ALVIA

ASSET PARTNERS

ARKKs don't always float

Alvia Asset Partners Investment Team Insights

December 2021 Quarter

A message from the CIO

Dear All,

Over the Christmas break, whilst adjusting to life as a parent of three girls (my wife and I welcomed our third at the end of 2021), I did some reflecting on what makes a good investor - and by this I don't just mean stock picker. I mean a well-rounded, all asset class, risk considered, old school steady compounder type.

I am fortunate to know a few of these grey-haired types and they come from varied industries and backgrounds. Interestingly, a few of them come from agricultural backgrounds. Not your hobby farm types but the multi-generational economies-of-scale styled farmer (my farther in-law included). Whilst spending time with him over the break, I formed a connection between why good farming practices work with a good investor mindset.

Farming is tough, gruelling work and to make a farming operation multigenerational, it takes a certain mindset that I think applies very well to investing and markets.

Here are my thoughts:

1. **They farm within their circle of competence, with critical capital allocation**

   You can only work with the land and climatic conditions available to you. These are predetermined and working outside this typically results in a punch in the face. Good farmers never diverge from their circle of competence, ignoring the numerous distractions.

2. **They diversify their produce - understand asset allocation (diversification)**

   Farmers work with multi uncorrelated crops/varietals/animals, not to amplify results, rather as a form of downside protection, with this mentality always front of mind. This is a risk mindset. Always reinvest earnings from the best years to make up for the inevitable bad years (rebalancing).

3. **Next generation considerations – long-term mindset**

   Farmers are long term planners. It isn't about next year - they think about the farm in the context of the next generation (super-long term). They truly plant to create shade for their grandchildren. Long-term decision making bodes well for long-term positive outcomes.

4. **Farmers are contrarians**

   They think countercyclically. As their neighbour bulldozes their crops, they plant. Taking short-term cyclicality out of the equation by working to longer cycles through their long-term thinking of supply and demand.

5. **Do things others find too hard**

   Probably the number one thing I have learnt from my inherited family. They always look to grow the hardest/most intensive crop, as they know where it is hard, there is margin. They don't do what part-time farmers can. There is a willingness to feel uncomfortable or look silly over the short term

6. **They build dams – controlling what they can**

   Build a dam when the rain is plentiful and it will bear fruit when the drought comes. In other words, add to your hedges when the market is plentiful and you will thank yourself when a bear market arrives.

7. **Nice orchards over nice trucks**

   They allocate to core cash flow earners, not worried about being seen in town in the old beaten-up Landcruiser.

Good investment practices and frameworks aren't just found by reading a couple of Warren Buffett books, they are uncovered in all aspects of life. They are supported by strong risk management practices, just as farming requires risk management thinking before all else.

Elderly farmers have seen everything and survived all elements. The wisdom is generated on the backend of a downturn not during the broad successes and excesses of an upturn.

Alvia strives to be a farmer on 100,000 acres in a 30-yearold Landcruiser, not the young farmer on 100 acres in a brand new Sahara.

Here is to a fantastic 2022. We hope as a planet, we can finally accept and learn to live endemically with COVID-19 as opposed to living in fear pandemically. Alvia is excited not by markets on a whole, but rather our positioning within markets. We think it's time for the boring end of the market to prevail over the sexy end.

Yours sincerely,

Joshua Derrington
Chief Investment Officer
Alvia Asset Partners

Back to basics in 2022

With the view that 2022 will require strict adherence to the basic (easy but not simple) investment tenets, we thought we would share what we believe these key basics are.

Invest for the long run: easy said no one. Zoom out and ignore the short term (likely bumpy). Markets don't care what you think or own, they will gyrate and this creates opportunity not crisis.

Avoid fads: page 1 investments are never a good idea…try page 30+…Froth = loss. Who cares what Mrs Jones is doing.

Silence is bliss: the world isn't ending…headlines promoting action? Get your action from Vin Diesel movies.

All assets go down: we are currently very spoilt – things will change. Don't extrapolate recent success into the future and get comfortable with mean reversion (the long-term average). Remember to reward your 'losers' with a rebalance…this takes real discipline!

Get excited by volatility: use it to your advantage and engage with it.

Think total asset allocation not all stock v all cash: an all or nothing strategy is doomed – use your allocation to manage risk. Hold yourself to account over long timeframes, not short ones.

Win a bottle of wine

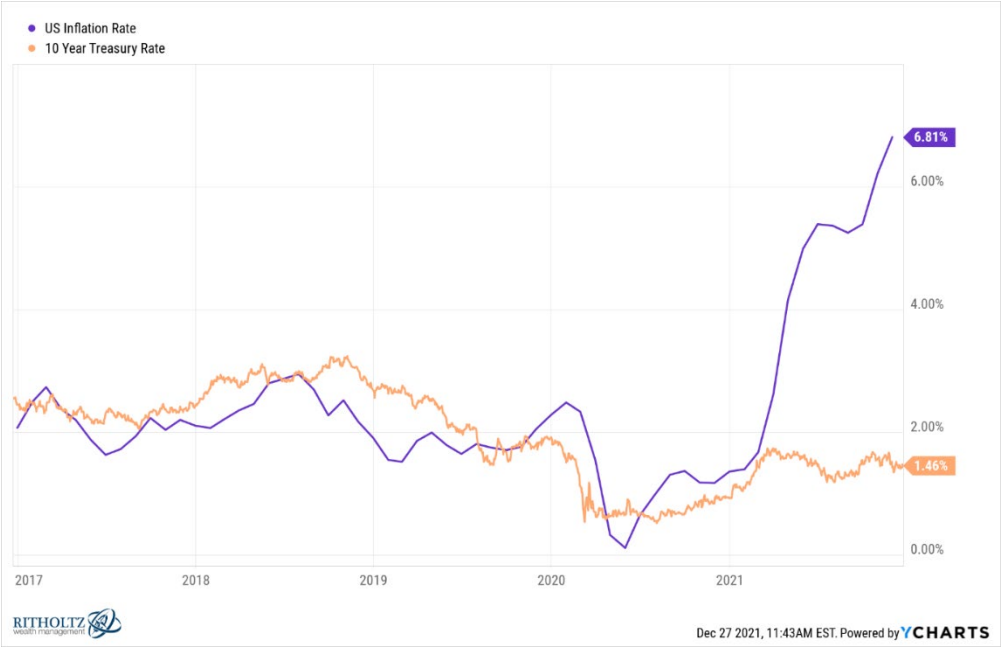
Back in our 4th quarter 2020 letter, we proposed a game to our readers - select what you think will be the best performing asset class for 2021 and the winner receives a bottle of wine. We want to thank all of you who participated, however no one wanted to join Alvia in the commodities camp so we had no winners.

We will be doing the same again this year. Please email through your name and asset class selection for 2022 to info@alviapartners.com.au. Entries need to be received by the end of February 2022 to be eligible.

Alvia's choice for 2022 is emerging markets.

Transitory no more

For most of 2021 Jerome Powell, other managers and the broader media were feeding us the story that this inflation will be transitory and why it won't be here to stay.



Goldman Sachs Chief Economist Jan Hatzius in October stated that there would be no rate hike for 2022. However, as we got to the end of 2021 Powell finally conceded, effectively retiring the word "transitory". The data coming through indicated that inflation could very well be here to stay.

"We tend to use [transitory] to mean that it won't leave a permanent mark in the form of higher inflation. I think it's probably a good time to retire that word and try to explain more clearly what we mean."
- Jerome Powell, US Federal Reserve Chairman

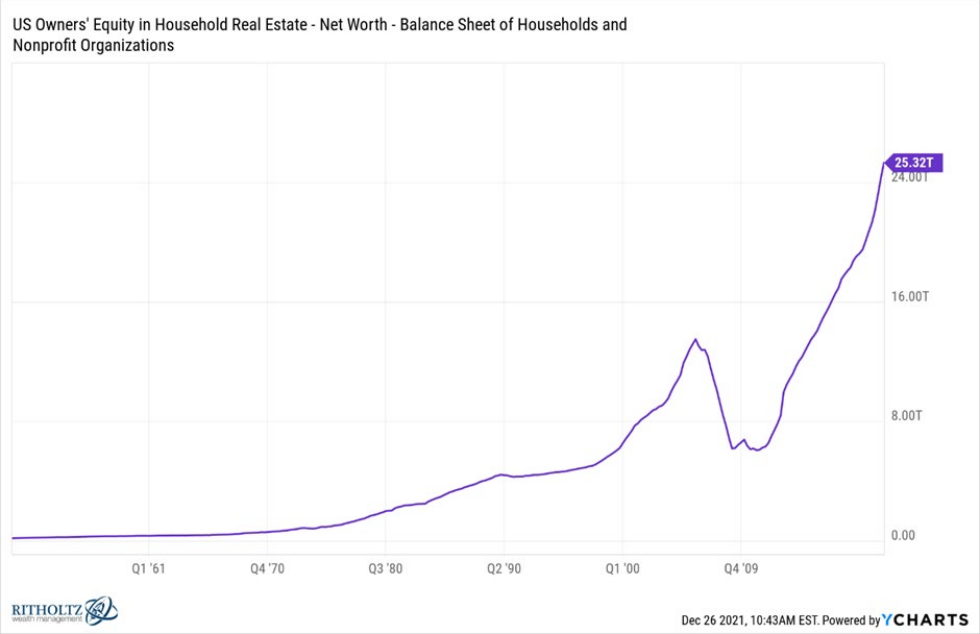
As a result, bankers everywhere, including Hatzius changed their tune, with a view to the Fed possibly increasing rates 4 times during 2022. However, it has become apparent that wage growth could possibly be here to stay, due to a phenomenon dubbed by the media as "**The Great Resignation**".

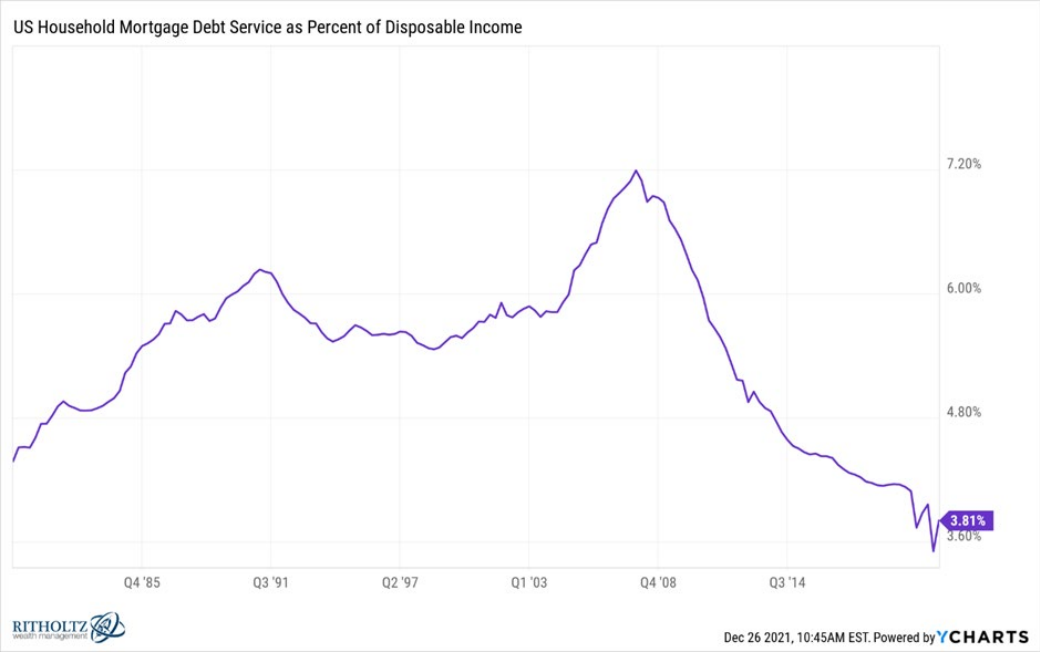
The Great Resignation

The Great Resignation is a theme, revered by news outlets, that indicates people are resigning from their jobs, with the pandemic causing people on mass to realise they no longer have to put up with poor pay, anti-social hours and abusive customers.

This is causing mass labour shortages, which results in wage rates creeping up (stickier inflation).

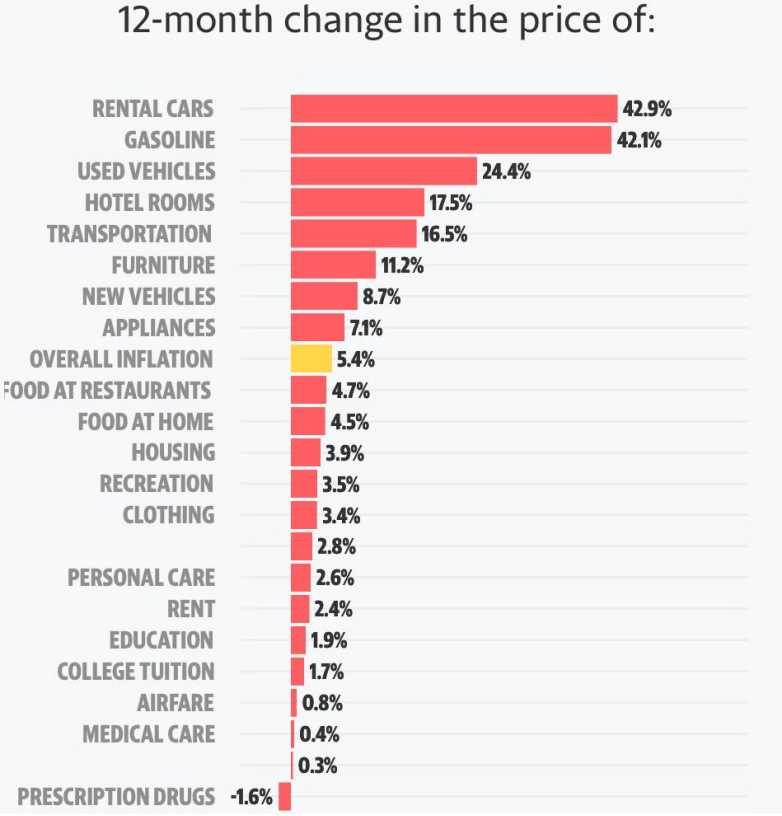
US job openings now sits at circa 11 million. However, we wonder how long this will last and if there is perhaps a little complacency with households feeling wealthier than ever before? Quite possibly, given household balance sheet growth and disposable income (Fed induced) is at all-time highs.





Perhaps individuals are inhibited by recency bias, extrapolating their share market returns and property price increases into the future.

Where you might be seeing inflation



Source: Yahoo! Finance

Its times like these you need Volcker

We are paying more everywhere. So far we are prepared to absorb this increase in our cost of living, however history suggests that nothing peeves people more than a price increase at Coles and Woolworths. It's well flagged that it's time for a mindset shift from banks around interest rates. However, rates moving 0.50% are not bringing wage negotiations to a head, this will take time.

This pandemic and government money printing issues are not related. COVID-19 hit and governments around the world reacted with stimulus and then the supply chain deteriorated. Central banks were already near 0% interest rates.

All central banks can do now is attempt to dampen the demand side via rate increases. They will do this gradually without a doubt but starving off real demand and inflation takes real courage. Volcker went to double interest rates digits last time. We just don't think anyone is brave enough this time round. **Volcker is a genius in hindsight,** however, at the time he received death threats galore.

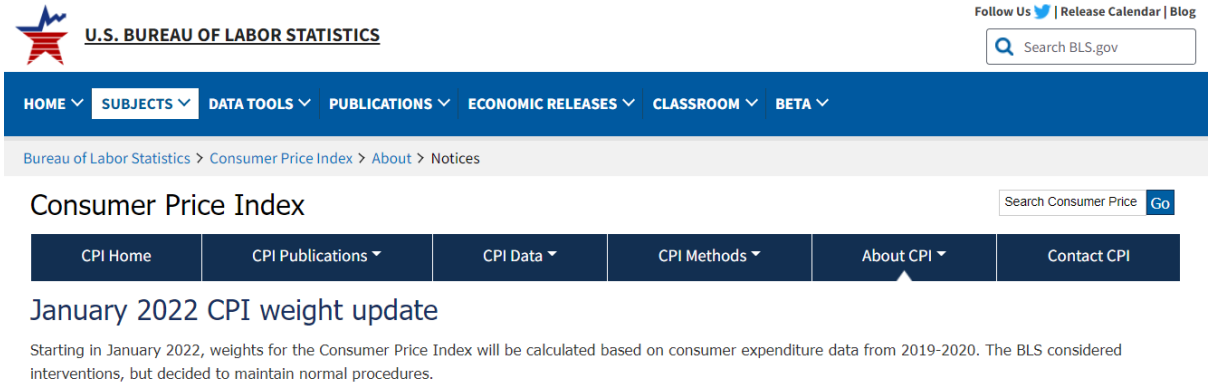
Perhaps in the US we could do with a little bit of Volcker and a little less Powell.

Or maybe they will make inflation disappear?

We have long joked that maybe governments will do something drastic and adjust the consumer price index (CPI) basket to make inflation "disappear". We mostly joke about this because it is in all governments' interests to do so (typically government contracts are CPI linked) and all governments are also dining out on these "lower for longer" rates with their large and growing debt piles.

However, it is known that CPI is at times adjusted cleverly. For example, in the 1970's house price inflation was included (until it impacted CPI too much, that is). Now a purposely opaque measure of "owner equivalent rent" (OER) is included and that can really be whatever works. The definition of OER has changed more than five times. The moral of the story being that if house price inflation was included, we all know CPI would be much higher, in fact likely in the double digits. This wouldn't read well, so we use OER, which can be tweaked as required.

Even in January 2022 a basket weight change was considered. In other words, the best way to measure inflation is to measure it based on your own purchasing priorities. Or perhaps ignorance is bliss 😊



The new news stories

We think there will be two major stories for 2022.

1. **A comparison to the 1970's; and**
2. **Stagflation.**

1970's comparison

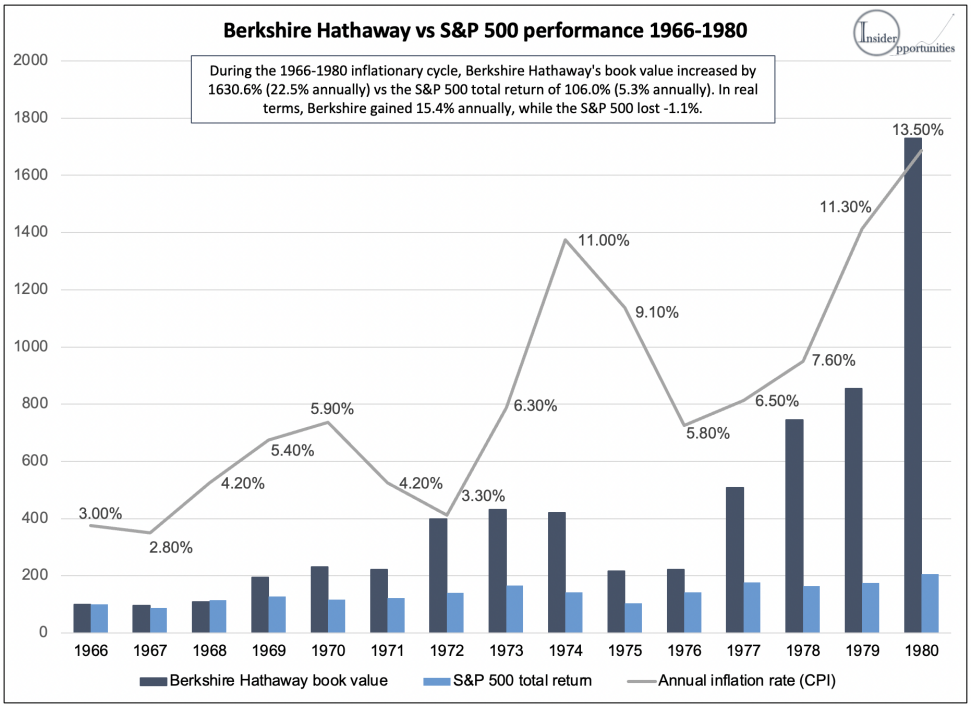
There will be more and more comparisons to the last truly inflationary period (the 70's) over the coming months. In a similar vein to now, where demand and supply dynamics were out of sync, accompanied by an increase in spending for the Vietnam War and 'great society' initiatives. Add to this the Oil Embargo which reduced oil supply and pushed prices much higher, with this flowing through to the cost of everything.

There exist some similarities to now. Most notable is the comparison to Nixon denying that money printing had any inflationary impact, resulting in low rates for longer.

Inflation hit 14.6% and caused massive dislocations due to the effective destruction of the purchasing power of global citizens.

Investment implications

Over the 15 years of this inflationary period, the US equity index failed to protect investors. It only gained 15.5% (with dividends accounting for almost 100% of the return). However, Berkshire Hathaway provides a proxy for good active investment returns. During this period from 1966 to 1980, Berkshire shares gained 1,631%, equating to 22.6% per annum, or a 15.4% real return (after inflation).



The lessons from Berkshire?

1. **Hold good businesses at decent prices**

Businesses that are well suited to an inflationary environment must have two characteristics. Firstly, an ability to increase prices easily, without fear of significant loss of market share or unit volumes. And secondly, an ability to accommodate large dollar volume increases in business with only minor additional investments of capital.

2. **Diversify into undervalued cash generators**

The value of a business is based on all future cash flows discounted to today. Investors paying expensive valuations are doomed to generate unsatisfying returns. Berkshire doesn't overpay and focuses on cash flow, not other metrics. Cash matters the most during inflationary periods. **Focus on businesses that generate cash, not those that consume it.**

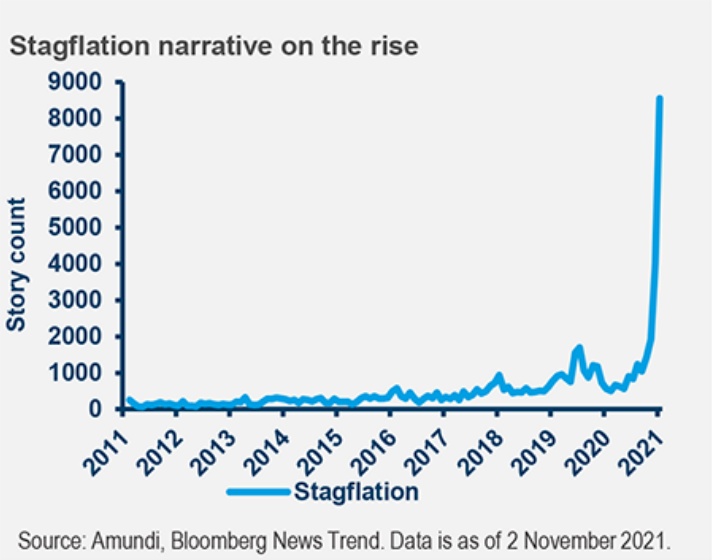
3. **Avoid leverage**

Berkshire has operated with a very low debt-to-equity ratio and only invested in businesses with low leverage during these periods. Low leverage provides flexibility and ensures your minimise investment zeros. Inflation exacerbates business failure likelihood via increasing input margin pressure and higher interest rate risk.

"Inflation is a particularly ironic punishment for bad businesses" – Warren Buffett

---

Stagflation



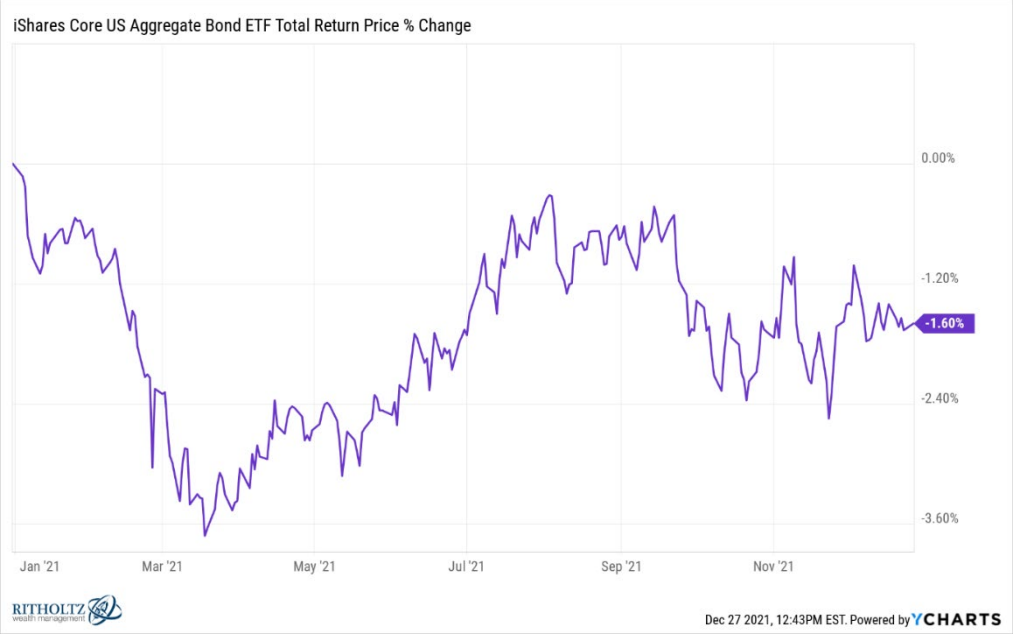
Like in the 1970's, the 21st century central banks hold the key. So far they appear to be juggling market reactions and popularity (vastly different to that of a 1970's central bank). We struggle to see a real hard-line tightening and tapering given the harmonious relationship between bankers and governments. Increased volatility around all central bank communication will become normal.

The 60/40 portfolio becomes increasingly difficult in an inflationary period as relative returns and value from fixed income (defensive assets) become hard to acquire. Increasing dynamism and real assets are required (scarce and expensive). We believe that real rates bring about mean reversion for bubbly areas of the market and that active stock picking has never been more important.

The green push, whilst required, will cause market distortions and opportunities for those who go against the grain. Without a doubt, the shift away from ultra-easy money will not be straight forward. It will cause lots of consequences we cannot account for, making margin of safety based valuation methods more important than ever.

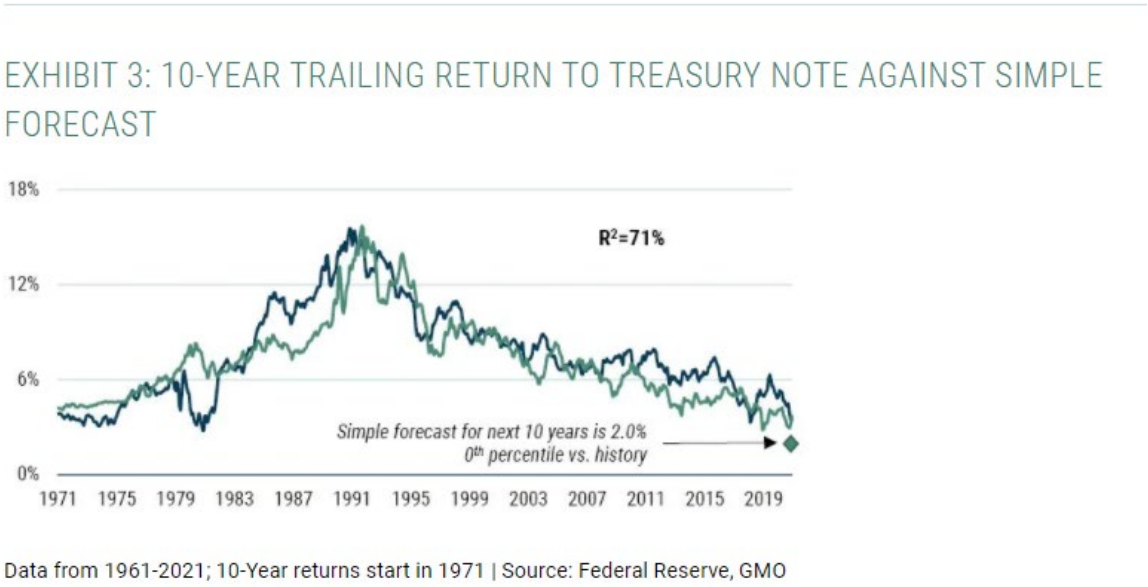
The early toll payer

The real return on 10-year US treasuries now sits at -5%, highlighting the impact of inflation. It appears that fixed income is currently paying its toll early.



It has been a long time coming for bonds. They are really starting to feel the pinch with negative print in 2021.

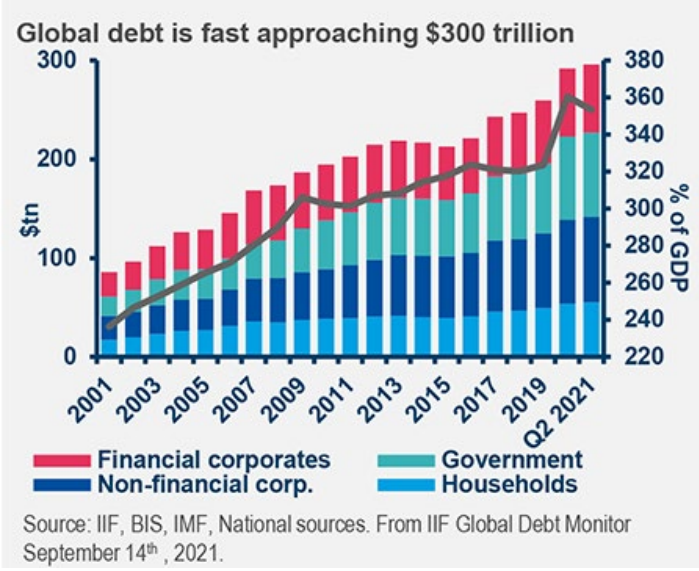
GMO (below chart) is forecasting the lowest ever returns for bonds on record, based on mean reversion.



Fixed income always plays its role, however, it is time to be very selective with this asset class.

What about the other central banks?

It isn't just the US facing this problem. There is both rising inflation and global debt approaching all-time highs. Central banks are facing pressures to address both – at a time when economic growth is slowing.



Source: IIF, BIS, IMF, National sources. From IIF Global Debt Monitor September 14th , 2021.

Bank of England (BoE): has to fight rising inflation and is increasingly under pressure to address this via rate hikes.

The People's Bank of China (PBoC): has global uncertainty, slamming the break on the economic growth accelerator. With concerns around the country's property development sector, it's hard to see any steep rate tightening on the horizon.

The European Central Bank (ECB): kicking the tightening can as far as possible down the road as rates remain bedded to the floor. There is a need to taper their plethora of wordy quantitative easing (QE) programs first.

Global Central Bank Policy Rates

Country	Rate	Central Bank Rate (Today)	CPI YoY	Real Central Bank	Last Move	Last Move Date
Switzerland	Target Rate	-0.75%	1.5%	-2.3%	Cut	Jan-15
Denmark	Deposit Rate	-0.60%	3.4%	-4.0%	Cut	Sep-21
Eurozone	Deposit Rate	-0.50%	4.9%	-5.4%	Cut	Sep-19
Japan	Policy Rate Bal	-0.10%	0.1%	-0.2%	Cut	Jan-16
Sweden	Repo Rate	0.00%	3.3%	-3.3%	Hike	Dec-19
Australia	Cash Rate	0.10%	3.0%	-2.9%	Cut	Nov-20
US	Fed Funds	0.13%	6.8%	-6.7%	Cut	Mar-20
UK	Bank Rate	0.25%	5.1%	-4.9%	Hike	Dec-21
Canada	Overnight	0.25%	4.7%	-4.5%	Cut	Mar-20
Norway	Deposit Rate	0.50%	5.1%	-4.6%	Hike	Dec-21
Thailand	Policy Rate	0.50%	2.7%	-2.2%	Cut	May-20
New Zealand	Cash Rate	0.75%	4.9%	-4.2%	Hike	Nov-21
Hong Kong	Base Rate	0.86%	1.7%	-0.8%	Cut	Mar-20
South Korea	Repo Rate	1.00%	3.7%	-2.7%	Hike	Nov-21
Saudi Arabia	Reverse Repo	1.00%	1.1%	-0.1%	Cut	Mar-20
Taiwan	Discount Rate	1.13%	2.8%	-1.7%	Cut	Mar-20
Poland	Repo Rate	1.75%	7.7%	-6.0%	Hike	Dec-21
Malaysia	Policy Rate	1.75%	2.9%	-1.2%	Cut	Jul-20
Philippines	Key Policy Rate	2.00%	4.2%	-2.2%	Cut	Nov-20
Peru	Policy Rate	2.50%	5.7%	-3.2%	Hike	Dec-21
Czech Republic	Repo Rate	2.75%	6.0%	-3.3%	Hike	Nov-21
Colombia	Repo Rate	3.00%	5.3%	-2.3%	Hike	Dec-21
Indonesia	Repo Rate	3.50%	1.8%	1.8%	Cut	Feb-21
South Africa	Repo Rate	3.75%	5.5%	-1.8%	Hike	Nov-21
China	Loan Prime Rate	3.85%	2.3%	1.6%	Cut	Apr-20
Chile	Base Rate	4.00%	6.7%	-2.7%	Hike	Dec-21
India	Repo Rate	4.00%	4.9%	-0.9%	Cut	May-20
Mexico	Overnight Rate	5.50%	7.4%	-1.9%	Hike	Dec-21
Russia	Key Policy Rate	8.50%	8.4%	0.1%	Hike	Dec-21
Brazil	Target Rate	9.25%	10.7%	-1.5%	Hike	Dec-21
Turkey	Repo Rate	14.00%	21.3%	-7.3%	Cut	Dec-21
Argentina	Benchmark Rate	38.00%	51.2%	-13.2%	Hike	Nov-20

COMPOUND @CharlieBilello

What to do in a non-transitory, rate rising environment?

If you've been reading our 2020 and 2021 insights, there have been some indicators of where we look. We've decided to provide a summary for you below:

Good: utilities, energy, consumer staples and some materials (including gold).

Bad: technology, consumer discretionary and crypto

For our clients and those we talk to, you know we continue to look at the energy sector for primarily two reasons.

1. **It has been positively correlated to inflation every single time during history**

Figure 55. **Correlation matrix (post-2000, weekly data)**

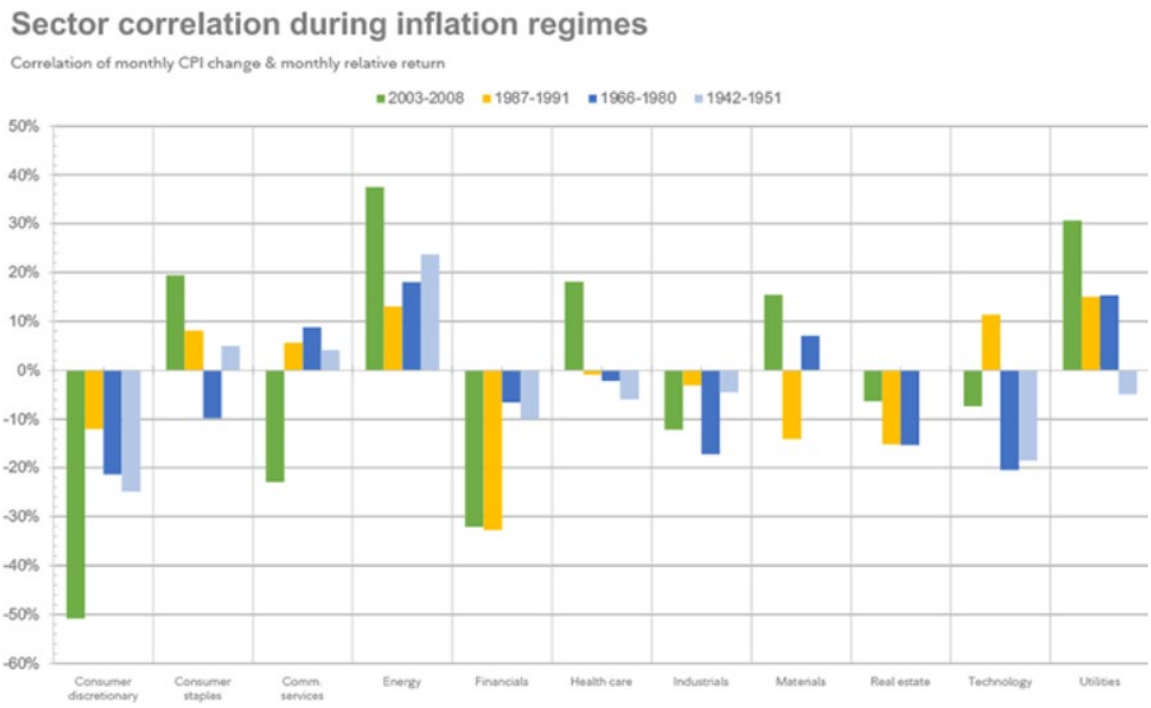
	US 5YR Inflation Break Even	US 2s5s Yield Curve Steepener	US 2s10s Yield Curve Steepener	Short US 10Yr Treasury Bond	NOKEUR	CADUSD	Crude Oil	Gold	S&P 500	S&P 500 Industrials (RV)	S&P 500 Banks (RV)	S&P 500 Energy (RV)
US 5YR Inflation Break Even												
US 2s5s Yield Curve Steepener	24%											
US 2s10s Yield Curve Steepener	18%	84%										
Short US 10Yr Treasury Bond	37%	-21%	-57%									
NOKEUR	30%	9%	10%	13%								
CADUSD	39%	15%	16%	14%	32%							
Crude Oil	40%	16%	14%	18%	38%	30%						
Gold	10%	-9%	-3%	-20%	17%	37%	18%					
S&P 500	43%	23%	14%	30%	38%	49%	20%	2%				
S&P 500 Industrials (RV)	16%	11%	9%	18%	15%	12%	3%	0%	21%			
S&P 500 Banks (RV)	17%	20%	18%	22%	5%	10%	3%	-14%	30%	22%		
S&P 500 Energy (RV)	33%	9%	12%	13%	30%	29%	55%	21%	8%	13%	4%	

Cont.

Source: Aviva Investors, Bloomberg as at 1 December 2021

2. **A starvation of capital fuelled by ESG (environment, social and governance)**

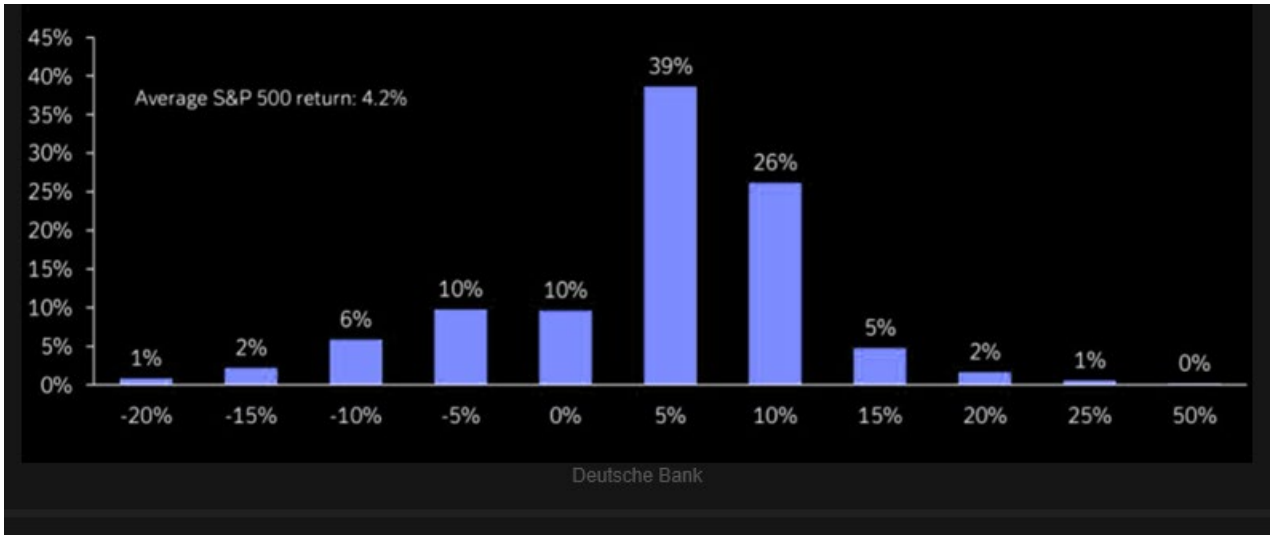
You can add in the nasty historical return environment and it bodes well for energy prices and the broader sector. In contrast, non-earning technology revenue growth only stocks (we debate whether we want to call them businesses) might find it difficult should inflation remain ingrained for longer. **Perhaps you should review your Nasdaq (QQQ) position if you believe inflation is here to stay.**



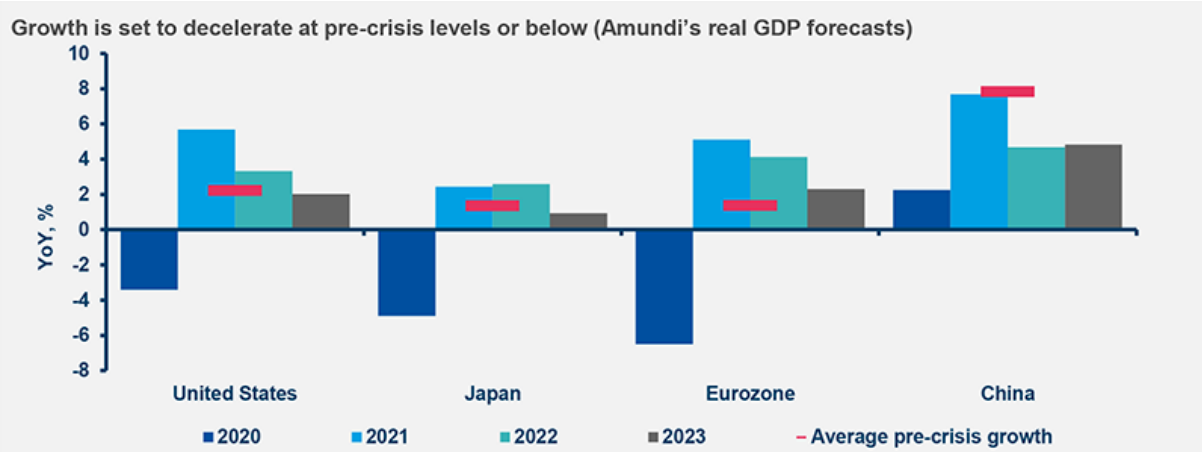
Source: Fidelity

What does the "smart money" expect? On average, institutional investors are expecting the S&P 500 to increase 4.2% in2022. This would be the third worst return of the last decade, in a decade where the average return has been 14.6% when including 2021.

19% of managers believe that 2022 will return a negative number.



Economists' GDP expectations



Source: Amundi, IMF. Data is as of 8 November 2021. Average pre-crisis growth refers to the 2010-18 period. Forecasts are by Amundi Research.

We find that these expectations are very aggressive to say the least. We believe there will be some level of deceleration in 2022, applying a 5% growth rate to 2021 (which was already coming off an incredibly low number) seems overly aggressive.

A mismatch to what the market thinks.

Alvia's 2022 outlook

Similar to Hatzius, we are going to put our view out there. We think the Fed could start the year raising rates and then lowering them towards the back end. They will realise how much the world is piggy backing off them… (perhaps they already know, see below)

December 15, 2021 Chair Powell's Press Conference PRELIMINARY

CHAIR POWELL. So, on the first part of your question, which is, why not stop purchasing now, I would just say this, we've learned that we're -- in dealing with balance sheet issues, we've learned that it's best to take a careful sort of methodical approach to make adjustments. Markets can be sensitive to it. And we thought that this was a doubling of the speed. We'll -- We're basically two meetings away now from finishing the taper. And we thought that was the appropriate way to go. So we announced it and that's what will happen. You know, the

If the Fed were initially to start raising rates, it'll very quickly become apparent whether the world can absorb the higher rates or if it cannot. If the latter occurs (as we think is a real possibility – see above) we may see the Fed back peddle and lower rates towards the end of the year. If this occurs, markets may doubt the ability of central banks to ever raise rates. With these actions, come significant implications - just look at Japan. Albeit the country also has a demographic issue to contend with, it still does paint a picture. The question becomes, are central banks willing to normalise as needed?

We are very much excited to see how this plays out in 2022.

We feel that 2022 will be defined by those who take the effort to do the detailed work.

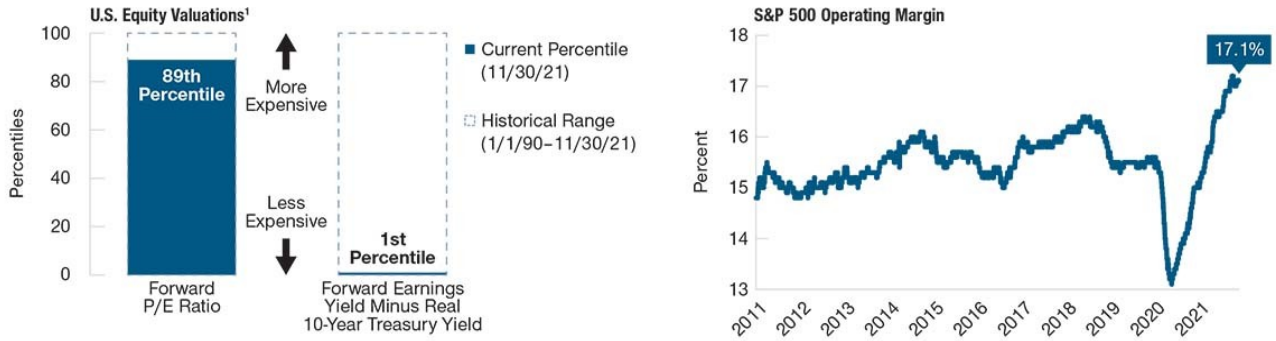
Inflation chatter will likely remain in 2022 as the concern that higher inflation of 4-6% becomes more entrenched in expectations. For this to be the case, it will require sustained wage increases and commodity prices to hold. Time will tell, but the stage is set with global debt at an all-time high, boosted by government indulgence and a greater public expectation for government intervention when things become a little turbulent.

Now that most in the market have joined our view and see inflation (risk in itself) leading to government tightening and increasing discount rates, it makes it harder for asset prices. **However, history indicates that valuation first principles can digest higher rates, especially in an environment where bonds are not a viable alternative.**

There exist arguments for equities in the US being under- and overvalued. Compared to bonds, equities appear cheap, however they look expensive on a multiple of normalised earnings basis. Did COVID simply bring forward a few years of growth?

Although Stocks Do Not Appear Expensive Relative to Bonds, Earnings Momentum Could Slow

(Fig. 3) Distribution of U.S. equity valuations and operating margin for companies in the S&P 500 Index



As of November 30, 2021.

¹ Valuation measures are based on the Russell 3000 Index. Stock versus bond yield percentile has been reversed. The earnings yield is earnings per share divided by stock price.

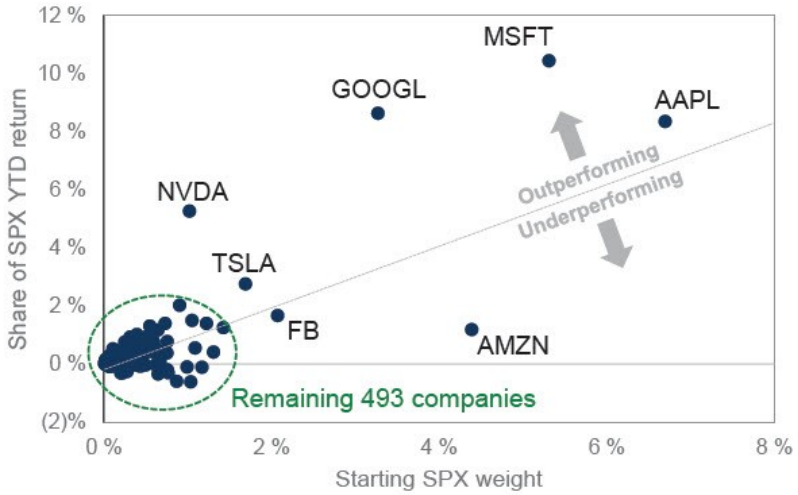
Sources: Bloomberg Finance L.P., Strategas Research Partners, and Standard & Poor's (see Additional Disclosures); data analysis by T. Rowe Price.

With this in mind, we think it may bring a potential peak in the dominance of the US market. The large (market cap), new, non-earning technology names have piggy backed off an all-time low-rate environment for a long time. We look forward to seeing their performance in a rising rate environment.

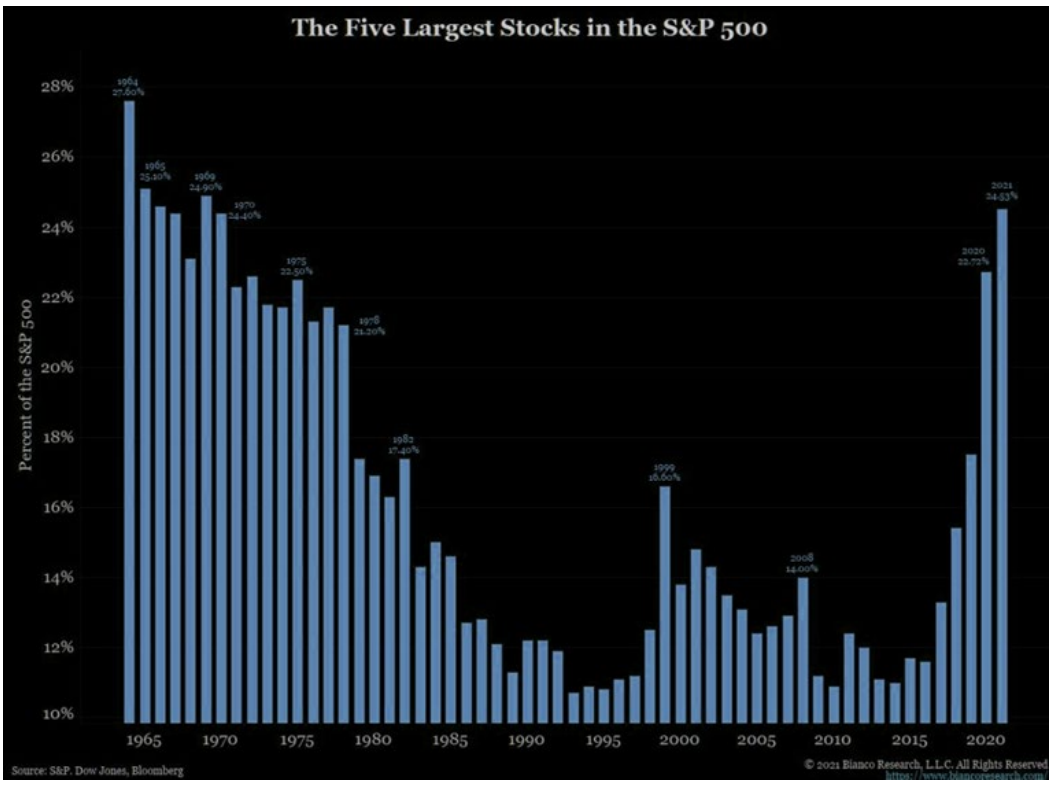
There is also the consideration that it is time to lighten US equities exposure. Remember the US market has produced annual returns over the last three calendar years of 31%, 18% and 29%. Perhaps it is time to be prepared for it to give a little back. Everyone has to pay the asset toll at some point. Our view is to reallocate beyond the US and pay it forward early.

In 2021, returns in the US essentially came from 5 stocks. This is abnormal as the "remaining 493 companies" barely moved the index. The final two companies making up the S&P 500 index, namely mega caps Meta (Facebook) and Amazon, underperformed. **Passive investing makes little sense unless you believe in a momentum strategy for 2022.**

Exhibit 2: 35% of the S&P 500's YTD return has come from five stocks
as of December 9, 2021

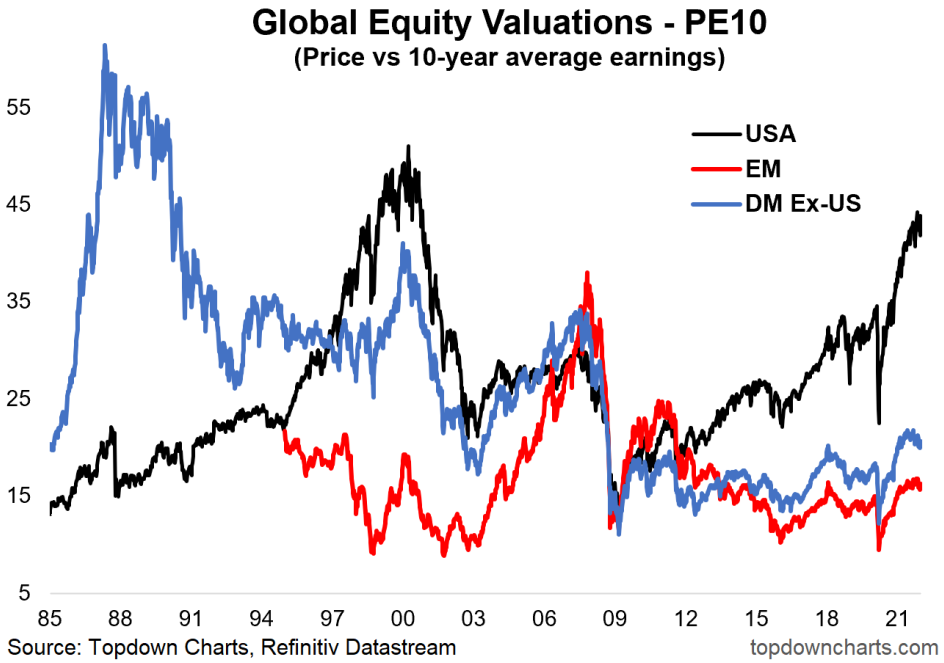


Source: Goldman Sachs Global Investment Research

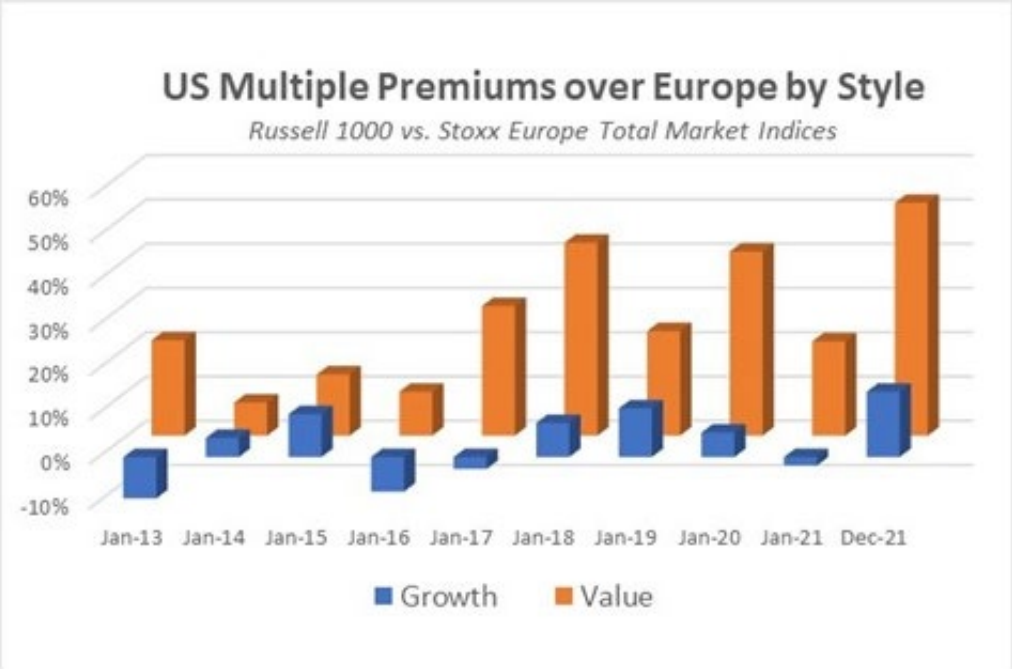


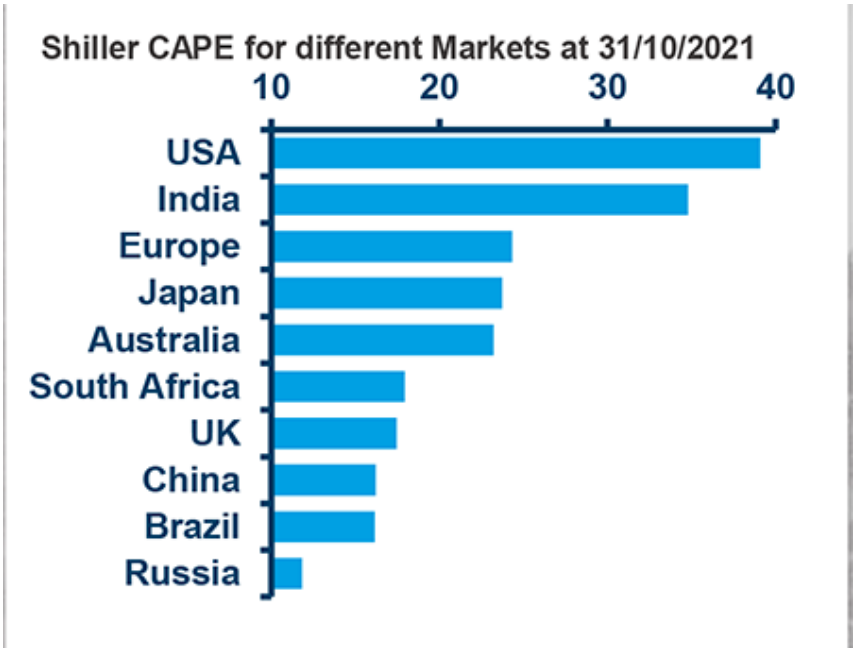
If we look further back than the past 3 years:

- The last 12 years have been fantastic for the US market;
- Long duration revenue growth stock investing has been in vogue and delivered strong performance;
- Multiple expansion was predominantly responsible for this performance;

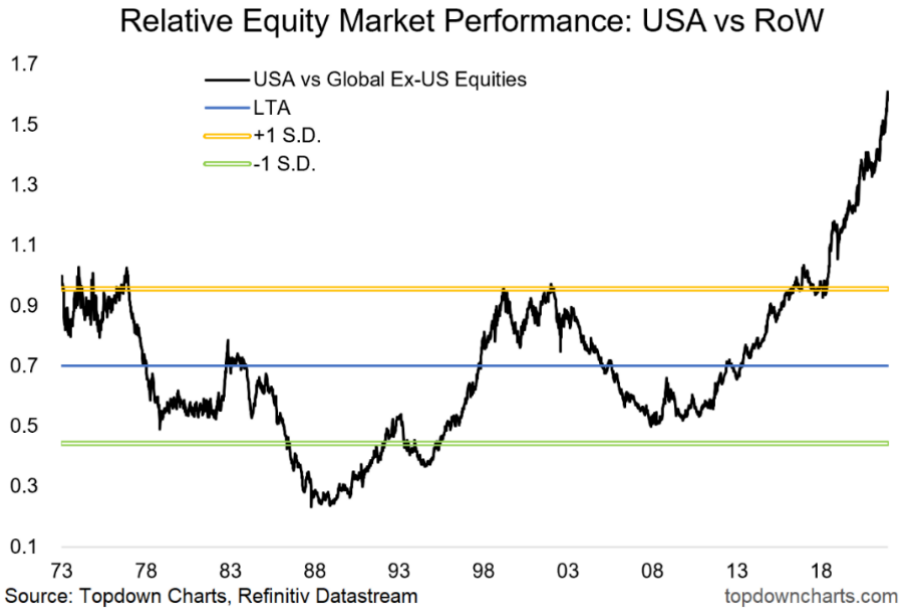


- Premiums for growth factor and US factor are extreme; and
- Europe/Asia have significantly underperformed the US, due to a lack of multiple expansion.





Source: Amundi research



We think you are better off to look where the probabilities support you.

Below is Vanguard's 10year forward return projections (based on mean outcomes). Obviously, they don't have a crystal ball and cannot predict the future, however, given the amount of data points and historical context that are factored into these numbers, they deserve acknowledgment and due consideration.

Equities	Return projection	Median volatility
U.S. equities	**2.3%–4.3%**	16.7%
U.S. value	**3.1%–5.1%**	19.2%
U.S. growth	**–0.9%–1.1%**	17.5%
U.S. large-cap	**2.2%–4.2%**	16.3%
U.S. small-cap	**2.2%–4.2%**	22.5%
U.S. real estate investment trusts	**1.9%–3.9%**	19.1%
Global equities ex-U.S. (unhedged)	**5.2%–7.2%**	18.4%
Global ex-U.S. developed markets equities (unhedged)	**5.3%–7.3%**	16.4%
Emerging markets equities (unhedged)	**4.2%–6.2%**	26.8%

Fixed income	Return projection	Median volatility
U.S. aggregate bonds	**1.4%–2.4%**	4.6%
U.S. Treasury bonds	**1.2%–2.2%**	4.7%
U.S. credit bonds	**1.6%–2.6%**	4.7%
U.S. high-yield corporate bonds	**2.2%–3.2%**	10.4%
U.S. Treasury Inflation-Protected Securities	**1.0%–2.0%**	7.0%
U.S. cash	**1.2%–2.2%**	1.2%
Global bonds ex-U.S. (hedged)	**1.3%–2.3%**	3.8%
Emerging markets sovereign	**2.3%–3.3%**	10.1%
U.S. inflation	**1.5%–2.5%**	**2.3%**

These probabilistic return assumptions depend on current market conditions and, as such, may change over time.

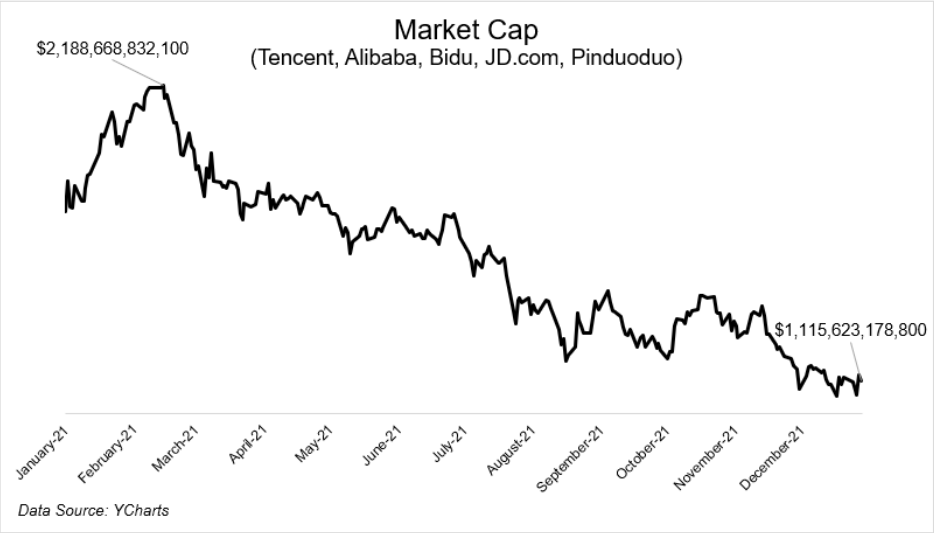
Source: Vanguard

US growth expectations over 10 years is the only equity category to have the lower range forecast in negative territory…truly a horribly outcome. However, this doesn't mean you need to go without international equities. International equities excluding the US are expected to produce an annual return of 5.2-7.3% at an index level. With the right active manager this could be closer to7-10% p.a. **Something we aspire to produce irrespective of the market environment.**

The point is to not be the last person dancing with a stale cocktail in your hand when the US mega cap growth party ends abruptly. When momentum swings against you, it really swings and the US has had a lot of the momentum, if it hasn't started to swing already.

China, perhaps?

Did you know Chinese internet companies are down 62% from their February 2021 high?



This has become one of our highest conviction propositions. China growth may soften in 2022, however, we believe there is a stronger negative sentiment around Chinese names causing them to be sold-off to levels well below their intrinsic value and so in the context of a broader asset allocation they deserve consideration.

We believe that bravery will be rewarded as the above chart tells the story. Our analysis indicates that the underlying fundamentals haven't changed drastically (in fact for Tencent and Alibaba there has been an improvement over this period).

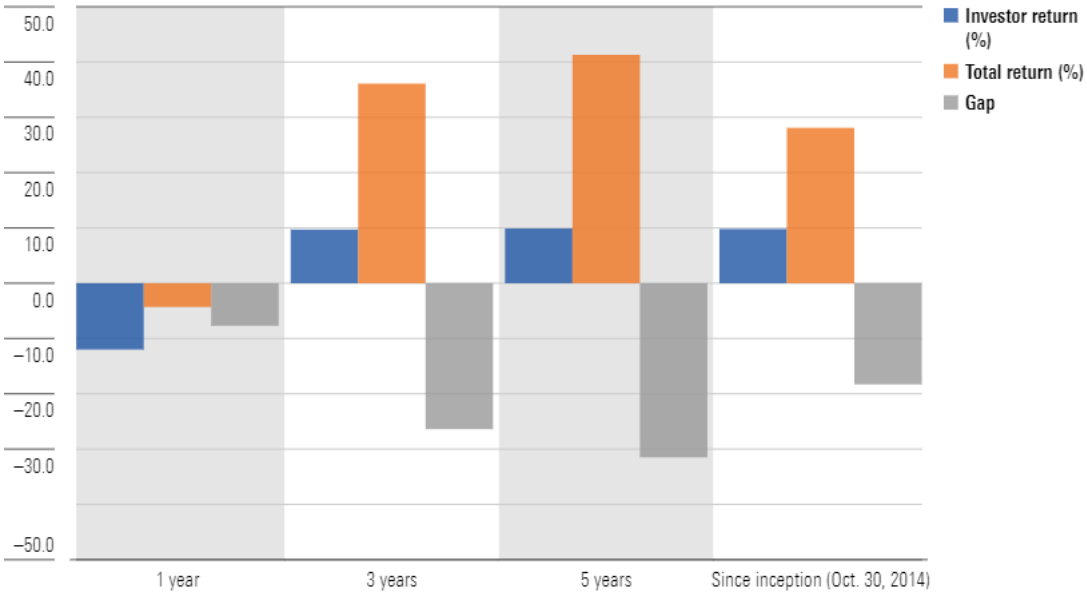
For us we are going to be hunting aggressively for active non-US opportunities, sticking to our normal fundamental valuation discipline.

Is Cathie's ARKK sinking?

We like to call this a lesson in momentum reversion.

There isn't much to say about this story, but the ARK Innovation ETF's (ARKK) poor performance in 2021 is just another story of greed and popularity and how both will always play a very human part in investment markets.

Exhibit 1 Investor Returns Versus Total Returns for ARK Innovation



Source: Morningstar Direct and author's calculations.

ARKK provides another example (best ever?) of the difference between fund manager performance and underlying investor performance (refer above). Why? Because funds attract capital at periods of peak performance, performance they inevitably struggle to maintain. In other words, humans are greedy and follow the crowd and fund managers market themselves heavily during these peak performance periods. When their performance dips, everyone pulls their capital and the vicious cycle repeats, continuing to mistime sales and purchases based on popularity or whenever they are feeling good or bad.

If anyone recommended ARKK to you as an investor on the back of their 2020 returns, we would truly question their credentials.

Perhaps it's time to review your active manager?

With such uncertain times ahead, we invite you to review your manager. Most will obsess more about beating benchmarks than delivering great outcomes. They will happily take performance fees and pop champagne if their fund is down 5% versus a market that is down 6%. **From Alvia's perspective, this is not investing. You cannot eat relative returns.**

Most of these index following managers mimic the market just to ensure they keep your funds.

For those who don't know what we do, we take the exact opposite approach. Your objectives become our benchmark with our sole focus being on generating excellent **absolute returns over the long term.** We follow investors that some readers may have never heard of. Wilmot Kidd III is such an investor, with an exceptional track record and a philosophy similar to ours.

Mr. Kidd has managed to produce better numbers than Buffett – how? **Patience, concentration and courage. If you try to please the wrong people you will end up pleasing nobody.**

Mr. Kidd has a model for how to think about and practice intelligent investing. The philosophy is simple – only take the right clients that will support you for the long term. Hold fewer stocks, watch them closely and don't trade much.

There are only two investing strategies that make sense – trade a lot or not at all…and there are very few successful traders.

Sacking a manager

With the above in mind, we decided to put together a little how to/when you should consider sacking a manager. Just like picking single investments, we all have had to pick a manager or two, therefore, we have all had to sack them. However, there is data that backs up the mistiming in sacking managers.

Source data suggests that most sackings tend to be very pro-cyclical as with asset class decisions, instead of being related to more traditional portfolio rebalancing techniques. When mean reversion strikes and the portfolio performance doesn't hold up, you end up missing the positive performance of the previous non-performing manager and pick up the underperformance from the previous performing manager.

Source: Verdad

In other words, sack carefully and promote even more so.

Trade of the Year – go short 2020 winners

2021 was a year where the age-old strategy of avoiding the previous year's winners and investing in the losers worked.

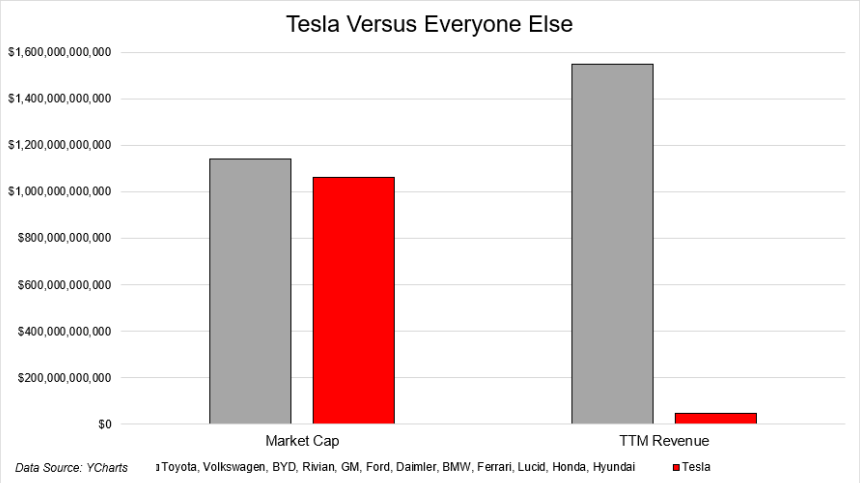
Teladoc, DraftKings, Penn National Gaming, Zillow and Zoom were up 139%, 335%, 238%, 183% and 396%, respectively in 2020. Their respective returns were not so good in 2021....

Source: Ritholtz

Continuing to be proven wrong

Tesla continues to defy the doubters...of which we are one.

We ask you to look at the chart below and see if it makes sense to you.

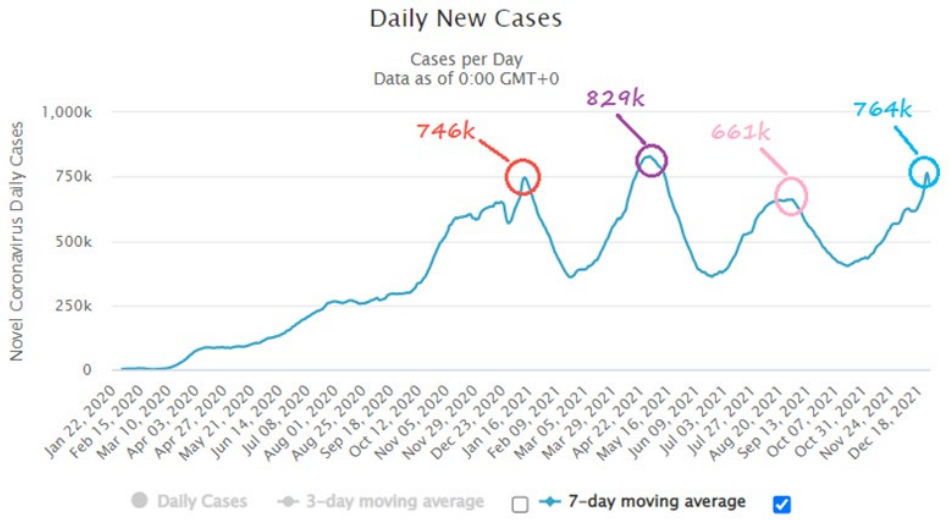


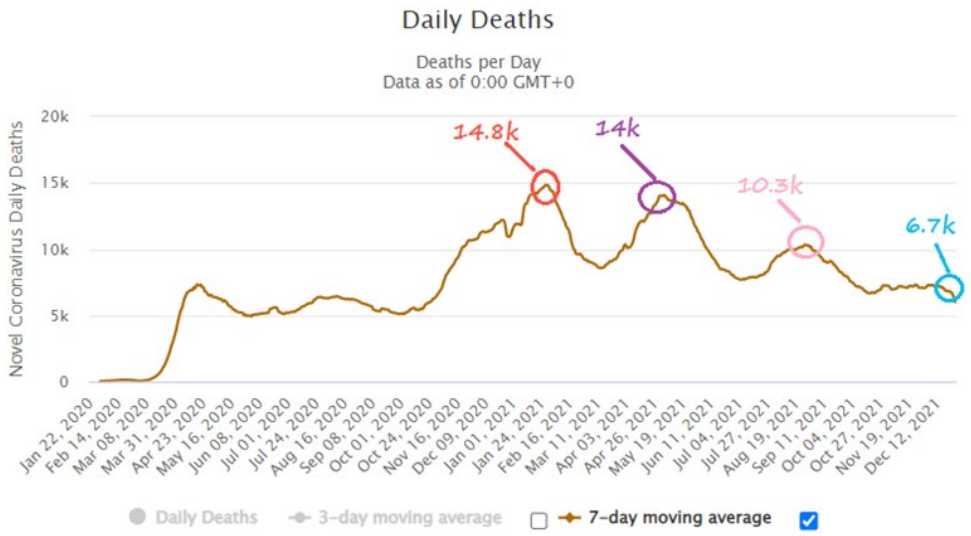
Our hope is that it doesn't and if you think that then you aren't alone as Elon Musk is also selling.

False start on a fresh start?

What we hope is for 2022 to be a fresh year where we start to return to some normalcy. However, as we write this, the Queensland government is requesting people to stay home once again, precisely 1 year after we had a snap-lockdown. Already it is starting to feel like 2020 and 2021 again.

At least it appears that Omicron is less deadly and more transmissible (see below). If this trend holds and natural immunity prevails, lockdowns could become a thing of the past.





Source: Charlie Bilello

With gradual acceptance that this is our new reality, living with the virus as opposed to fighting it becomes the norm. Our hope is Omicron is a blessing in disguise and the virus does mutate its way into a less severe transmissible space, tied with a media focus that dissipates along with the severity.

Anti-ESG…for now

The E to the S to the G definitely feels like the new rhyme by the Wall Street machine. **We want to make it upfront and clear, we aren't anti sustainability or against social working rights and good governance. We are anti the current duping we believe is possibly happening in the market.**

We continue to write about this topic as:

1. A fee earning cash cow for product issuers; and
2. It makes sense to dig a little deeper into why these 3 letters are seeing astronomical capital flows.

Fee earning cash cow

The institutional investor breaks the ESG movement into the 5 acts below:

- *Act I: companies wake up to their responsibility to address growing social and environmental challenges.*
- *Act II: academics create a body of research around the topic.*
- *Act III: ratings agencies, index providers, data firms, consultants, and other financial institutions rush to create environmental, social, and governance (ESG) products, highlighting the opportunity for companies and investors to deliver financial outperformance and social and environmental impact. The ultimate win-win.*
- *Act IV: investors and others slowly recognise that ESG investing, as currently practiced, will not likely lead to financial outperformance and is mostly unconcerned with planetary impact.*
- *Act V: reawakening to the opportunities and limits of investing to address growing social and environmental challenges.*

We believe we are firmly in the third act and it's a marketing dream inside investment banks.

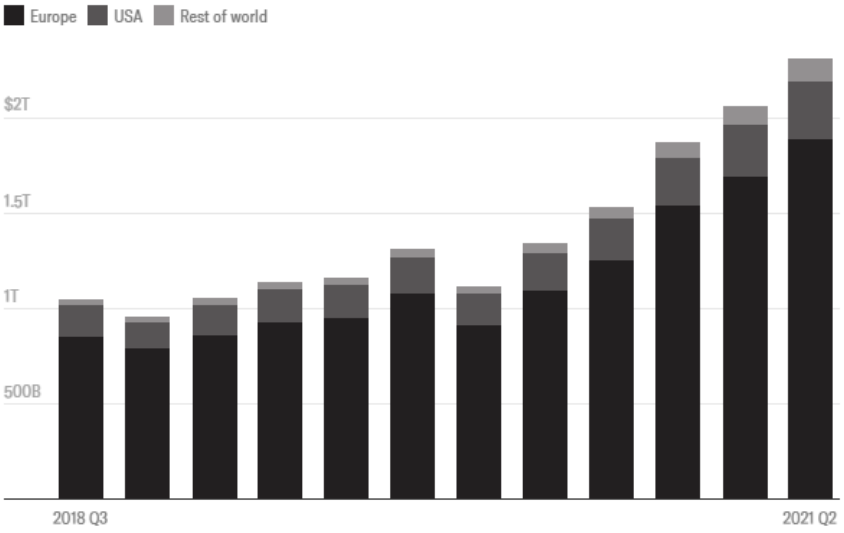
The current win/win promotion is exaggerated and a simple ESG screening tool is far from revolutionary. It may in fact lead to subpar performance. Yes, any long-term risk awareness (not just E, S and G) is important. However, it seems naive to think it can simply be screened for at the click of a button.

Even if 'ESG' branded funds perform, it is almost impossible to separate causation from correlation given the thousands of variables at play, especially over such a short time frame.

We are in the midst of a marketing blitz (refer to next chart) and you can't blame firms for taking advantage of the supposed win/win story being sold. Our hope is merely it helps promote positive long-term thinking at a board level about **all facets of sustainability**.

Sustainability to us is the most important concept, as it is the sustainability of a business model and economic success going beyond simplistic labels handed out by 'ESG' consultants.

Exhibit 1: Quarterly sustainable fund assets



Source: Simfund

What does a focus of capital flows do to the broader market?

The shunning of companies with 'bad' ESG scores (still subjective) sees these assets require higher discount rates, thus becoming relatively under-priced, allowing those willing to disregard external ESG ratings to buy them cheaper and potentially generate higher long-term returns.

Conversely, as more capital flows into the 'good' ESG score companies, more capital fundamentally reduces the long-term returns. Add in the political elements of ESG and it creates an interesting dynamic.

Currently, private equity firms are finding these 'dirty', highly profitable assets (typically through politicians forcing divestment) on the back of a decarbonisation mandate. As the world looks to divest to 'decarbonise' they continue to purchase these 'dirty', highly profitable assets.

What Alvia is doing

We believe there is room again in the context of a portfolio to own the less toxic end of the anti-ESG movement to boost returns. Our view remains that the energy transition will take much longer than anticipated, providing significant margins of safety for the likes of Aurizon, which merely transports necessary commodities across its network.

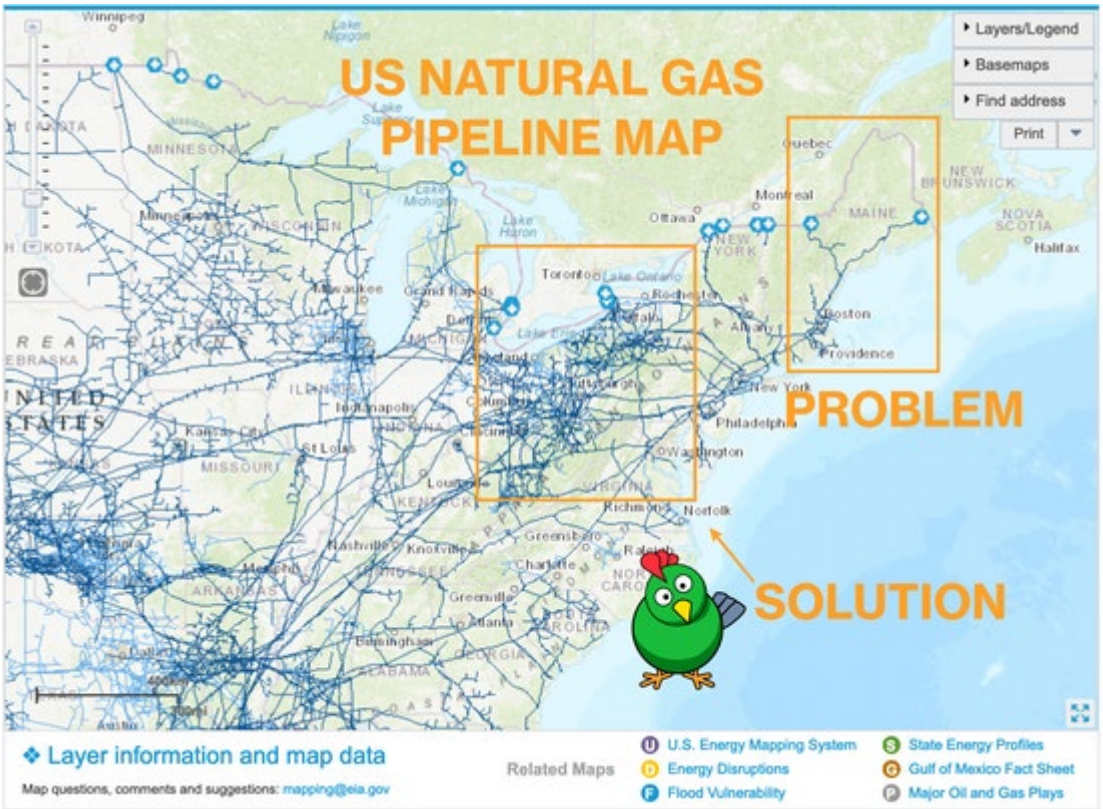
Our belief is that in a world starved of income, genuine long-term bond like opportunities exist by simply investing where the 'ESG' risk intersects such an opportunity (Aurizon trades on a c.9% dividend yield).

Ask yourself this simple question – **despite the noise, do these companies exist in 20+ years and am I being compensated for this uncertainty?** We think the answer is yes to both.

Self-inflicted cold wounds

Globally we continue to see strange baseload energy decisions being made. We have been reading recently about New England in the US and a near miss in 2018 with a grid failure due to a very cold spell that was only circumnavigated by the burning of oil.

Such burning averted a disaster with the grid being only hours away from blackout. **You would think that a near miss such as this would bring rational conversation around energy security, however this doesn't appear to be the case.** Instead, the decision made was to dismantle one of the region's three nuclear facilities and block any further advancement of natural gas pipelines to the region.



Source: Doomberg

The decisions being made around natural gas appears at least to be superficial and driven by politics and pressure from activists' adamant to block all fossil fuels, irrespective of the need for transitional gas to supplement the intermittent loads of renewables. Thanks to Doomberg research above you can clearly see the irony around these decisions. **New England sits a few hundred miles from the most prolific gas region on the planet.**

NFL & investing

Bill Belichick is one of the greatest NFL coaches of all time. The most interesting part of Bill is his ruthless roster management and ability to consistently maximise outcomes with scarce resources (salary cap). His decision to move on from all-time great quarterback Tom Brady has looked horrible in the short term, however, this decision wasn't about what's best for the team next season, it was about what is best for the team 5 seasons from now. That takes real courage.

The parallels with an investment portfolio are clear. The willingness to stand alone with a view for the portfolio that 5 years of steady compounding will be better than 1 year of wonder, with you possibly receiving no positive feedback is difficult. It requires rationality and grit.

Comparisons exist to Buffett and Munger in an investing context as they never make decisions based on what anyone else is thinking or suggesting. They are willing to make tough decisions that in the short term might look peculiar. They always remain pragmatic and never display emotion or FOMO. They just get up each day and work within the same framework.

Warren's Wisdom

When Buffett was asked why he liked insurance businesses, he responded by saying he looked for companies that he could have a general feeling for what they looked like in 5, 10, or 15 years. This means he stays away from a lot of things.

In other words, he only invests in opportunities where there is a degree of confidence they will be around doing what they do in 15 years' time. This process results in very solid returns and sometimes truly brilliant results with very few 0's.

When phrased like that it doesn't seem overly complicated, however, human behaviours of temptation and greed get in the way, making it difficult to avoid fads and speculation. To actually do the above requires you to consider with depth and ensure you garner an understanding of how businesses make money and how they will in the future.

For the cricketers out there, it's simple but when most investors are chasing boundaries (and risk), it can be difficult taking the easy singles on your way to a century.

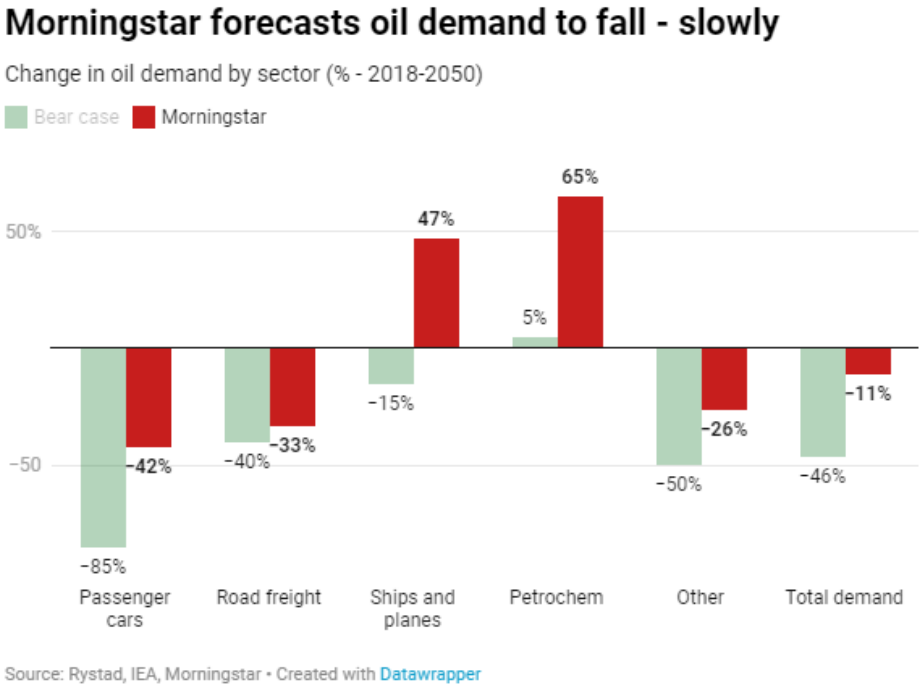
Consider this, if you were buying a stand-alone news agency with all your savings – you would deeply consider the dynamics of location, population growth, longevity of physical media for the next 15 years before making the investment. You would also deeply consider what could go wrong before thinking about what could go right before putting your life savings to work. **Investing in listed companies should be no different – this level of concentration and detail is required.**

Precision does matter but so does consideration.

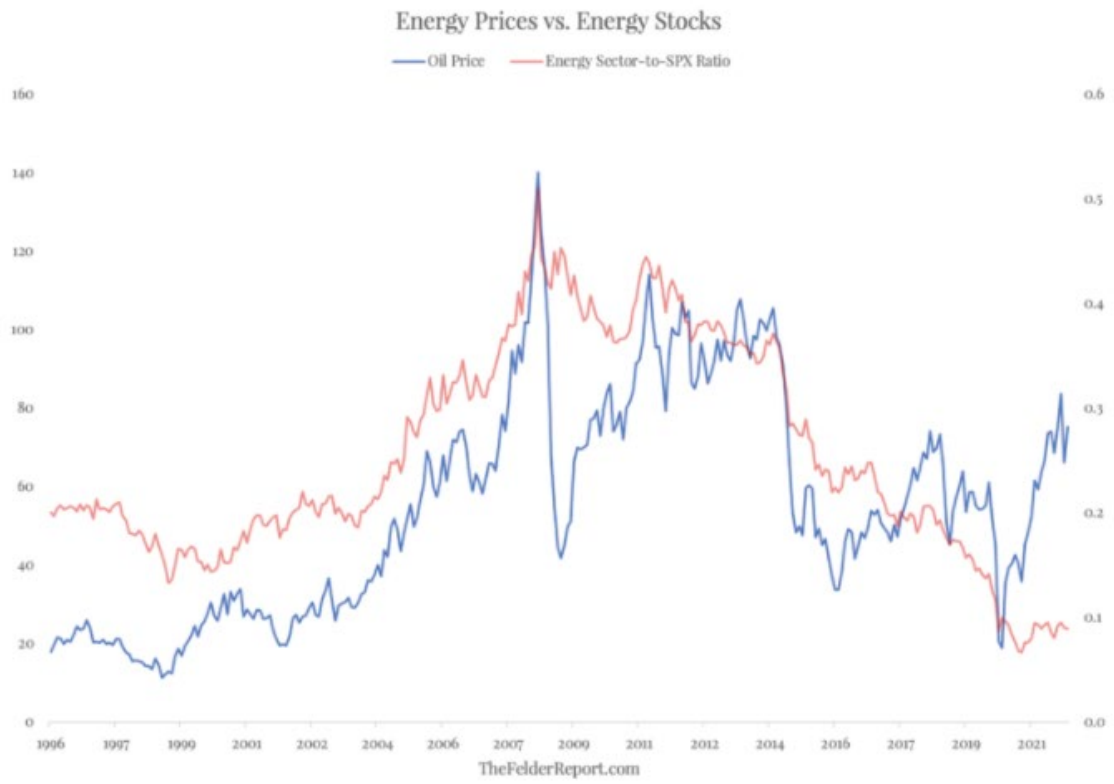
Oil not so dead?

Below is the oil demand expectation by 2050 as published by Morningstar.

Oil is incredibly difficult to displace entirely from the demand side and despite many prophesising a complete eradication, more rational minds are flagging a circa 11% reduction by 2050. Consider this; where the supply side dynamic involves reserves being eroded with little capital to replenish, this could only lead to much higher pricing.



We remain convinced that the energy sector presents plenty of opportunity for astute investors.



Despite the oil price strength it's apparent from the above graph that the size of the energy sector by market capitalisation remains almost floored at all-time lows, and this bodes well for reversion. This can come in two ways, either energy outperforms to the upside or protects on the downside. We think the former.

What we look for in business leaders

Most importantly, they are eating their own cooking, not going along for the listed company salary ride. How about characteristics? Deeply ingrained humility and respectful self-assurance that enables them to actually hire smarter people than themselves. Everyone says they hire smarter people than themselves, but to action this a person needs to be humble and self-aware enough to realise their flaws and hire around them.

Great leaders genuinely want the best for the business and their people and it really isn't about them or their identity.

"Leadership is about making others better as a result of your presence and making sure that impact lasts in your absence" - Sheryl Sandberg

---

Fraud watch

We've written about Theranos and its relationship to market exuberance many times over the years.

So it is interesting to see that Elizabeth Holmes has now officially been charged with fraud (wire fraud to be precise) and will likely do some jail time. In short, it proves investors were willing and continued to be willing, to pay for the dream of a start-up, especially when they are attached to a visionary type persona or narrative.

The common thread amongst Theranos and other frauds that astounds us is the **distinct lack of any due diligence undertaken by any underlying investor.** We cannot understand this as unlisted investors. We simply put it down to egos seeking unicorns in a world awash with careless cash.

Holmes was able to continue to lie, as long as these investors remained gullible and under-researched. When cash is plentiful you either become more cynical or open yourself to handing over to those of low integrity.

If you come across charismatic founders with bold promises, don't rush. Do the required due diligence, otherwise you may just be buying into more BS.

Easy come, easy go

When you start to see lots of quick fortunes made on the back of speculative projects, we think back to Theranos. There are a lot of people out there making quick fortunes on non-fungible tokens (NFTs), however, we wonder how many of these are converted into intergenerational wealth.

We place a high probability that the average crypto/NFT speculator will not convert any gains into long-term asset allocation portfolios or real assets. They will simply roll the dice again and again until they land back at ground zero. No due diligence, just getting caught up in the glitz and glamour.

Watch from the sidelines for the sake of entertainment only...

Using 2008 in 2022

After something bad happens, just don't freeze like a snowman.

2008 was hard as an investor and when things are great like now it's a good time to reflect on the past. Below are our learnings that we use to hold us to account. We have borrowed a few from the truly gifted investor Seth Klarman.

1. Big things happen (things you would never imagine) more regularly than you imagine. Be prepared.
2. When excesses build (debt) and complacency becomes widespread, increase cynicism.
3. Don't push to make every last dollar – always put risk before reward. Conservative into a crisis is key to long-term returns. **Never be a forced seller!**
4. Risk is always relative to price paid. **Uncertainty is not the same as risk.**
5. Reality is always too complex to be accurately modelled.
6. There is no alternative to cash. Those few extra % are not worth it if it comes with complexity.
7. The last price point of a stock is not true value. Focus on value not price (it can be illusionary).
8. An investment approach must allow flexibility in a crisis and your clients must be educated. Opportunities can be vast and wide. Rigidity can hold you back.
9. You must buy on the way down and keep at with a plan - you will never pick bottoms.
10. Financial innovation is dangerous.
11. Do your own research and don't trust 3rd parties (rating agencies in 2006 and 2007).
12. Illiquidity deserves a premium, which can be a blessing and a curse. Ensure anything illiquid is not needed within 5 years.
13. Equal opportunity – take public over private, which allows you more opportunity to add or subtract (liquidity).
14. Beware of leverage in all its very many forms.
15. All ROE is not the same – leverage banks ROE is not steady compounder ROE.
16. Having clients with long-term orientation is crucial. Nothing else is more important to the success of an investment firm.
17. Governments truly have little understanding of the economy and are the ultimate short-term investor – they only care about the next employment cycle.

"You're crazy if you're rich to deliberately go out and do a lot of things you don't have to" – Charlie Munger

---

Diversification vs deworsification

This age-old dilemma is always prone to recency bias so we like to challenge it regularly. Recent success from a concentrated portfolio will lead you to overconfidence and risk, as does spreading yourself so thin it removes any likelihood of active returns.

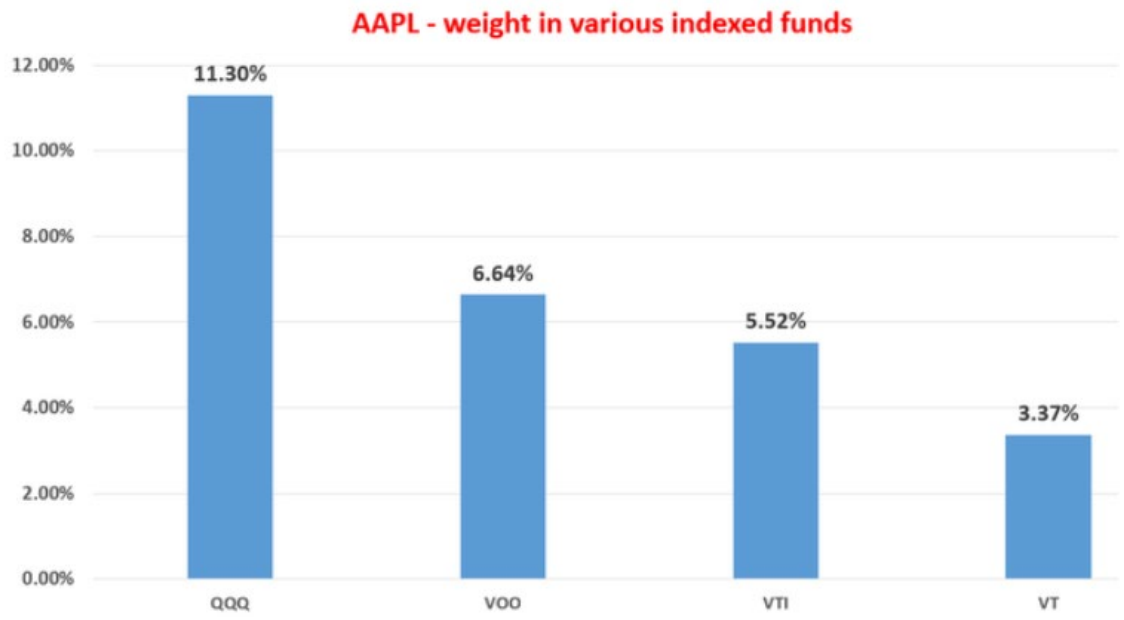
It is the first concept we learn as we start to invest – don't place all your eggs in one basket. However, upon reflection, our position in Apple has recently made me think about this.

Are we holding too much Apple (long-term holding)? Are we overly concentrated given its strength and should we review?

It is also exacerbated by our holding in Berkshire Hathaway which maintains a large Apple position itself. However, more investigation shows that perhaps it's a question for the passive investor. For example, Apple now represents c.11% of the Nasdaq and about 7% of the S&P 500. We think most indexers who want to spread their eggs don't actually know that c.1/10th of their eggs are in 1 company.

With index funds being so prominent and index concentration nearing all-time highs, it poses a dilemma for the index investor. In fact, the average index investor right now would be more concentrated than the average active hedge fund.

We aren't saying Apple is a great business, it is merely an example, but risk is risk and awareness of such risk is key. We are still unsure if we are yet to de-Apple ourselves but we are at least aware. Perhaps Berkshire at 12x might be the better way to own it.

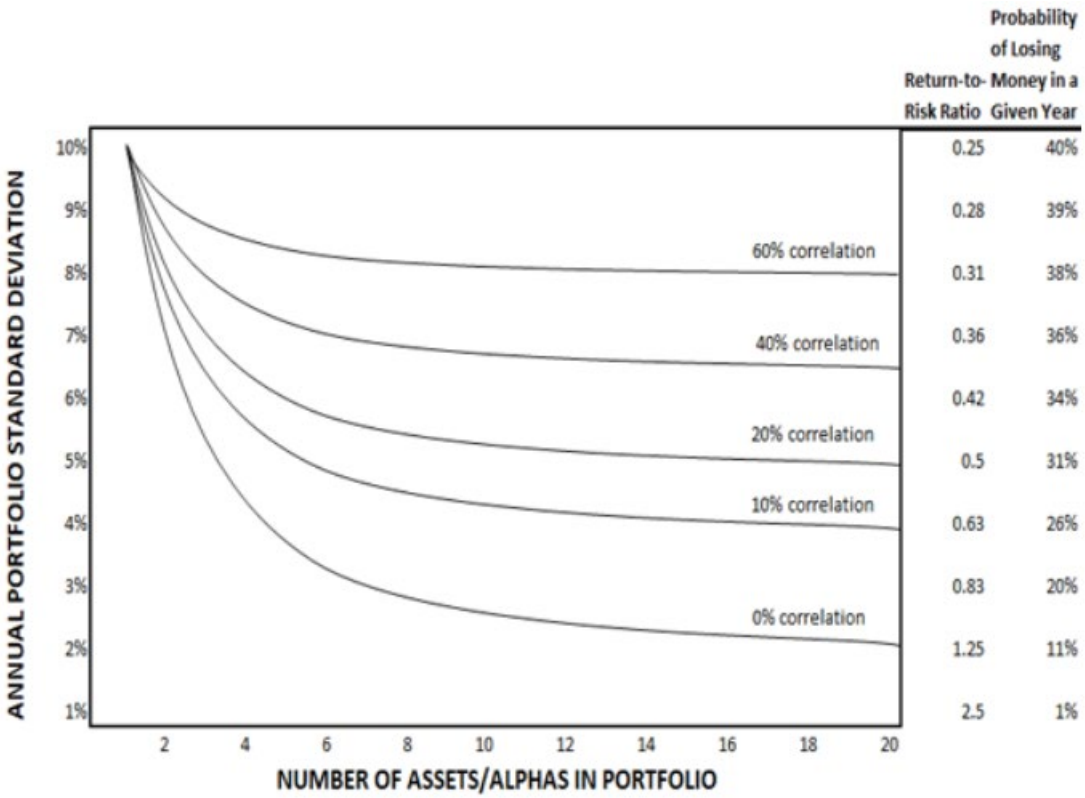


Source: Seeking Alpha

Risk guide to diversification

It is all about correlation and in our opinion 20 to 30 positions is the happy balance (see below). Above this you become prone to deworsification and below this and you are prone to overconfidence and blow-ups hurting long term performance.

Finding the happy balance is the secret source of portfolio management, however, it should be noted 20 stocks exposed to the same interest doesn't provide appropriate protection either.



Josh Derrington's final thoughts

When I first got into investing professionally, I remember meeting with a new investor's son who professed he was a much better investor than me and his parents were wasting their money by giving it to me. The son's solution – own Macquarie Bank (Pre-GFC).

I have never forgotten this as Macquarie was and had performed very well at the time, however risk never entered the conversation. Despite me laughing off this comment at the time, Macquarie shares fell to c.$13 during the GFC.

I get similar feelings now as I did then, lots of ignoring the basic arithmetic and replacement with non-financial metrics.

Thanks to Richard Pzena for providing an example using Tesla:

"*Tesla just become a trillion dollar company. To make 15% a year, if I were to own the whole company, Tesla would have to earn $150b a year. The entire auto industry in the world earns $75b a year. So I'm thinking there's something wrong with that arithmetic too!"*

We think it's time for the boring end of the market to prevail at the expense of the sexy end – similar to 2001/2002.

Level 2, 283 Elizabeth Street, Brisbane City QLD 4000
GPO Box 212, Brisbane QLD 4001
07 3153 4879
info@alviapartners.com.au
alviapartners.com.au