ALVIA

ASSET PARTNERS

Resuscitation of Value...ation

Alvia Asset Partners Investment Team Insights

March 2022 Quarter

A message from the CIO

Dear All,

Well, what a very eventful quarter that was – I think we literally had every possible market disrupter thrown at us, to the point that the financial noise hit decibels we haven't encountered in sometime.

However, for the purpose of this letter I really don't want to focus on the noise (you can read our quarterly insights for all the exciting bits). In this insight, I want to take it back to basics. Sometimes you need to push the noise aside and refocus the attention. Getting rich is simply not easy, and the job of the noise is to discourage this as much as possible…

Remember, save, invest, do nothing, repeat until sufficiently happy.

With so much happening around us, it can be debilitating to deploy capital but sometimes it helps to bring it back to the core principles.

The secret to financial freedom, staying rich and enjoying flexibility is the above. Save, invest, do nothing and repeat until you have enough to enable the flexibility you require. I know this is almost condescendingly simplistic, but it's the truth.

When the noise ramps up (this time it's inflation/war/supply chains), we need to get back to first principles - review the budget. Quite simply, if we reduce some of the 'nice to haves', save a little more and reign in investment assumptions, future *you* might just be pleasantly surprised.

Invest the excess savings with caution but don't stop investing as a result of fear. Perhaps own a little less Nasdaq on the basis of 20% pa extrapolated assumptions, and own a little more undervalued European industrials with a conservative 8% pa assumption – rejig your models, reset your expectations and enjoy the ride. Cash under the mattress is a really bad proposition right now.

The simplicity of the above requires patience and a resilient mindset. It's almost laughable how many investors talk to their patience but offer up the complete opposite with their activity. It's so much easier said than done in practice, and requires an almost sadistic adherence to inaction over action. This is something we aim to always get better at as investors at Alvia – more opportunistically waiting and holding, than buying and selling.

Sitting is hard, sitting on cash is even more so – especially if that cash came from years of effort recently realised. The two most obvious questions that almost always arise are;

What if I lose this? What if I invest it all right before a huge crash?

However, just remember you have the below on your side:

"Since 1965 if you've invested at the peak of the market each year, your annual returns were 10.6% If you timed the market perfectly and invested at the low point each year, your return was 11.7% The difference between great and lousy timing was only 1.1%."

-Peter Lynch

At Alvia, to really test our long-term thinking and owner mindset we consider the scenario where we are unable to interact with our portfolio for 10 years. Would you feel comfortable with your holdings today if this happened to you?

It might just change the way you think about your portfolio and leave you with what should resemble a very strong core of durable holdings. It's a simple, quick test to ensure you aren't migrating away from a long-term mindset.

This thought process forces you to get back to basics, ignoring the quarterly noise and have clear thinking around these 2 key areas:

1. Franchise durability and defence. Focuses on the moat, competitive advantage and assess longevity of the business
2. Rotate away from anything cyclical or over leveraged. Good for a short time not a long time, too much can go wrong in a decade without a watchful eye

You want to ensure that you have ample margin of safety, trying to accurately forecast a business 10 years out can be an impossible exercise.

We thank you as always for supporting the firm and we hope that during any times of uncertainty our risk first mentality enables you to free your mind of the volatility.

We are happy with how our client portfolios have held up with this recent bout of volatility. If you would like to discuss our performance, please reach out.

Yours sincerely,

Joshua Derrington
Chief Investment Officer
Alvia Asset Partners

Macro-Overload

At Alvia we remain macro aware but avoid letting it take us down the garden path. Rather, we understand what we own and focus on the underlying business. Leading us to hold a core of quality franchise entities, bought well and held well. Sprinkle some opportunistic holdings entered through macro dislocations driven by behavioural enthusiasm leaving areas behind.

This is where good old-fashioned understanding of history and macro environment works. Consider, how unloved commodities have been, this was one of those prime opportunities. They became so fundamentally cheap and unloved even with the grumblings of supply/demand dynamics mismatching underneath.

Our focus is 90% of getting to know high quality companies and patiently waiting for our opportunity. We read for awareness to understand potential impacts on our portfolios, not to prompt action or prediction. We don't speculate on timing of commodity "Super-cycles" or the timing of rate rises, we instead aim to understand directions, probabilities and how these can impact our portfolios.

"I've always said you spend 13 minutes a year on economics, you've wasted 10 minutes" – Peter Lynch

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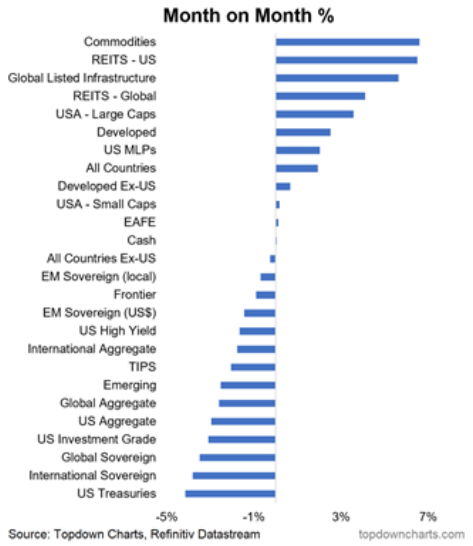
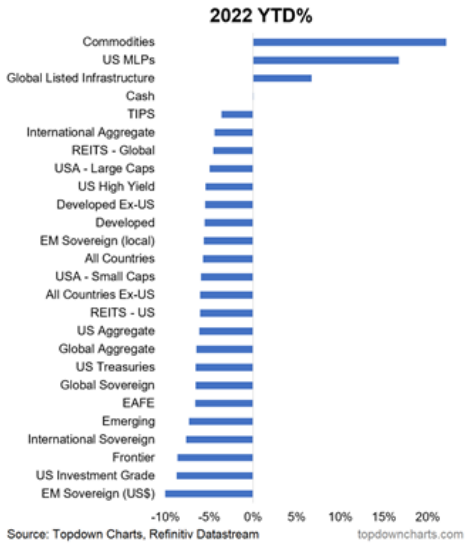
The repeatable lesson tends to be that strong fundamental franchises have resilient models that survive over time and adapt to macro, not dictated by macro. The very best investors opportunistically deploy capital into macro uncertainty and become better for it, disturbing this rigour because you are now personally predicting something you weren't a mere 6 months ago to us seems silly.





The Quarter of Paradigms

Paradigm One. The Fed

'Transitory' inflation is just inflation. Larry Summers is calling for lasting inflation and a resulting recession with potential for stagflation (inflation without the growth).

The Fed's objective (besides reading up on the translation of Transitory) is to stick a soft-landing i.e. inflation at 2-3%, no recession and gentle rate hikes…going for Gold in Vault. Mr Powell is a believer that this is possible, even with all of the moving parts (Political instability, War, Commodities supply, Asia lockdowns, just to name a few).

Let's just take a look at historical performance of rate hikes:

- 1964-1966: The Federal funds rate rose from 3.4% in October 1964 to 5.8% in November 1966.
    - Unemployment declines 5.1% to 3.6%
- 1984: The Federal funds rate rose from 9.6% in February to 11.6% in August.
    - Unemployment declined from 7.8% to 7.5%
- 1993-1995: The Federal funds rate rose from 3% in December 1993 to 6% in April 1995.
    - Unemployment declined from 6.5% to 5.8%.

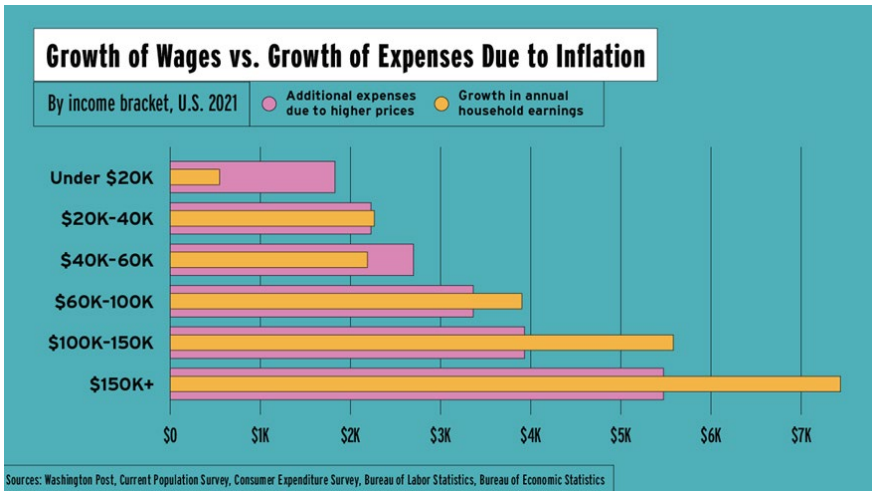
Although historically, it appears they have managed. This current situation seems very different, consider the starting points: Unemployment is much lower (3.8%), inflation above Feds target (2%). This indicates the need for a potential push higher on unemployment, posing a problem for the Fed as any significant increase in unemployment locks in a recession.

Just looking back at the 1970's as a proxy (we hope this is not the case) – there was excessive demand expansion and inflation, then external events (Oil shock) drove this further. Creating a bubbling cauldron of heat resulting in aggressive hiking, leading to an eventual recession.

Our concern is that layering of external shocks continuing to dismantle the supply side of the economy, add in a few cups of energy and commodity input issues, and this is creating real problems for Central Bankers cauldron's. **Australia is 6 months behind this.**

The Central Bankers have a real tough ask on their hands in this soft landing. Our gut is Mr Powell will want to let inflation run a little higher this time round given the debt load at a government and corporate level. However, in doing this, the Fed continues to widen the wealth gap, one of the hot topics in politics currently.

With the rise in cost of living being mostly felt by lower income earners (below), the anti-wealth mantra grows. Millennials just entering the workforce are feeling the brunt of this…we are only a few years away from Millennials being the largest voting class (in the US). Ms Yellen and Mr Powell do know each other quite well.



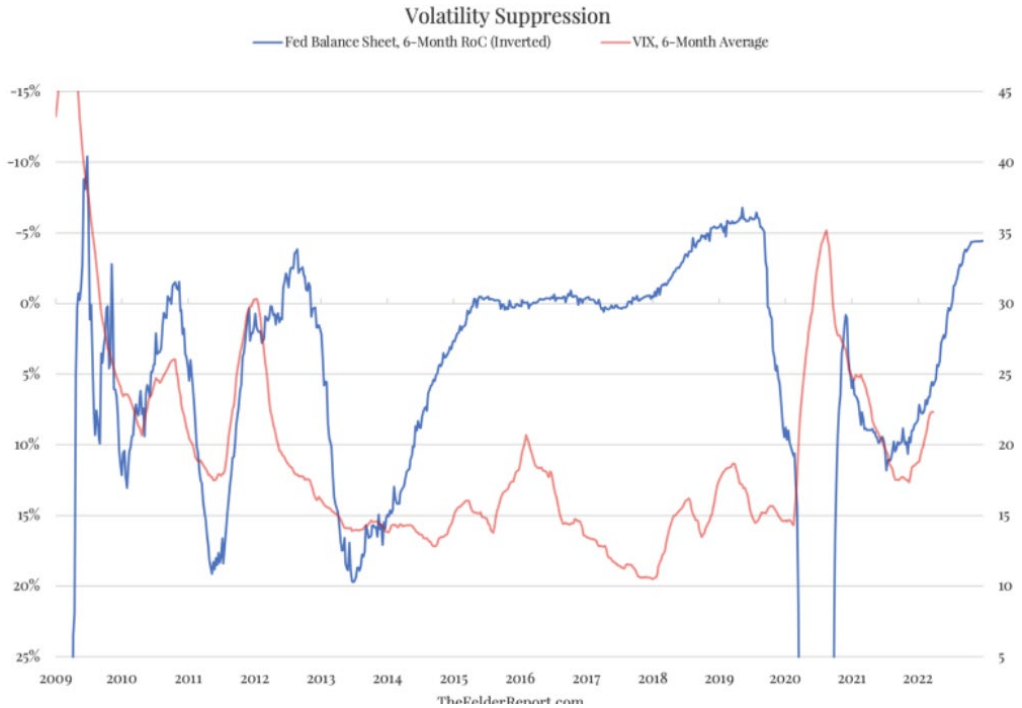
To us, this soft landing seems as difficult as putting out a fire with hand sanitiser, our fingers are crossed that the wind blows and bails them out. With the wind being the old narrative of yester year – demographics and productivity taking the heat out of the equation.

How is this affecting markets?

The current (US rates) market expectations are:

- 81% likelihood of 50 bps hike on May 4 (0.75% to 1.00%)
- 87% likelihood of 50bps hike on Jun 15
- 65% likelihood of 50bps on July 27

The market is closely monitoring the Fed's management of its balance sheet. Having announced a reduction of as much as $95b quantitative easing starting in May. When it was established, QE reduced volatility from the market. As they unwind the suppression assassin, there is likely price volatility in the short term as it removes a big buyer from the market.



Source: Jesse Felder

Paradigm Two. ESG a good times only investing style?

We have been pushing this agenda for a while. Our view is a bit nuanced – ESG in all aspects should formulate in an decent investment philosophy as it highlights a long-term focused process. However, the rise of superficial ESG managers utilising checklists to raise funds was prolific the past two years. This isn't 'sustainable' investing, it is subjective retail marketing. When returns appears great it is the most important asset class, what if these ESG hero's turn to zeros? It has been astonishing to see the rhetoric out of "ESG Only" circles change…why?

Energy has been the best returning sector of the past 12 months. Add in defence sector, which could outperform in a war environment…the ESG criteria is apparently expanding. A Citi analyst stated "Defence is likely to be increasingly seen as a necessity that facilities ESG as an enterprise as well as maintaining peace stability and other goods"…

Kane Brenan, CEO at TIFF Investment Management: "Investors are like wait, it feels concessionary to be ESG investing now".

We think it will be interesting to see how this plays out – are you willing to give up returns and future savings to invest with your heart at the expense of food in your stomachs? To us, wishful thinking won't help – unfortunately, we still need fossil fuels for now.

Marcus Frampton, CIO at Alaska Permanent Fund puts it nicely, "the unfortunate reality is that people haven't weaned themselves off of fossil fuels."

Paradigm Three. Oil and the Old-World Commodities

Oil price will correct in time, it takes two things – supply to come online and excitable/exuberant executives via exploration. Below shows that neither of these have really started to come through yet.

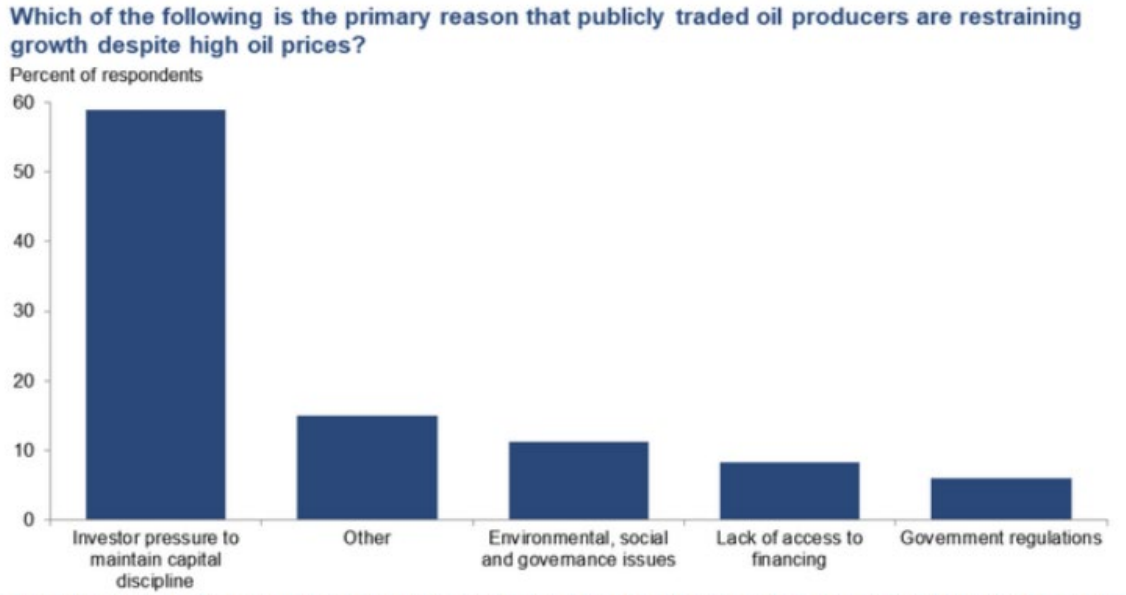


Fig. 3. Statistics of the answers of executives from 132 oil companies to the question why publicly traded oil producers are restraining growth despite high oil prices. (Dallas Fed)

Even the EV King himself doesn't believe we can leave the older world commodities behind:

"If there was a button, I could press to stop all hydrocarbon usage today, I would not press it" – Elon Musk

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Elon knows the mining equipment used for extracting nickel and lithium for Tesla EV Batteries will stop humming without diesel. Irrespective of what we want (lower fossil fuel usage) it will take time, and the lack of capital investment in natural resources has simply been reduced too much during the commodity bear market.

How about us as investors?

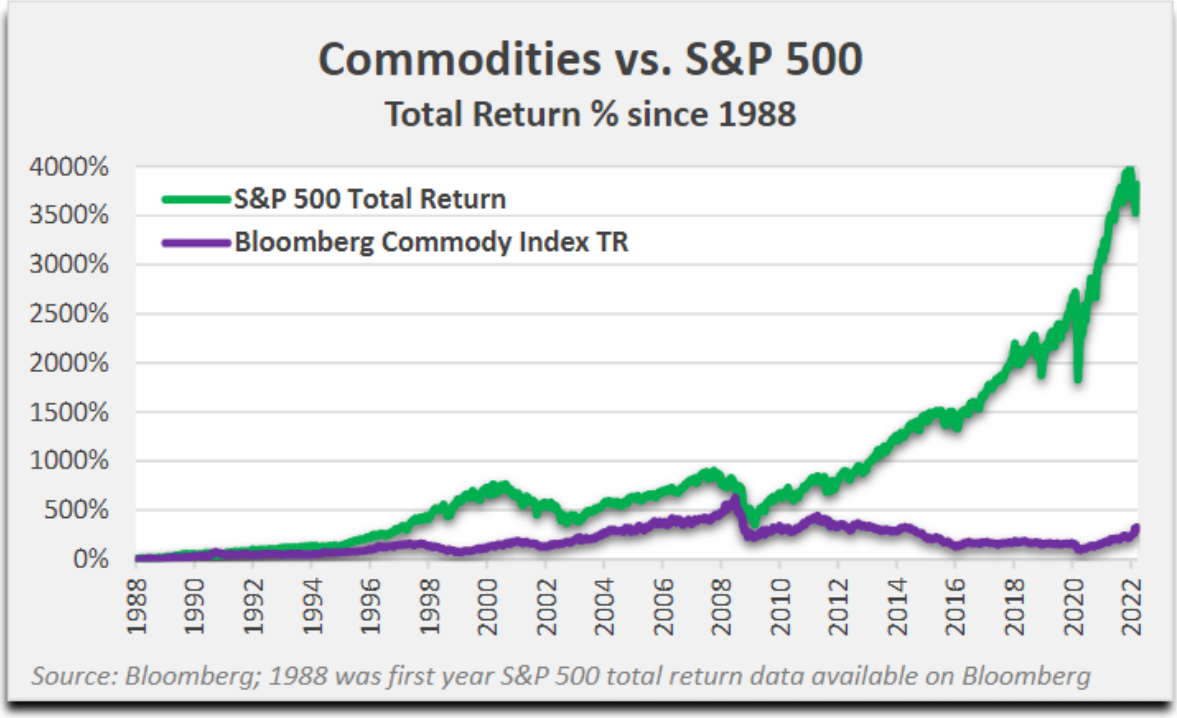
Having been long commodities for some time, we are less excited than we were 6-12 months ago, primarily because of how bullish the investment community is on the sector. 12 months ago it was so deeply unloved, we had relentless questions from clients why we were holding "old world commodities".

To be truthful, we would rather be early than late, however, we still see very favourable times ahead for the sector.

How we think about commodity investing:

- Focus on high quality assets with long tenures (20+ years) and low cash costs to weather cycles
- Understanding management – the industry tends to attract sharks. Try to align with the shareholder friendly few
- Ensure margin of safety at initiation to account for cyclicality (Low PE doesn't mean price is at a discount). Model the cash flows on conservative pricing
- Picks and Shovels aren't a bad idea to de-risk and add income (i.e. Pipelines)

Whilst our focus is firmly centred on enduring franchises, at times market dislocations create contrarian cyclical opportunities. Oil at -$37 was one of those opportunities. Cyclicals are hard but not uninvestible all the time.

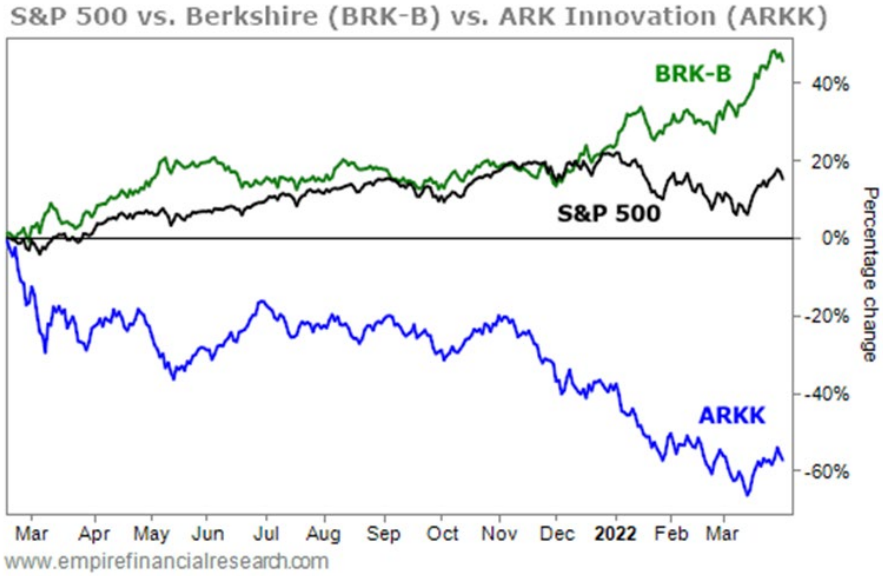


Source: Palm Valley Capital Fund

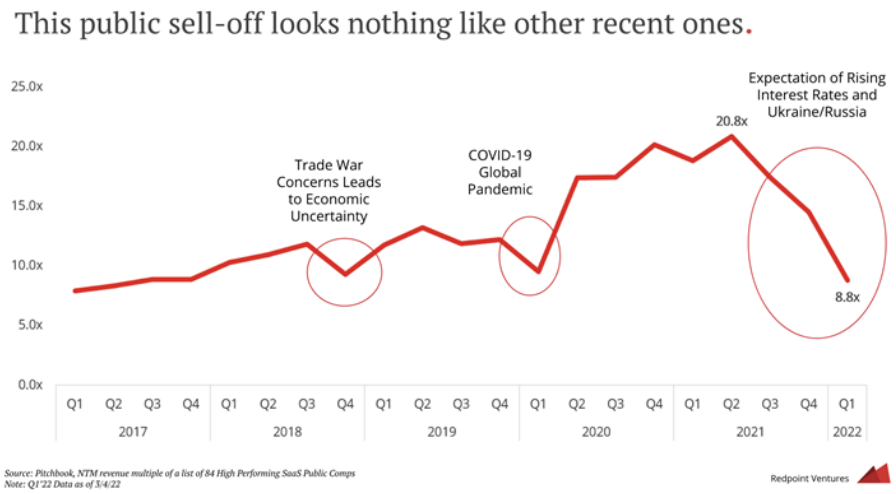
Paradigm Four. Resuscitation of Valuation

Dave Portnoy, internet celebrity, founder of Barstool Sports turned prolific-day-trader,at one point would buy stocks based on a ticker he picked out of a scrabble bag described Warren Buffett as a "washed up investor who's no longer relevant" ...comments like this turned us very bullish Berkshire.

There were numerous other comments being made about Cathie Wood, Founder of ARK, being a better investor than the Oracle of Omaha. Below is the respective performance since the height of these comments.



We find markets shift around self-fulfilling narratives; it is important to acknowledge history as you will likely learn more about today's new cycle through history. On an eye test, the correlation between ARK and profitless Tech seems quite high.



Source: RedPoint Ventures via @SnippetFinance

The 1970's saw a seismic shift in narrative with "value stocks" prevailing (below).

Although Alvia don't forecast paradigms, we think any shift that highlights the importance of valuation is a healthy one. **A good business does not always equal a good investment**.

Earnings do matter and the price paid for those earnings matters ever more.

In an environment with rates following inflation upwards, a quality franchise with pricing power at a reasonable price with a sufficient margin of safety to account for valuation error should bode well.

The narrative of the last few years has become increasingly unhealthy, we like to see less NFT's and more FCF's 😊 .

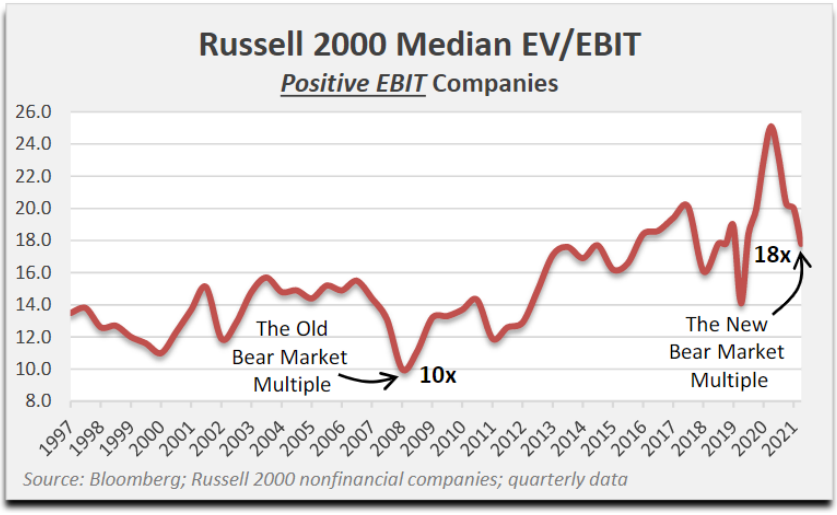
Paradigm Five. Market correction for some

Tiger Global was founded by one of the all-time greats Julian Robertson, however, it has changed its stripes a lot in recent years becoming a larger-than-life mix of public and early-stage private assets…with this early stage investing valuations and public market downgrades all aligning.

Beware the hot hand.

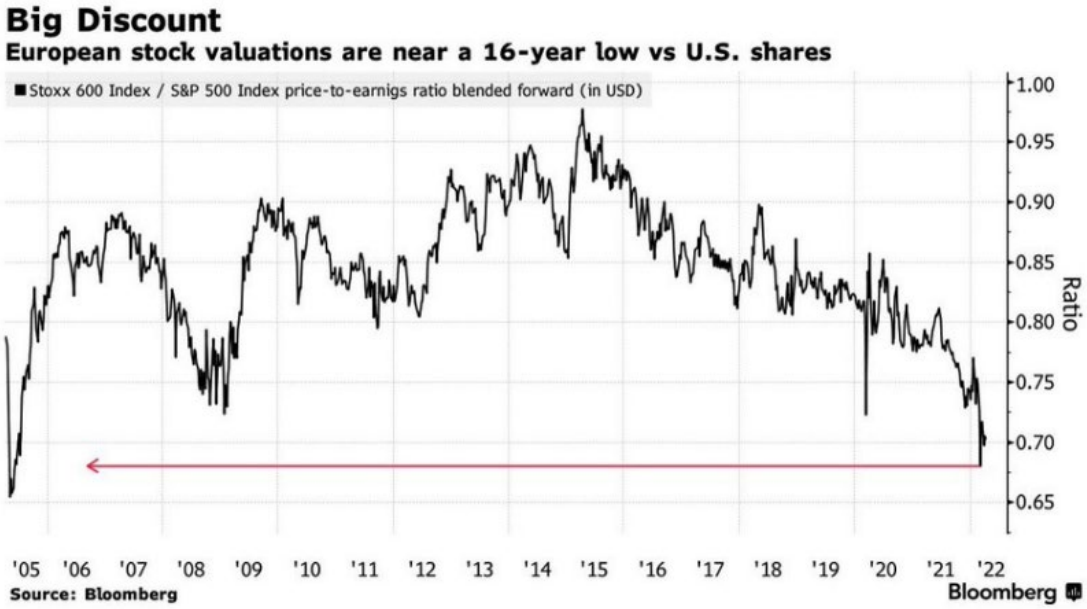
Tiger Global is just a headline manager, but we feel there will be a few like this. Utilising the Russell2000 as a barometer of the market, 2021 shows it got a touch inflated. Looking at the below (this only includes the profitable companies), it is certainly not bargain terrain, however, it looks healthier and beneath that surface there are opportunities.

We are big believers in the older, durable economy entities seeing some revival, with the index seeing a healthier breadth (outside technology) and rebasing at sustainable levels.



Outside the US, we certainly believe opportunities exist in Europe and Asia who haven't seen the US technology valuation revolutions. It's amazing what the threat of rate hikes can do to create new equilibriums.

Source: @Ozard_OfWiz



Should I stay (in cash) or should I go (into the market)?

A lot of cash has been created and made in recent times, the most common question is what should I do with it?

It is a fantastic problem, the only downside is there is no silver bullet answer. It is quite ironic to us sometimes, that the pile of cash can create stress for those questioning what to do with it. The most frequent we see are

- What if I lose it?
- How do I invest?
- Surely there is another crash coming? Should I just wait?

The common thing we almost always encounter is a lack of plan or policy as a family to manage the money intergenerationally. Most just say "I want the best return" with no consideration for risk, or the conditions. That's the same as opening the bowling with the late great Shane Warne irrespective of the opponent or the conditions.

Every family/person has a different appreciation of risk, time horizon, cash requirements and expectations. The first step in this process is to take the time, think about a strategy that works for you and your family, then find the right people to help you get there.

Why we promote Dollar Cost Averaging over Timing

It is quite humorous the number of self-proclaimed 'investment experts' that exist who have never managed any external money or most only own investment properties. They refer to share investing as a gamble and have only dabbled in (usually unsuccessfully) over the years.

They talk to how they will simply just time the market, as if it is such an effortless phenomenon. They typically flap like fish to the change in headlines. There are a multitude of data points that point out this being a poor strategy, we like Peter Lynch's the most.

"Since 1965 if you've invested at the peak of the market each year, your annual returns were 10.6%. If you timed the market perfectly and invested at the low point each year, your return was 11.7%. The difference between great and lousy timing was only 1.1%".

Even with this known, a lot of people maintain an all or nothing principle. They tie themselves in knots, costing both money and stress. They forget the basic premise that the economy does not equal the market, with timing being futile.

One of the smartest economists we have ever met has been calling a 30% drop in markets since 2012…If we were to get one today, we would return to 2020 levels.

- A 50% drop returns us to 2017
- A 60% drop returns us to 2016
- A 70% drop returns us to 2012.

Being a bear costs money…being cautious saves you money.

Tweet of the Quarter

If we asked you what are some recession proof assets, what first comes to your mind? Essential services e.g. Waste, Healthcare, key infrastructure etc

Well Alex, would disagree with his belief that Mini Golf is recession resistant.

What goes first, the bread or the Sunday morning mini golf with 3 kids?

To us this simply further highlights there is a large cohort of current investors who have seen very little difficult periods…

Scar tissue can help

This is a bit of a Segway from investment markets, but we were interested to understand the lack of reaction from Chris Rock when Will Smith slapped him. Reading around, Rock spoke about how he was bullied frequently as a kid, one day he assaulted his tormentor with a brick to the verge of death.

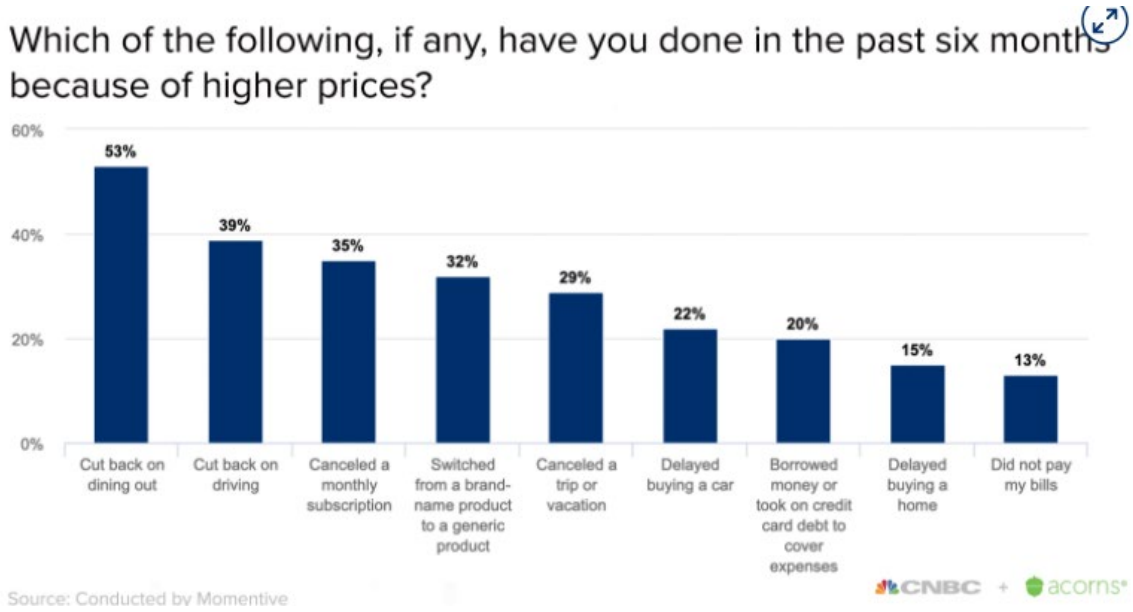
Rock, understood his issue and worked intensely on managing his anger problems. Training himself to respond and react in a certain way. The scar tissue matters, it builds internal mental models allowing you to deal with adverse circumstances.

The relationship to investment markets is obvious…it helps to have been here before.

Inflation deflating choices

It is slowly becoming apparent to the rest of the market the Great Gatsby type low inflation, low-rate party is slowing and with it creating decisions' at a household level.

The new world household budget looks very different to the last time any real inflation was felt so it will be interesting to see what is designated a 'need' is and what is a 'want'. Does the mini golf or avocado toast go first? With less than 40% of Americans having $1,000 in savings, the consumption will have to shift.



Elon vs. the SEC

Another quarter, another time Elon has once again flexed his power over the SEC…at this point we think he might as well be the chairman.

During the quarter, Elon purchased a 9.2% stake in Twitter…this was submitted via a Schedule 13G, traditionally used by passive investors. However, he should have submitted a 13D which is more detailed especially if he has any view to influence. At the same time of submitting his 13G, he started posting Twitter polls around changes to the business…so being active.

On top of this, he filed the incorrect schedule late (not within 10 days)…maybe the SEC will present him with yet another token fine. It is pretty nice when you can buy an active stake, via a passive form, not announce it and then utilise the very platform to talk about it…Twitter +27% since the announcement.

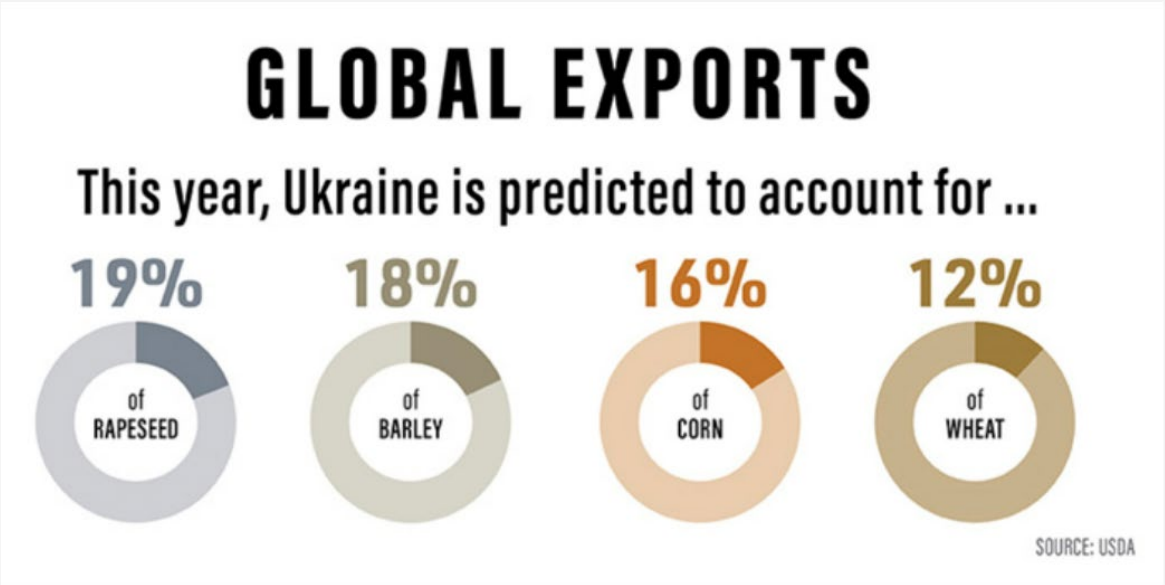
Elon wins again.

Political Pocket

We have been asked regularly throughout the quarter our opinion on the tension between Russia and Ukraine and what it means economically. It is one of the world's bread baskets, where ~0.5% of the world's population meets ~9% of the world's calories. US Department of Agriculture put out these data points

- 1st in the world in exports of sunflowers and sunflower oil.
- 6th in the world in barley production.
- 6th in the world in corn production.
- 7th in the world in rapeseed production.
- 9th in the world in wheat production.
- 9th in the world in soy production.

When we translate this to exports:



Source: US Department of Agriculture.

As noted, we are currently feeling this pinch now...however, what about the longer lasting impact as the world retreats to close boarder production (no exports) and global trust softens.

Add on fertiliser affordability and it's hard to see food price deflation coming through...and we haven't even mentioned the potential for a forced asset sale event. Keep an eye on the marginal, small scale/hobby farmers fed up with the cost stress.

The thin economy

The Russia/Ukraine conflict has highlighted the thin nature of both these economies, an unsophisticated export profile, relying on the exports of basic goods and imports of sophisticated products. Leaving the economies susceptible to economic warfare which is exactly what has occurred.

We have found numerous criticising Germany for becoming dependent on Russia for energy and questioning how they allowed this to occur.

How about Australia's economies reliance on China to continue to purchase our Iron Ore? We feel these are almost one in the same.

A Financial Times article, titled 'Houses and Holes' further confirmed this. Australia is also a 'thin' economy. An economy heavily dependent on a functioning housing economy and exportation of bulk materials without alteration.

On paper, the Australian housing wealth hit $9 trillion in 2021 (~7x our GDP), a continual cycle of bailouts via mineral booms and yet we are on the cusp of another to exacerbate our complacency. We find investors tend to extrapolate cyclical growth is and this can lead to a nasty result…consider this being played out in real time with Australia's current living standards.

We want to highlight the big difference between US homeowners and Australian homeowners – in the US a large portion of homeowners are long-term fixed. Whereas in Australia these is impossible to come by as our banks don't offer long-term fixing…so what does this mean?

While some were lucky enough to fix a portion of debt 4-5 years out in 2020/21 at sub 2%, much like is the cyclical nature of commodities, we wonder how these payments go when they roll off in 2023/24/25 in a new world of 4-5%.

Source: Twitter

It isn't just Alvia thinking this, the RBA have been jawboning to some of their own models to try and manage this. They are talking to a c.15% correction for every 1% hike…and with savings at a household level so weak and reliant on the family home it is easy to see why any interest rate movement has the media in a frenzy. The Australian banking system is over half mortgage related, with a significant portion of small business loans secured by residential housing…no wonder the **4-year fixed rate available is 4%+.**

In all honesty, we find it very difficult to predict how asset prices will respond to rate increases, although, it is without question all asset prices will need to digest higher interest costs, with this impacting the marginal (less sophisticated) borrower most.

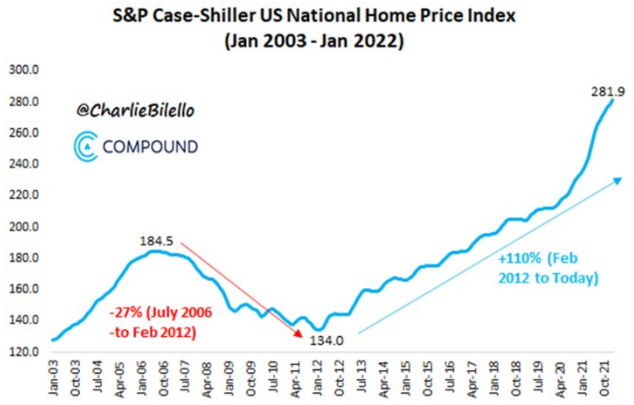
We saw last year an inexperienced new syndicate of investors and new SMSFs purchase commercial assets on 3% cap rates. Only FOMO can explain this…. even if there was attempted valuation work it assumed 1% interest rates into perpetuity.

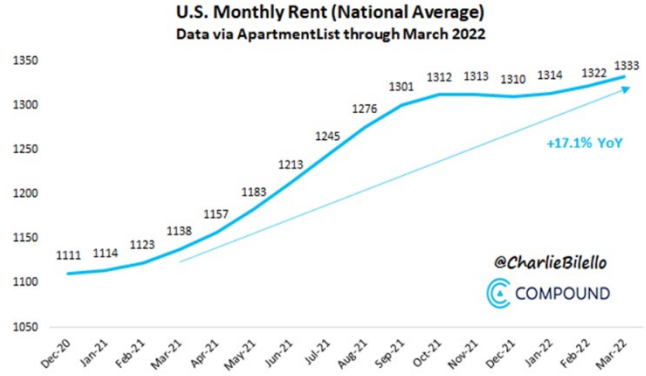
Governments will struggle to address this, with all levels relying on the commodity royalties and property stamp duty. However, we think there needs to be a raised awareness about this, otherwise we are facing a real risk in a reduction of living standards.

Sadly, this won't be discussed at election…we all know thinking long-term doesn't translate to votes.

US Property Wobbling

We aren't looking to call anything here, just highlighting the US housing market is starting to look a little wobbly. The saving grace is undersupply but not even that can save it from mean reversion into rate hikes.





Lessons from an under the radar compounder

Another one of our favourite investors is Allan Mecham. He runs a fund called Arlington from a small office above a taco shop with his long-term returns being Buffett like. He doesn't have a Bloomberg terminal or 20 analysts, he doesn't have a Harvard degree or a fancy algorithm.

Allan believes in simplicity, to him less is more. He reads newspapers, avoiding financial news to enable clear thinking. He acknowledges that his office is like a library with some bums loitering around reading.

He is incredibly inactive, saying if you don't have the patience to wait you don't have the patience to hold. Act like an owner with a long-term mindset.

There is so much goodness in this simplicity, that we aim to live by this at Alvia.

Decentralization preventing Centralisation

Just recently there was a denial handed down to a proposed Bitcoin spot ETF led by Cathie Wood. In its 55-page order rejecting the application, the SEC pulls no punches. Here's a key passage that begins on page 22 (emphasis added):

> "... does not sufficiently contest the presence of possible sources of *fraud* and *manipulation* in the bitcoin spot market generally that the Commission has raised in previous orders. Such possible sources have included (1) *'wash' trading*, (2) persons with a dominant position in bitcoin *manipulating* bitcoin pricing, (3) *hacking* of the bitcoin network and trading platforms, (4) *malicious control* of the bitcoin network, (5) trading based on *material, non-public information*, including the dissemination of *false and misleading information*, (6) *manipulative* activity involving the purported "stablecoin" *Tether* (USDT), and (7) *fraud and manipulation* at bitcoin trading platforms."

It is almost as if the decentralisation of crypto through the lack of regulator(s) is preventing it from becoming a central allocation of any speculators (investors) allocation.

Also, when was the last time you heard about an Initial Coin Offering (ICO)? They were daily just a few years ago. There is a simple test in all this.

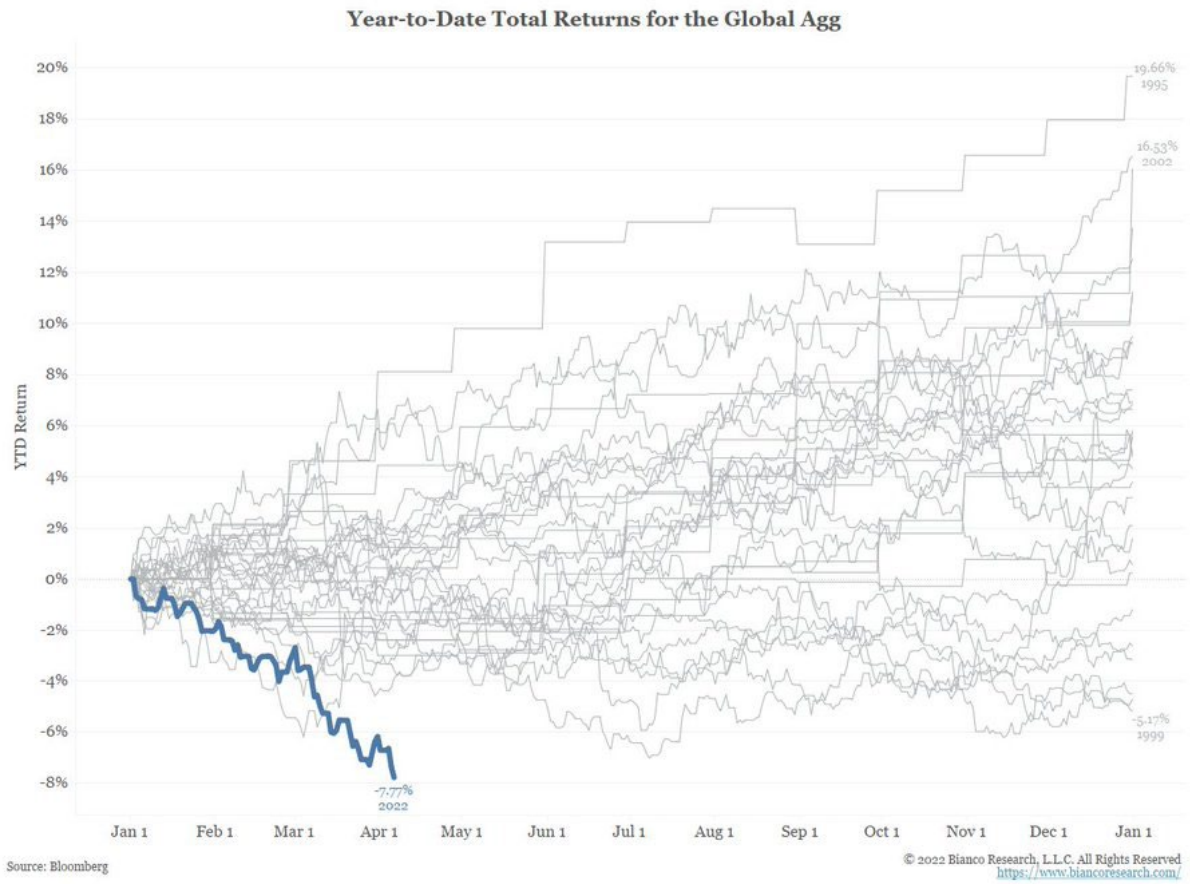
How do you tell when there is a bubble?

Check your requested Instagram messages for the answer.

Is 60/40 the future?

For the past half-century, the 60/40 portfolio has been the way to go. Bonds and equities rose together, thanks to declining interest rates, relative peace and globalisation keeping inflation low.

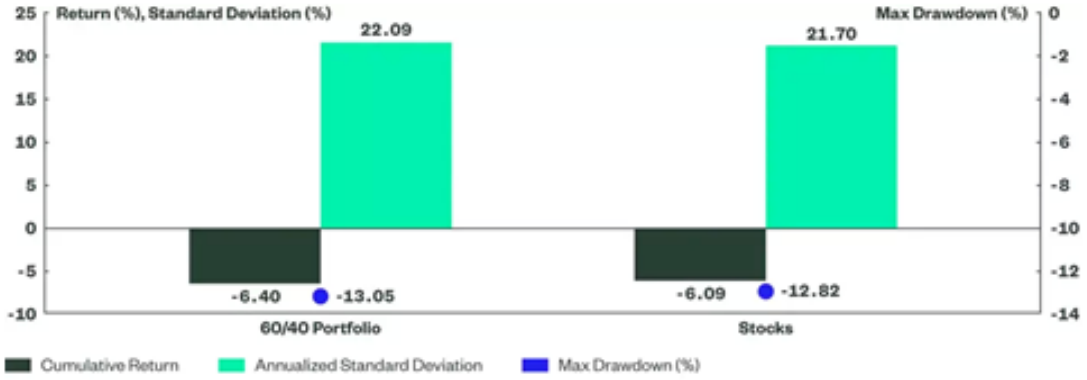
So, what if we saw rising rates, inflation and a marginal deglobalisation…how would the 60/40 portfolio work?



We have been early underweight fixed income for some time. Our view that bonds after an incredible half-century run of declining interest rates were due to face the test of rising rates. Our fixed income selections are designed to manage through this environment. However, we think the big test for fixed income markets is still yet to come.

Lots of managers are negative and still charging high fees despite the nasty outlook. Could bonds actually be 'certificates of confiscation' after all this time. Recall, the bond market is significantly larger than equity markets and the 60/40 portfolio is the basis of almost all lazy modern portfolio construction. Look at how this construction has increased your portfolio volatility this year.

60/40 YTD Versus Stocks



Source: FactSet

Now we aren't calling the death of fixed income or the 60/40 either but it's worth a review of the asset allocation. Just last year it the narrative was buy long duration technology names and you will be fine…but times change.

What's our opinion?

Less bonds, more cash, more genuine alternatives to surround a core of excellent franchise cash flow generators held at a margin of safety.

Below are the returns during a hike cycle, we think that floating bonds at some point make sense, however, the rate needs to be compensating for the risk (which we feel it currently doesn't).

Figure 2: Asset Class Returns and Drawdowns during Hiking and Easing Cycles (1954–2022)

	S&P	10 Yr Treasury	HY Bonds	Gold	Oil	Inflation
Easing Cycle	17%	6%	10%	7%	1%	3%
Hiking Cycle	9%	4%	5%	7%	9%	4%
Worst Drawdown	-51%	-19%	-33%	-62%	-96%	

Source: Bloomberg, Robert Shiller data, Morningstar SBBI datasets, Verdad Analysis

EV – charging the cost of living?

Ammonia Paranoia

Source: Doomberg

It seems like an issue for far-away lands, but it truly impacts everyone. We have spoken about this a few times, but think it remain an underdiscussed topic. Ammonia production is very energy intensive (gas reliant) and is the major input into fertiliser. The double whammy here is it creates higher fertiliser prices which flows onto higher food prices.

Anecdotally, consider a family in the corporate farming game, they are now encountering 2/3x increase in fertiliser costs. Without fertiliser crop yields drop by 40% in year 1, not to mention the longer-term impacts in years beyond. Higher prices best case and shortages worst case.

Recently, a local community in Scotland held its town hall meeting. Historically it has single digit attendance, however, this time 200+ people attended asking for a local government subsidy for fertiliser assistance. **For those unaware, cropping has a 6-9 month lag…so expect this intensity to come through in 2022.**

Basic Metals

Consider the right graphic, add Nickel and Cobalt to the mix and you will see the EV narrative is really starting to hurt. We would not want to be a vehicle manufacturer in this pricing environment – or most environments with Autos being one of the most competitive markets on earth.

Don't even get us started on the environmental impact of disposal/ recycling of all the batteries.

Our plan is to navigate this issue via our private investment in Pure Environmental.

Lithium price ($/tonne):

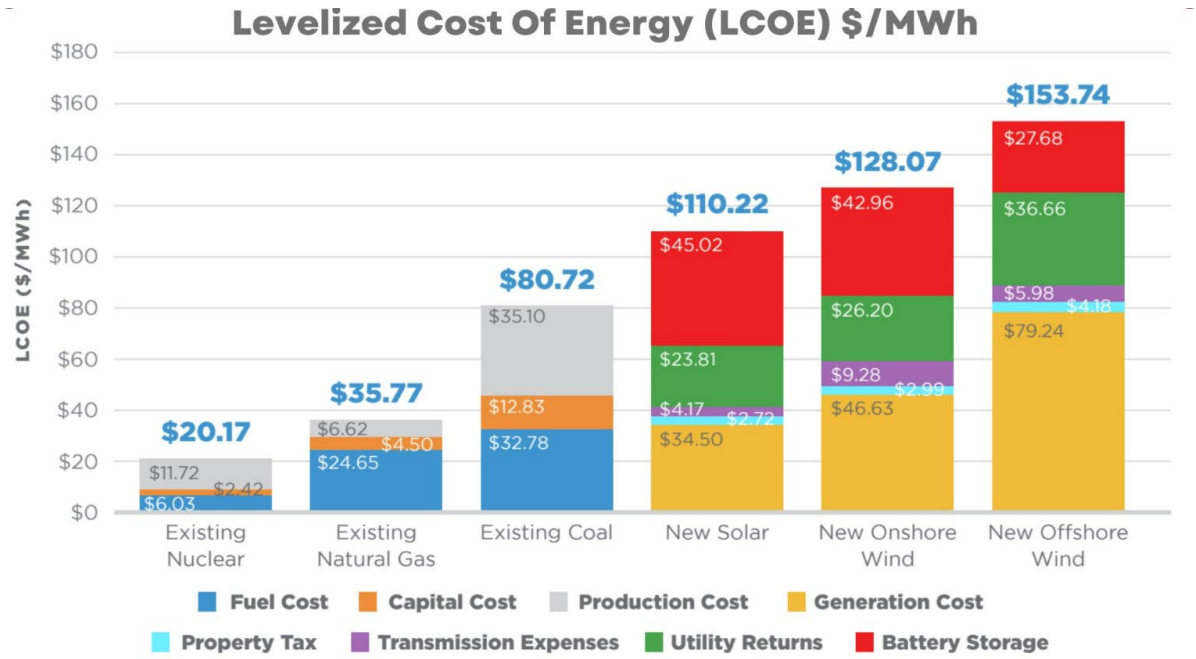
2022: $78,032
2021: $17,000
2020: $6,800
2019: $11,310
2018: $14,660
2017: $12,070
2016: $8,840
2015: $5,110
2014: $4,680
2013: $4,750
2012: $4,450

The nuance of nuclear

Still a long way to go before renewables becomes the cheapest source energy… the interesting outlier here is Nuclear which is such a logical source of carbon free baseload in a world in need of baseload. We have been invested in Uranium for some time. The thesis to put it simply is that there is a distortion in the long-term supply is not enough to feed the demand (especially in India and China). The prices were far below the cost of production causing a lack of new long-term supply to come online. The market ignored it, stigmatised it and unloved it, seeing it become uncorrelated with most of the market.

Fast forward to 2022 and it's finding the support to be the secure clean energy transition. Helping alleviate the European reliance on Russia.

Europe is currently experiencing what it feels like to move with haste towards renewables without considering baseload first.



Source: Brian Giitt Twitter

Russia and the moving parts

1. Russian Commodities

It is apparent that Putin has decoupled the Russian economy from the West, when you consider Russia makes up circa 1.5% of the global economy it appears the impact will be minute (unless you are Germany).

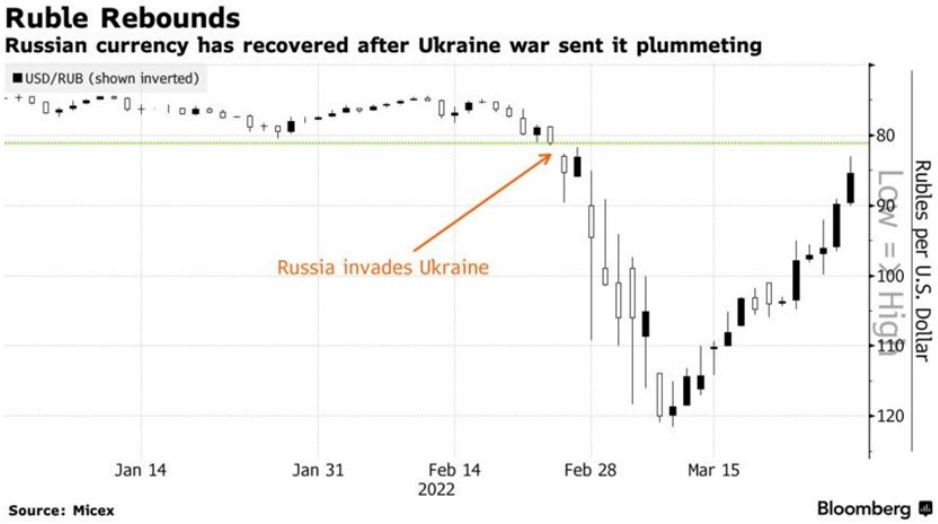
However, what the 1.5% failed to show is the immediate impact on oil & gas markets, with the marketplace already in a very tight and short of investment curbing supply, Russia's removal is less than ideal. The oil price has stabilised at circa US$90, however, this volatility in spike may be around for sometime – causing dislocation across all industry.

When you consider Oil, it is more than fuel…it is a basic input into almost any industry. When you fill up water bottle, think Oil price. It isn't just Oil, it is also gas (keeping Germany warm), wheat, nickel (EV batteries), fertiliser, platinum, uranium, coal and aluminium.

2. Ruble Revived

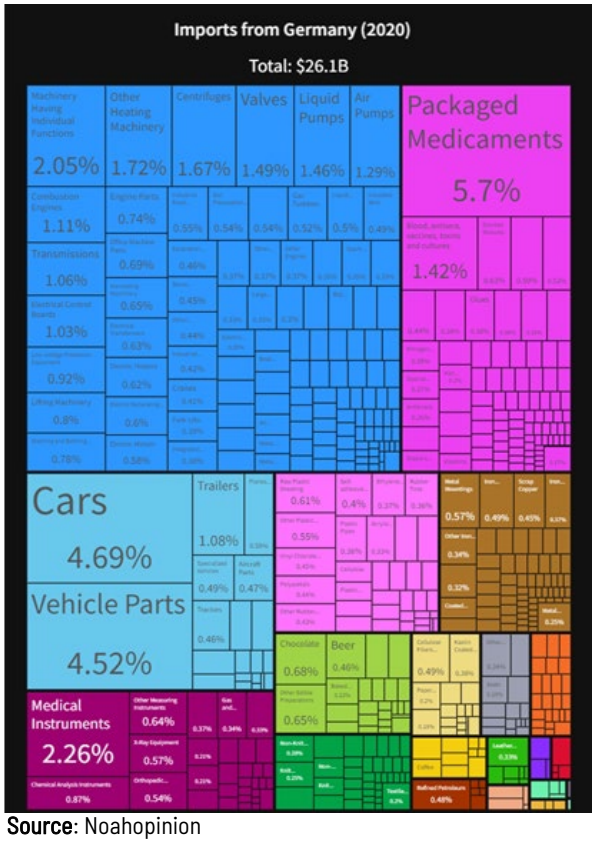
For those wondering why the Ruble has rebounding so significantly, it is because of what the Bank of Russia has done. It went and pegged the Ruble to Gold. As Gold trades in US dollars, they have set a floor price for the Ruble in terms of the US dollar.

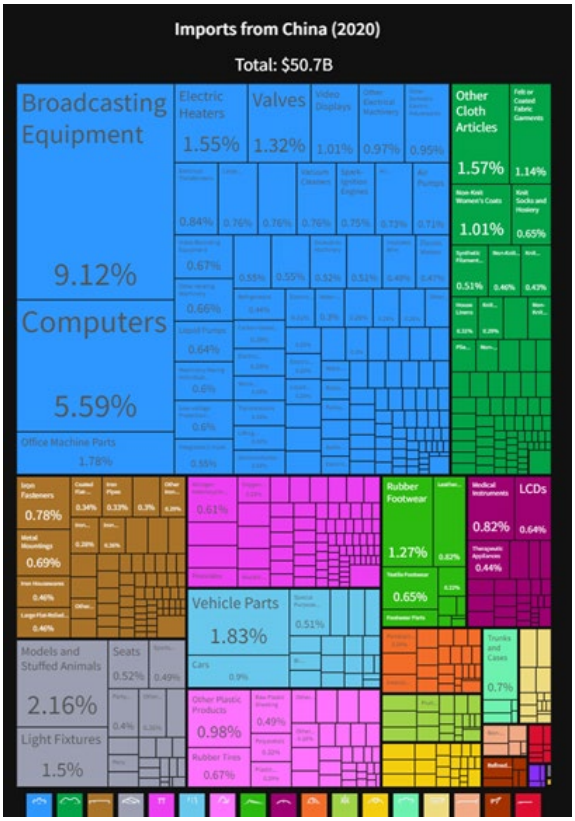
If we were to overlay first level thinking, it could suggest a stronger gold price with this linkage now placing a floor in the gold price. Further, by linking the Ruble to Gold and setting energy payments in Ruble Russia have circumnavigated the US's largest economic weapon of being the reserve currency. **This is something to watch**.



3. Trade Dynamics

As discussed, Russia is a thin economy, relying on the West for imports of sophisticated parts. Limiting the imports from Germany (left chart below) hurts Russia in the short term as they cant get foreign sophisticated parts, however, it appears they have a clear alternate route via China (right chart below).





Source: Noahopinion

For Germany, it comes down to energy security ex-Russia, which is going to take some time. It should be highlighted that gas pipelines don't divert easily and without LNG import terminals, it is a costly and long process. The West will need to embrace Germany and support them, the US in particular (unpopular).

On the other hand, Russia could possibly divert Oil exports to China and India to support its economy…isolating Germany. Although it won't be admitted, it looks like the trade dynamic from Russia may just shift to China.

4. Hedge Fund Contagion?

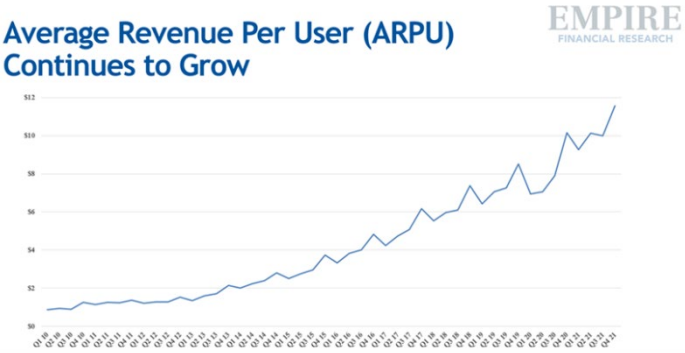
At the end of 2021, foreign investors held USD 62 billion of Russian sovereign debt, USD 86 billion of stocks and total foreign debt of Russian entities of USD 381 billion. We can only guess the extent of markdowns being estimated on these holdings…almost all of which are held at ransom, illiquid and in default. It normally takes some time for real liquidity concerns to emerge, and it normally starts with the blow up of a hedge fund (haven't seen yet) but it certainly is probable.

Check here in two years

In the interest of disclosure, we do own Facebook (Meta Platforms). We feel this is one of those irregular opportunities where the market migrates to narrative over substance and misses the facts. The psychological aspect has completely taken over the market reflexivity **taking the stock price down on a single quarter result**.

Analysts scrambled in a fight of who can extrapolate this single quarter into the future, all whilst moulding their models to fit the pre-established conclusion that death is at the door of Meta.

The rational investor should fight the psychological urge to run and look at the numbers. It's the stock market's job to pressure you into losing your cool, try to ignore it as the fundamentals tell a different story. If you buy good companies at good prices, you will be perfectly fine.



Save, invest, do nothing, repeat.

The level of noise right now makes it debilitating to deploy capital for most, but we find it helpful to break down to core principles. The secret to being wealthy, staying wealthy and enjoying flexibility is above. Save, invest, do nothing and repeat until you have the financial flexibility you require.

When the noise ramps up (this time it is inflation, next time it will be something else) perhaps consider the household budget. Reduce some 'nice to haves' and save a little more, reign in investment assumptions as you may be pleasantly surprised.

Invest the excess savings with caution but don't stop investing, perhaps own a little less Nasdaq on the basis of 20% p.a. assumptions and own a little more undervalued European industrials with an 8% p.a. assumption. Rejig your models and reset your expectations. Cash under the mattress is just a really bad proposition.

Defining Quality

We regularly talk about quality, but what is it really. The first thing most investors think of is profit margin…in fact the most common initial investment screen used is profit margin > 10%. This will clearly screen out a lot of investment opportunities.

Buffett purchased McLane from Walmart with incredibly low margins (1%), however, there was a level of sustainability to these margins to suggest it was a good business with cash flow conversion.

It's the cash flow conversion that made it appealing to Buffett, not the absolute margin.

Table 6.34: McLane—acquisition analysis

($ millions)	
Revenues	$23,000
Pre-tax margin	1%
Pre-tax income	$230
Berkshire's purchase price	$1,500
BRK going-in pre-tax return	15.3%

Sources: Berkshire Hathaway Annual Report 2003 and author's calculations.

P.s. It still exists (having paid back it purchase price many times over) and contributes cash every year. A 1% margin business can still generate a 15%+ return to the investor.

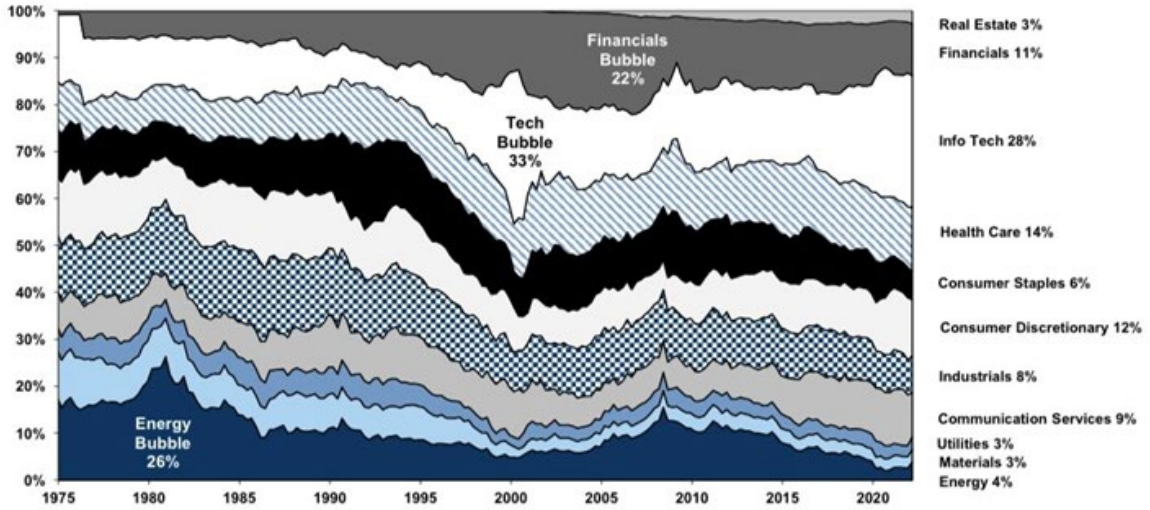
Mum & Dad Hedge Fund – S&P High Conviction

A market weighted index = momentum investing.

Holding this index these days it not a passive bet, it is a concentrated bet, most concentrated than it has ever been in half a century.

Source: @SoberLook via @jessefelder

Exhibit 7: Sector composition of the S&P 500 by equity capitalization, 1975-2022
as of March 31, 2022



Source: Compustat, FactSet, Goldman Sachs Global Investment Research

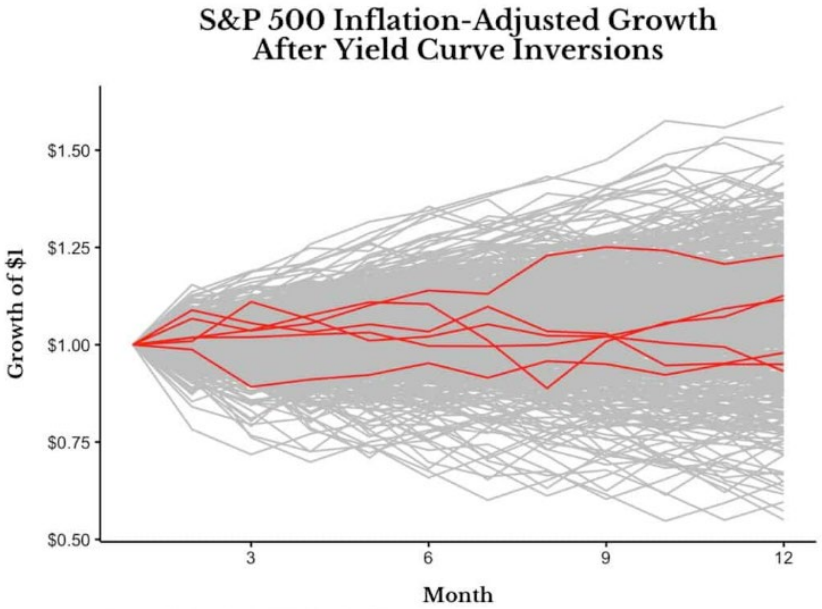
Yield Curve Centre Stage

Eugene Fama and Kenneth French concluded in a paper from July 2019:

"We find no evidence that inverted yield curves predict stocks will underperform treasury bills for forecast periods of one, two, three and five years."

Fama & French arguably some of the greatest market researchers of all time. Below shows a Monte Carlo analysis on the theoretical performance of S&P500 after a yield curve inversion.

The curve inverted in August 2019….equity markets are up 60%



Source: Shiller data (OfDollarsAndData.com)
Note: All figures include dividends and are adjusted for inflation.

Yield Curve Inversions & Recessions

Yield Curve Inverts	Recession Begins	Lag Time
Aug 1978	Jan 1980	17 Months
Sept 1980	July 1981	10 Months
Dec 1988	July 1990	19 Months
Feb 2000	March 2001	13 Months
Dec 2005	Oct 2007	22 Months

Table: Ben Carlson • SOURCE: NBER

FORTUNE

Given all this information, what should an investor do? Nothing. Absolutely nothing.

So, what are the options?

Bonds: Not really an option, they certainty aren't without downside risk and are coming off a 5000-year base in interest rates. Perhaps posing more downside than upside.

Cash: Negative by some margin. Still worth holding for a liquidity buffer and utilised in times of volatility.

Other Alternatives: Real assets and commodities exist but beware of entry points. Whilst the income might be inflation linked to the short term, the asset is priced on interest rates over the long term.

The market is already pricing for your short term.

By the time a recession occurs, if it does, you will have missed the boat…unless you have access to data the collective market doesn't – it's best to stay the course and use volatility to your advantage.

Amplifying Risk....why would you?

First let's define risk. Textbooks present market risk as volatility...gee wouldn't that be great if it were so simple. The truth is, it depends. Risk means different things for different people, meaning risk profiling to a checklist is an imperfect exercise. Almost everybody is risk averse – if not we would all be professional skydivers.

Real risk for all of us is 'uncertainty' about future consumption. We all want to hit an expected return with ideally less volatility (textbook risk). Real risk permeates from the imperfect nature of the assumption around return expectations.

We invest out of necessity to fund future 'us', with the requirement from future 'us' uncertain. We set return targets (ideally realistic ones) and push to beat these, so we have more flexibility around future 'us' spending habits. However, the problem is we hate the uncertainty this creates as we base our targets on historical data and our current selves. With these being subject to change and textbook risk.

So why amplify textbook risk?

Investors/Individuals start to amplify this with the dangerous L – leverage. They utilise leverage to amplify and accelerate the returns, proving to be a successful strategy in the good times...however, when times are bad leverage really hurts.

Here is an example:

If you owned Berkshire Hathaway for decades – you have earnt 20% annualised without leverage. Let's say as an early investor in Berkshire Hathaway you decided to utilised margin debt to try and amplify your return. You have now successfully amplified your risk, making your holding susceptible to headlines and market movements, thus, more prone to decision errors. With this amplified risk, you likely would have been margin called at least 5 times.

- Down 59% in 1974 – 1975
- Down 37% in 1987
- Down 49% in 2008-2009
- Down 26% in 2020

So why not just buy, hold and add to the best businesses you know and have completed your valuation on with a cash balance included in the asset allocation decision i.e. exactly what Berkshire Hathaway do 😊.

So, what can you do to manage through tricky times?

Focus on the L and ensure you don't have too much. Go easy on yourself and set reasonable expectations that enable future flexibility. Stick to the plan with just enough (not too much) diversity, allowing legroom to avoid too much *textbook risk*. Make decisions today based on the future you and not in the heat of the moment based on the current you.

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