Eighteen48 PARTNERS

Quarterly Perspectives

Q3 2022

Dear clients, partners and friends,

Market volatility has continued to dominate this last quarter and is likely to remain for as long as the path of interest rate rises remains uncertain. Investors get cold feet when the cost of capital is unpredictable.

As mentioned in last quarter's letter we remain focused on knowing what we own and take comfort in the quality of our portfolio holdings (public and private) despite the volatility. The key is that we see attractive mid to long-term expected returns, which have risen as valuations have adjusted. We also continue to favour equities which have a better chance of beating inflation by making a claim on nominal growth.

Having said that, downside volatility is inherently uncomfortable especially when in double digit territory (MSCI AC World -25%, Global bonds -21%). The temptation may be to reduce risk and go back in later. Unfortunately, market timing is notoriously difficult. The trade-off in investing is always risk versus return, but what clients are often missing is a concrete projection of what that really means. Post 2008, we saw many clients who had been advised or decided it was smart to wait on the side-lines. The cost only became apparent a decade later when portfolios had generated 3-4% per annum versus 14%+ for equities and private equity. **Achieving acceptable returns in the long run likely means accepting volatility in the near term**.

But is there a 'free lunch'? What about hedging? Goldman Sachs recently published an in-depth study of "risk mitigation strategies". The conclusion is that there is limited consistency over time. Historically, the risk mitigation strategy which has been the most successful and easiest to implement has been owning sovereign bonds. However, this positioning stopped working in 2022 with rising interest rates. Another common strategy which clients often ask about is 'put protection' – which worked well during COVID due to the sharp drawdown in March 2020 but has not been effective this year due to the high costs of options at the start of the year. Quantitative trend following funds have been the place to be in 2022 (+16%). However, over the last 10 years the total return of such funds is 1.6% per annum versus 9.3% for the S&P. There was therefore a high opportunity cost which required some form of market timing and a decision on how much to allocate. The point is not to dismiss these strategies (and we continue to evaluate options) but to highlight that there is no silver bullet. This takes us back to knowing what we own even in the face of volatility. **Ultimately investing is a long-term game that requires discipline, mental fortitude and patience**.

We passed our third anniversary milestone in July, with a team of 27 and a similar number of client groups. Our focus is on helping clients achieve your financial goals. We try to do this by building relationships of trust, underpinned by meaningful alignment. Finally, we are delighted to welcome Anne Marie Fleurbaaij to our advisory Investment Committee. Anne Marie is MD at Cambridge University Endowment Fund, responsible for marketable assets.

As ever, we express our deepest gratitude to our clients for their confidence and loyalty, and to our partners, colleagues and friends for your thoughtful contribution and unwavering commitment.

Julien Sevaux

Tarek AbuZayyad

14 October 2022

CIO Review

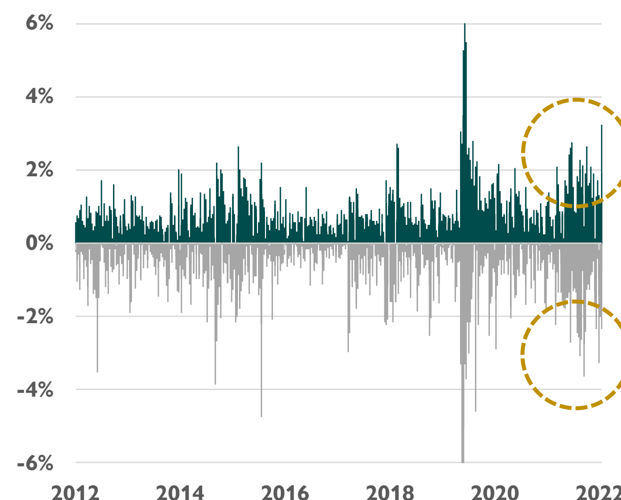
A macro-driven market

Following a powerful but ultimately short-lived rally off the June lows, tightening fears reasserted themselves with a vengeance during the third quarter as central banks, led by Jerome Powell at Jackson Hole in late August, emphasised their determination to defeat consumer price inflation which has proved more stubborn than their projections. This has resulted in market expectations for policy rates to reach levels in the next 12 months which were hardly imaginable before this year: 4.9% in the US, 3.0% in the Eurozone, and 5.4% in the UK – which has its own political challenges to contend with – down from a staggering 6.3% expectation at the end of September. This policy tightening is already causing a significant slowdown as policymakers attempt to reduce liquidity and dampen demand across major economies.

As rate expectations rose, the US dollar index surged to a two-decade high, scattering other major currencies in its wake: since its recent lows in June 2021 it is up some 20% against both the Euro and Sterling. At the same time, US 10 Year Treasury bond yields touched 4% intraday in late September, a level last reached (briefly) in 2009 and 2010 but which is more characteristic of the pre-2008 environment. With this backdrop of tightening conditions and weakening investor confidence, global equities fell by 7% during the quarter to end September down 25% for the year in US dollar terms – approximately where they remain today. Fixed income offered little protection, with longer-dated investment grade bonds (to which we have no exposure) falling by over 20% year to date and, unusually, underperforming high yield credit as a result of their higher interest rate exposure.

Markets have developed an obsessive focus on regular macroeconomic data releases (in particular employment and inflation numbers) together with every last utterance of the various Federal Reserve and other major central bank members. Interest rate projections are constantly shifting, with market estimates of the Fed Funds Rate in 6 months currently at 4.9% but having ranged between 4.1% and 5.4% in the last month alone. This has led to daily equity market volatility second only to that seen during the COVID crisis in 2020, with the frequency of 2%+ moves in each direction at its highest level for at least the last decade:

Figure 1: We are experiencing historically outsized daily moves in global equities



Source: Bloomberg

Our portfolio holdings were not immune in this environment. Our core global equity composite was down 30.8% to the end of September, behind the global equity index (-24.6%), but remaining in line with global quality and growth indices. Our specialist managers (which we expect to generate higher returns than core global equities over time) generated significant alpha versus the global equity index, outperforming by some 15% year to date. Hedged strategies – which we expect to have beta to equity markets of just below 50% as a group – were down 9.3%, capturing 36% of the market drawdown. Given their much lower downside capture, these managers have substantially exceeded global equity returns on three and five-year time horizons (e.g. +8.4% annualised vs. global equities +4.4% annualised over five years), illustrating the value of diversification at different points in the market cycle.

Portfolio activity through the summer (where rebalancing had not already occurred 'naturally' through capital called by private or hybrid fund managers) has included gradual rebalancing into growth stocks and biotechnology, both of which have suffered from rising interest rates but where our managers are excited by projected IRRs which are at multi-year or even career highs. We have also focused in on liquidity levels within portfolios and selectively switched several hedge fund holdings to more liquid variants, where the slightly lower expected returns are more than offset by the value of that additional liquid 'dry powder'.

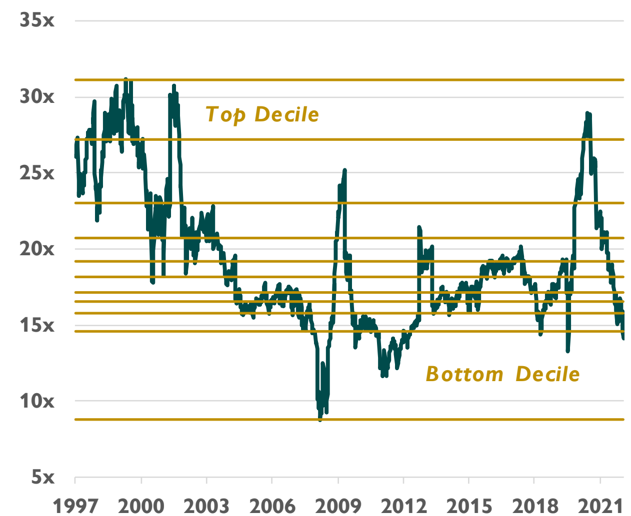
We also continue to monitor and analyse assets classes and funds which we do not own (or do not widely own), to see whether we can improve portfolios by finding assets which have greater potential return with the same or lower risk. One such area of consideration at the moment is high yield credit, where spreads above government bonds have widened significantly and the index yield to maturity is now north of 10% – apart from a few weeks in 2020, a level not seen for over a decade. We are also considering the merits of liquid alternative strategies which have very low or negative correlations to equities and could provide a source of rebalancing capital in future drawdowns.

With markets being buffeted by 'top down' factors, some investors are naturally wondering whether we are entering a 'macro market' where fundamentals no longer matter. It does feel likely that we are entering a period in which interest rates, geopolitical risk and market volatility are structurally higher; and where the support of the 'central bank put' has been removed, at least temporarily. That said, the opportunity set for long-term investors who are able to 'look through' the macro noise has become increasingly attractive. History tells us that the fundamental value creation and superior compounding power of the businesses we own will ultimately be rewarded – and probably more so in this kind of environment than the broad index or 'value' names which have greater macro sensitivity and a lesser ability to drive their own growth. In the meantime, we can wait confident in the quality of what we own and the external mangers we partner with, which means that by far the **greatest risk within portfolios is mark-to-market volatility rather than permanent loss of capital**.

A lot of bad news in the price

Reflecting the impact of rising interest rates and the potential for corporate earnings to decline ahead, valuations have reduced significantly over the last 12 months. **Global equity valuations are now within their lowest decile of the last 25 years**; in other words, they have been more expensive more than 90% of the time:

Figure 2: Global equity valuations are now in the bottom decile

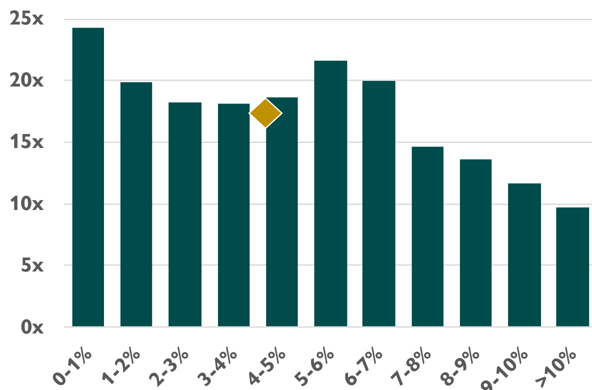


Source: Bloomberg

The valuation of high quality, growth stocks of the type which we prefer to own has also fallen back significantly; at 16.2x historic P/E these are **now trading *below* their COVID low valuations** of early 2020 and at a premium of some 15% to global equities which we think is well justified by their lower business risk and higher fundamental return potential over time.

But – if equity markets have until lately been supported by low rates, should rising rates mean that valuations ought to fall further? It is certainly correct that yields rising from very low levels have hurt almost all investment assets. However, while investors have become accustomed to the narrative that higher rates somewhat mechanically lead to lower multiples for equities, the history of where valuation multiples have sat through various rate environments suggests that this is not in fact the case. For global equities, one might compare the period between the TMT bubble and the global financial crisis, when US Treasury bond yields were similar to or somewhat above today's levels while the median global P/E ratio was 17.1x (some 20% above today's). For a longer-term perspective we can look at the US equity market over the last 60 years:

Figure 3: S&P 500 P/E valuation vs 10Y UST yields

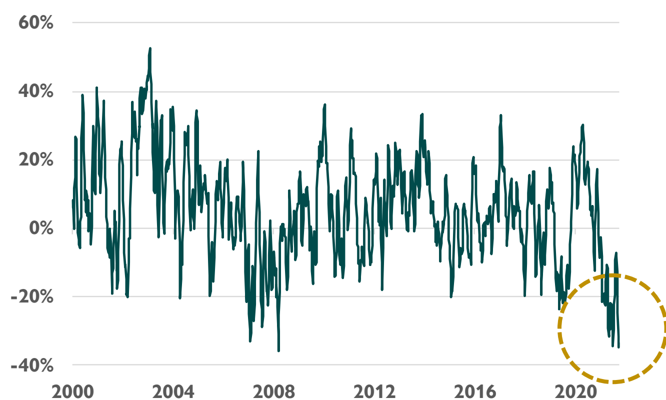


Source: Bloomberg

What is striking about this chart is that, aside from at very low levels, rising rates (we show here the benchmark 10 Year US Treasury) have had on average **no discernible negative effect on valuations until the yield has risen above approximately 7%**. That is a level which was last commonly seen some 45 years ago following a period in which inflation had become deeply engrained, having averaged some 6.5% per annum for a decade. In fact, when the 10 Year Treasury has yielded between 4-4.5%, as it does today, the P/E ratio on the S&P 500 has ranged between 15x at the low end and 23x at the high end (it is around 17.5x today). It is hard to argue that the current (or even somewhat higher) rates levels have *per se* proved challenging for equity market valuations in the past.

Looking nearer term, sentiment remains extremely negative, which is often a sign that market participants are fully or even excessively discounting the prevailing bad news. Retail investor sentiment is near rock bottom, well below levels reached during COVID and similar to the global financial crisis of 2008:

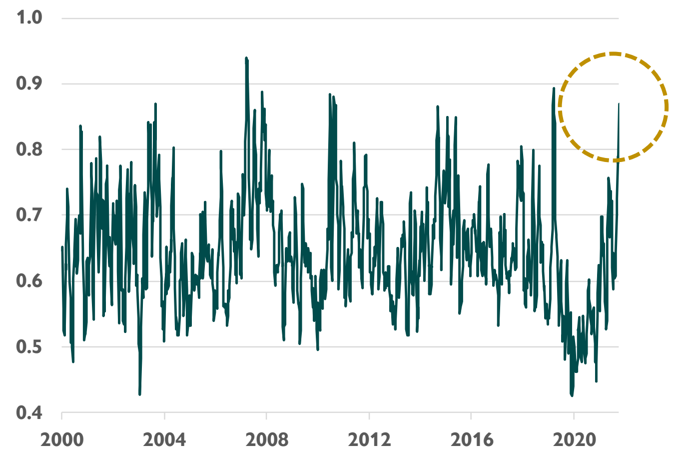
Figure 4: Retail investors are move negative than during COVID



Source: Bloomberg

The ratio of put options to call options (i.e. the number of negative compared with positive market bets in the options market) is also indicative of a high degree of investor capitulation, having moved sharply higher during September:

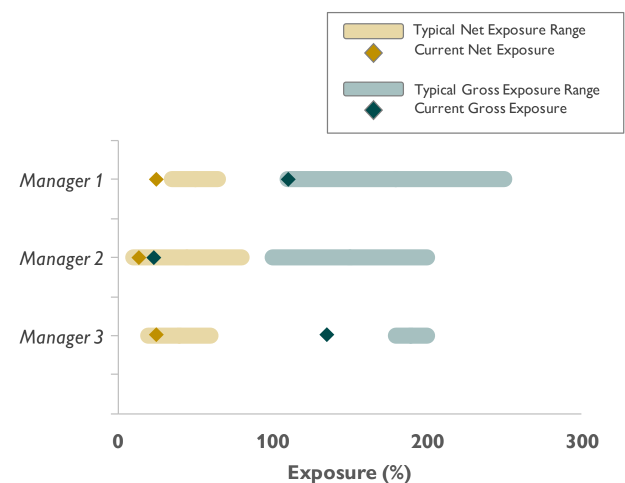
Figure 5: Puts outnumber calls by a high margin



Source: Bloomberg

Hedge funds have been as short S&P futures as they were during the COVID crisis, while a number of well-known growth-oriented US Technology hedge fund managers – in which we have not been invested – have sold down gross and net exposures to the low ends of their 'normal' ranges and in some cases far beyond (also well below where they were in the middle of last year when prices were a lot higher and many were close to peak net exposure):

Figure 6: Well-known Tech hedge funds have substantially reduced market exposures



In the near term, markets are likely at least to stabilise when the rhetoric and actions from central banks become less aggressive, which itself is contingent upon inflationary pressures easing. The timing of this is quite challenging but **there are a number of encouraging signs which suggest that US CPI could moderate further in the coming months**: from housing (where long term fixed mortgage rates have more than doubled from 3% to over 7%) to fuel costs (where gasoline prices are more than 20% off their June peaks) to industrial metals (34% off their March peak) and shipping costs (42% off their May peak). Longer-term inflation expectations have remained anchored and indeed fallen quite significantly from their recent highs; the 5 Year US Breakeven, which captures the current elevated inflation rate plus expectations for the coming five years, has fallen back from 3.5% in March to below 2.5% today. It was striking that the disappointing September CPI release this week was followed (after a knee-jerk selloff) by a powerful rally of some 5% off the intraday lows, suggesting that a lot of bad news is already baked in.

Figure 7: 5Y inflation expectations have tumbled

Source: Bloomberg

The dollar's rise has been perhaps the clearest bellwether of this year's market moves given that it reflects both tightening expectations and also broad risk aversion. As Mohamed El-Erian (former CEO of bond manger PIMCO) well described it, the dollar has benefited from interest rate, growth and safe haven differentials relative to other major economies. Following a more than 50% rally on a trade-weighted basis from its early 2008 lows (second only in scale to the 1980s, when Paul Volcker raised rates to over 20% in the face of deeply engrained inflation), and **given recent extremes of investor positioning and 30%+ deviations from measures of purchasing power parity**, it may well be that the dollar is nearer the top than the bottom of this cycle – especially as we see signs of (deliberate) slowing in the US economy which will moderate at least the first and second of the advantages described above. This is likely to be coincident with a moderating of inflationary pressures and central bank hawkishness, as above.

Looking ahead

Times of market volatility like this can be frustrating and unsettling. It is worth emphasizing that **drawdowns are a normal occurrence and can be seen as the price that investors pay to make equity returns over the long term**. The most rewarding assets for investors to own over time have been equities, whether public or private. US listed equities, for which we have the longest track record, have returned 11% nominal / 8% real since the end of the Second World War, despite war, inflation, pandemics and major recessions along the way: this means that over that period their value has more than doubled every decade in real terms. However, equities have also been among the most volatile investment assets, with **drawdowns in excess of 20% on average every six years** (and in excess of 10% roughly once a year) in the post-1945 period.

This volatility is the 'cost' of achieving those outstanding long-term returns, and explains why most investors do not manage to beat simple passive benchmarks over time. Morgan Housel puts it well in his book *The Psychology of Money*: 'Successful investing demands a price. But its currency is not dollars and cents. It's volatility, fear, doubt, uncertainty and regret…' – all of which emotions are quite understandably occupying investors' minds at the moment. As a wise man once said, investing is 'simple but not easy'. That is especially the case when the bill is periodically presented, as today.

With equity valuations considerably lower than in recent years, tightening expectations really quite elevated and sentiment at very low levels, markets (which are always looking several months or more ahead) do now appear to be pricing in a material level of earnings decline, or even higher rates, or both. That is not to say that equity (or credit) prices cannot go lower during this bear market; risk assets are – as always – vulnerable to any further deterioration in the geopolitical or macroeconomic backdrop. We take reassurance however from three key factors:

First, we continue to feel that **a systemic crisis such as 2000, 2008 or 2020 is a low probability outcome**. Serious imbalances such as those which preceded the former two do not appear to be present, whether valuation excesses (even staid Johnson & Johnson peaked at 38x P/E in 1999, compared with 24x in 2021 on artificially reduced earnings) or bubbles in corporate capex (1995-2000) or household leverage (2003-08; we have illustrated before the substantial consumer deleveraging that has occurred in the US and peripheral Europe from their extreme levels prior to the global financial crisis). As things stand today, US and European consumer balance sheets remain cushioned with excess lockdown savings and global bank balance sheets are a different order of robustness from 15 years ago. Unemployment rates remain low – perhaps even too low for central bankers' comfort. The 2020 recession meanwhile was a very specific case and perhaps best regarded as an event-driven crisis caused by the deliberate shutdown of economies in the face of a dangerous external threat.

Second, **projected returns across risk assets look attractive from here**, even if markets do fall somewhat further. One of our core global managers explained when we met in September that even if revenue growth were to slow by a quarter or more in the coming years, and operating margins to return to long-term trend levels, the projected return from his portfolio would still be comfortably in double digits on a 5+ year time horizon – similar to his projection from the early 2020 lows. Our broadest high yield credit fund, which includes high yield bonds, senior loans and some structured credit, has a projected net yield to maturity of almost 10% even in a downside scenario where we see a 2008-style default pattern unfolding over several years. With both rates and deal spreads having moved materially higher, our long-standing global merger arbitrage manager is now targeting 10%+ net returns from here, even after accounting for deal breaks at their historic rates.

Third, history shows that – while trying to pick the bottom is a thankless task – the **returns following even the first 20% of a market decline have generally been very rewarding**. Equity manager Oakmark Funds examined the prior eleven bear markets since 1945 with a focus on what happened once the market was down 20% (i.e. once it technically became a bear market). They found that the median additional decline was 10% (which would put us close to the 'average' bear market bottom today) and the median bear market low occurred four months after the initial 20% decline (ditto). Taking the analysis further, we can see that even after any further declines, the **median total return two years from the time the market first drew down by 20% was +41.5% – almost double the rate from investing on random dates**. Out of the total eleven, the only two bear markets in which negative two-year returns followed were 2001 (following extreme valuations; a further -16.1% per annum over the two years) and 2008 (a severe credit crisis; a further -4.7% per annum). This is a compelling argument against, as Oakmark put it, "getting more cautious after the market has declined" – especially if it is correct that the situation today is quite different from those systemic events of the relatively recent past.

As we see it, investors have three broad options for how to act in declining markets:

Option 1 is to reduce risk and wait for the backdrop to improve. This can be very tempting and has the virtue of providing short-term relief when implemented. However, it has the major disadvantage that markets are forward-looking and there is a high likelihood that prices will already have moved considerably higher by the time that the backdrop does in due course improve – locking in a permanent loss of capital on those assets which were sold lower down.

Option 2 is to sell risk assets in the hope of buying them back more cheaply at some point in the future. The challenge here is twofold: first, there is no guarantee that lower prices will occur; and second, if they do, the backdrop is likely to feel even less conducive to owning those assets back than it was when they were sold.

Option 3 is to maintain or selectively rebalance risk back up to target levels where falling prices have reduced exposures to below those targets. We consider that the discipline of sustaining an appropriate level of market risk through periods of volatility, and even adding opportunistically, has been **critical to the ability of long-term investors such as endowments, foundations and sophisticated single family offices to generate the outstanding returns which they have done**.

We too recognise how difficult it is to predict the timing, duration and depth of bear markets – and then to position portfolios appropriately – without causing significant

impairment to those long-term returns. Investors with a genuinely long-term horizon have the huge advantage that such timing exercises are not necessary. We remain firmly in this camp and ever conscious of Peter Lynch's cautionary words that: "People who exit the stock market to avoid a decline are odds-on favourites to miss the next rally."

Edward Clive

Chief Investment Officer

Sixteen02 Global Equities

Five Largest Holdings as of September 2022

1	Alphabet Inc.
2	Amazon.com, Inc.
3	Microsoft Corporation
4	Salesforce, Inc.
5	ServiceNow, Inc.

(Holdings shown in alphabetical order)

Macro has handily overwhelmed micro this year but as bottom-up investors there are some healthy developments on the ground. September is often a month of company investor days, briefing the investment community on progress and long-term outlook. This year was no different and we have a few anecdotes from your portfolio companies to share.

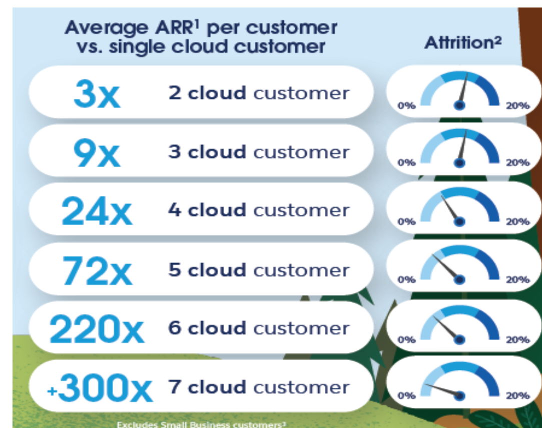
CRM — Positive Network Effects

As you may know, Salesforce (CRM) is one of the earliest SaaS companies and well known for its customer relationship management software, but in total it provides seven cloud offerings spanning Sales, Services, Marketing, Commerce, Platform, and Analytics.

CRM provides "carpenters tools", which are critical to generate revenue and manage operations for an enterprise or a middle market firm. Most importantly, it aids digital transformation around the world, a secular growth trend that has accelerated post-COVID. It operates in a large and growing market, which is expected to growth at a circa 13% CAGR to reach circa $290 billion by 2026.

As a subscription-based business, CRM enjoys a multiplier effect in recurring revenues as its customers adopt more of its products. Compared to an average customer with one cloud product, a customer with two clouds generates an ARR (Annual Recurring Revenue) 3x as much and a customer with 4 clouds 24x as much. This effect is phenomenal as a customer buy all the seven clouds from CRM (see figure below). Most importantly, attrition rates also drop as the customer gets deeply embedded within the ecosystem, increasing the lifetime value for CRM.

Figure 8: CRM – product adoption and ARR growth



Source: Salesforce

Approximately 20% of existing customers have adopted 4 or more clouds and CRM generates only 37% of its ARR from international markets, both of which suggest that there is a long runway for significant growth.

Despite a $2 billion headwind from FX, CRM reaffirmed its $50 billion FY26 (fiscal year ending Jan 2026) revenue target representing a 17% CAGR. It also reiterated its commitment to expand operating margins from circa 20% to 25%+ by FY26, and most importantly this target is inclusive of new M&A and independent of its FY26 revenue target. In terms of capital allocation, CRM announced a target to return 30-40% of its free cash flow on average and the company announced its first ever share repurchase of $10 billion.

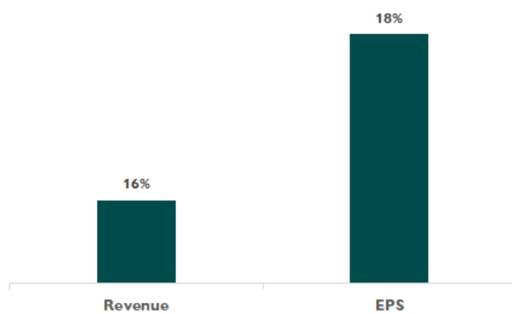
Given the top line growth opportunities, and improving margin & capital allocation discipline, we came out significantly more confident on CRM's ability deliver on its pledge of "profitable growth at scale". We believe that it can sustain a double-digit earnings and free cash flow growth over the coming years, and we continue to retain it as one of the top names in the portfolio.

We heard similar messages from a few other companies that held investor days and from almost all of your

portfolio companies in the 2Q earnings calls, ended August. Management teams are focussed on navigating these difficult macro conditions and the medium-term growth potential of these businesses is intact.

Despite significant volatility in the market and uncertain macro-economic conditions, the companies we own continue to thrive and grow. Looking back over the last two years, the companies in your portfolio have delivered double-digit growth such that the overall Sixteen02 portfolio grew annualised revenue and EPS by 16% and 18%, respectively.

Figure 9: S02 Portfolio Growth – 2Y CAGR (2020-2022)

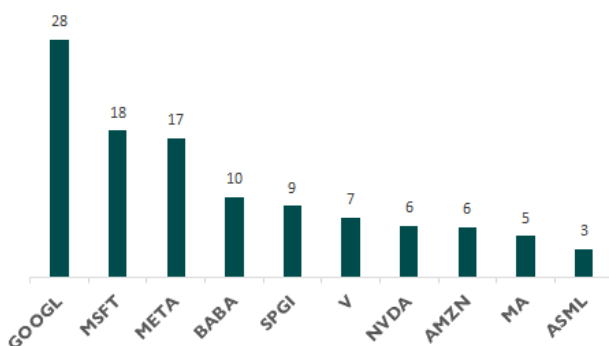


Source: Sixteen02

The portfolio companies' balance sheets also remain strong with most of them in a net cash or low leverage position. In aggregate, the composite portfolio is in net cash.

Many of the companies have significant buyback programmes in place. To give you a hint of scale, during 1H2022 alone Sixteen02 portfolio companies spent circa $123 billion in repurchasing shares with the largest purchases coming from Alphabet, Microsoft, and Meta. Alphabet has c.$70bn in buy back authorisations and META about $24bn.

Figure 10: S02 Portfolio: Top 10 buybacks ($bn) in 1H2022



Source: CAPIQ

We believe this trend will likely continue as current market dislocation is making share buy-backs one of the best capital allocation decisions available for our management teams. We would not be surprised to see more companies joining the bandwagon: Salesforce and Nvidia have been the newcomers in the 1H. Abbott has a highly underutilised balance sheet (conservatively we estimate $20-30 billion in capacity) as it has not deployed the windfall from COVID revenues. We suspect it could choose to do both value accretive M&A and buy backs.

Speaking about Abbott, we recently caught up with an old friend, who mentioned that his father uses Abbott's CGM (Continuous Glucose Monitoring) sensor to help manage his diabetes.

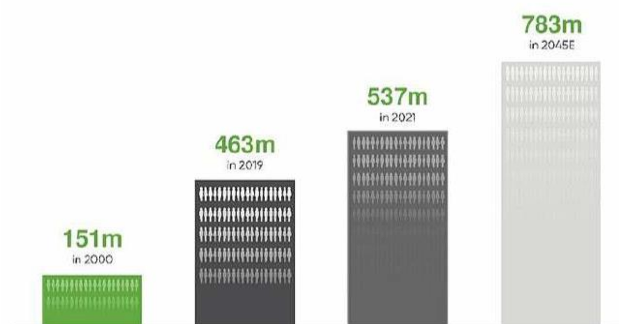
The Silent Killer! Growth & Opportunity

Diabetes is a medical condition in which the body is unable to maintain blood sugar levels and, if left untreated, leads to several long-term complications including damage to heart, kidneys, eyes and so on.

Type 1 diabetes generally develops in childhood as the pancreas loses its ability to produce insulin. Type 2 develops later in life and is attributable to many factors including family history, food habits, physical activity levels, etc. In this case, the patient becomes insensitive to the insulin produced by the pancreas.

Diabetes is increasingly becoming an epidemic – by 2045 there will be approximately 780 million twenty- to seventy-nine-year-old adults with diabetes compared to 540 million today.

Figure 11: Adults (aged 20-79) with diabetes globally



Source: Dexcom

Increasing prevalence is creating a significant burden on healthcare systems around the world. Globally, diabetes related expenditure grew from $760 billion in 2019 to

$966 billion in 2021 – a 27% increase over 2 years. In the US alone, circa $17,000 is being spent per person with diabetes and is expected to reach circa $27,000 by 2030.

Figure 12: Global Diabetes Related Health Expenditure

Source: Dexcom

The growing menace of diabetes means healthcare agencies and governments around the world are actively looking at solutions to reduce prevalence as well as effective treatments. Significant innovation is taking place driven by companies ranging from start-ups to big pharma.

Traditionally, 'finger-stick' readers have been used to measure blood glucose levels at home. This method is both highly unreliable and painful. For a patient with a severe form of diabetes, he/she may have to 'finger-stick' multiple times per day which only gives a point estimate. The method can miss the most critical peaks and valleys[1] in glucose levels, which are potentially life threatening.

Companies such as **Abbott** (owned in Sixteen02 Portfolio) and **Dexcom** have come up with an innovative solution in the form of a Continuous Glucose Monitoring (CGM) Sensor. It is the size of a coin and is normally worn under the arm. It takes blood glucose levels at certain intervals and sends data to a phone app or a dedicated reader. In this way, the patient knows his/her glucose level at any given time plus the sensors predict and warn of an upcoming sharp rise or fall in glucose levels, so that the patient can take immediate corrective action. Physicians and/or a family member can be connected remotely to these sensors and warned of emergencies. These are also very useful features in a clinical or emergency room setting.

For Type 1 patients, CGM sensors are connected to automatic insulin pumps such as the ones produced by **Insulet**, **Tandem** or **Medtronic**. Together they work like an "artificial pancreas" by releasing appropriate levels of insulin into the tissues/bloodstream free of manual intervention.

Most importantly, CGM is a useful tool to delay the onset of diabetes by encouraging physical activity as well as help in keeping it in the levels so that it does not create significant health issues down the line. For example, a person screened for a high probability of developing diabetes could use CGM sensors as a way to keep sugar levels within the limits. He/she could take a walk in the park if CGM warns him that his/her sugar level is exceeding limits or eat a delicious chocolate cake if CGM warns of crashing sugar levels!

Treatments to monitor and maintain sugar levels have evolved and improved over time. Artificial insulin that is administered when the pancreas can't naturally produce it was first discovered almost 100 years ago and extracted from beef and pork pancreases. However, insulin is sometimes ineffective and a different mechanism to treat diabetes is needed. Companies such as **Eli Lilly** (a recent addition to the portfolio) and **Novo Nordisk** have been innovating in the diabetic treatment space.

They have been leaders in developing drugs that target incretins, which are gut hormones secreted immediately after eating to control the release of insulin by pancreas. The latest iteration of these types of drugs targets two of the known incretin hormones thereby enabling much improved and longer lasting ways to control sugar levels than insulin does.

Eli Lilly's latest drug, Tirzepatide (brand name Mounjaro) is a twin-cretin that targets both the incretin hormones and recently received regulatory approval to treat diabetes in the US.

The clinical trials have also shown that this drug can deliver impressive weight loss reduction for the patients. The average weight reduction has been around 22.5% in adults taking the drug, one of the first medicines to deliver more than 20% weight loss on average in a Phase 3 study. This is closer to the ~25% weight loss typically observed with the highly invasive bariatric surgery.

Obesity is a chronic disease that leads to serious health complications over time including heart disease. Globally, it is yet to be recognised as such and even in the US

[1] *A low glucose level (hypoglycaemia) could be fatal. If it occurs during sleep, it could potentially lead to seizures or coma.*

debate is still raging about whether treatment should be paid for by the government. However, in recent times there are signs of regulatory landscape thawing in favour as more studies emerge to prove the seriousness of the illness.

There are circa 2x the number of patients with obesity in the US compared to diabetes (circa 100 million) of which only circa 20 million have access to therapy and a far smaller percentage is currently pharmacologically treated. Globally there are 1.5x the number of obesity patients than diabetes of which only 2% are treated. Morgan Stanley estimates that obesity drugs could quickly become a top-12 global therapy growing from approximately $2.4 billion to a circa $54 billion category by 2030. So far, Tirzepatide is proving to be a superior drug compared to its competitors, including Novo's weight loss drugs Saxenda and Wegovy.

Unlike Novo, Eli Lilly also has a diversified pipeline of products focused on oncology, immunology, and Neuro/pain. Alzheimer's is an area Eli Lilly is focused on and preliminary results of its drug show signs of superiority in treatment vs competitors. It is another large category that still lacks an effective medicine despite decades of effort from multiple big pharma companies.

Given the potential for Tirzepatide to be a first-class treatment for two of the large chronic illnesses affecting humanity coupled with a well-diversified pipeline means, Eli Lilly can generate a consistent high teens earnings growth over the next five years and well beyond.

Market dislocations brew interesting opportunities at valuations hitherto unavailable to us and in segments of the market we find attractive and have monitored for a while, such as diabetes. Increasingly, we find the baby is getting thrown out with the bath water!

In light of this dynamic, we are continuously evaluating and upgrading your portfolio to sustain an attractive compounding of your capital over the long run.

Chandan Khanna

Portfolio Manager, Sixteen02 Global Equity

Nineteen01 Private Investments

Nineteen01 – Private Funds

Where are we now?

In the topsy-turvy world that we live in, to be honest, it's pretty difficult to know right now. Particularly if you're a middle-aged, male, home counties-dwelling, traditional Tory voter whose lifelong belief that the Conservative party stood for low taxes and economic competence and that Sterling should be worth about $1.50 has been blown away in two short weeks of Trussonomics. But enough about yet another KamiKwasi Old Etonian; as they say a week is a long time in politics and my alma mater seems to have a lot to answer for in terms of the UK's current predicament.

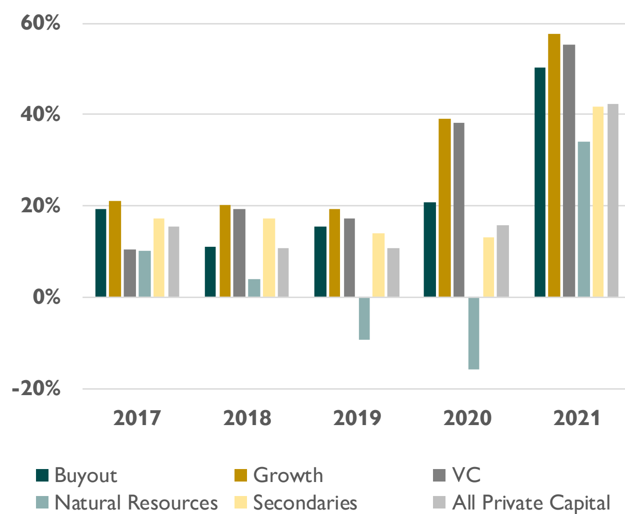
Back in private equity land, as alluded to last quarter, the lack of real time, bang up to date information still leaves us wondering slightly where we are. Underlying company performance appears to be holding up relatively well across the portfolio, dry powder is at all-time highs and fundraising continues apace – not quite at 2021 levels but not far off previous years. Valuations are being massaged down slowly but we have not yet seen the dramatic drops that public market comparables might suggest could yet come. The asset class's ability to determine its own quarterly valuations continues to be a significant advantage – and remember of course that your private markets net asset value is likely to be understated given that when companies are sold these exits usually happen at a premium to the most recent mark and, once sold, the cash received is then usually recorded as being outside of your private equity portfolio.

The following charts show one or two interesting trends that we thought were worth highlighting this quarter.

The first shows annualised performance by strategy in the US over the last five years. Of ten distinct sub-strategies (not all of which are shown here), Growth has been the best performing in each of the last five years and over the last 15 years has generated 16.3% annualised, which also leaves it in top spot. No surprise, Venture has tracked Growth very closely to be the second-best performing sector in four of the last five years and generating a 13.2% IRR on a 15 year time horizon. The weakest performer has been Natural Resources, a market segment that we do not invest in, and which has been at the bottom of the

table for 7 of the last 15 years, generating an IRR of just 4.2%. These are the volatile categories which tend to vary significantly from year to year: for example, Natural Resources only fell outside of the top two or bottom two performers in 3 of the last 15 years while Venture was the best performer in 2013 and 2014 but the worst in 2016. The most striking point to highlight however is the consistency of the Buyout strategy which over 15 years has generated the second best performance at 13.7% annualised, and has been in the top 4 strategies in 11 of the last 15 years. Needless to say, allocating to high quality Buyout managers remains a central component of our private markets strategy.

Figure 13: Annual performance by strategy

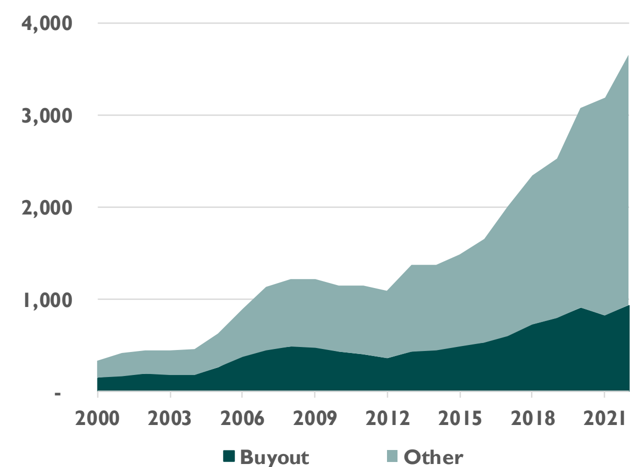


Source: Pitchbook (One Year Pooled IRRs, US market only)

This point was reiterated in some recent statistics provided to us by Hamilton Lane. Looking at the highest and lowest five year annualised performance for different asset classes, they show that public markets' best five year period generated 19.3% per annum compared to -5.7% for the worst five years. By contrast, VC and Growth generated 51.6% per annum in the extraordinary five years to Q3 2000, but -12.5% per annum in the following five years. The best five years in developed market buyout generated 27.5%, some 800 basis points ahead of public markets, but in the worst five years returns remained positive at 2.5%, still outperforming public markets by c. 800 bps. At its most fundamental level, this significant outperformance is the main reason why investors are viewing the private markets as a compelling asset class in ever increasing numbers.

The amount of capital available for investment, or dry powder as it is known, reached a record $3.7 trillion as at September. Although Buyout funds represent the largest single source of dry powder at almost $1 trillion, Buyout's share of the total has declined steadily over the last two decades from 45% in 2000 to just a quarter today. The growth in other areas has really been across the board including Growth and Venture funds, the fund of funds category, Real Estate (which now represents 10%), as well as Direct Lending, Infrastructure and Secondary funds. Investors' appetite for private markets shows no sign of slowing.

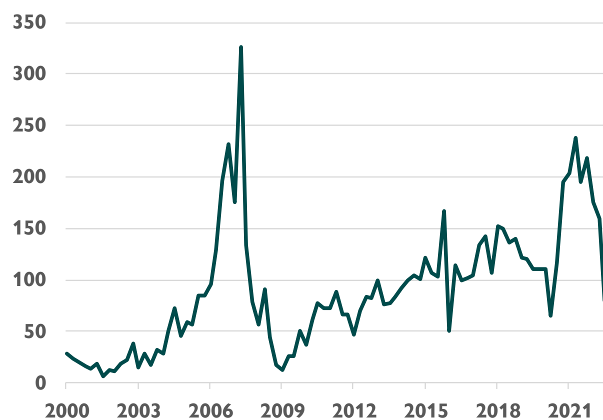
Figure 14: Dry powder available for investment ($bn)



Source: Preqin

The one area where there has been a clear slowdown is in deal activity. Reminiscent of 2007, the market peaked in 2021 at a level significantly above the average of the previous decade and has seen a rapid drop-off this year with the average deal size falling from $671 million to $366 million. The question now is how much further this will fall but given the amount of capital looking for a home – as highlighted above – it seems unlikely that the drop-off will be as precipitous as it was in 2009, particularly given that financing markets remain open, if more expensive than they have been.

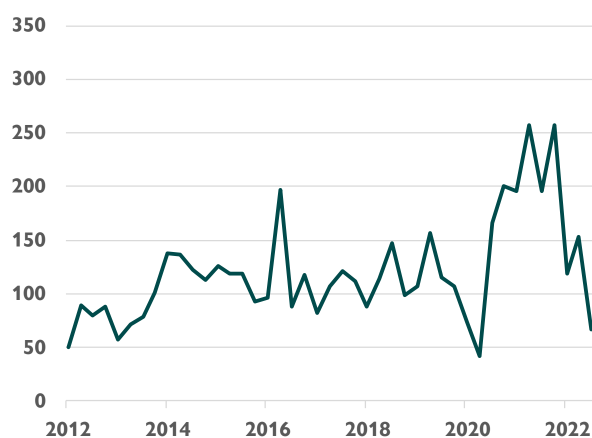
Figure 15: Buyout deal value ($bn)



Source: Preqin

This is mirrored by a slowdown in exits which have declined rapidly since a peak in Q4 2021. Part of this is the closure of the public market as an exit route although in reality in the Buyout world (as opposed to the Growth space) this is an exit route which is used relatively infrequently.

Figure 16: Buyout exit value ($bn)



Source: Preqin

We expect that the downturn in new deal and exit activity will continue for a while yet, certainly into 2023, but given the amount of dry powder available and the fact that financing markets remain open, deals will continue to get done. We end this quarter as we did last quarter by reiterating that there will be good opportunities to put capital to work over the next few years at more attractive entry prices, and that 2021, 2022 and 2023 should turn out to be very good vintages.

Charles Magnay

Head of Private Fund Investments

Nineteen01 – Direct Co-Investments

We did not approve any new investments in Q3 2022, but our existing 11 investments continued to perform very satisfactorily. Most importantly, given the discipline with which we approach business quality and deal economics, we did not get involved in companies with excessive leverage or entry valuations, or that have required further liquidity to continue trading.

A key source of transaction opportunities for us has been a growing stable of 'fundless sponsors'. For these sponsors, criteria such as the ability to execute transactions swiftly and certainty of funds are critical. Our ability to deliver on these criteria has been key in creating a stable of relationships and repeat transaction opportunities. From a due diligence perspective, when looking at any transaction we always start with the sponsor. Does that fundless sponsor have a deal-by-deal track record, sector expertise and proper alignment i.e. are investing on the same terms as us? Unless we can check the box on each of these factors, we do now look at the investment. This two-step due diligence process and our unanimous Investment Committee decision making, are key tenets of our execution process.

We have several transactions underway and in the near pipeline which we look forward to providing updates on in upcoming newsletters.

Oliver Mayer

Head of Direct Private Equity

What we have been reading …

What We Owe the Future: A Million Year View

by William MacAskill

Why should we sacrifice anything for posterity; what has posterity done for us?

This quip, delivered by philosopher John Stuart Mill to parliament in 1866, lays bare the counter-intuitiveness of asking a contemporary polity to consider its obligations to a group of distant descendants that are both entirely theoretical and unable to offer any form of reciprocation. Indeed, given the gloom that has descended on the present, with the very immediate geopolitical, financial and social challenges we face, thinking carefully about the distant future seems less relevant by the day. But should this be the case, and are we guilty of a shortsightedness that risks missing the wider context of our place in history, and our potential to safeguard and pave the way for billions of years of human flourishing?

So argues Oxford academic and philosopher Will MacAskill in his new book *What We Owe the Future*. MacAskill, who rose to prominence as a founder of the 'Effective Altruism' movement that seeks to identify and support the most consequential forms of charitable giving, turns his attention to thinking about our responsibilities to future generations. We are, after all, hopefully very early on in our species' possible history: if *homo sapiens* has existed for about 100,000 years, and with a sun that should continue to power life for the next 5 billion or so, we are, even in this post-post-modern age, still "the ancients", as MacAskill puts it.

Indeed, as JS Mill would go on to set out in answer to his own question, there is something noble and edifying about thinking about our position in relation to future generations:

Whatever has been done for mankind by the idea of posterity; whatever has been done for mankind by philanthropic concern for posterity, by a conscientious sense of duty to posterity, even by the less pure but still noble ambition of being remembered and honoured by posterity; all this we owe to posterity, and all this it is our duty to the best of our limited ability to repay.

Furthermore, as MacAskill notes, there is surely also a moral imperative not to prevent billions of happy lives being lived in civilization's distant future by our indifference or neglect today. Warning against fatalism, MacAskill argues that our greatest moral advancements, such as the abolition of slavery or the decriminalisation of homosexuality, should not be looked back on as inevitabilities, but rather as historical contingencies that were the product of hard won intellectual – and in some cases physical – battles, made possible by the bravery and determination of a handful of individuals and facilitated by the power of free speech, which we must fiercely protect. Accordingly, today we shouldn't ignore the challenges posed by bio-weapons, unaligned artificial intelligence, or changes to the climate just because they aren't immediate threats.

But why do we find the distant future so difficult to reckon with? For one, as behavioural finance wonks have long noted, humans are prone to recency bias and generally struggle with very long-term thinking; and so many facets of modern life seem to be heading in an increasingly short-term direction, from our attention spans to the political news cycle. Furthermore, we also find it difficult to appreciate the power of long-term compounding and the spectacular progress that even low levels of continued growth could deliver to our distant descendants.

This optimistic note characterises MacAskill's argument, and ensures the book is far from a laundry list of Thunberg-ish admonishments for any present excesses. For a work of philosophy, *What We Owe the Future* is also refreshingly practical, offering concrete steps to address our cognitive and institutional shortcomings, and reads as much as a paean to humanity's past and potential future achievements, as it does an alarmist account of the dangers of self-absorption and parochialism that threaten our long-term survival as a species.

Stuart Fox

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