-door neighbour's short term rainbow orientated profits.

*"True value-based investors buy assets when investors are fearful and where pessimism is already reflected in valuations, but the long-term earnings potential is not recognized."*

*- Richard Pzena*

### Investing is complicated not complex, but sometimes you get a free hit!

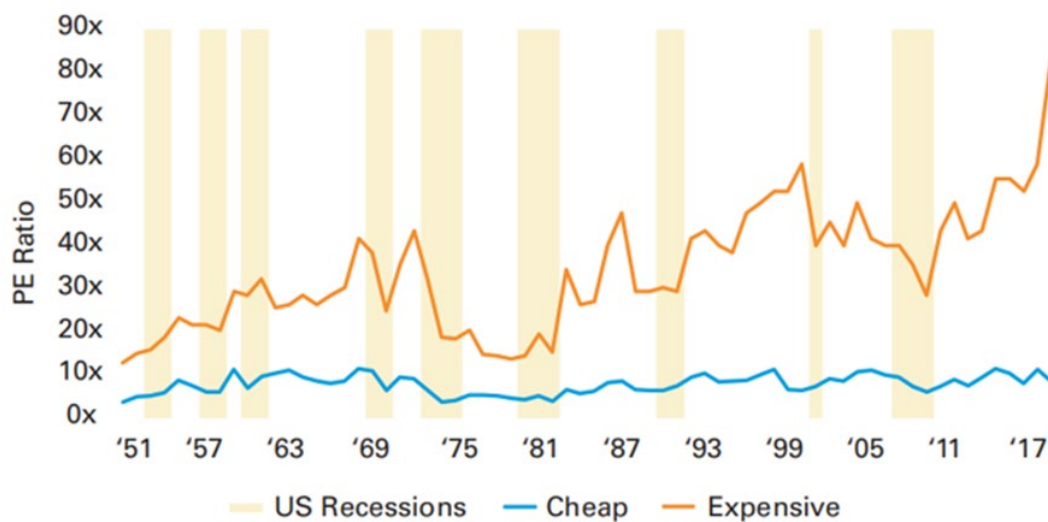
We are currently witnessing the largest dispersion in valuations in the 68-year history of the data – a distortion that we argue is not sustainable and providing a massive opportunity.

Investors should simply exploit it.



**Figure 2: The Most Highly Valued Stocks Have Led the Market Higher**

*Record Valuation Dispersion*



Source: Pzena Asset Management

## Quotes of the Quarter

*"The last man standing is patience. We call it time arbitrage. Other people call it time arbitrage – just being patient. That's in really short supply, and it's not getting better. Things are moving to faster and less patience. So that's really the secret."*

– Joel Greenblatt

Casper, Uber, Lyft, WeWork and DoorDash will collectively lose nearly \$13 billion this year!

*"Dear Venture Capital,*

*Thank you for subsidizing these new services for us all these years*

*Signed,*

*The Consumer"*



## Frustration / Crazy of the Quarter

Increased rhetoric out of the investment world stating that quality of any investment is all that matters and the price paid is irrelevant.

In our view 'quality' is clearly important, however so is the price paid – we all want to own quality enduring franchises, we just don't want to pay too much for them. A good business does not equate to a good investment if you pay too much for it.

For example, Coca Cola hit a P/E of 40 back in 1998. People said the valuation didn't matter. Multiples are dumb, they had a moat and high ROIC. What happened? The return of valuation to a normal level led to a -1.58% CAGR for the next decade and a 50% drawdown during the early 2000s.

Deere sold 30-year bonds at an initial yield of 2.877%, breaking the previous record of 3.197% that Disney had set when it sold 30-year bonds in July 2016.

**That's a corporate raising 30-year money at sub 3%... what a wonderful world.**

## Cautionary tale of the quarter – Mayfair 101

We are seeing a significant number of full-page advertisements in mainstream Australian newspapers, including the News Corp and Nine Entertainment mastheads (including the AFR) from a UK-registered, High Net Worth (HNW) Investment group called Mayfair 101 (previously branded as IPO Wealth).

Digging a little deeper on this group we noticed they have raised \$120m from investors and poured it into a basket of random (illiquid) 'investments' including islands, cryptocurrency companies and other questionable early stage offerings – all whilst despite offering fixed income like returns (feels a tad Ponzi to us?).

The managing director has next to no investment experience and subtly aligns the firm's brand profile with the security of a term deposit.

The MD also highlights that profits are no longer a benchmark of company performance – whilst targeting a 6.4% fixed return – which I presume would be earned via investment related profits?

"All investor distributions have been paid in full every month since inception."

**'Profit is no longer the sole benchmark'**

<https://www.theguardian.com/australia-news/2019/sep/28/concern-over-ad-blitz-for-high-end-investment-fund-buying-into-island-resort>





## The Passive Bubble

There has been a lot of noise regarding the global shift from active to passive asset management.

Most recently, famed Big Short investor Michael Burry warned of a bubble in passive investing.

"The bubble in passive investing through ETFs and index funds as well as the trend to very large size among asset managers has orphaned smaller value-type securities globally," Burry told Bloomberg news.

Fear aside we think risks are increased in pockets due to mindless index flows. Why? Because index funds and ETF providers go where 'what sells' and 'what sells' are current winners (meaning self-fulfilling momentum ensues).

### 'Selling' current winners

ETFs represent more the US market than other areas – why? Because the US has outperformed and its high profile mega cap companies are well known by the average punter.

Figure 2: Big 3 Passive Providers vs. Total Market Cap by Region

Region	Market Cap	Big 3 Passive	% Big 3 Passive
United States and Canada	\$39,615,753	\$5,934,295	15.0%
Europe	\$21,098,385	\$1,056,191	5.0%
Latin America and Caribbean	\$3,204,649	\$94,888	3.0%
Asia / Pacific	\$28,281,381	\$783,718	2.8%
Africa / Middle East	\$1,695,182	\$34,111	2.0%
Total	\$93,895,350	\$7,903,202	8.4%

Source: Capital IQ

ETFs represent more of the Large Growth market – why? Because it has performed irrespective of valuation:

Figure 3: Big 3 Passive Assets vs. Total Market Cap by Style

Style	Market Cap	Big 3 Passive	% Big 3 Passive
Large Growth	\$34,470,116	\$3,564,133	10.3%
Mid Growth	\$7,986,784	\$641,488	8.0%
Large Value	\$38,678,267	\$2,819,601	7.3%
Mid Value	\$7,707,109	\$557,529	7.2%
Small Growth	\$2,817,389	\$166,457	5.9%
Small Value	\$2,793,297	\$153,993	5.5%
Total	\$94,452,962.2	\$7,903,201.9	8.4%

Source: Capital IQ

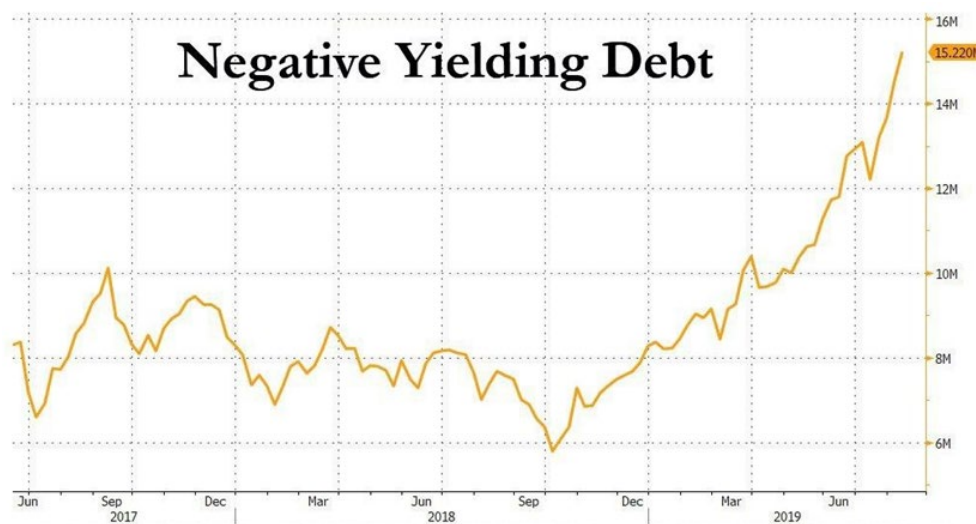


And in the bond market:

Since October 2018, negative yielding debt instruments have increased by over 300%. This now equates to approximately 25% of the total debt market offering.

**What does this mean?**

1. Creditors (investors) pay debtors (countries) to borrow money;
2. Those creditors are so worried about the overall state of the market, they would rather pay "safe" countries such as Germany to hold their money; and
3. There is currently significant amounts of cash that cannot find a good (safe) investment.



Source: Bloomberg

What is happening right now is real and a touch scary without doubt – its unprecedented. However, there is nothing you or I can do about it.

There will always be a gloomy story about the next bear market coming. Most of them never materialise into real market threats, but the story keeps selling and investors keep clicking.

Therefore, we would rather concentrate our time and energy on what we can control and that's our portfolio.

The fact is we all need to be invested (partially or fully). This wasn't the case 10 years ago when cash offered a viable return.

**So, invest carefully, protect yourself and focus on 'real' assets.**



## Economic Policy

### What is the RBA really up to?

- Governor Lowe is talking to the potential for measures which might be in total more effective than monetary policy (i.e. some form of QE);
- **What have other's done?** They have tried negative rates, provided stimulus to banks to lend more aggressively, bought assets direct (such as mortgage-backed securities or government bonds) and furnished the currency;
- We think it's hard to see the economy being weak enough to justify the above on a massive scale but a bit of RBA jawboning doesn't hurt;
- QE is difficult because on the whole it lifts asset prices and doesn't really stimulate the real economy (as evidenced globally by the rise in the S&P 500 vs. a slight increase in real wages); and
- The most likely outcome in our opinion – lower rates for longer and a direct policy at a banking level to free up their credit departments to increase lending.

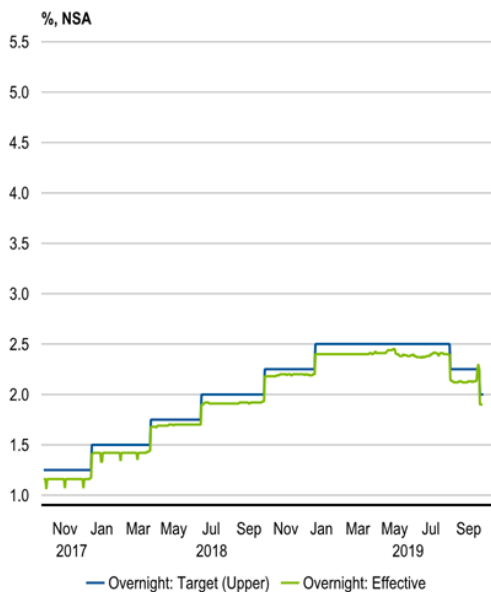
Source: Wilson Asset Management

### US interbank rate spike fears

- Whilst we certainly don't claim to be experts in repo (repurchase agreement) markets it was interesting to see and read about the recent spike in the US Interbank rates (very simply the rates at which banks lend to each other).
- This spiked pre GFC, so the story understandably gathered some traction.

United States Interbank Rate

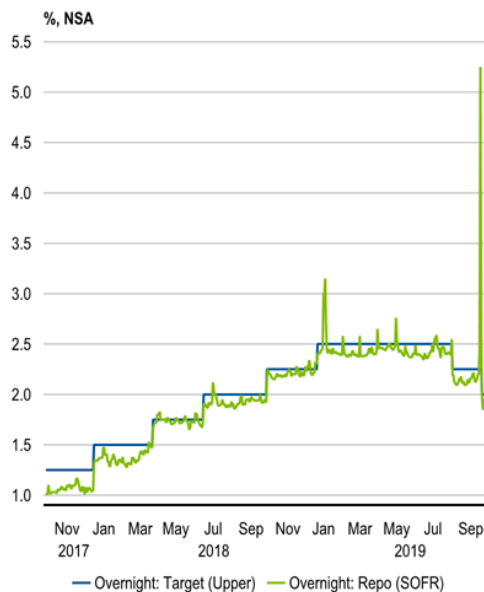
9/25/2017 – 9/25/2019



Source: Franklin Templeton, Federal Reserve, Macrobond.

United States Interbank Rate

9/25/2017 – 9/25/2019



Source: Franklin Templeton, Federal Reserve, Macrobond.



## So, what's the problem according to the experts?

The most likely explanation is the United States Treasury draining US dollar liquidity. Households and private corporations deposit US dollars with commercial banks and commercial banks can re-lend most of these US dollars (up to the required reserve ratio...RRR).

Growing United States government budget deficits increases demand for US dollars. In addition, disagreements among elected officials about the budget, which lead to temporary government shutdowns, causes volatility in demand for US dollars.

When you combine this with a shrinking pool of excess reserves and the usual cyclical demand for US dollars by the private sector, you have all the ingredients for a liquidity squeeze in United States money markets.

In short, there wasn't enough USD to go around – which is certainly interesting.

Part of the reason we hold a USD long view.

## Lesson of the Quarter

### Do company visits help or hinder investment performance?

We meet with lots of funds managers and one of the most common utilised measures of fee justification is the volume of company visits.

Recently, we have been reflecting on this and certainly in our experience meeting with management, especially charismatic CEOs has actually been to our performance detriment.

Why? Because most CEOs are employed to sell their business and they do it very well. Better use of time in our opinion is interviewing lower level management, operations staff and even better direct competitors in addition to shadow shopping.

We personally believe the old "*Trust me, I play golf with the CEO*"?

*It means very little in respect to adding excess returns and more likely adds to risk of confirmation bias (i.e. hearing what you want to hear).*



## What makes a good Investor?

Source: Collaborative Fund. <https://royalsocietypublishing.org/doi/pdf/10.1098/rspb.2010.1579>

A group of Australian biologists once discovered something remarkable. More than a third of all mammals deemed extinct in the last 500 years have later been rediscovered, alive:

*We identified 187 mammal species that have been missing (claimed or suspected to be extinct) since 1500. This number includes all such mammals for which we were able to find key variables for analysis. In the complete dataset, 67 species that were once missing have been rediscovered.*

A lot of what we know in science is bound to change. Science is filled with rules, evidence-based theories, and probabilistic observations. Laws – immutable truths lacking exceptions – are rare. Most fields only have a handful.

**Investing is much the same, however there are a few simple principles (soft laws) that truly stand the test of time and are utilised by good investors.**

Source: Tony Santos Columbia University

1. **Be numerate (and understand accounting):** to be a successful investor, you have to be comfortable with numbers. There are rarely complicated calculations but a feel for figures, percentages, and probabilities is essential. Most importantly being able to understand cash flows and a balance sheet and effective use of capital.
2. **Understand time value of cash and opportunity cost (the present value of free cash flow):** "Remember, cash is a fact, profit is an opinion." Investing is a relative opportunity set.
3. **Properly assess strategy (or how a business makes money):** this attribute has two dimensions. The first is a fundamental understanding of how a company makes money. The idea is to distill the business to the basic unit of analysis. For example, the basic unit of analysis for a retailer is store economics. How much does it cost to build a store and fill it with inventory?
4. **Compare effectively (expectations versus fundamentals):** comparing is a critical element of investing. Investors compare all day: stocks versus bonds, active versus passive, value versus growth, stock A versus stock B and now versus later. Humans are quick to compare but not very good at it.
5. **Think probabilistically (there are few sure things):** investing is an activity where you must constantly consider the probabilities of various outcomes. Warren Buffett summed up this attribute well: "take the probability of loss times the amount of possible loss from the probability of gain times the amount of possible gain. That is what we're trying to do. It's imperfect, but that's what it's all about."



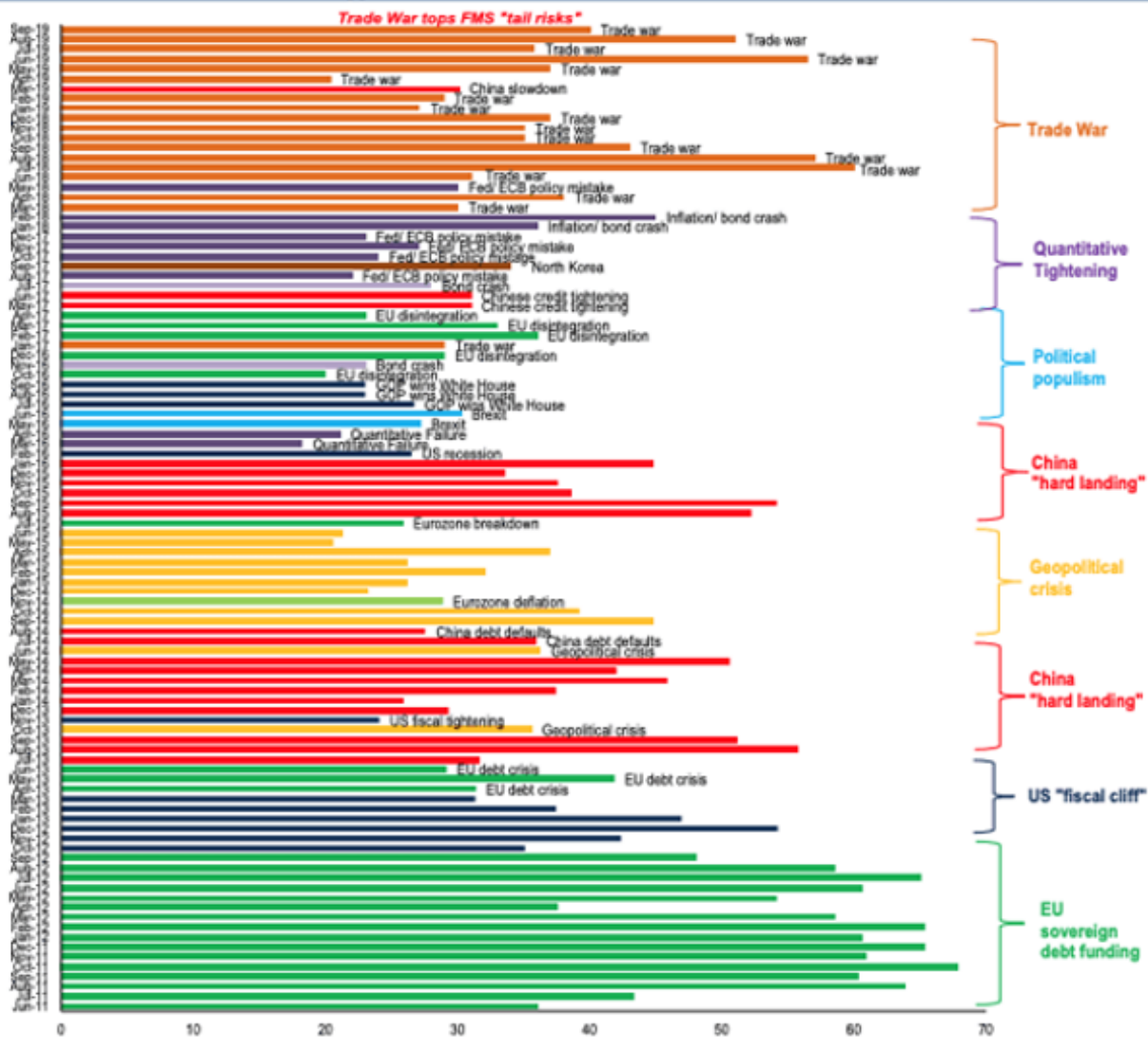
6. **Update your views effectively (beliefs are hypotheses to be tested, not treasures to be protected):** Warren Buffett – “I always look at IQ and talent as representing the horsepower of the motor, but that the output—the efficiency with which that motor works—depends on rationality. A lot of people start out with 400-horsepower motors but only get a hundred horsepower of output. It’s way better to have a 200-horsepower motor and get it all into output.”
7. **Know the difference between information and influence:** great investors don’t get sucked into the vortex of influence. This requires the trait of not caring what others think of you, which is not natural for humans. Indeed, many successful investors have a skill that is very valuable in investing but not so valuable in life: a blatant disregard for the views of others.
8. **Position sizing (maximizing the payoff from edge):** Puggy Pearson was a cigar-chomping gambling legend who won the World Series of Poker and was one of the world’s best pool players. When asked about his success, Pearson said, “ain’t only three things to gambling: knowing the 60-40 end of a proposition, money management and knowing yourself.” Similarly, success in investing has two parts: finding edge and fully taking advantage of it through proper position sizing. Almost all investment firms focus on edge, while position sizing generally gets much less attention.
9. **Read (and keep an open mind):** every year, Columbia Business School sends a group of students to Omaha, Nebraska to meet with Todd Combs, a graduate of the school (and former student) and Warren Buffett (also a graduate), at Berkshire Hathaway. After one of those trips, I asked the students for their impression of the meetings. The students, in somewhat of a state of disbelief, said that Combs suggested that they read 500 pages a day.

Great investors generally practice a few habits with regard to their reading. Second, good readers tend to take on material across a wide spectrum of disciplines. Finally, make a point of reading material you do not necessarily agree with.

## What keeps Fund Managers up at night?

Investors biggest fear of the Quarter – **it's the same as the last 5!**

**Exhibit 11: Evolution of Global FMS “biggest tail risk”**



Source: BofA Merrill Lynch Global Fund Manager Survey

## Trade war worry

Trying to put yourself in the heads of either Trump or Xi is an interesting proposition.

As is attempting to forecast the outcome of their extended game of chess.

We find the below view out of **Basis point** the best interpretation that we have come across.



## The Chess board

Source: Basispoint advisory

1. 2020 US presidential election is the immediate end-game;
2. Trump must win another 4-year term to make America great again (see note below);
3. Xi must see that Trump loses – an unknown Democratic President is the better outcome;
4. Trade wars, financial wars, currency wars, debt wars, oil wars, are some of the chess pieces;
5. So are Iran, Russia, Venezuela, South China Sea, Taiwan, North Korea, India/Pakistan/Kashmir and now Hong Kong;
6. Allies are to be used. As Henry Kissinger once said, “America has no permanent friends or enemies, only interests.” Ditto for China;
7. There can be only one “top dog” in this world... history and human nature proves it;
8. There is no effective umpire. Trump and Xi need to sort out their differences or risk an out-of-control escalation that leads to MAD outcomes (mutually assured destruction); and
9. It’s not a game.

## How it will be played

### *Trump’s view*

- Trade deal under my terms so I will win the election. (See 2 above);
- After I win, I can overturn the deal, so as to contain China, (see 7 above) with new 25% tariffs ...and blame the deal failure on them;
- Before the election, a No deal/25% tariffs situation is also fine...as long as China crashes far more than the USA. US winning and China losing means I can win enough votes. (See 2 above);
- Nearly all economic problems started in the financial markets. Global Financial Crisis, Asian Financial Crisis, 1987 stock market crash, Dot Com bubble, 1929 crash, etc.;
- So China is ripe for a financial crisis – they have too much debt and too many non-productive assets; and
- Elevate nationalism so the electorate has a single common enemy. China, to boost my election mantra that I am the only leader who can take on China.





### *Xi's view*

- Trade deal under my terms so my export industry can continue to generate jobs, especially in subsidised SOEs;
- Then a few months before the US election, I can overturn the trade deal and blame the deal failure on them. Blame the resulting US chaos on Trump so he loses the election. (See 3 above);
- We can live with a 10% tariff to buy time (we've devalued currency 2%, Chinese exporters can take a 3% hit to their profit margins, US importers get hit 3% and US consumers cough up a 2% price rise);
- No trade deal/25% tariffs is also fine... as long as the US crashes far more than China...as we start selling USD and US debt;
- For decades, despite the persistent US current account and budget deficits, the US has monopolised the world's reserve currency and safe haven status;
- So the US is ripe for a financial crisis. China has enough Dollars and Debt to sell to cause a crash; and
- Elevate nationalism so the people have a single common enemy. **The USA.**





## Twitter Watch

Allocating capital is interesting when he uses Twitter as below:

**Donald J. Trump**   
[@realDonaldTrump](#) 

We are winning, big time, against China. Companies & jobs are fleeing. Prices to us have not gone up, and in some cases, have come down. China is not our problem, though Hong Kong is not helping. Our problem is with the Fed. Raised too much & too fast. Now too slow to cut....

 52.5K 5:21 AM - Aug 15, 2019 

 27.3K people are talking about this 

**Donald J. Trump**   
[@realDonaldTrump](#) · 4h **Donald J. Trump**   
[@realDonaldTrump](#)



## Stress Testing

**WeWork (a bad real estate story stock masquerading as technology – capital erosion at its very best)**

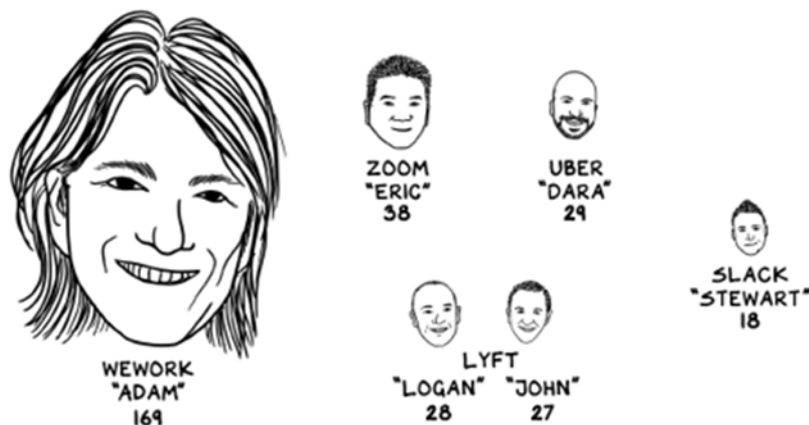
In markets like this it's easy to distort reality with grandiose stories of glamour and philosophies of world changing grandeur.

WeWork's recent prospectus is the greatest of all time – with more red flags than a Liverpool home game.

A few highlights:

- It begins by dedications to the power of 'we';
- Adam, the name of the charismatic founder, is mentioned 169 times (average 25);
- A David Bowie lyric like mission statement 'to elevate the world's consciousness.'; and
- Crazy pseudo accounting metrics like community-based EBITDA aka total BS earnings.

### MENTIONS OF FOUNDER/CEO IN S-1 FILINGS



Source: Scott Galloway

We have been relentlessly questioning the paper gains of glamour story stocks for what feels like too long. Desperate to see more of 'weighing machine' and less of a Kim Kardashian trend obsessed voting machine.

**Our view is that investors are finally judging with more scrutiny and finally testing valuations. Its been a tough year for other sexy narrative based investments:**

- Uber: down 30%
- Lyft: down 42%
- Grubhub: down 61%
- Zillow: down 53%
- Spotify: down 38%



Locally our WAAAXy ladies are also starting to feel the welcome pinch – distortions have been caused by scarcity of technology names and we think there is room for caution, irrespective of the growth profile as even the sniff of a disappointment / fear could cause a cascade of shareholder disappointment-based re-rating. Afterpay and Wisetech this week are great examples of this.

WeWork however is the worst of all and probably one of the worst businesses we have come across in our investing careers.

It's absolutely astonishing to think that it was last valued at \$47 Billion by Japan's SoftBank ('Vision') Fund. Only SoftBank can keep this zombie alive from here.

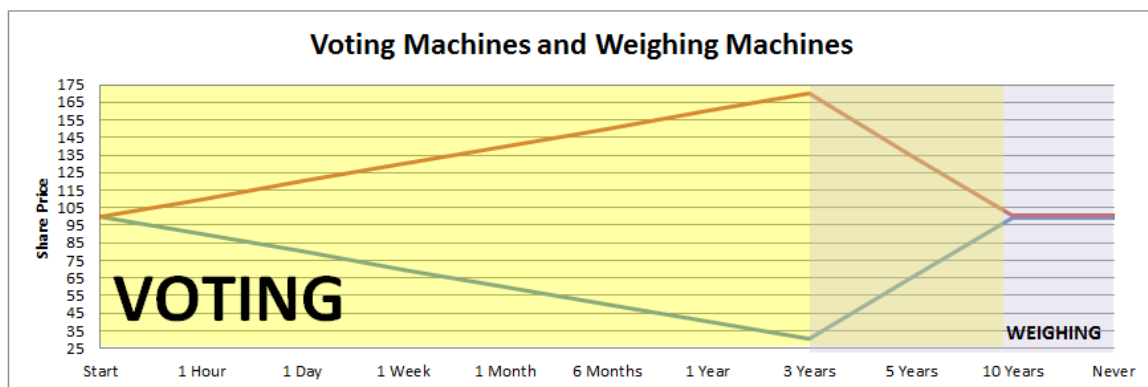
## Alvia Rules

### Mental Models

The WeWork sham and others recently got us thinking internally about what our internal rule of thumb is when it comes to patience?

Just how long are we (or more importantly our clients) prepared to 'wait' it out until the 'weight' of fundamentals are realised or we cut our losses accept blame and move on?

Source: Pzena Asset Management



On average we said three years but be prepared for ten and I think this correlates nicely with our internal rule of thumb when it comes to any allocation to equities as an asset class.

Buying equities is playing the long game as a business owner and you simply must be prepared to hold long as any good owner should.

**Our rough rule is 10% to equities for every 1 year you don't need the money for.**

I.e. 1 year holding period – only 10% equities, 5 year holding period – 50% maximum equities. It's a rough rule but it works.



## Questions of the Quarter

If we have a recession, are we looking at the 2000 or 2008 example?

Year	US Stock Market	Small Cap Value	Difference
1973	-18.18%	-24.12%	-5.94%
1974	-27.81%	-21.09%	6.72%
1981	-4.15%	15.69%	19.84%
1990	-6.08%	-19.05%	-12.97%
2000	-10.57%	21.88%	32.45%
2001	-10.97%	13.70%	24.67%
2002	-20.96%	-14.20%	6.76%
2008	-37.04%	-32.05%	4.99%
		AVERAGE	9.57%

Source: Value Stock Geek

### Why the difference between value performance in 2000 vs 2008 (above)?

Very simply, the 2000 recession in the US was mild and the underlying economy aka the business cycle and therefore cyclicals held up fine. In more serious recessions, like 2008 or 1973-74, many of these cyclical businesses were undergoing serious problems as a result of debt load and the heaviness of the economy's deep despair.

They are similarities between now and 2000, pockets of technology non-earning exuberance and migration to certain large cap US compounders for shelter (however not to the same extremes). The venture capital world has become entirely fixated on 'disrupting' stuff and serial entrepreneurs are springing up faster than cryptocurrencies.

Sceptics are treated like lunatics for questioning business models and asking for financial models – valuation-based investors are treated with disdain.

Personally, we back 2000 over 2008.

Largest S&P 500 Components in 2000			
Stock	Price/Sales	Price/Book	P/E
General Electric	400%	10x	40
Exxon	200%	5x	30
Pfizer	1000%	15x	40
Citigroup	200%	4x	20
Cisco	2000%	20x	60
Wal Mart	150%	10x	40
Largest S&P 500 Components in 2019			
Stock	Price/Sales	Price/Book	P/E
Microsoft	840%	10x	26
Apple	350%	9.5x	17
Amazon	360%	17x	75
Alphabet	560%	4x	22
Berkshire Hathaway	198%	1.2x	17
Facebook	860%	6x	32



Are you an investor or a business operator or a Hybrid?

This is a great article from a private equity investor out of the US comparing investors to business operators which really resonated.

The crux of the article essentially acknowledges the differences between the investment world and business operations and what can be learnt from stepping in one another's shoes.

Investors think the business world is clean and methodical, run by high level strategy that correlates perfectly with underlying financial models.

Business operators think investors have an easy job and they tend to think business success transfers easily to managing investment capital.

Source: Brent Beshore of Adventures.

## What investors can learn from operators...

### **ALL BUSINESSES ARE LOOSELY FUNCTIONING DISASTERS, AND SOME ARE PROFITABLE DESPITE IT.**

At 30,000 feet, the world is beautiful and orderly. On the ground, it's chaotic and confusing. Nothing ever goes to plan. Surprises lurk around every corner. Things are constantly breaking. Someone is always upset. Mistakes are made daily. Expecting anything less is being out of touch with reality.

This is the challenge of running a business but also the opportunity available to investors. There are outsized returns available for solving these problems.

### **FORECASTS AND PREDICTIONS ARE EXERCISES IN GUESSING AND GUESSES ARE ALWAYS WRONG.**

Precise spreadsheets are maps of a world that never existed and will never come to fruition, even if the numbers are hit. Business is about people and people are hot messes, capable of incredible feats of brilliance and stupidity. What's more, they're either optimistic or pessimistic, but rarely accurate.

### **OUTSIZED RETURNS REQUIRE DIVERGENT THINKING AND ACTION.**

Every operator has a collection of moments that changed the course of their company's fate. Almost all of them — on the surface — look absurdly risky, if not downright crazy. These stories of personal guarantees, accepting outsized orders without ready production capability, product offering pivots, and other bet-the-farm moments change trajectory, both for good and bad.

### **RARELY IS THE PROBLEM STRATEGY.**



Activist investors are some of my favourites to watch. They pontificate and prance about declaring how the current leadership are a bunch of cold ham sandwiches, while they have a brilliant and obvious plan that will undoubtedly lead to success. And occasionally they're correct. But most often, that brilliant strategy has been considered and discarded, or tried and failed. Strategy is important, but for most businesses, it's not rocket science. The best course forward is typically neither complicated, nor difficult to determine. What's hard about strategy is execution and culture and systems-building and incentives and leadership.

## What operators can learn from investors...

### **CAPITAL EFFICIENCY AND CAPITAL ALLOCATION MATTER.**

It's rare, especially in the lower end of the lower-middle market, to find operators even aware of their cost of capital or return on invested capital (ROIC). But capital has a cost and returns matter, particularly if your aim is to create sustainable long-term value. Business unit economics are the operating earnings minus the reinvestment necessary to hold the competitive position. Excess investment, in people or machinery or acquisitions, should be analysed based on the return realized. Growth is meaningless and sometimes destructive without corresponding increases in the present value of future cash flows.

### **CIRCLE OF COMPETENCE WILL LIMIT YOU BUT KEEP YOU ALIVE.**

Being an expert at something doesn't make you an expert in anything else. Being a seasoned construction exec doesn't make you knowledgeable about retail, or manufacturing, or any other business model. If it did, doctors would be notoriously good investors. Understanding your specialty and wading into new waters seem diametrically opposed, and they usually are.

### **GET A LIBERAL ARTS EDUCATION IN BUSINESS.**

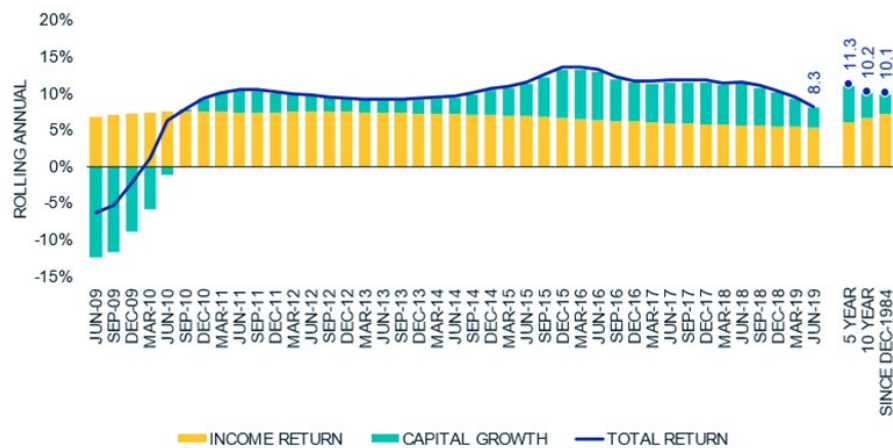
No matter if you're building buildings, or manufacturing widgets, or developing a mobile application, a proper understanding of best practices across marketing, sales, technology, HR, finance, accounting, and operations will dramatically increase a leader's decision making and performance.



## Australian Market

Aussie property – rates equate to lower returns as cap rates reset

### ▀ Total return at lowest level since September 2010



Source: MSCI

5

### ▀ Australia still outperforming some markets



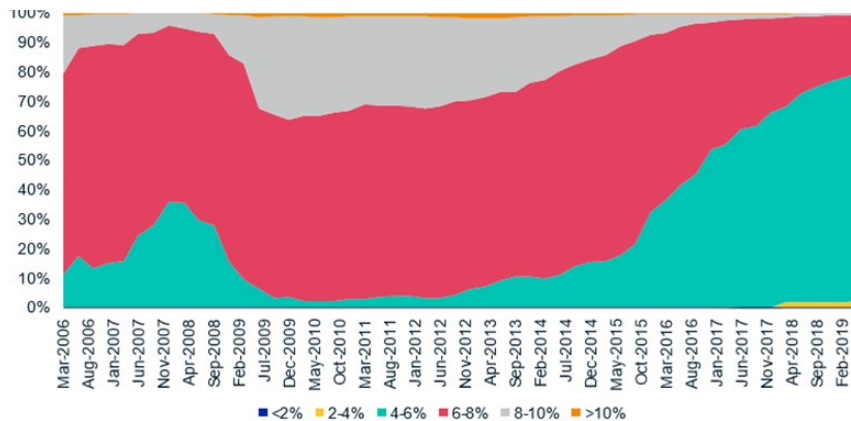
Source: MSCI

6





## Value cap rates are concentrated in 4-6% range



MSCI

Source: MSCI

14

## Family Wealth Management Thought of the Quarter

Ask for detailed performance attribution of money managers?

In this environment if your fund manager has supercharged returns.

Ask why? Where from? If they hold Afterpay please ask them to show you their valuation. If they refer to its runway or its total addressable market (or TAM, which is very sexy at the moment) – ask them to quantify this and what their margin of safety is – just in case their TAM assumptions are wrong.

Ask them what their thoughts are of the founders selling?

How do you value a business without earnings or cash flows?

Be a cynic and don't chase performance now – chase it over the long term.

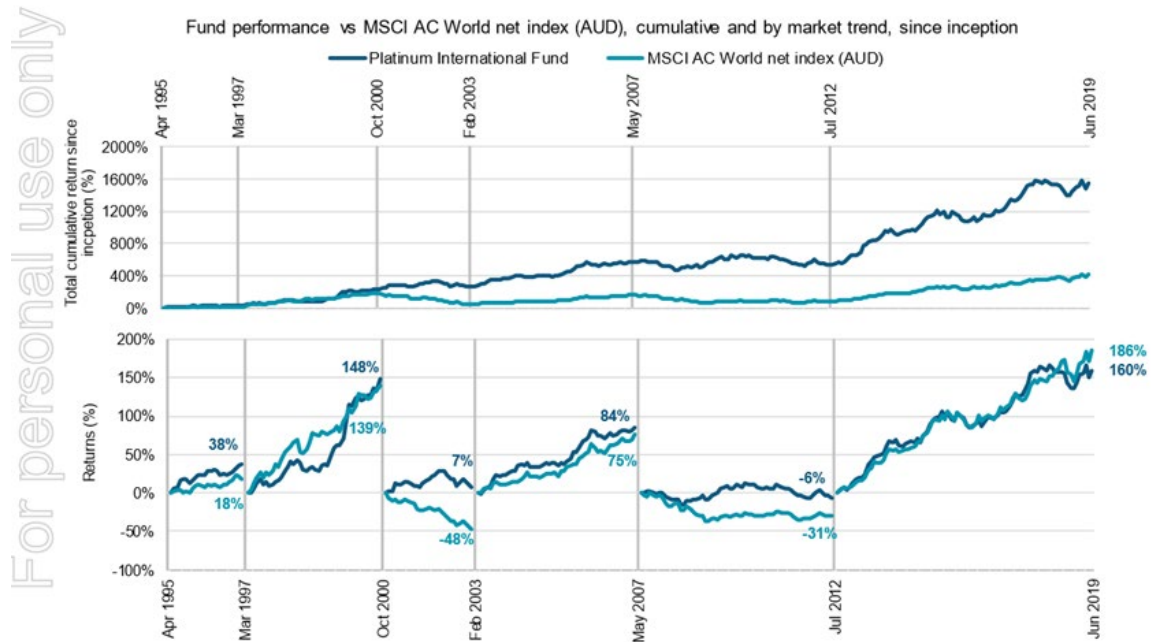
Some of the best managers globally with the longest records struggle in these environments

Why? Because they are cynical and risk averse (reflective and prudent). See Platinum below.



## Platinum International Fund

Investment performance: bull & bear market view since inception to 30 June 2019



### Berkshire Watch

During Q2 2019, Berkshire Hathaway's (BRK.A)(BRK.B) 13F stock portfolio value increased ~4% from \$199B to \$208B.

The top five positions account for ~65% of the portfolio: Apple Inc., Bank of America, Coca Cola, Wells Fargo, and American Express.

There are 44 individual stock positions many of which are minutely small compared to the overall size of the portfolio.

