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Alvia Asset Partners Investment Team Insights

September 2021 Quarter

A message from the CIO

Another quarter has come to a close and the talk of inflation and central bank policy feels like it's never ending. To keep in tune with my previous letters, I thought I would focus on the behavioural elements of finance as opposed to noisy minutiae of market forces.

These are my etchings of personal investing post-mortems:

1. Turn off cost bases as they are largely irrelevant numbers. Seeing red and green on the screen adds no value. The market has no concern for your cost base and neither do management teams. **Worry about what the company is worth, not what it currently sells for. Turn off the market numbers and focus on the value;**

2. There exists no vaccine for overleveraging. A combination of overleverage, lack of due diligence, aggressive assumptions and a scarcity of information, is destined to generate poor results. **When unsure or uncertain, increase your equity buffer or do not participate;**

3. Being patient and sitting on your hands is not the same as doing nothing. Use this time wisely and get a little smarter everyday (read broadly). Ignore the noisy market news headlines. **Holding your portfolio is an action in itself. Use that time to advance your knowledge in areas you wish to improve your circle of competence;**

4. Avoid letting your first level brain do all of the work. Take the time and energy to allow your second level brain to kick in and work for you. **Almost all news you read is first order based and investing is far more nuanced/complex;**

5. Very comfortable investments at the beginning are typically not exceedingly profitable at the end. The most profitable outcomes tend to be garnered by being uncomfortable at the beginning. **Worry when you are investing alongside comfortable optimistic groups, not when you are alone amongst pessimists;**

6. Backable management is aligned, invested and humble. Unbackable management is shiny, defensive, arrogant and there for the salary. **Beware nice watches and negative cash flows;**

7. There is no right or wrong, only expectations and it is okay to change your mind;

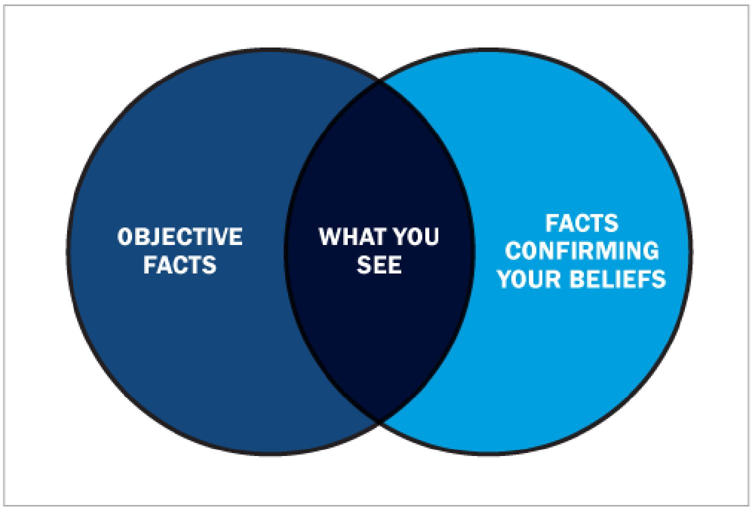
8. Do the work, invest with conviction when odds are in your favour but within set boundaries (consider asset allocation);

9. Cash flows over revenue. **One of my more important lessons;**

10. Follow management via their financial acumen, not their social one;

11. Force yourself to rebalance – it is why you have an asset allocation - it forces risk management. **Avoid chasing returns or recent winners;**

12. Don't treat your savings haughtily and become very comfortable with being wrong. Confirmation bias is very dangerous and once you formulate a thesis it tends to be all you will see. **Be prepared to challenge it like a scientist testing a hypothesis.** Being wrong is perfectly fine. Mr and Mrs Market can be right!



www.empirefinancialresearch.com Source: ResearchGate/Journal of Social Sciences and Humanities

13. Finally, I recently read a story about an institutional money manager who was pressured by an investment committee to invest with Bernie Madoff. This manager had concerns around the validity of Mr Madoff's fund. Nevertheless, under the pressure of the committee he invested as he didn't want to lose his job. The irony here is that decision is why he hasn't worked in the industry since. **Good investing is part analytical, part behavioural and it is perfectly polite to say no repeatedly…don't succumb to pressure.**

We want to thank all of you for your support of Alvia; it truly has been overwhelming. If anyone would like to discuss anything they read below or have a general conversation, please reach out.

Yours sincerely,

Joshua Derrington
Chief Investment Officer
Alvia Asset Partners

Wall Street sell-side at maximum utilisation

We are conscious to not make grandiose statements, although we prefer to be quite the contrarian investor. However, we are overwhelmed with the propaganda churned out by the sales side in finance and we are concerned that these new investments aren't aligned with investors' best interests. Rather they are a mechanism to transition shareholders' wealth into that of a flashy salesman.

As of late, we have slowly become more vocal in challenging this and it is all visible on our website. Below is what we are seeing more and more of.

Base load power struggles in developed countries

We are seeing a lack of baseload power. First it was Texas during the winter storms earlier this year and now we're seeing major issues in Europe. The sell-side machine isn't the cause of this – it is a decade long period of underinvestment in a sector that has slowly steered us to this point. For reference, page 15 of our insights from last quarter, titled "Narratives over Numbers" will show this.

However, lately, it feels that this woke corporate push for ESG has possibly gone too far. We are seeing a lot of opportunities to invest in the newest ESG, renewable ETF, fund, asset, etc, etc. We do not dispute this is a good thing, we want to make that clear, however, is this pivot on a whim to renewables causing a huge dislocation? Should we have a more orderly approach and understanding of the 2nd level effects?

Is this lack of underinvestment paired with negative narrative around fossil fuels causing a surge in electricity prices across Europe? Is this foreshadowing what is to come for the rest of the world?

For those who are unaware, natural gas futures are up 89% year to date, flowing through to a significant impact on the wholesale and retail prices of electricity, in addition to carbon credits. The existing dependency on wind power and imports is proving to be unreliable. These surging prices are impacting basic business operations in Europe and are naturally exacerbating concerns around long lasting inflation.

A quick breakdown of what is happening in Europe

- UK is closing coal plants by 2024 and focusing on wind as the replacement. However, recently wind turbine output has decreased, resulting in a lack of baseload power (any 5-year-old would ask, "what happens if there is no wind?")
- A shortfall has now seen a forced return to gas and coal, which is not cheap to restart and without long-term purchasing agreements it forces spot market purchasing
- This spot market purchasing has caused the significant upward price shock, with years of underinvestment impacting the supply in the spot market (the price of thermal coal out of the Hunter Valley, considered a benchmark for global prices, has just smashed through its all-time high, set in July 2008)
- This underinvestment is exhibited through capex for new projects being down 25%, which superficially doesn't address this supply problem
- Europe has become far more reliant on Russia, which would clearly manage the relationship in their favour
- UK energy retailers are distressed due to the surge in prices and as a result folding (PFP Energy just declared bankruptcy)

What else is gas used for?

- Gas is a significant input into ammonia. We aren't chemists but ammonia is required for fertiliser production
- Fertiliser is an input required to grow food (and even more so as global arable land supply continues to decline, the crop yield per square metre of land needs to increase)
- Two large fertiliser factories in the UK have now also closed due to the high prices. The UK government is now contemplating a bail out… as food funnily enough is quite important…**anyone else see the irony here?**
- Higher fertiliser input prices reduces farming production and applies upward pressure to food prices

We could go on and on but our frustration is from the basis of first order thinking versus the ripple effect.

We don't dispute we need to consider the environment and we need to incorporate renewables. Our children and their children require a change in this mix. However, the all or nothing mantra is having massive causal effects that need to be considered.

We wonder who is feeling the pinch of all of this? We are comfortable to bet it isn't the woke governments, corporates or individuals who are pushing for the all or nothing approach.

The salesmen cash cow

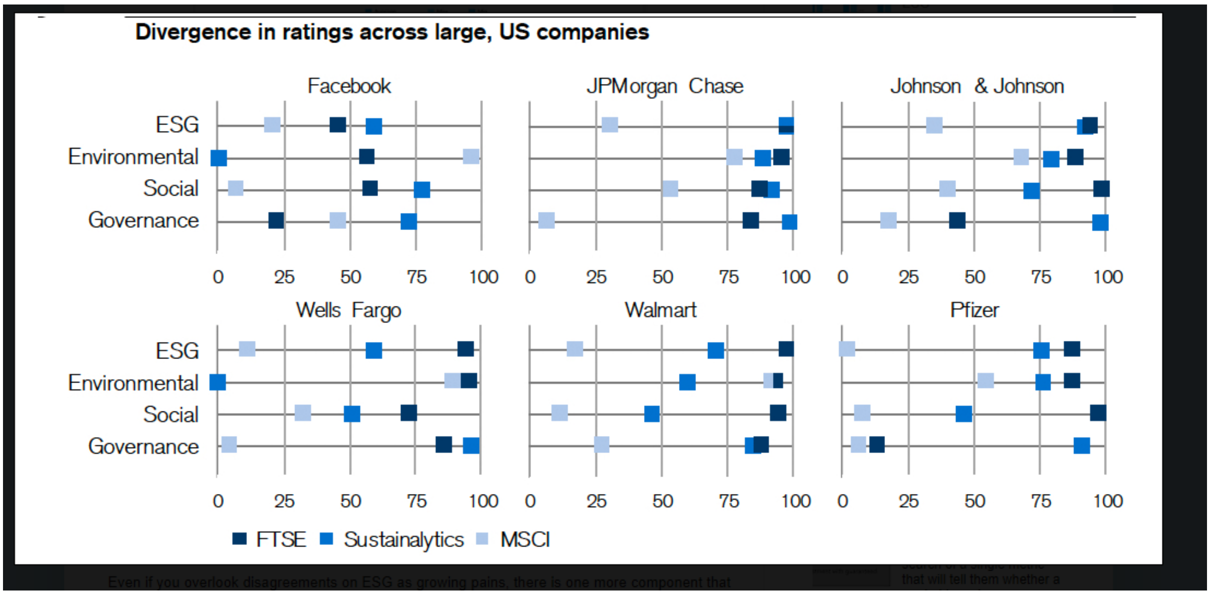
ESG is so open to marketing propaganda and extremely subjective. You cannot simply screen for morality as it is deeply ingrained in the long-term thinking and culture of an enterprise. We see this area being open to being "gamed" and it appears the sell-side Wall Street machine has done exactly that.

Any good long-term investor considers these risks; however, they don't just simply allocate to something with a name that suggests it superficially adheres to ESG principles. Rather it is ingrained in their process.

"We have always considered ESG as part of our investment process. We've never called it out as something in isolation... for us it's just part of making a good investment decision."

– Chris Scarpato on Ausbiz

See below the divergence in ratings by agency for 6 large US businesses (and all names you will know). So, why the divergence? It's deeply subjective based on personal criteria and personal bias/circumstances.



Source: *Bloomberg*

What's the investment opportunity?

The opportunity lies in finding the superficially first order ignored non-ESG aligned assets that are stranded for capital…and let the market wake up to itself over time.

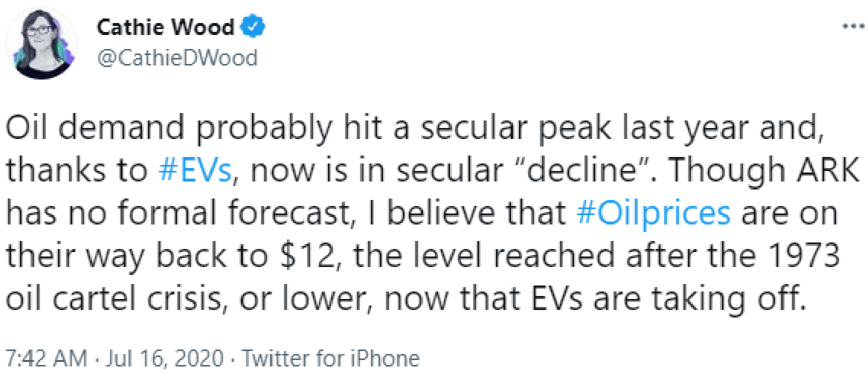
Investors/celebrities making grandiose statements

1. Cathie Wood

Cathie Wood was one of the top performing fund managers in 2020. She ran a one sector, technology only allocation and it resulted in excellent capital appreciation for her investors (we would normally say "paid dividends" but only a small number of her holdings have free cash flows to be able do that).

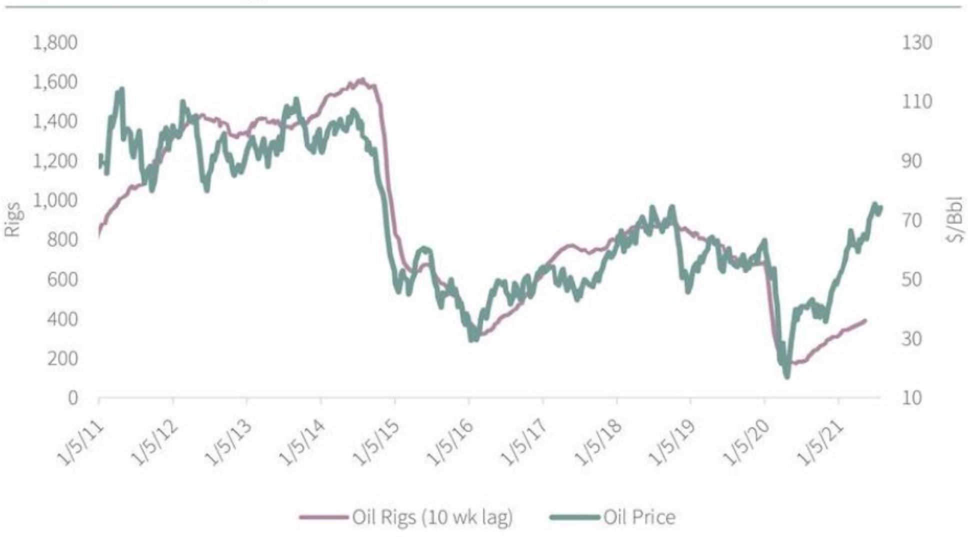
Her rise to fame was through "accurately" forecasting the growth in Tesla. We invite people to look at her model, because her assumptions are nowhere near where the business is today.

Nevertheless, she made another forecast last year, calling the end of oil.



Let's take a look at how oil has performed

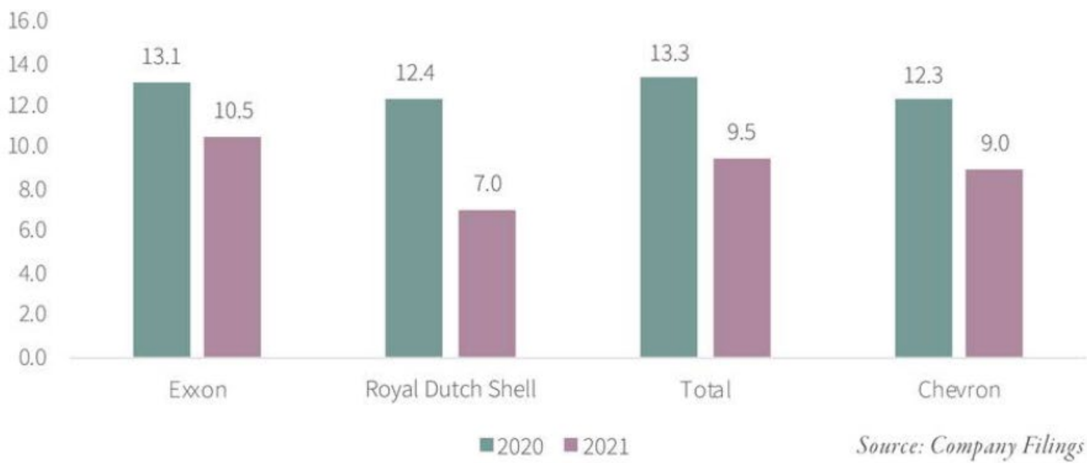
FIGURE 5 Oil Rigs vs. Oil Price



Source: Baker Hughes and Bloomberg.

We appreciate that this is over a short period of time and there was no timeframe set, however with the lack of oil rig activity limiting supply, we struggle to see how the price declines. Even looking at the oil reserves to production it starts to become worrying.

FIGURE 3.2 Oil Reserve to Production Ratio



Source: Company Filings

Is this because these companies don't want to face the wrath of woke individuals pushing their ESG narrative?

Alvia's investment case on this?

It was semi obvious - when supply is reduced massively whilst demand is unchanged, prices will simply increase. This is why we put our necks out there picking commodities as the best performer of 2021. We feel we have babbled on about energy for a while now. It remains unloved and one of the more compelling sectors. Insiders are buying whilst the larger institutional money is being driven away due to first order thinking ESG mandates.

What is happening in commodities is interesting. It is also an unloved sector, starved of capital. It is impossible to predict the long-term cycle but we do believe there are opportunities to own the higher quality end of the sector (diversified with low cash operating costs when commodity prices get depressed). The secret is to not fall in love with cyclicals as they will always disappoint, which is why we struggle to support the "supercycle" narrative. Rather, we review weights, thesis and exposures regularly.

2. Mark Cuban

We are always interested in researching areas that see large amounts of negative sentiment. Most of the time the market is right and we are respectful of that, however, sometimes it presents us with great opportunities. This sentiment continues to bring us to gold.

Gold has fallen for seven months from almost US$2,100 to $1,670 an ounce, a c.20% decline. Now there are a lot fewer calls for $2,500 gold…pervasive bearish sounds.

Mark Cuban stated "I hate gold. Gold is a religion. I do not see it as an alternative to currency". The thing to note here is Cuban is a big crypto fan so is inherently biased…the same way we are disbelievers in crypto.

However, what can't be disputed is that sentiment is low for gold and the only time it has been lower was in 2000 and 2013.

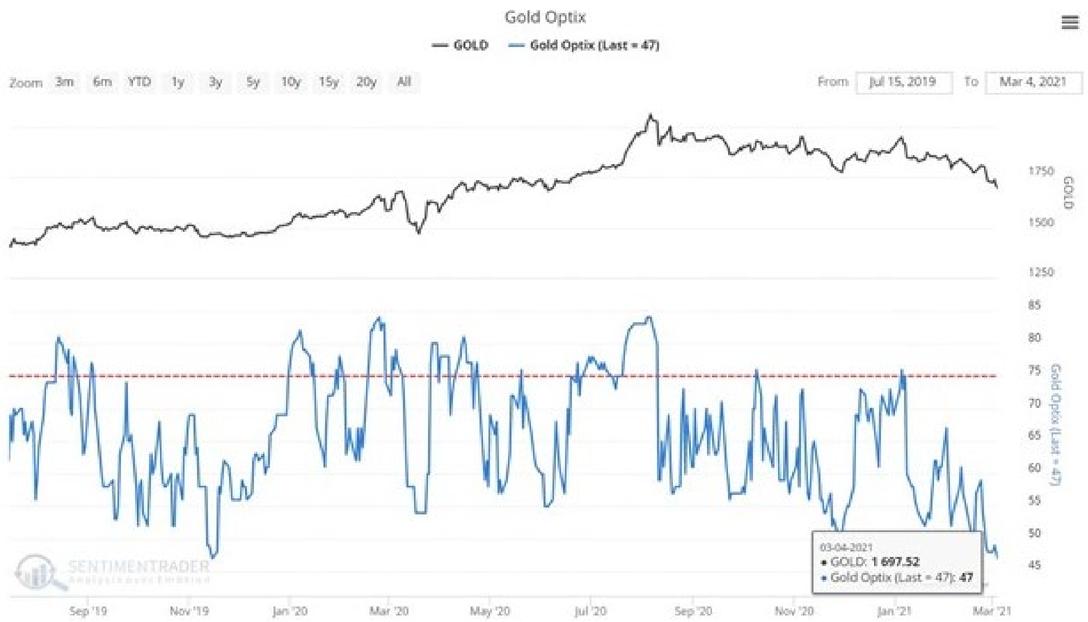


Exhibit A – DotCom bubble

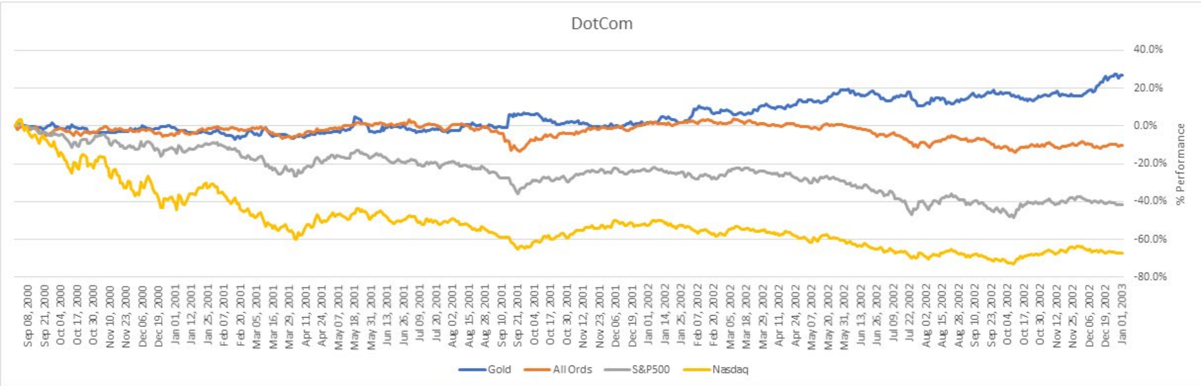
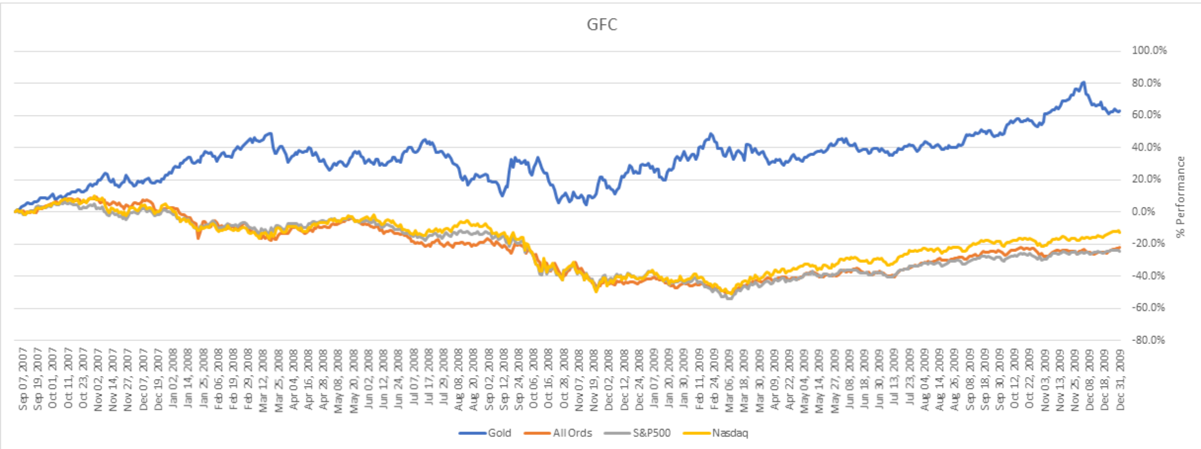
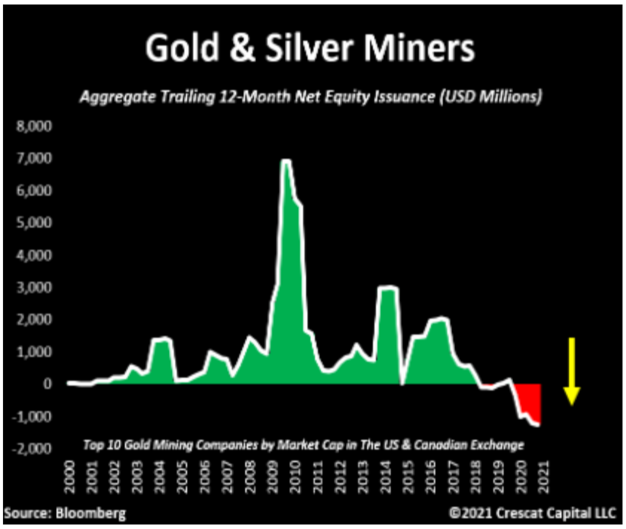


Exhibit B - GFC



We aren't sure about Mark, but we prefer something that has been tried, tested and prevailed through the cycles (unlike cryptocurrency which came to be only in 2009, at the end of the global financial crisis).

We haven't even discussed the miner's proposition yet…



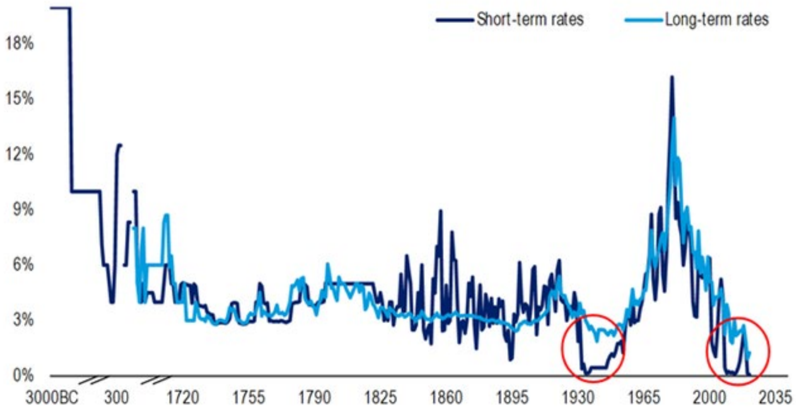
The FAD Factory

Before we go too deep into this, we want to discuss some potential drivers behind the euphoria we are seeing in the market.

Money is as cheap as it gets, which therefore makes assets expensive.

We still find people who don't quite understand how low interest rates and asset prices work in unison.

Chart 2: Price of money remains at 5000 year lows
Interest rates since 3000BC

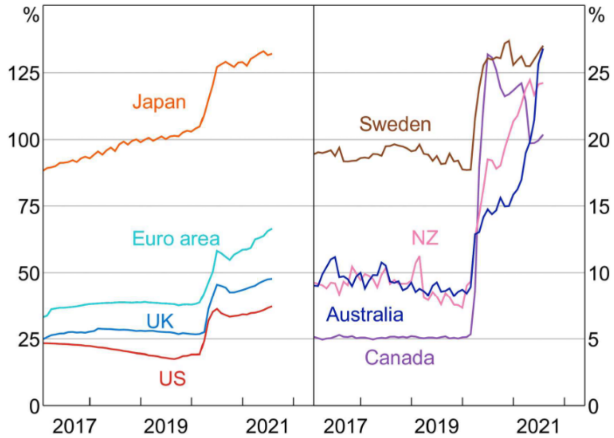


Source: BofA Global Investment Strategy, Bank of England, Global Financial Data, Homer and Sylla 'A History of Interest Rates' (2005)
BofA GLOBAL RESEARCH

The printing of money has seen the household cash levers increase dramatically

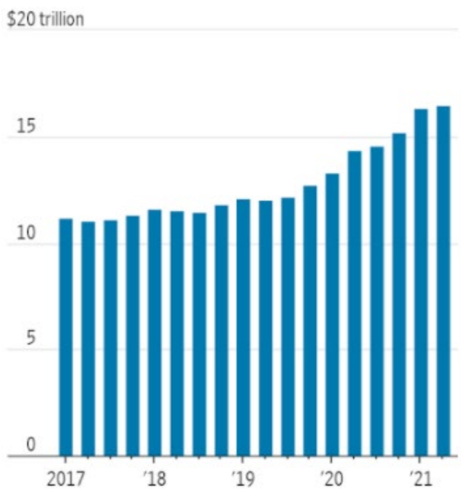
In a world awash with liquidity at a corporate/household level and bankers reluctant to hike rates, it is certainly supportive of 'buying the dip' – however, we are always conscious of falling for this first order rhetoric.

Central Bank Total Assets
Per cent of GDP



Sources: Central banks; RBA; Refinitiv

Money in the Bank
Household cash and cash-equivalent holdings



Source: Federal Reserve

NFTs Nifty Fifties

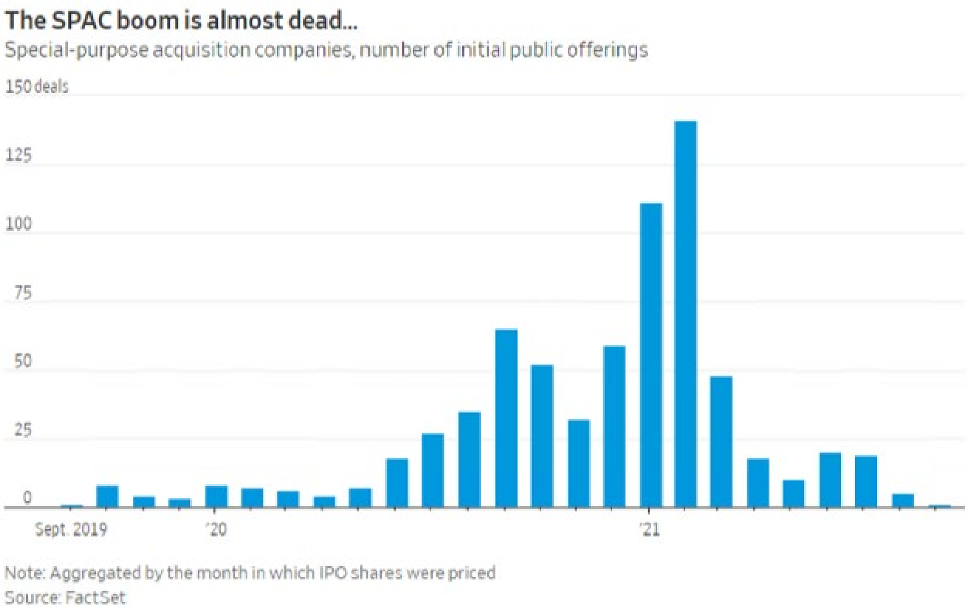
NFTs were quietly introduced several years ago but recently their interest has really stepped up. Sotheby's and Christies are now in on the auction of NFTs, with a $69m sale of a digital piece of who knows what. There were sales of $2.5b during the first half of the year, then $2.5b of sales in August alone on one platform. We recently read a story about the granddaughter of Warren Buffett, Nicole Buffett selling digital art pieces.

"NFTs are really art as money, art as currency, which means there's more accessibility for artists and for people who want to buy art," she tells the *institutional investor.* "It's great just to have more eyeballs on the work."

We think it goes without saying that plenty of value destruction will occur in this space. When people hand over hard earned cash for JPEGs you can be certain that too much cash has been generated.

SPACs

SPACs were the hottest thing earlier this year but now are barely spoken about. Seems the FAD factory has moved on to the next cash cow.



Investors' best interests at heart…

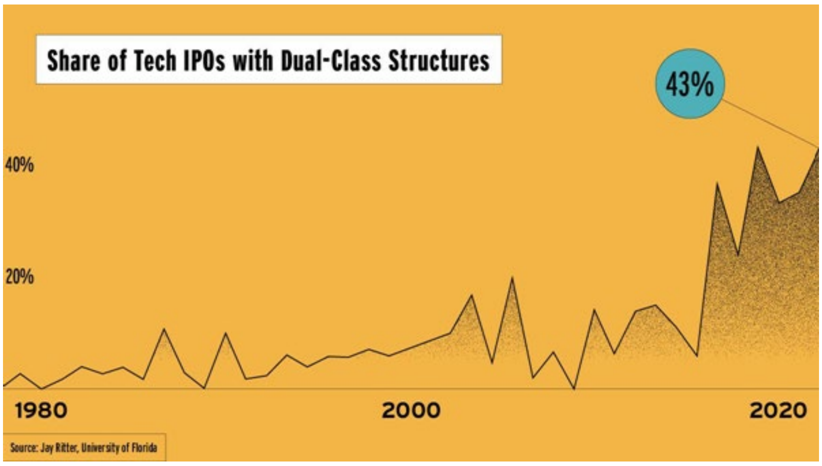
The best we have seen of late is **WiMi Hologram Cloud (NASDAQ: WIMI - US$690m market value)**, a Chinese hologram augmented reality company. They claim to have spent $35m to acquire "artificial intelligence and cloud computing technologies", when it actually bought a wholesale electronics and assembly business.

Investors believed they were buying a hologram business when in fact they got a low margin, low growth, unprofitable advertising and electronics business with a tiny R&D budget.

Clearly a total sham, however in light of cheap money and current buoyant market conditions, companies can attract large amounts capital, solely based on their name and a glossy prospectus outlining a vision to do great things in the future.

Source*: Bear Cave*

We are also seeing more and more dual class tech IPOs. We wonder why this is happening?



Napa Valley wineries

Another example of Euphoria. Napa Valley wineries are generating Buffett like returns. Watch certain fund managers sell a story of sustainability around this. The bull thesis is probably to do with its proximity to the Silicon Valley entrepreneur region.

Exhibit 9: Average annualized income, capital returns and volatility for each district (2001-2020)

	Average Return		Volatility	
District	Income	Capital	Income	Capital
Napa	7.9%	9.1%	1.9%	12.5%
Sonoma	5.4%	3.6%	1.6%	12.4%
Monterey	14.6%	6.3%	5.7%	8.8%

Source: Westchester analysis of industry data

Source: *Nuveen*

An add back economy - EBITDAALLCOSTS

The number of adjustments to earnings to fit a narrative continues to bewilder us and we often wonder who is buying into these things.

If you're investing based on add backs, just simply ask yourself this - if you only had statutory accounts without any of the gloss (presentations, infographics, stories about the future), would you invest?

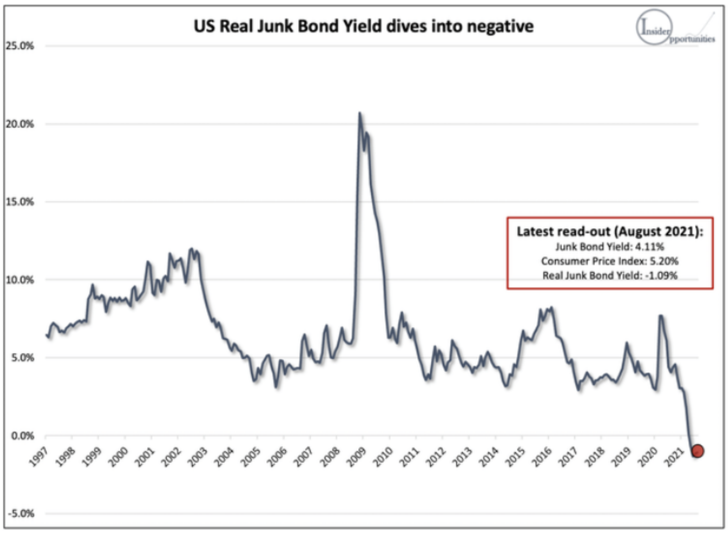
The truth almost always lies somewhere in the middle between the accounts and adjusted earnings (however, there is a tilt towards the accounts).

What risk? Yield hunger remains

We are seeing a lot of investors locking in 4% returns on junk fixed income and telling us how amazing this is. We question if you have factored in the following:

- Default risk premium that should be paid – circa 3-5%
- Inflation – circa 4%

Are you really being compensated? The below shows the appetite for headline pre-inflation yield. There is clear desperation for yield, so much so investors are buying junk bonds that have a negative return...**crazy**.



(Source: Insider Opportunities based on FRED data; junk bond yield is based on the yield of the ICE BofA US High Yield Index)

Seeing red?

We always love talking about behavioural biases. Here is a simple one to improve your long-term returns.

Turn off your cost base as it is an irrelevant number (except for tax purposes). The red and green on the screen add no value. Think like a portfolio manager and disregard – underwrite your positions and portfolio based on the business today and its future cash flows, not based on your cost base.

Whether it is red or green will not change the risk. More risk mistakes are made waiting to meet a cost base than any other investing mistakes. Portfolio percentages as loss aversion will cripple the decision process. "Book profits" is a similar retail mantra that does more harm than good.

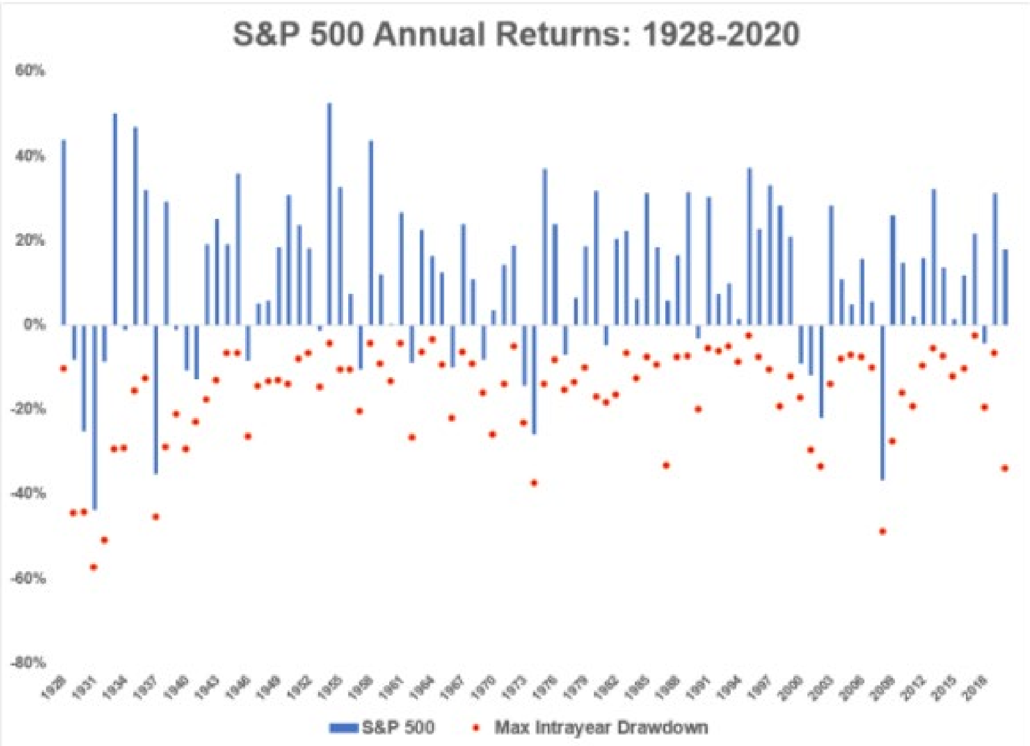
Reds and greens are irrelevant, be a manager not a market maker.

Worry about what it is worth, not what it sells for.

Sometimes it is better to sit still

We find that drawdowns do not equate to annual returns, with the lesson being not to overreact to short term drawdowns as they repeatedly occur. Rather, utilise them opportunistically to take advantage of the power of compounding.

We prefer to let our asset allocation work for you and rebalance accordingly.

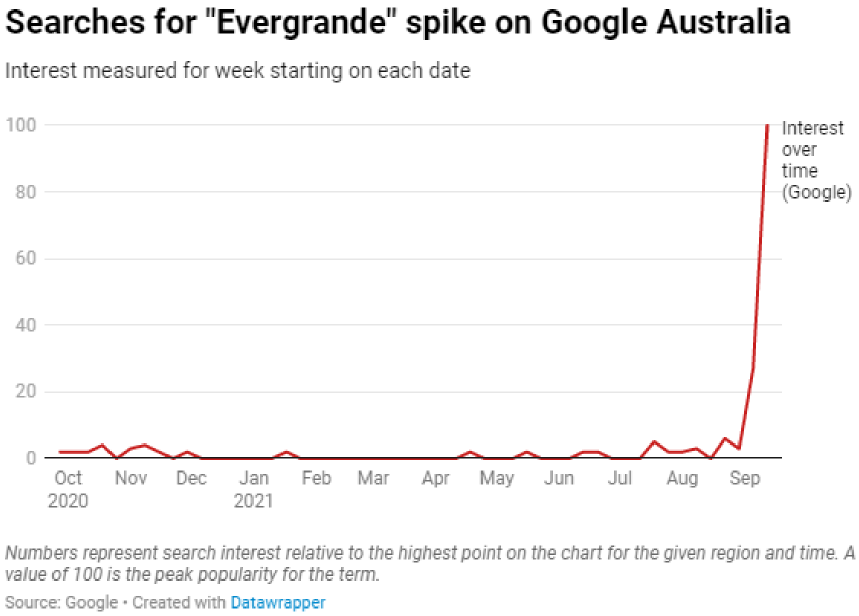


Source: *Ben Carlson*

The overnight expert

If you went back to the start of the year, how well did you know and understand the Chinese property market?

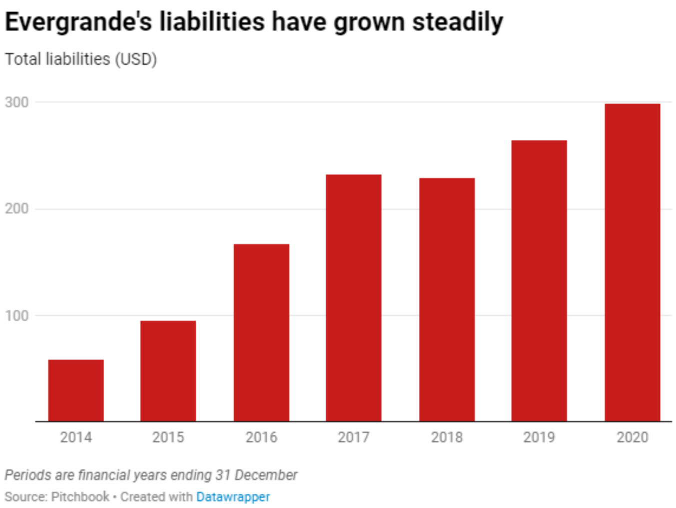
Why is everyone now an expert on it?

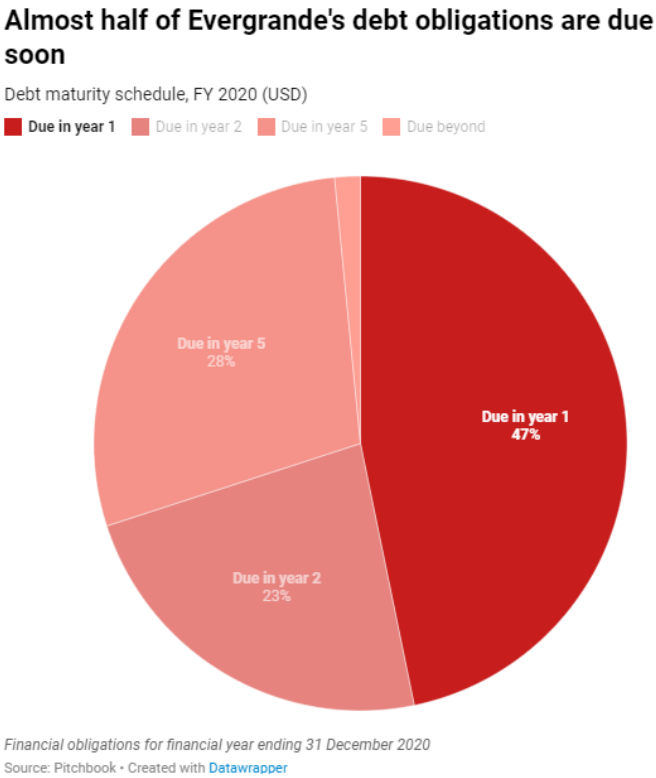


Hunting for the next Lehman event has become a market fascination since...well, Lehman. We do not profess to being an expert on all things Chinese property development, however, the risk of global contagion to the same extent as that of Lehman Brothers in late 2008 occurring as a result of issues in the Chinese property market, is on the lower probability side.

Our brief thoughts

- Chinese property is a very risky arena in which to invest. Property development alone in any country is itself a high-risk exercise
- Evergrande is large and highly indebted, insolvent and thus creditors (many) are circling
- We were surprised at those that invested in their debt (yield chasing?)...very gross
- The market was worried about contagion which is impossible to predict as it relates to liquidity and the actions of the Chinese Communist Party or CCP (who provide the liquidity)
- Evergrande are closely tied to the CCP. The developer has a large presence in 280 cities and has been aggressive on all fronts, especially with its balance sheet (see below thanks to Morningstar)
- The CCP is attempting to reign in property development risk via new policies that banned lending by state-owned banks to the sector
- The CCP is also attempting to address housing affordability (as profits on homes in a socialist regime are a bad look)





So why is it blowing up now?

- Capital markets got tired of supporting it and are running for the exit (liquidity crisis)
- Property sales have slowed (liquidity issues again)
- It doesn't need to be contagious to be bad for China as these issues will starve China of external capital for a period of time
- All related property companies have seen their share prices decimated and the broader Chinese market has rerated for this apparent new risk (in our view a risk that has been present for some time)
- Lots of hard risk lessons for allocators…in particular with regards to investing in a socialist economy with stretched balance sheets

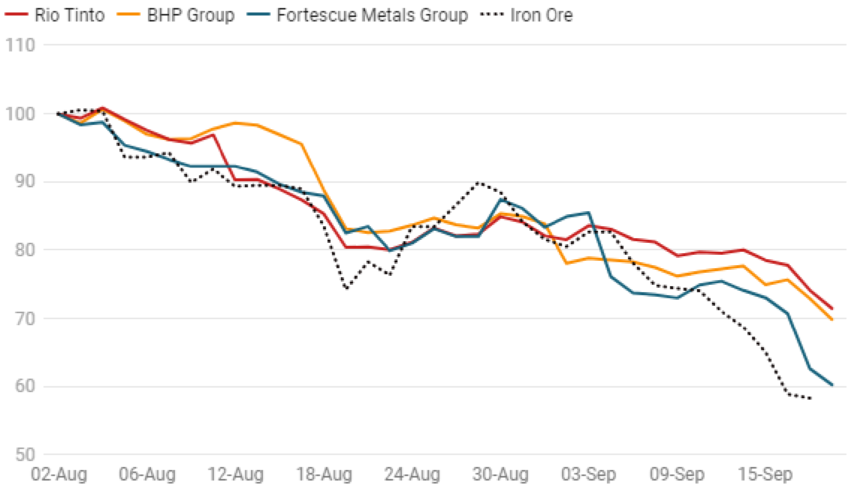
We were quite surprised as to the holders of Evergrande junk – some very large well-known names…they will feel some pain.

Why does it matter to us and AUD/iron ore?

Simply if China sneezes we Australians get sick, at least from a capital inflows perspective. Australia will always see first order outflows as Chinese risks become more discussed. We are seen in the investment community as the China urbanisation proxy, hence, when China becomes a target, so do we. Have a look at the AUD and iron ore price of late.

The market starts to factor in broader Chinese slowdowns, which drives down model forecasts on iron ore volume/price and Australian GDP growth.

Big miners tumble as iron ore falls

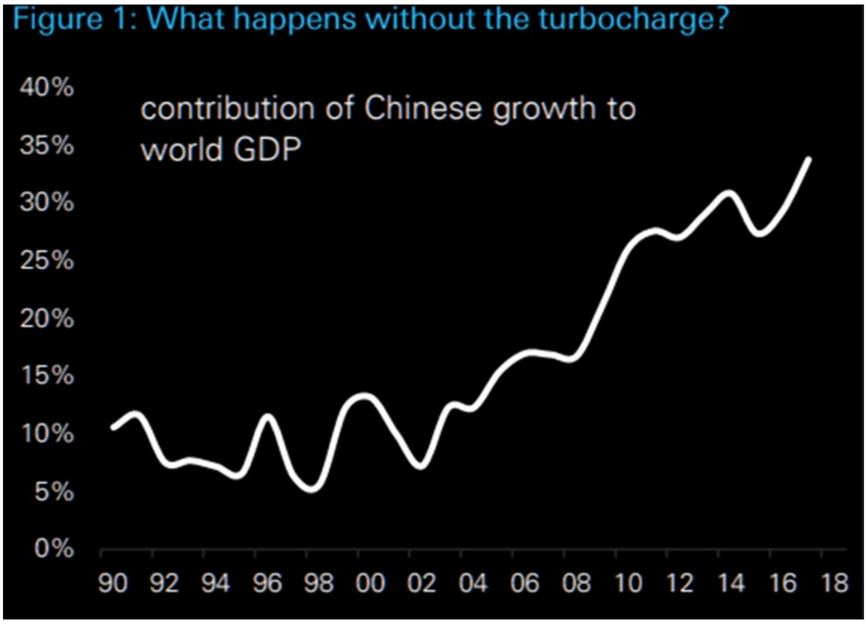


Prices rebased to 100 on 2 August

Source: Morningstar • Created with Datawrapper

Source: Market Ear

However, it isn't just an Aussie issue…it appears we all need Chinese Growth



Source: Market Ear

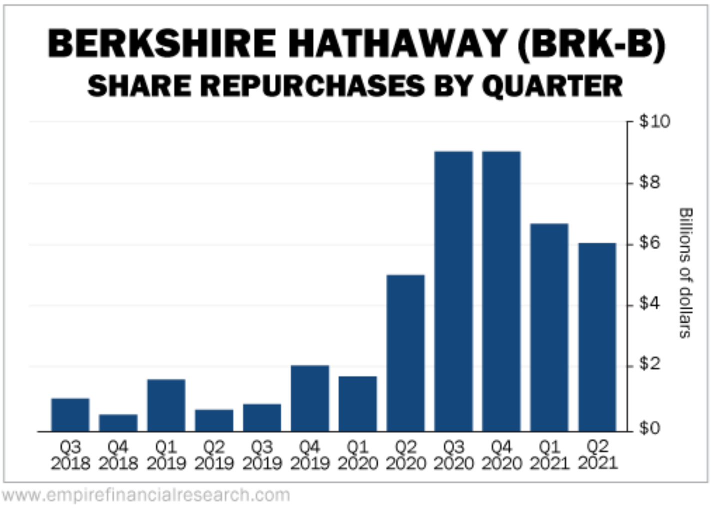
In Summary,

Evergrande isn't great and investing in China is fraught with risk (which needs to be priced in). It becomes a choice about whether risk compensation is there (this has never changed). Excessive credit expansion will always add to risk and when the taps stop flowing all those reliant on the expansion will be under extreme distress.

How this distress plays out becomes a game of probabilities.

Buffett Watch

Buybacks continuing which is good enough for us 😊.



We all know what Mr Powell wants for Christmas

Mr Powell continues to pitch us the same story that inflation is transitory, effectively when we wake up Christmas day it will have all disappeared.

"So, I wonder if we ever looked at inflation in the past and said oh, this is here to stay, so you need to adjust for it. I think we always think it's transitory."

- Tobias Carlisle, California based, ex-Brisbane investor

Inflation according to Terry McCrann

"Inflation? Inflation? What inflation? That's been the pathetically desperate response from the Fed as the ever-mounting evidence has rolled out from month to month.

Back in March, not a single one of the two dozen or so Federal Reserve Board members and Federal Reserve Bank presidents saw consumer inflation higher than 2.6 per cent over the course of 2021.

On the latest figures, it's already added to 4.2 per cent in the seven months to July.

Just to make it very clear, that's not 4.2 per cent over the 12 months to July, but 4.2 per cent in the seven months of this year to July.

That's to say, in the first seven months of the year, inflation has run at a 7.1 per cent annual rate.

Now the Fed can keep the music playing for a while, by pretending the inflation doesn't exist."

So why is this on Mr Powell's wishlist?

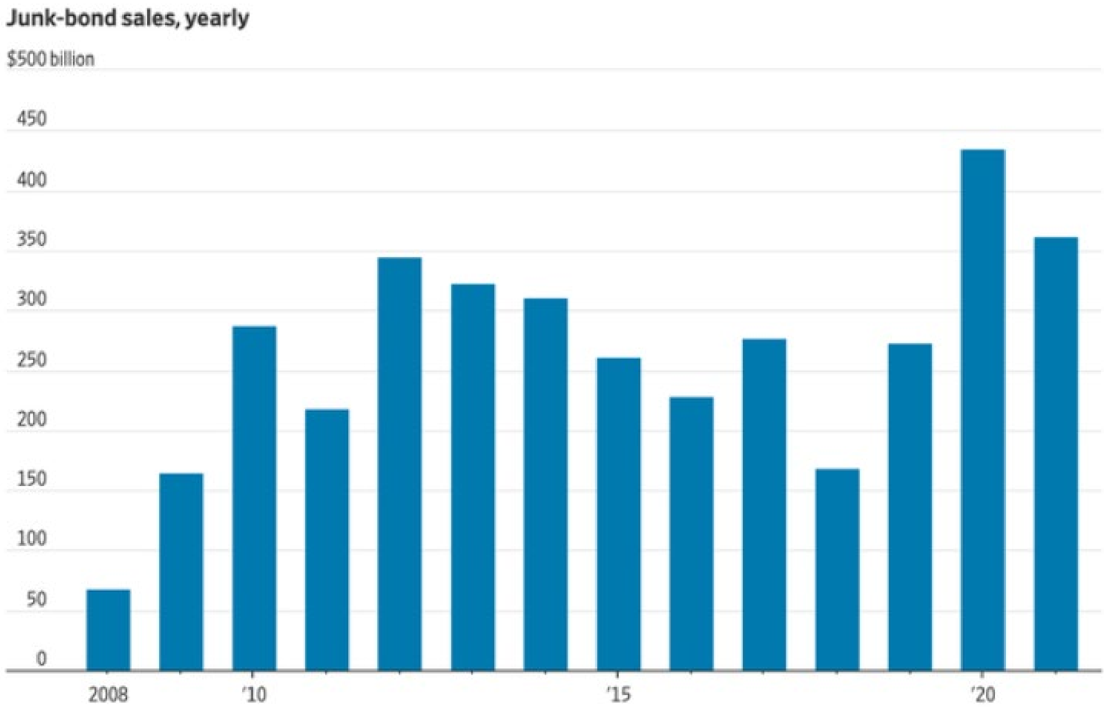
The problem with assuming high inflation equals high rates.

We are in a world choked to the gills with debt (just look at the junk bond issuances below). Higher rates clearly cause a problem, especially when governments themselves are particularly indebted. There becomes this clear and present conflict of independency between central banks and governments.

The main problem is that governments cannot pay off their debts so need inflation to run it down, and they cannot afford negative sentiment associated with high consumer burdens. This is why risks like Evergrande exist (they are one of thousands of debt-related issues within both corporates and governments).

In economic terms, it is referred to as a debt trap (defined below).

"The global economy is heavily indebted and too financially fragile to handle tighter credit conditions."



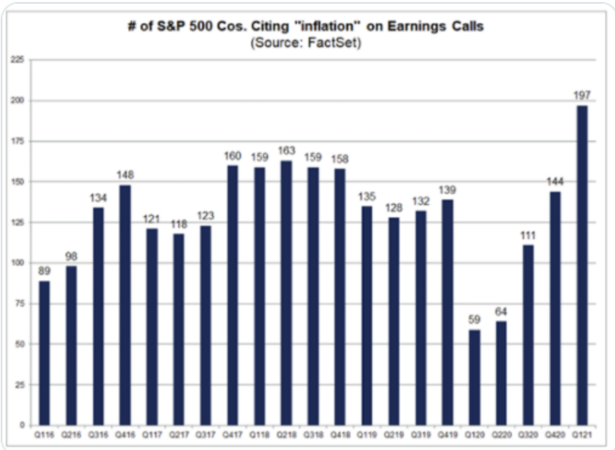
Note: 2021 data are as of Sept. 14
Source: S&P Global Market Intelligence's LCD

How's the market positioning for this?

Circa 74% of capital allocators are positioned for transitory inflation and this is what matters, not if they are right or wrong. Risk lies in expectations not outcomes. Being wrong is based on what you know is true 😊.

HorizonKinetics
@HorizonKinetics

Last month, FactSet reported that a record 197 S&P 500 companies cited the term "#inflation" in their 1st quarter earnings call. The prior record was 163 companies. Apparently, this database goes back to 2010.



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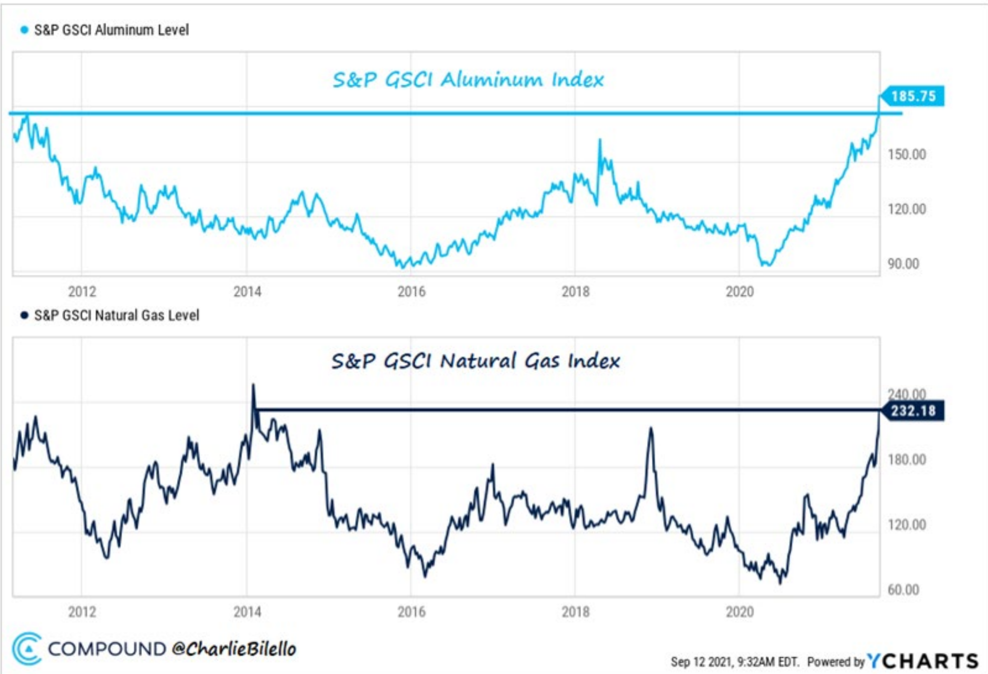
When looking at wages data, it suggests a 4.3% increase in American wages paired with CPI up in the order of 5.3%. This implies that the average basket of goods and services increases more rapidly than wages, which tends to cause political headaches.

It is also apparent that many areas are certainly outstripping the CPI rate. Housing is averaging 1.5% a month and haircuts are showing 20% year on year increases. At some stage this has a consumer confidence impact.

As we know, corporate profits remain very healthy, however, we worry about their sustainability as everything normalises and tax hike talk gathers steam. Our view is that profits revert closer to 2019 levels as stimulus subsides and markets normalise.

This doesn't help



Monopoly money

It seems the numbers don't matter and the Afterpay outcome (which we got dead wrong) provides a great example. Afterpay joins Square via an all-share deal (feels a bit like Monopoly money). Neither business generates free cash flow, however, tech billionaires with beards and a vision are all that matter at present.

Anti-rich, anti-finance movement continues

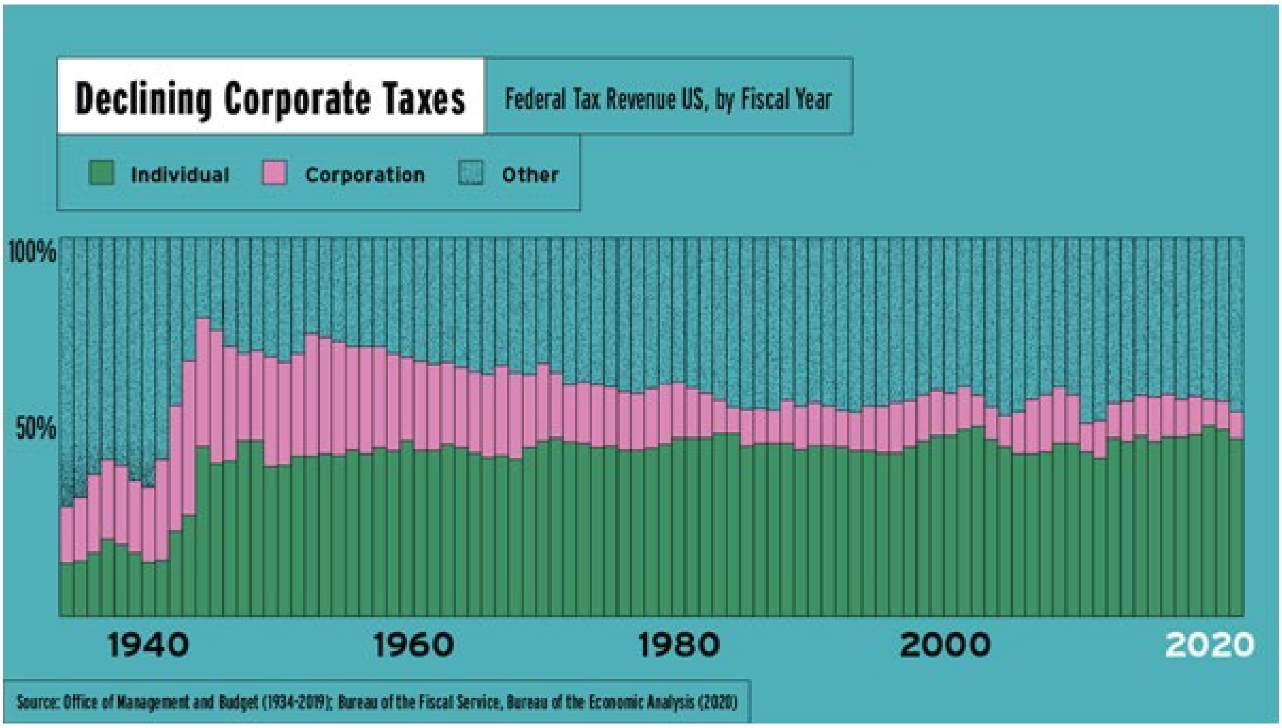
We have previously referenced that it is apparent tax hikes are coming globally and in multiple forms. Hardworking successful individuals/families will feel the brunt. Typically, it has just been wealth and death taxes raised, however, just this week, **unrealised capital gains have been flagged as a source of potential government revenue raising**. Every government is now on the hunt for revenue (maybe they could focus on the bottom line as well?).

If you have ever invested in anything you know how absurd thinking about taxing unrealised gains is.

Private equity managers become the latest to be targeted where performance fees or any carry will accrue a special tax rate above the highest income tax rate (just because). This poses a real challenge for an industry that holds illiquid assets for long periods of time, based on set investor return targets (net of fees and taxes).

Why target these areas when there is a clear elephant in the room in the form of corporates...perhaps investigate tax havens?

- *In 1952, corporate income taxes accounted for 32% of federal revenue.*
- *That number has since fallen to 6%, a record low*
- *Meanwhile, income taxes on individuals have remained stable, generating nearly 50% of federal revenue for the past seventy years.*



Source: *Scott Galloway*

Or maybe it is all the no profit businesses being propped up by paper valuations??

Finding the right investment partner

We recently read an awesome article relating to the superb returns of the Washington University endowment fund which invested in a relatively unheralded private equity firm run by Brent Beshore (who we have a great deal of time for).

Brent's summary as to his dealings with WashU's investment team highlight exactly what we want to see in an investment partner. In the current climate, capital is easy but character flaws are permanent and long lasting. Below is a summary of their interactions and why it's important and how we want to be seen:

- The first interaction was over lunch – not a gruelling Q&A. It was all about finding a cultural fit, good questions without the interrogation
    - WashU highlighted what made them unashamedly different (curious, concentrated, kind and creative). Conviction with true proven long-term focus, testing if there is alignment
    - Alignment existed so the conversation continued – Brent believed there was a low chance of moving forward as their firm was very non-traditional (actually working in their favour). WashU's willingness to migrate away from herd towards the non-traditional probably has a lot to do with their returns…something we believe deeply (ignoring the competition and running our own race, based on our values)
- The second interaction was with the broader team – placing them at ease with respectful questioning. Not pulling apart but gathering an understanding of culture and process (the enduring part)
- Despite the power imbalance – humility and genuine conversations evolve into DD without it being assertive. **Uncovering truth, not intimidation.**
- No accusations just curiosity based on second level questioning. More work goes on around processes/philosophy/motivation over time and an investment is made (eventually).

Then the true test with COVID comes – is this a partnership or a servant/master relationship?

- At least initially Brent had concerns about the portfolio and messaged the WashU CIO

Within 5 minutes, Scott the CIO called him. It was calm and Brent greatly appreciated his encouragement and generosity. The talk being leisurely, walking through the concerns and Scott pledging to do whatever it took to help out, even with previous investments.

This is how we choose our clients/partners:

- Choose low ego partners that are principled and truly understand us and align on a values basis. Stepping outside of this opens up to misalignment issues and ultimately redemptions at the wrong time.

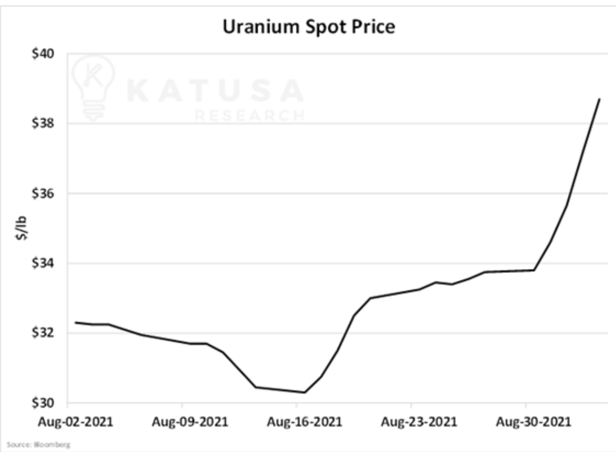
The Alvia client checklist to ensure alignment on investment timeframe

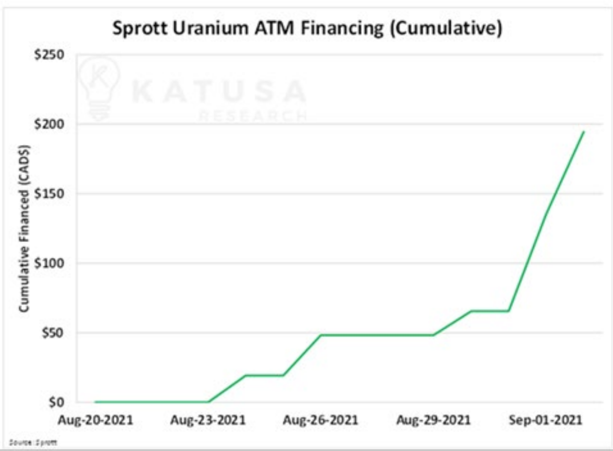
- Is there an appreciation of the concept of intrinsic value? Businesses can be under- or overvalued but will converge to intrinsic over time
- Is longevity appreciated? Speculators are short term, investors are long term
- Can they endure and embrace drawdowns or do they live day-to-day green or red?
- Is capital thought about in real terms (i.e., purchasing power)? Or is it all relative?
- Do they appreciate the concept of rebalancing to be difficult (buying underperformers vs allocating more to performers)?
- Is there an appreciation for what they don't know and are they willing to learn with us as we do?
- Investing requires a continual learning mindset. Are they able to accept this?
- Are they willing to embrace our process and place trust in us?
- Do they appreciate that true risk is not volatility and the easiest edge to gain is a behavioural one?
- Can we build a relationship based on mutual respect for one another's skills?
- Is there an understanding that compounding requires time and consistent systems to succeed undisturbed?
- Are we able to buy them the scarcest resource on earth (time) to enjoy their wealth?

Uranium, continually banging the table

We have liked this for a while. It is a very tight market prone to long periods of negative sentiment that can turn on its head. We have highlighted the struggle for baseload power and believe this genuinely needs to be embraced to aide decarbonising the world. The supply dynamic simply makes sense for higher pricing – China and India are increasing adoption. However, the recent drive of strong producer performance relates to a new player in the market (effectively looking to corner the spot market). Tight markets are prone to this.

Sprott Physical Uranium Trust has become the largest buyer of physical uranium, resulting in price increases correlating almost perfectly with their market entrance.



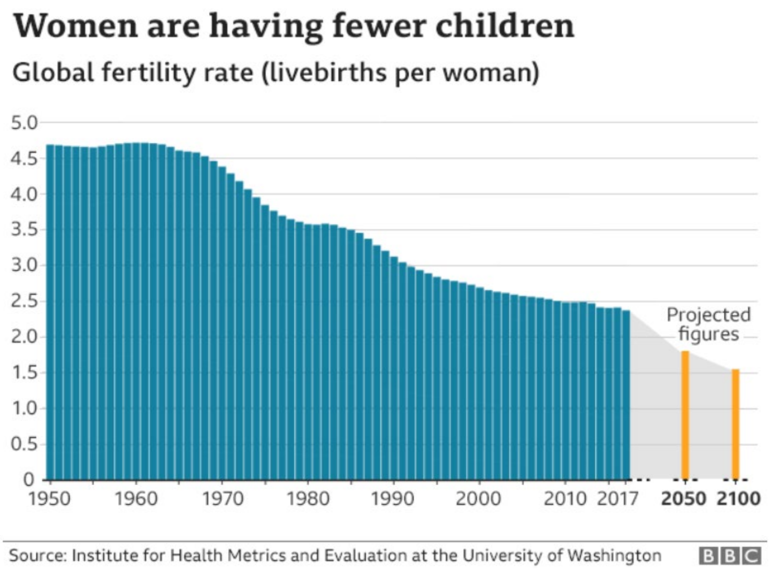


Source: *Katsua Research*

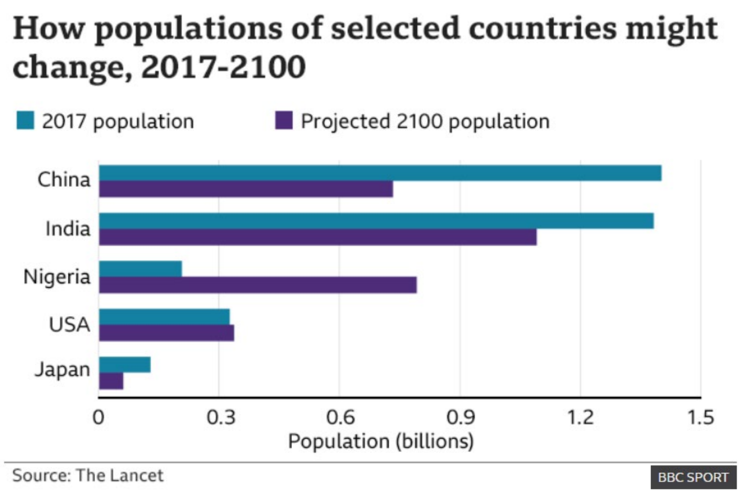
Why Healthcare?

There seems to be a growing problem within healthcare. The aging population is outgrowing the younger generations. If we were to look at it from an investment perspective, the existing asset (humans) are depreciating in economic output (getting older) and this is occurring at a rate faster than the reinvestment (new humans).

A recent article from the BBC highlighted an almost crisis-like reduction in fertility rates. There is a significant risk on many levels and one of the counter arguments that is important to acknowledge with regards to global economic growth rates.



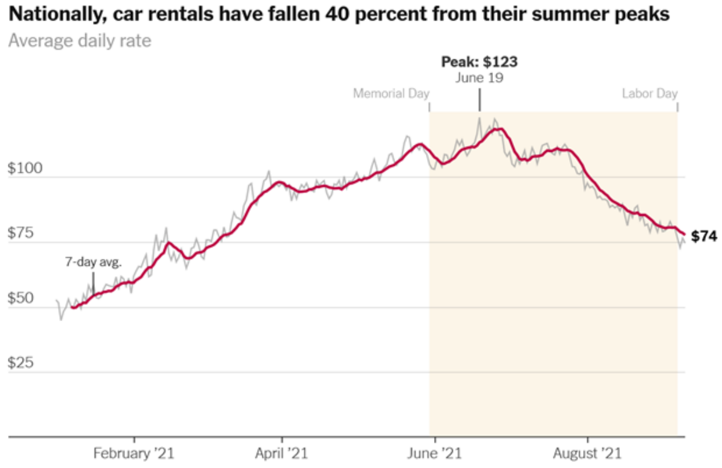
We know forecasting is a dangerous game, but it makes some grand notions. Especially when it is estimated the population of 23 countries are on track to halve by 2100. Countries will start to see more people turning 80 than being born. This supports the thesis of investments in essential services such as healthcare, but also, the investment into India which has a far younger demographic.



Good businesses and their decisions

We find good businesses don't make long-term decisions based on surge dislocations. Car rentals provide a great insight into the COVID dynamics at play and presents us with a great lesson in capital decisions made on surge versus long term.

We believe that many capital allocation decisions made during this period will be tested in future years, with good managers making hay while the sun shines but don't stretch long term capital decisions on surge pricing (i.e. like a car rental business buying a new fleet based on return modelling at $100 per day pricing in June 2021, which quickly dissipated).

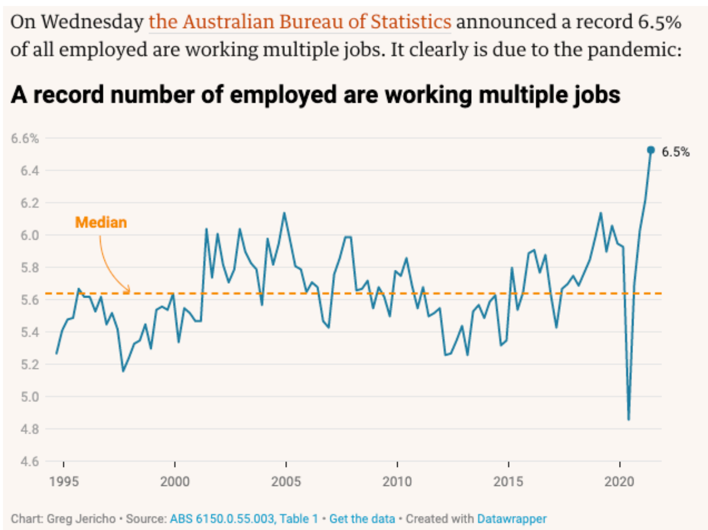


Source: Hopper

This made us reconsider how we use Uber Eats…

Cesar (Solano) recently biked from 77th on Upper East Side, 18 blocks south and over the Ed Koch Queensboro Bridge, then up through Long Island city and over another bridge to Roosevelt Island, all to deliver a single slice of cake for no tip. **Good businesses are good for all stakeholders.**

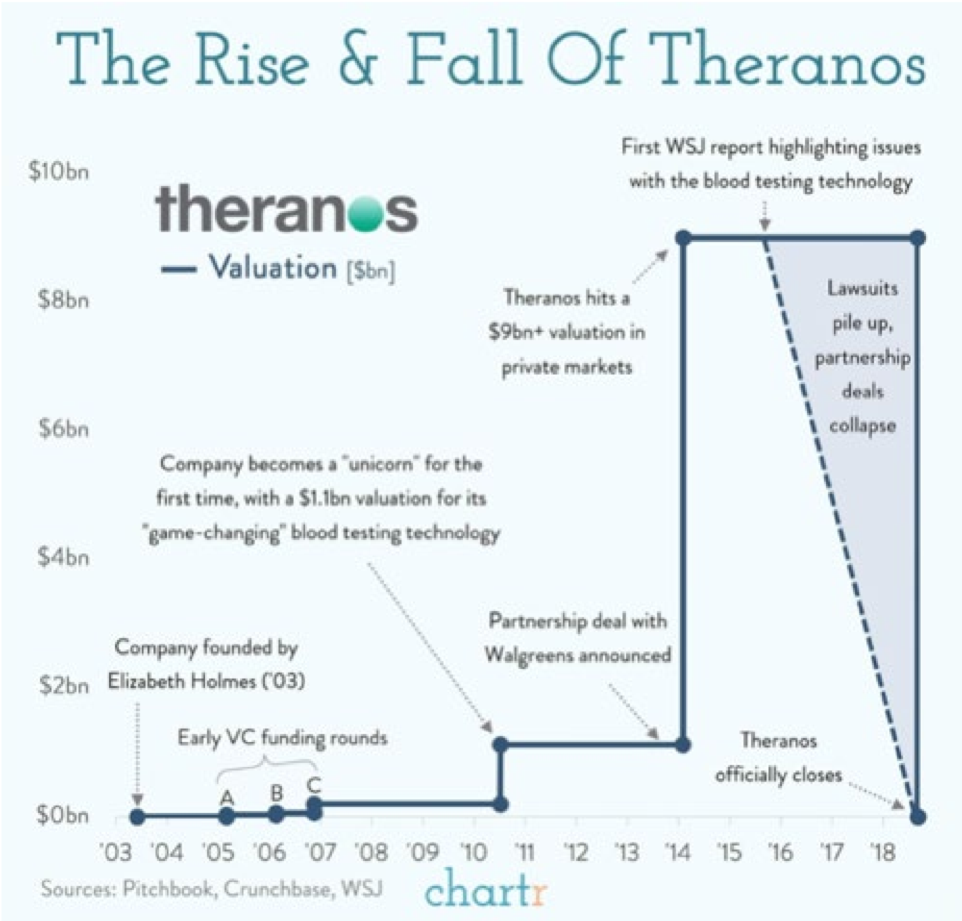
It also likely explains the phenomenon which distorts the unemployment rate in our opinion



Bust avoidance...check cash flow statement

Example – Theranos. Lots of grandiose claims but never showed any inklings of cash generation.

Elizabeth Holmes is currently in court, facing 12 counts of fraud over her role at Theranos, the now notorious blood-testing firm that was once an illustrious Silicon Valley unicorn. The trial comes 3 years after she was indicted on charges of defrauding investors, doctors and patients on Theranos' capabilities.



Example – Blue Sky Asset Management

Profit growth did not match cash flow growth – accruals kept increasing and they kept raising cash from equity markets despite profit and FUM growth

Example – Dick Smith

They had large receivables due to aggressive inventory purchases induced by short term rebates (retailers shouldn't carry big receivables. They booked these as profits and the gap between profits and real cash widened...).

Cash is king.

Focus like an absolute laser on cash flows

As such, it is now more important than ever for you to focus on the basic principle of investing and you should be fine.

The fair value of a business is based on all future cash flows discounted to today.

Why is this so important? Because it reigns you. Lots of businesses (listed and unlisted) are being priced above fair value, however, opportunities exist if you are prepared to do the work and research.

Markets change, but greed and fear never do.

Industries change, but ambition and complacency don't.

Laws change, but the tribal instincts of politics don't.

Greater fool fallacy

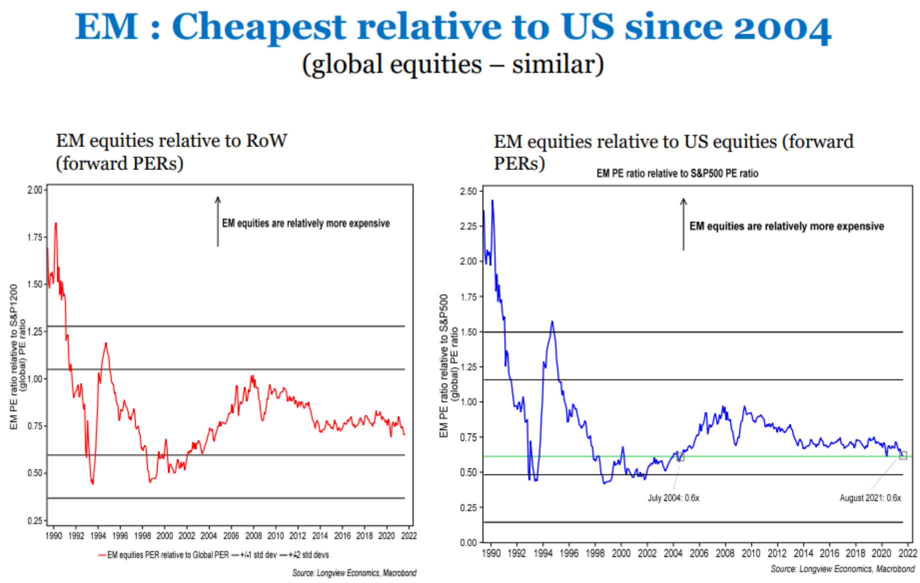
In a time of semi-extreme conditions, it is sensible to be aware of your surroundings (like a squirrel in a lion enclosure). It is times like these the greater fool fallacy is heightened, thus, reducing future returns. Even more conscious of your surroundings when there is reaching for non-profitable glamour propositions. **In other words, if the greater fool dies, you become the greater fool.**

This is where the risk lies in the current market (observe below). Returns from participating in these companies at these levels are almost certainly negative on the whole. Might get lucky with one, however take a whole portfolio of them and the outcome might be quite bleak.

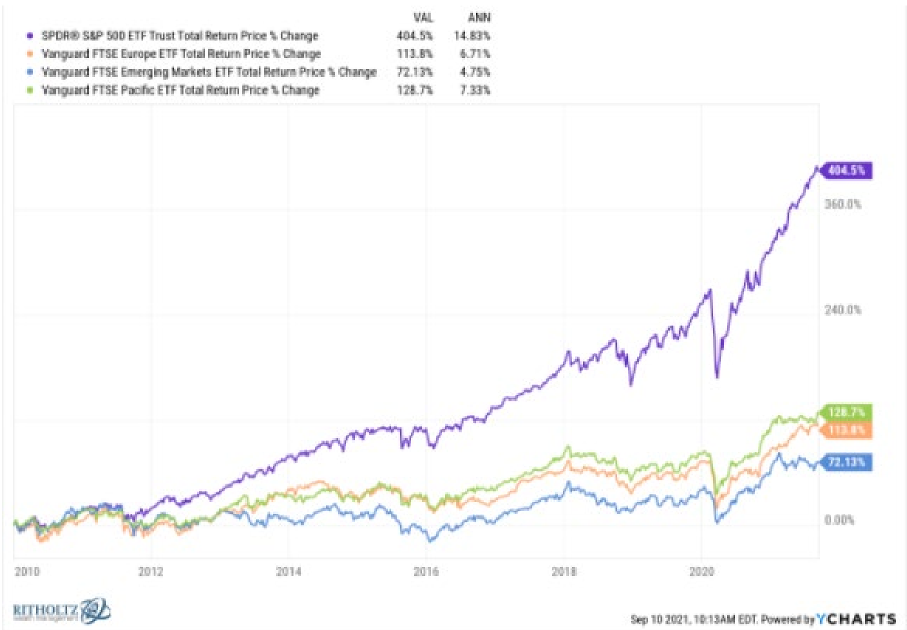
The quiet contrarian investor

We continue to hear suggestions that "the Nasdaq is the only benchmark that matters and investing outside of the US is a worthless exercise" or such similar phrases. The below chart highlights the extraordinary experience of investing in the US over the past decade, but those prepared to challenge the norm believe it pays to review this with a different lens for the next decade. **It pays to challenge recency bias.**

Beware the quiet investor. While others speak, they watch. When others act, they plan. And when the moment is ripe, once greed gives way to fear, they strike.



Source: *Longview economics*



Excessive extrapolation

We are big believers that there are no certainties, only probabilities. We have written about this for a while and are happy to continue to do so. We think there is a higher probability of reversion to the mean than trees growing to the sky…if value traps exist, then so do growth traps.

Extrapolation adds to valuation risk as it is more likely that reversion occurs earlier than later. **This is why we always talk about margin of safety.**

Trend is your friend for only so long

We talk about this a lot as we believe it is a dangerous game to play. Momentum investing is a good strategy right up until it isn't and we see a migration back towards the long-term average. This isn't just applicable to investing, it is exhibited in all areas of life. Just look at the trade value of sports players. Agents do deals for players during their best runs, not slumps…we see owners tend to overpay.

The Lesson? Don't extrapolate recent performance into the future and think this has a margin of safety and conservatism. Playing quarter-on-quarter performance is a very dangerous game.

It is the equivalent of assuming Pat Cummins will take 5 wickets per game for the rest of the series after he has just taken 5 wickets…seems non-sensical. It is possible but non-sensical.

Sir Francis Galton was a statistician and sociologist who first discovered mean regression. He developed the principle which states that in any series with complex phenomena that are dependent on many variables, where chance is involved, extreme outcomes tend to be followed by more moderate ones. **To summarise, when the unexpected happens, it is likely to be followed by something that is more aligned with mean statistical projections or expectations.**

Check your models

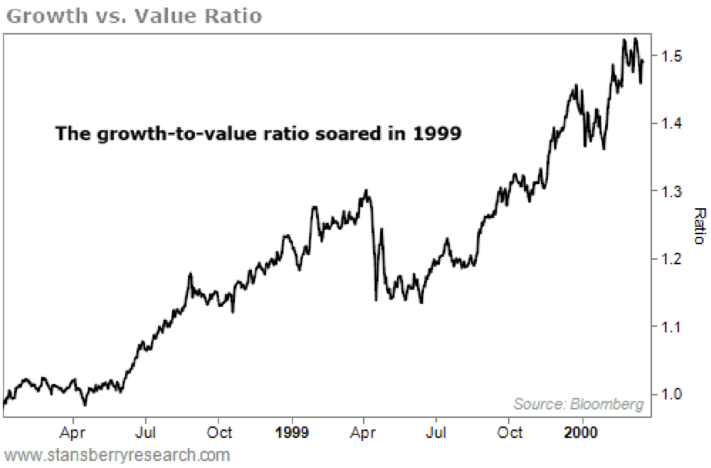
The best and most in-depth review of this topic is "The Level and Persistence of Growth Rates", written by Louis Chan, Jason Karceski and Josef Lakonishok and should be a staple read for any equity investor.

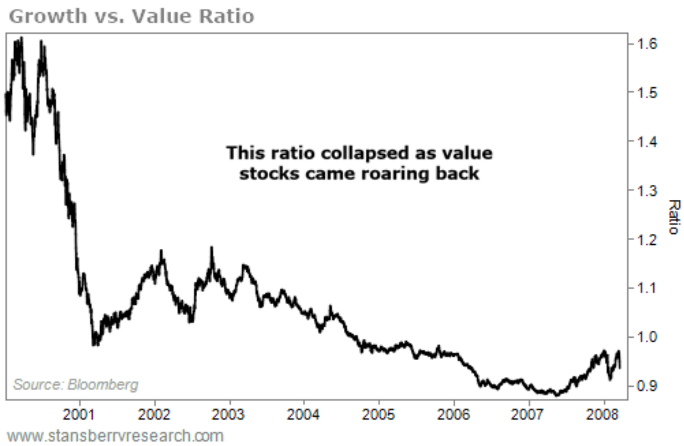
They had a look at the US stock market from 1951 to 1997 to examine how persistent revenue and profit growth were and how analyst estimates and valuation ratios were in the future.

Upon reviewing 50 years of data, their conclusions indicated a lack of persistence in long-term earnings growth. Neither analyst forecasts nor valuation ratios have significant predictive power, with the paper arguing that an investor over the period would have been more accurate using GDP growth for every forecast than making individual predictions.

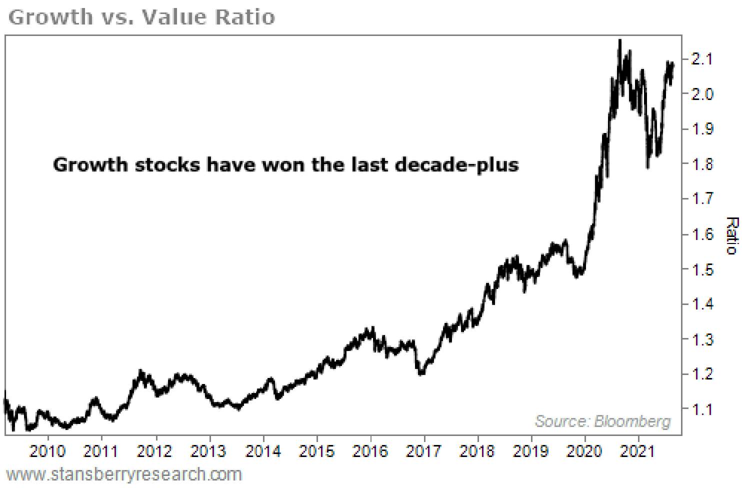
1990's

Anyone remember the names Andy Kessler and Fred Kittler? They were two hedge fund guys who turned away $1b in a week…this was in 1999 just before the dotcom peak. They were coming off incredible performances, making 377% for investors that year…remind you of anyone we aforementioned? Guess what type of investors they were…





Post Dotcom the growth decade was over and the boring value stocks left behind in late 1990s came roaring back.



As of late, investing in 10x+ multiple of sales technology companies may very well continue to generate excess performance. We are watching to see if this gap to "boring" old, less optically expensive stocks starts to close.

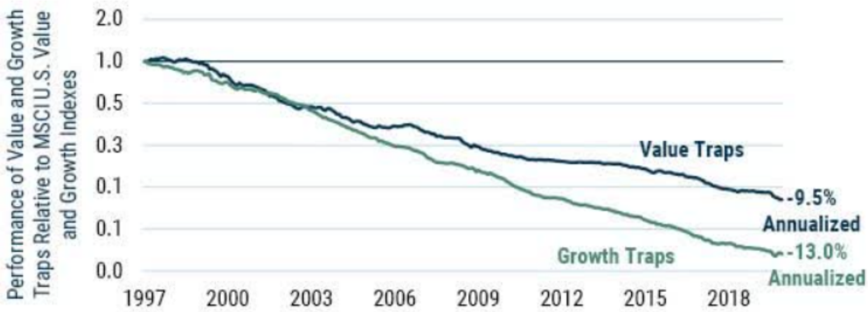
Few people want to hear about fundamentals right now. Most want rainbow unicorns that are destined to become global elites. Who would want to own an insurer with an exceptional track record on a 5% dividend yield when the next pre-IPO tech glamour is raising $100m at a $35b valuation, despite non-existent cash flows. **It just isn't sexy and sexy sells.**

Value traps or valuation mishaps?

It is the nature of the beast…everyone talks about value traps but what about growth traps?

For those unsure, growth traps are overestimating future growth and overpaying for it. This overestimation is more costly than the dreaded value trap.

EXHIBIT 5: VALUE AND GROWTH TRAP RELATIVE PERFORMANCE



Data from 8/1997-7/2021 | Source: GMO, IBES, Compustat

Overpay and returns decrease – becomes a forecasting exercise…you may be a super forecaster but probability would state otherwise.

EXHIBIT 8: PERFORMANCE OF STOCKS TRADING OVER 10X P/S VS. INDEXES

Data as of 6/30/2021 | Source: GMO, Compustat, Standard & Poor's The over 10x P/S portfolio is a market capitalization weighted portfolio of all stocks trading above 10x trailing 12-month sales, rebalanced monthly.

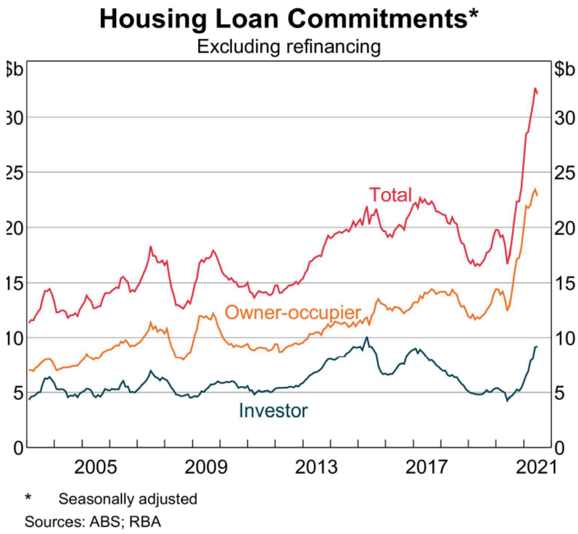
Growth is not persistent so best to be very conservative with your growth assumptions…i.e. if you need 20% for 10 years to justify a buy (your odds are low…).

"Secular" growers don't grow into the sky.

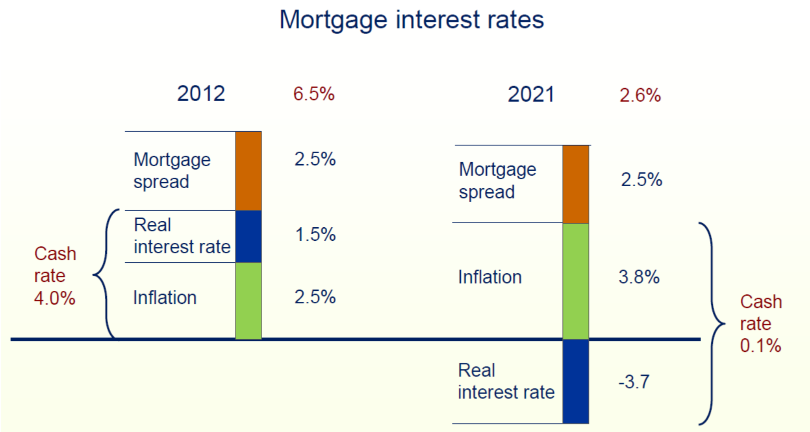
The best course of action is to reign in the assumptions and be conservative. If you are having to jump big hurdles, then move on.

Houston, we have a problem

When you start to see a significant uptick in home loan commitments, especially when it is predominantly owner-led, we start to witness an environment where low rates cause an upgrade cycle.



The below highlights a negative real interest rate and for retail investors, residential property is a logical place to address/speculate, especially as prices increase with excitement. However, there are no free lunches and housing affordability is becoming a major political hot button issue, just look at the government intervening with APRA.



Source: *Sam Wylie*

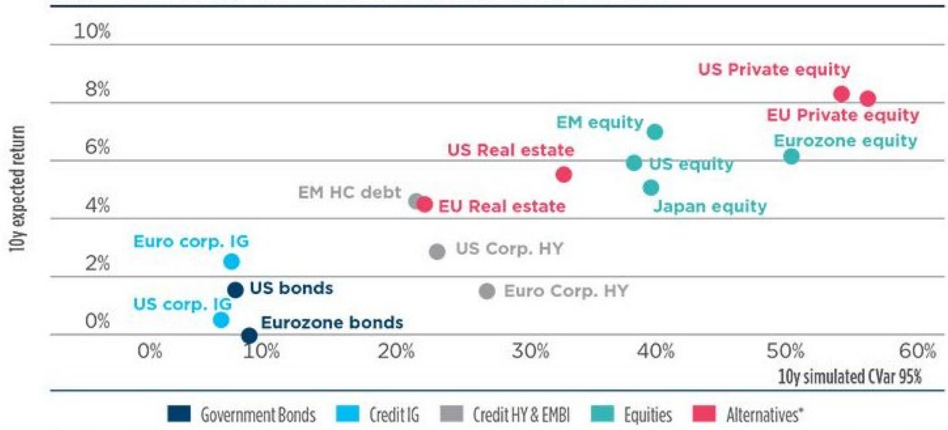
Expect further conversations and tightening of macroprudential policy, driven by politicians that need to be seen to be doing something. This takes the difficult decisions away from the central banks.

Letterbox offers for homes is becoming the new norm, however, when prices outstrip income in a zero-rate environment there becomes a long term problem.

Alternatives attraction

An asset class our clients know we have always held in high regard is now becoming one of the hottest tickets in town. It appears to be driven by low base rates and inflation, negating the transitory commentary but rather existing for the here and now. Investors are taking negative yields this year that force hard decisions, with this driving funds to real assets that can offset inflation via price increases.

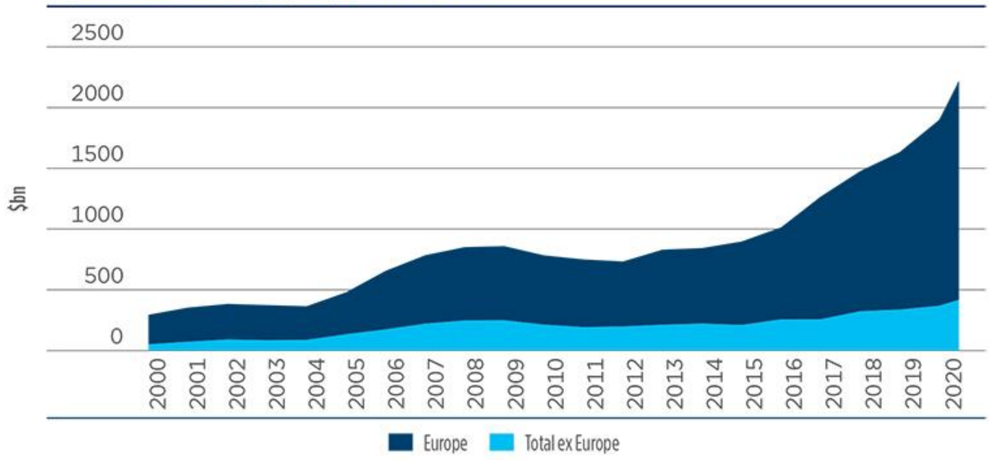
Figure 1. Alternative assets under management and forecasts



Source: Amundi CASM Model, Quant Solutions and Research teams, Bloomberg. Data as of 20 April 2021. Macro figures are as of latest release. Data is updated as of 31 March 2021. Figures shown are in local currency. Returns on credit assets include default losses. On real assets, we consider a core real estate strategy (moderate risk) and direct lending on the private debt side. The expected returns do not consider the potential alpha generated by portfolio management, which can be significant, above all for real and alternative assets. Forecasts of annualised returns are based upon estimates and reflect subjective judgments and assumptions. These results were achieved by means of a mathematical formula and do not reflect the effect of unforeseen economic and market factors on decision making. **Forecast returns are not necessarily indicative of future performance, which could differ substantially.** *Historical figures on real and alternatives are calculated using a quarterly sample.

The big point here is that similarly to listed markets, not all fund managers are the same. Private equity index returns do not exist, so significant diligence and selectivity is required. There exists cannons of cash seeing deal competition increasing. This is where we believe experience in unlisted markets starts to become very important.

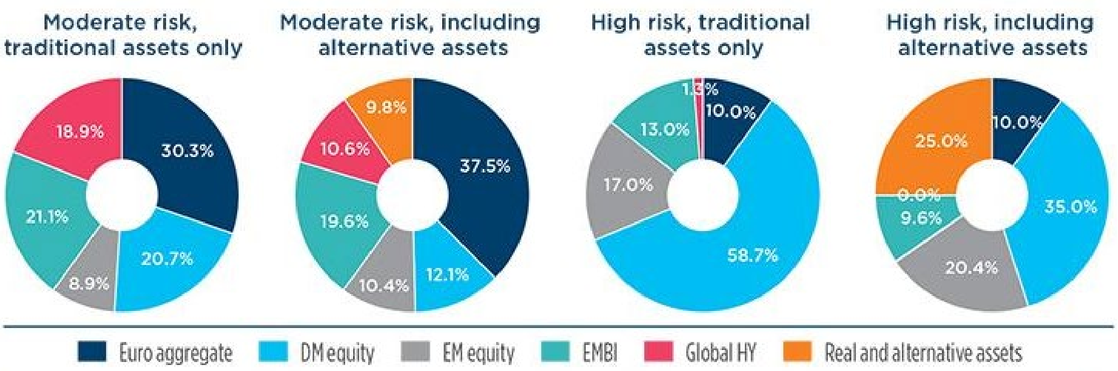
Figure 3. Private equity dry powder, $bn



Source: Amundi, Preqin. Data as of 23 June 2021.

The question of, "does a negative yield drive a portfolio change?". Yes, yes it does. This isn't necessarily a bad thing, provided the manager stays within their circle of competence. However, it should always be noted that this extra portfolio complexity increases the research breadth requirements, thus increasing management costs.

Figure 2. Including real and alternative assets in diversified portfolios



This becomes a dilemma for all asset classes, as you can see. Whilst headline cap rates are near all-time lows in Europe, their historical spreads to the 10-year rate are high and above average...relatively cheap but certainly not absolutely, especially in lieu of normal 10-year rates.

Figure 4. Spread between office prime yields and domestic ten-year government bond yields since 2000, end of period

Source: Amundi Immobilier on CBRE Research (Q1 2021) and ECB data. Data as of 7 May 2021.

A lesson on portfolio construction

We spend a lot of time internally debating the right number of holdings. A lot of it depends on bandwidth, style and ability to devote the required time to the portfolio. There exists a lot of commentary that suggests 10 to 15 names, similar to Buffett's approach, is the right number however, there aren't many Buffett's that can truly stomach the volatility of this approach. **It is quite easy to be concentrated in a bull market, much harder to stay concentrated in a 40% drawdown.**

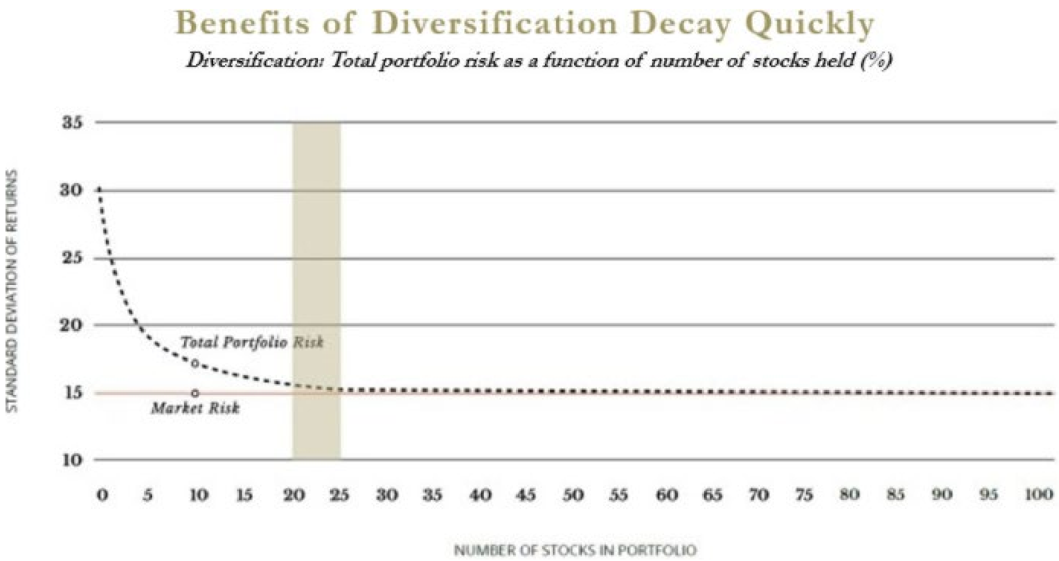
There seems to be 2 camps – **diversify, diversify, diversify** and **concentrate, concentrate, concentrate**. But what about the middle ground? The one that uses asset allocation to manage risk and optimally concentrate in each asset class? This is where we think optimal outcomes can be garnered. **Diversifying enough to manage ego but concentrated enough for returns.**

Sounds easy…

> *"Investors have been so oversold on diversification that fear of having too many eggs has caused them to put far too little into companies they thoroughly know and far too much in others which they know nothing about."*
>
> – *Phil Fisher, 1958*

So, what is the right number of holdings in an equities only portfolio? In our view it is similar to the below (sourced from Ensemble Capital in the US). 20-25 names where you don't let the weights drift beyond 10% to manage risk. Sufficient diversification to manage overconfidence/thesis drift and huge volatility but too much more will erode the likelihood of outperformance. Time will tell if this is the right number.

Adding names come with an extensive research burden (time opportunity cost) so is only enacted with extreme care. So why are there managers with 80+ names…well because their mortgage repayments rely on them not incurring volatility dissimilar to the index they hug.



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