Quarterly Perspectives

Q2 2022

Dear clients, partners and friends,

Warren Buffet is often credited with the aphorism 'only when the tide goes out do you see who's swimming naked' – well, it sure feels like an apt time to reflect on that sage advice.

The last nine months have been vicious in markets and have caused many to question the very rationale for why they own certain investments. The sudden rise in interest rates to combat the spectre of sustained and substantial inflation has barrelled through market segments, seeing them tumble one-by-one like dominos – high val / high burn stocks (down 50-75%), quality growth (down 20-30%), broader market indices (down 20%) and crypto tokens (down 50-75% plus).

It is precisely at times like these that you need to embody every aspect of your investment philosophy, process and protocol. Why do you own it? Does the thesis still hold? Would you buy more? Where are you simply wrong? Our 'guiding light' in periods like this is to studiously 'know what you own' (be it a fund manager or firm), judiciously rebalance in, and patiently allow earnings growth to create the compounding over the long term. While this re-underwriting may be more obvious on the investment side, it nonetheless extends to every corner of the firm – systems and operational control, key custodians and counterparties to name a few. At Eighteen48 we are in constant pursuit of this re-validation, and we call this 'running tight'.

On the investment side, the conclusion is that we are comfortable with what we own despite the volatility. Our endowment approach means that we have a structural growth bias; however we have been reasonably disciplined over the last few years and are under-exposed to those areas that have experienced the most substantial repricing ('spec-tech', crypto, etc.) and which may not recover. Volatility is inevitable and acceptable as long as it does not portend permanent capital loss.

On the organisational front, we warmly welcome Tim Evans, our new Partner on the client team and hailing most recently from a distinguished career at JP Morgan in both Hong Kong and London.

Speaking of that venerable bank and 'running tight', Eighteen48 recently fielded 12 runners in the JP Morgan annual 5.6K Corporate Challenge in Battersea Park. Running a race certainly has parallels to investing as you have to know the course, conditions and competition – in addition to yourself. Start strong out of the gates and risk not finishing, or start slower and finish strong with a burst? Hydrate or hyperventilate? We were relieved to finish on the cusp of the top quartile and – as our team shirts professed – remain committed to be 'in it for the long run'.

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

Julien Sevaux
Tarek AbuZayyad
14 July 2022

CIO Review

A rocky start

Following a brief rally from their lows towards the end of June, global equities ended the first half of 2022 down 20% (and remain around that level as we type) as interest rates rose and central banks began the somewhat vexed process of quantitative tightening. The S&P 500 Index of US large cap stocks posted its worst first half since 1970. Once again 'value' equities (especially in the energy sector) and traditionally defensive sectors (including staples and utilities businesses) both outperformed 'growth' stocks, although to a lesser extent than during the first quarter of the year.

Meanwhile the **violent sell-off in 'profit tomorrow' tech stocks** (to which we had very limited exposure) continued and indeed accelerated, with a number of high-profile tech funds down 50% plus and investors even starting to question their managers' viability as independent businesses. Perhaps the greatest casualties of the reduction in liquidity have been crypto assets, as leading 'stablecoin' Terra USD imploded, Bitcoin declined by 60% year to date (erasing almost three quarters of its Q4 2021 peak value) and lesser known but widely owned tokens such as Solana and Polkadot are almost 90% off their peak levels – equivalent to their prices halving three times in a row. We looked in some detail at the liquid crypto space but did not invest as we did not feel confident in our ability to value the tokens on a fundamental basis. Recent performance has validated that decision. We continue to look selectively for opportunities to invest in 'Web 3.0' and its infrastructure from a venture capital angle.

The sharp equity market declines were driven **almost entirely by valuation derating** rather than falling earnings, although it is probable that this reflects both the impact of higher interest rates (which increase the cost of capital at which investors discount future cash flows) and an expectation of some earnings weakness ahead. Encouragingly, the message from our core managers is that **the market is starting to be more discriminating**, especially between those companies which generate free cash flow and those which do not; while high growth stocks had another very weak quarter, cash-generative 'quality' stocks performed much more closely to the index as a whole (despite the index benefitting from the energy sector tailwind). Our core global manager composite was around 1% behind the global index during the quarter, despite holding virtually no exposure to energy-related equities. The performance of our Specialist funds was – as it should be – much more idiosyncratic, with returns ranging symmetrically from -23% to +23% during the quarter. Including these, our liquid equity fund composite (i.e. the highest-risk portion of portfolios) was down 12.5%, or around 3% better than the global equity index. We feel that the **outlook for these exposures is particularly attractive** both in absolute terms and relative to the index itself.

The extreme moves continued in government bond markets, where rising interest rates savaged longer-duration holdings (which are often held as portfolio protection). The 'TLT' 20+ Year US Treasury ETF ended the first half down 22%, while – showing the awesome power of duration – the price of the Austrian Government 100 Year 0.85% Bond (yes, you read that correctly) fell by 47% year to date, to end 67% off its December 2020 peak. Clients and regular readers will recall that we have **retained a short duration positioning** (target duration under 2 years) within our fixed income holdings since our launch, which has somewhat insulated 'Balanced' risk portfolios against such macro-driven volatility.

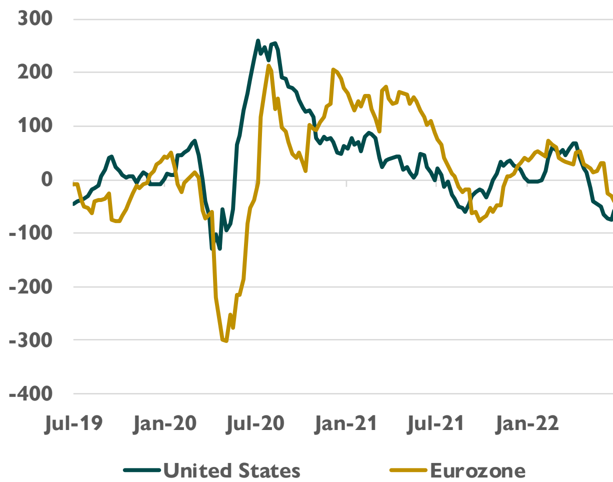
The risk-off tone has also been reflected in currency markets, with the US dollar index surging by 9% during the first half (now up 13% and touching parity with the beleaguered euro). This move has been exacerbated by recessionary and other geopolitical fears in the Euro Area. Investor positioning in the dollar is as high as it has been for seven years (often a contrarian warning); the interest rate differential between the dollar and euro is in its top decile of the last 20 years; and other key currencies such as the euro and sterling look inexpensive on a purchasing power parity basis. We do not make currency timing 'bets' in portfolios, but following these moves we feel that it is especially important to retain the discipline of hedging back to strategic base currency targets.

From inflation to recession?

The bleak economic backdrop has provided plenty for investors to worry about. **Growth expectations are clearly moderating**, even if still materially positive (the latest sell-side forecasts for global GDP growth in 2022 and 2023 are still north of 2.5% in aggregate, albeit down from approximately 4% at the beginning of the year). Monthly inflation readings remain stubbornly high. Despite hints of relief in *core* inflation numbers, the potential for *headline* inflation to bleed further into consumer expectations (and wage demands) does risk inducing central banks to overtighten and push economies into recession. Policymakers have to navigate an unenviable tightrope between tightening too hard and crimping GDP yet further, or taking their foot off the brake too early and adding fuel to inflationary pressures.

While inflation and interest rates were the major fear as recently as mid-June, signals of economic slowdown – such as weakening consumer sentiment, small business surveys and home sales – have recently **redirected investor concerns more towards the possibility of a recessionary policy misstep**.

Figure 1: Citi Economic Surprise Index turned negative



Source: Bloomberg

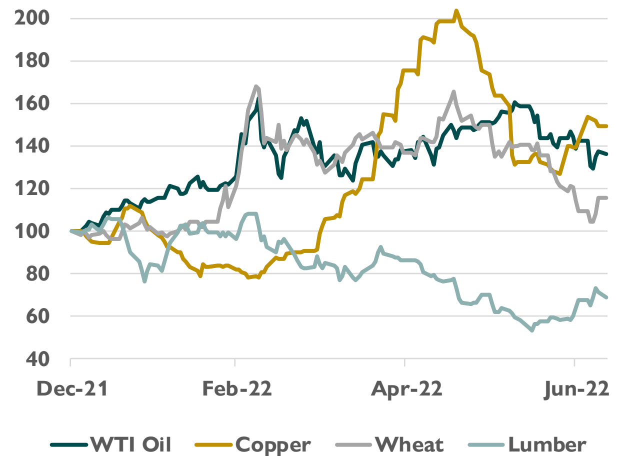
It is striking how quickly **longer-term inflation expectations have moved down** as central bankers have convinced market participants of their hawkish intentions – even as monthly inflation readings have advanced relentlessly upwards.

Figure 2: 5 year 'breakeven' inflation expectations have meaningfully rolled over

Source: Bloomberg

The easing of inflationary expectations has been accompanied by **significant declines in key commodity prices** from their year-to-date peaks: oil down 22%, copper down 28%, lumber down 36% and wheat down 37%. While many commodity prices are still quite elevated in historic terms, flat or falling food, energy and raw materials costs should considerably reduce the pressure on broad inflation gauges as their impact feeds through in the coming months.

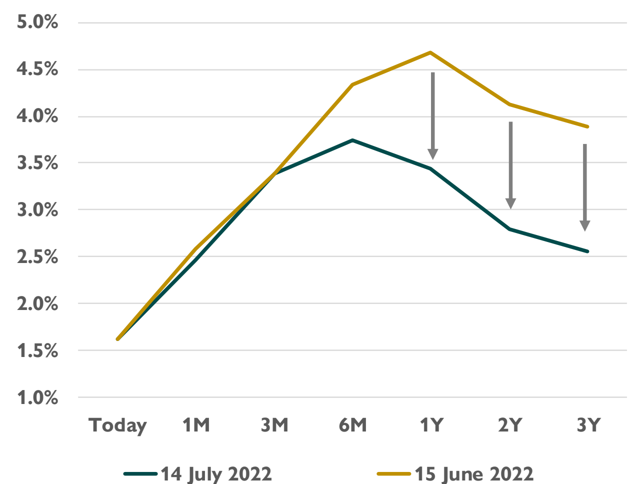
Figure 3: Commodity prices are softening



Source: Bloomberg

Declining inflation and growth expectations are also clear in the longer-term outlook for interest rates, with market expectations for the US base rate in 2025 having fallen from a peak close to 4% one month ago to c. 2.5% today and the Fed projected to be *lowering* interest rates as soon as H1 2023. Longer term rate expectations in the Eurozone have also dropped by some 100bps from their mid-June peak. Even as US headline CPI reached its 9.1% high this week, longer-term expectations barely budged.

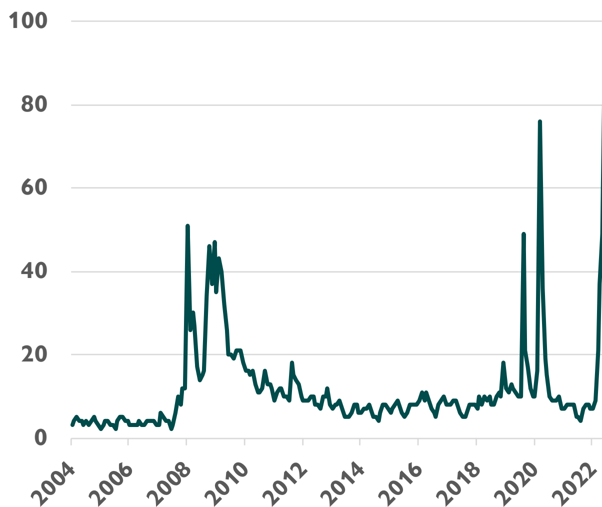
Figure 4: Market implied future Fed Funds Rates are well off their recent peak



Source: Bloomberg

In this context, recessionary concerns are rising strongly as reflected in risk asset pricing, the media and even Google search results (as below, where 100 represents peak interest):

Figure 5: Everyone is searching for "Recession"



Source: Google

As we know, macro developments are extremely difficult to predict. With the benefit of hindsight, everyone always saw 'it' coming; but for the most part they either kept very quiet at the time – or if they didn't, they had cried wolf for so long that it was hardly surprising that events eventually caught up. As star fund manager Peter Lynch vividly described his experience of the recession of the early 1980s (a passage which is worth quoting in full):

There was a 16-month recession between July, 1981 and November, 1982. Actually this was the scariest time in my memory. Sensible professionals wondered if they should take up hunting and fishing, because soon we'd all be in the woods, gathering acorns. This was a period when we'd had 14 percent unemployment, 15 percent inflation, and a 20 percent prime rate, but I never got a phone call saying any of that was going to happen, either. After the fact a lot of people stood up to announce that they'd been expecting it, but ***nobody mentioned it to me before the fact****.*

- *Peter Lynch, One Up On Wall Street*

Lynch's comment is particularly striking as – with the benefit of 40 years of hindsight – it seems perfectly obvious that Fed Chair Paul Volcker would achieve his goal of crushing inflation through perhaps the most aggressive application of monetary tightening in history. But it clearly didn't feel that way at the time, even to one of the leading investors of his age (nor to his no doubt well-informed interlocutors).

Likewise, it is extremely challenging as things stand today to predict whether we will have a recession; or, if we do, what form it might take, how deep it might be and how long it could last. (Even the process by which the US National Bureau of Economic Research decides whether we have had a recession is rather obscure.) While stagflation is certainly a possibility, it must be at least equally possible that monthly inflation readings slow along with demand, and that rates peak at lower levels than expected only several weeks ago – quite materially above their extreme lows but **nonetheless at levels which have been historically quite normal**. Economic indicators are pointing to a slowdown (and the Atlanta Fed's GDP model suggests that we may have just experienced a second quarter of modest GDP declines in the US) but not an extreme one as yet.

One thing we can say with a degree of certainty is that **the underlying conditions for a deep recession are not readily apparent**. Firstly, the jobs situation is very different from any of the 12 recessions since 1945. The unemployment rate has increased in every one of those recessions, by a median of 3.5 percentage points. So far this year, the **jobless rate has actually fallen** from 4% at the end of December to 3.6% at the end of June. Meanwhile, 25% fewer Americans are collecting Federal unemployment cheques than in the three years prior to the COVID pandemic. And crucially, jobs remain plentiful: the US has recorded over 11 million job openings each month during 2022, some 4 million more than before COVID.

Secondly, and as we have regularly discussed in the past, the significant imbalances which have preceded systemic crises in the past (such as the bubble in residential investment and associated consumer and bank leverage prior to 2008; or the bubbles in business capex and broad stock valuations prior to 2001) are quite absent. **Consumer balance sheets remain healthy** in both the US and Europe, with household debt below 1.0x disposable income (compared with a 2007 peak which was some 35% higher in the US). Debt payments to disposable income are near a 40 year low. The US consumer still has excess savings built up during the pandemic of over $2 trillion, equal to some 10% of GDP. Wage growth has been strongest among the lowest paid, where demand elasticity is the highest. Home prices may see some weakness as sales slow in response to higher mortgage rates, but the market remains tight with existing housing inventory also at a four decade low (and less than one third of its historic average level). Meanwhile **bank balance sheets have been transformed** since the global financial crisis, with Tier 1

equity ratios rising from around 8% pre-2008 to 15% in the US and 17% in the Eurozone today.

Given the above, the set-up feels more like a prospective 'growth shock' or shallow recession than a deep recession, exacerbated by the compositional rebalancing away from 'excess' goods spending during lockdown to services spending as economies reopen. It is not surprising that such rebalancing should cause **temporary bottlenecks and inflationary pressures as supply shifts to match the changing demand dynamics**. Professor Brad DeLong (University of California, Berkeley) describes the current environment as being closest in nature to 1947 (as the US economy reoriented itself from a wartime to a post-war environment, and tank factories became car factories) or 1951 (as the country's military capabilities were rebuilt in the early stages of the Korean and Cold Wars). In both cases, long-run inflation expectations remained anchored (as is the case today); monthly CPI readings fell back below 5% within 18 and 12 months of their peaks respectively; and equities generated positive returns of 11% and 19% per annum while they did so.

It does nonetheless seem fair to say in this environment that the risks to both inflation and growth are unusually high (or in finance speak, that the 'fat tails' have got fatter), given the monetary tightrope described above and the prevalence of factors – such as energy and food prices, or supply chain disruptions in China – which are beyond the jurisdiction of financial policymakers.

Lessons from MIT Endowment's 15 Year Review

One of the great privileges of operating in our industry is the ability to stand on the shoulders of giants. These can be the titans of the equity world (Benjamin Graham, Philip Fisher, Warren Buffett, Peter Lynch et al.) or the lower profile pantheon of top institutional multi-asset investors whose annual letters, lectures, and now podcasts provide invaluable insights and sustenance – especially through volatile times such as today.

One such nugget which recently came our way is the 15 Year Letter written by the team which manages the Massachusetts Institute of Technology's $18 billion endowment. Over the last 15 years they have returned 11.7% per annum (and 14.5% per annum over the last decade), outperforming their passive 70% equity / 30% bonds benchmark by some 5 percentage points per annum and placing them in the top 1% of the Cambridge Associates endowment universe. They are clearly doing something right.

There is plenty to think about in this brief but insightful note, including the value of being generalists and doing more direct investing (we agree with both) and the excess returns that can be available from earlier stage managers (we are increasingly looking in this space, even as we feel that striking a balance between new and established will always be important). We took away three key lessons from the letter which we think are especially relevant today.

1. **Do not waste time worrying about potential causes for downturns**. "Possible triggers such as terrorism, political change, natural disasters, war, increased interest rates, the spread of a new disease, changing risk appetites, or an economic slowdown are inherently unpredictable, and time spent trying to predict the nature or timing of such events is time wasted".

2. **Instead, recognise that volatility is a fact of life and build portfolios accordingly**. "We invest knowing that a downturn will always inevitably come and spend our time thinking about the potential consequences on our portfolio". The two main lines of defence: a) Selecting great managers who are not focused on any benchmark; and b) Promoting portfolio resilience through guidelines which ensure that they "maintain adequate liquidity, avoid over-leverage, and diversify by asset-type, geography, and investment strategy".

3. **Remain focused on the long term and do not try to time markets to avoid drawdowns**. "Our goal is not to avoid mark-to-market losses (an impossibility given our large holdings of equities and an unwise goal for a long-term investor) but rather to structure the portfolio in such a way that we can avoid selling compelling long term investments at distressed prices to fund short-term capital needs".

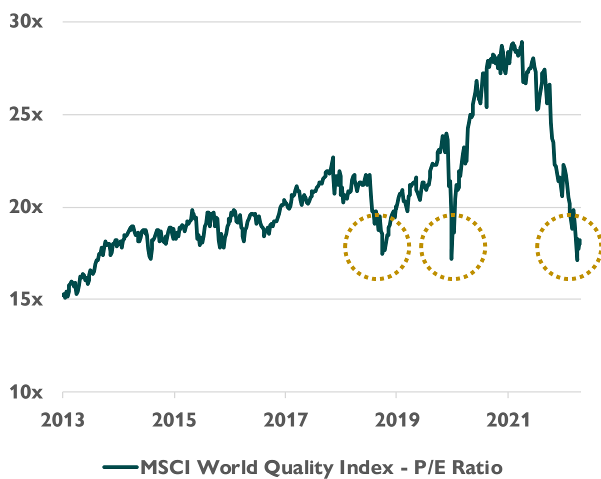
The real value of letters and other media such as these is not so much their views on the macro or market outlook (which are often strikingly absent). It is rather in exploring the fundamental investment principles which they follow, and in understanding how these outstanding investors think about building their portfolios to perform despite, rather than because of, the macro; so that they can, in the

immortal words of Charlie Munger, '**keep swimming and let the tide take care of itself**'. The principles above elucidated by the MIT Endowment team are worth bearing in mind during that swim.

Looking ahead

We are now in a situation where the broad market has fallen further than in late 2018, and high quality, growth stocks have fallen almost as far as they did during the COVID crisis of Q1 2020. The 24% decline in the S&P 500 to mid-June has already exceeded the average non-recessionary pullback (21%) since 1945 and played out over a similar time horizon (6 months). The valuation of high quality, growth stocks of the type we prefer to own has fallen to its trough levels of both 2018 and 2020. Earnings may well decline from here but that doesn't mean that valuations are less cheap; **markets are discounting mechanisms and 2018 and 2020 both showed that valuations (and prices) can bottom *before* material earnings declines get underway**. A growth shock or shallow recession appears to be substantially priced in.

Figure 6: Quality valuations at recent crisis lows



Source: Bloomberg

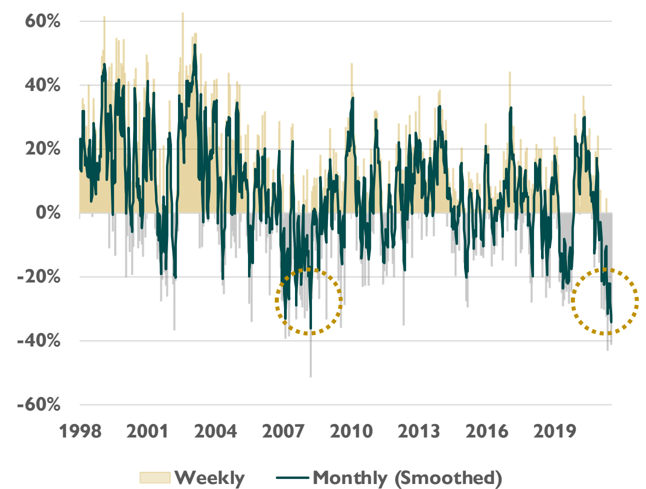
It is certainly possible for these valuations to fall further (as they were during the long grind upwards following the global financial crisis), especially if rate expectations rise much higher. However we feel it more likely that materially lower valuations would require a deep recession (to which we assign a relatively low probability) rather than rate rises: it is instructive that the consumer staples sector (a proxy for quality stocks, with a longer available history) **barely fell below its current level of 18x P/E between 1994 and 2007, a period during which the Fed Funds rate averaged 4.2%**.

Peter Lynch continued the passage quoted earlier:

Then at the moment of greatest pessimism, when eight out of ten investors would have sworn we were heading into the 1930s, the stock market rebounded with a vengeance, and suddenly all was right with the world.

While we cannot predict whether the market will stage a strong rebound from here, there are **clear signs of that pessimism appearing in investor sentiment and positioning**. Goldman Sachs reported in mid-June that following the strongest week of short selling since the global financial crisis, hedge funds' gross exposure (the sum of long and short positions) sat at five-year lows. Morgan Stanley reported in late June that hedge funds' net exposure (long minus short positions) was its lowest since April 2009. Bank of America's monthly Global Fund Manager Survey indicated that long-only equity managers hold the highest cash weighting in their portfolios since 9/11, over two decades ago. Individual investors in the US are as bearish as they have been since the global financial crisis and close to their most pessimistic level recorded:

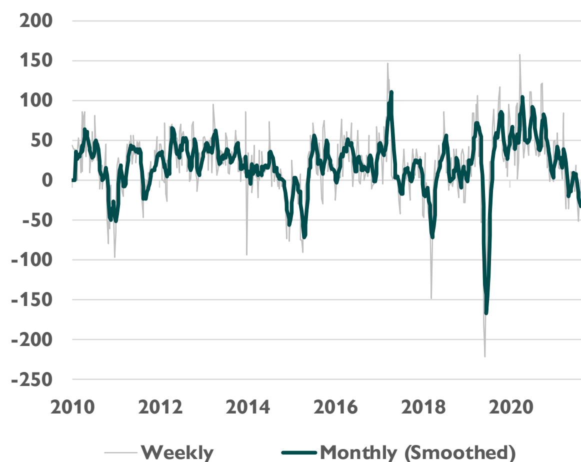
Figure 7: Retail investors are extremely nervous



Source: Bloomberg (AAII Investor Sentiment Survey)

Lastly, sell side analysts – who generally prefer to hide their heads in the sand until the last minute – have finally got in on the game and started to downgrade frantically, to an extent which falls somewhere between the capitulation levels of Q4 2018 and Q1 2020:

Figure 8: Capitulation on Wall Street (stock upgrades minus downgrades in the S&P 500)



Source: Bloomberg

These extreme readings can't unfortunately call a market bottom; but they do suggest that a lot of selling has already occurred and have **generally signalled good times to be invested for the long term in the past**.

Aside from the downside case of a deeper recession than is currently priced in – which could provide a further, if temporary, challenge to risk assets – one interesting question is whether we are entering a period of 'regime change' as inflation and interest rates rise to structurally higher levels than the last decade. This seems a reasonable assumption to us, even if we would characterise it rather as a return to more *normal* pricing of capital than something entirely new and unfamiliar. The question is – what should such a regime change mean for portfolios?

It seems likely to be **good news for credit investors**, who are now seeing yields in the region of 4-6% in investment grade bonds and 8-10% in high yield without the need to take excessive credit or interest rate risk. This will also feed through into the spreads above the risk-free rate which are available in merger arbitrage strategies. All else equal, this should increase the returns available to medium-risk 'Balanced' clients who have a greater exposure to these areas than more equity-oriented 'Growth' investors.

The impact on equities could be quite varied. Businesses with high leverage and/or low pricing power may well struggle in such an environment. Meanwhile the impact on those with **low leverage, high pricing power and leadership positions which enable them to drive their own growth** should be significantly less. If the unusually low cost of capital for most of the last decade and a half has throttled dispersion and enabled businesses to 'swim naked' which shouldn't be in the water at all, then net-net this should be a healthy development both economically and also for our owned businesses.

Comments from our managers (both long-only and long/short) bear this thesis out. Owned portfolio businesses with meaningful raw materials costs have been able to pass through higher costs – for example industrial supplies business Fastenal, given its strong market position and ability to satisfy orders in a timely manner. Contrast the situation with Stanley Black & Decker, a disclosed *short* position within the portfolio, where poor customer satisfaction has resulted in higher retailer discounting and therefore much lower potential to offset cost headwinds through price increases.

Generally, the high quality businesses which we own have either a high degree of inflation protection (most notably companies like Visa and Mastercard whose revenues are directly linked to nominal spending) or the ability to increase productivity through scale, technology and the development of contiguous offerings. Despite widespread bearishness among market pundits and analysts, our managers are encouraged by what our companies are telling us in terms of their **resilience to both material and labour cost inflation and their strong growth outlooks**.

We have always recognised that there are many 'ways up the mountain'. Some managers have made excellent returns from 'top-down' tactical and market timing decisions. Some managers will do so in the future (not necessarily the same ones!). However the real challenge is that there is something of the zero-sum game about these activities, as shown quite starkly by HFRI's Thematic Discretionary Macro index: this has returned just 25% since inception in late 2007, compared with global stocks which have doubled and global high quality stocks which have tripled over the same period (even after the ravages of the 2008 drawdown in which the macro index hardly participated).

The point is, there is an intrinsic 'risk premium' to public and private equities (and indeed credit assets) and you don't need to expect markets to go up in a straight line over the next 12 months to be confident that you have a greater chance of achieving satisfactory returns by holding these assets over a 5-10 year time horizon. This is especially the case if you truly know what you own and

have a **high degree of conviction in both your managers and the quality and earnings power of your underlying holdings**.

Our name 'Eighteen48' is a nod to the potential for building lasting wealth during periodic times of turmoil. Short-term volatility is the – often uncomfortable – price we pay for long-term compounding. We believe that the results should be well worth the price of admission from here.

Edward Clive

Chief Investment Officer

Sixteen02 Global Equities

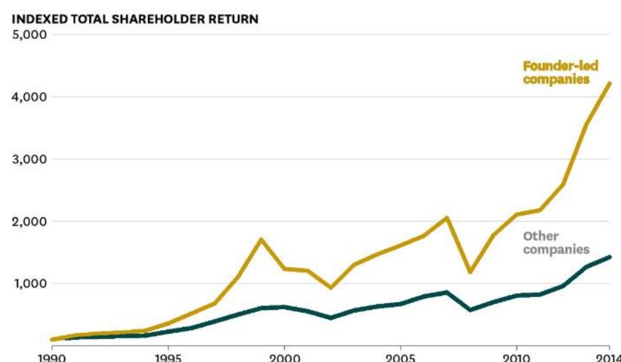
Fearless Leaders = Founders' Alpha?

In tumultuous times like this where the "baby often gets thrown out with the bathwater", investors may use market dislocations to their advantage by upgrading their portfolios. One of the softer factors we look for in our portfolio companies is founder or management ownership. Wartime management teams can use crisis periods to build more sustainable moats and distance themselves from fragile competition.

Looking at the Sixteen02 portfolio, we are naturally drawn to businesses where the founder or founding family is involved in a meaningful way in either the management team, board of directors or where the original focus & principles put in place by the founders have still endured. This phenomenon makes us wonder whether "founders' alpha" is a consistent theme in the public markets or a spurious correlation we happen to notice.

In our quest to find an answer, we stumbled across much quantitative and qualitative evidence that suggests "founder alpha" does indeed exist in the listed company space.

Figure 9: Founder-led companies outperform the rest

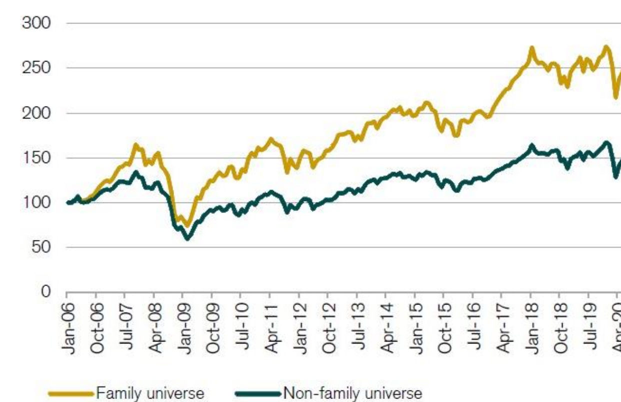


Source: Bain & Co

Bain & Co conducted one of the most comprehensive studies on the subject. It tracked the performance of all global public companies over a 15-year period (1990-2014) and found that companies most successful at maintaining profitable growth over the long term were disproportionately companies where the founder presence was high or his/her principles & focus still endured.

The result was quiet staggering – for instance, an index of S&P 500 companies in which the founder is still deeply involved **performed 3.1x better** than the rest over the past 15 years.

Figure 10: Another dataset suggesting founder alpha



Source: CS

A similar analysis by Credit Suisse also found that founder led / family-owned companies outperformed non-family-owned peers **on average by 3.7% per year since 2006**. **The family-owned alpha has been greatest (6.50% per year) for smaller companies (market capitalization <$3bn) and smallest for large companies (market capitalisation >$7bn**).

So, what drives this outperformance?

The founder, struck with an "Eureka" moment, seeks to find a unique solution to a problem or in some cases identifies a need even before the user recognises it (think iPhone, for example). At this stage the founder seeks to execute with super-human focus and tenacity to bring his idea to life and delight his customers. Over time a successful initial venture transforms the use case into a larger opportunity, scales it up and ultimately seeks a public market listing. In his book *The Founder's Mentality*, Chris Zook of Bain & Co call this initial phase, where the founder & his team wage a war against industry norms while obsessing about every detail of serving the customers as ***"business insurgency".***

Here we are reminded about the history of TSMC's CEO founder, Morris Chang.

In 1950s, as an electrical engineer, Morris Chang had an established carrier with Texas Instruments. He noticed that there were many chip designers wanted to start their own semiconductor companies but were unable to do so as it means heavy capex to build out their own chip plant – the industry norm those days. He realised a pure-play foundry model could solve this problem and with the help of Taiwanese government formed TSMC. Over time, it helped spawn numerous fabless companies such as Nvidia, Qualcomm, Broadcom and even the chip operations of Apple.

Once the founder-led firm reaches a public market listing, the focus of the founder shifts to a new sphere. He seeks to solidify and transfer the originality (that sense of purpose, culture of innovation and specialisation) of his company to the next stage so that it continues to exist and guide the next generation of leaders as they scale the company further. Scaling and preserving the firm's success is now his/her life's calling or legacy they like to leave behind. Now, the founder has substantial ***"soul in the game".***

In the first ever annual letter (1997), Jeff Bezos under the title ***"It's All About the Long Term"***, lays down the first principles by which he seeks to operate and scale Amazon:

Because of our emphasis on the long term, we may make decisions and weigh trade-offs differently than some companies. Accordingly, we want to share with you our fundamental management and decision-making approach so that you, our shareholders, may confirm that it is consistent with your investment philosophy:

- *We will continue to focus relentlessly on our customers.*
- *We will continue to make investment decisions in light of long-term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions.*
- *We will continue to measure our programs and the effectiveness of our investments analytically, to jettison those that do not provide acceptable returns, and to step up our investment in those that work best. We will continue to learn from both our successes and our failures.*
- *We will make bold rather than timid investment decisions where we see a sufficient probability of gaining market leadership advantages. Some of these investments will pay off, others will not, and we will have learned another valuable lesson in either case.*
- *When forced to choose between optimizing the appearance of our GAAP accounting and maximizing the present value of future cash flows, we'll take the cash flows.…………*

Since then, in almost every subsequent annual letter, he repeatedly used these principles as a yardstick to measure the success or failure of Amazon's actions. We see this as Jeff Bezos' way of showing the decision-making culture at the company and attracting similarly-minded stakeholders – both employees and investors.

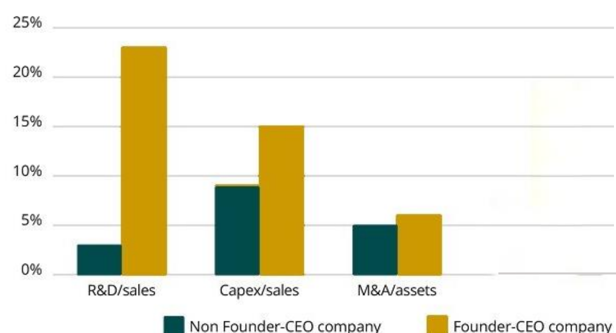
As **innovation** is a core founding principle of a founder led firm, they heavily encourage experimentation and the associated failure as unique components of their culture. Again in the 2016 annual letter Jeff Bezos identifies this distinct part of Amazon's culture:

One area where I think we are especially distinctive is failure. I believe we are the best place in the world to fail (we have plenty of practice!), and failure and invention are inseparable twins. To invent you have to experiment, and if you know in advance that it's going to work, it's not an experiment. Most large organizations embrace the idea of invention but are not willing to suffer the string of failed experiments necessary to get there. Outsized returns often come from betting against conventional wisdom, and conventional wisdom is usually right. Given a ten percent chance of a 100 times payoff, you should take that bet every time….

Innovation led growth also means that founder led firms allocate a higher portion of their sales to innovative reinvestments such as R&D and capex versus M&A. As

discussed in our January 2022 Newsletter, innovation-led companies do outperform.

Figure 11: Reinvestment profile of founder-led companies



Source: Schroders

Public market listing also means that at this point the founder will generally have bulk of his/her wealth (***"skin in the game")*** tied to the company via their shareholdings. This dynamic aligns founders' interests with that of the shareholders. As corporate strategy is about making choices and trade-offs, this founder-shareholder alignment ensures that founders continue to adapt rigor and discipline in capital allocation decisions and take a long view. This fact is yet another reason why reinvestment at these firms is higher than average and focused on R&D and Capex.

However, there have also been exceptions where firms have faced controversies due to founder involvement. Recent examples include Uber where its founder Travis Kalanick resigned due to allegations about an untoward company culture, for example.

Figure 12: S02 Portfolio Founder Presence & Shareholdings

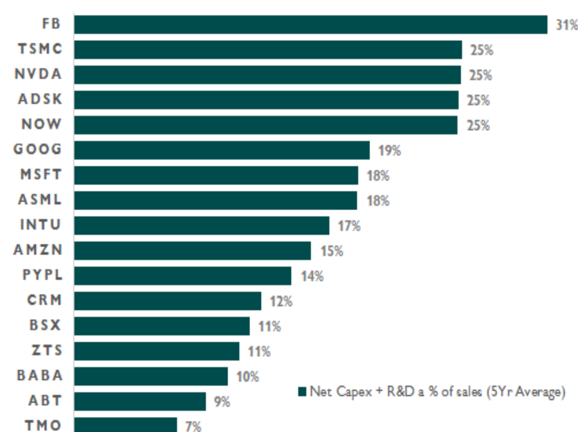
Company	Founders, co-founders	Position past - present	Period	Holding
Alphabet	Sergey Brian, Larry Page	Founder, director	1998-present	14%
Meta	Mark Zuckerberg	Founder CEO	2004-present	12%
Amazon	Jeffry Bezos	Founder, ex-CEO, Chairman	1994-present	10%
Tencent	Huateng Pony Ma	Founder CEO	1998-present	8%
Adyen	Pieter van der Does, Arnout Diederik Schuijff	Founder CEO	2006-present	6%
Salesforce	Marc Benioff	Co-founder, chairman & co-CEO	1999-present	3%
Nvidia	Jen-Hsun Huang	Co-founder CEO	1993-present	3%
Intuit	Scott David Cook	Co-founder, ex-CEO and current Chairman	1998-present	3%
Alibaba	Joseph Tsai	co-founder, executive vice chairman	1999-present	2%
TSMC	Morris Chang	Founder, ex-CEO, ex - Chairman	1987-2018	
Microsoft	Bill Gates, Paul Allen	Co-founder , ex-CEO	1975-2000	
Service Now	Fred Luddy	Founder & Chairman	2004-present	

Source: CAPIQ; S02

In summary, many of your Sixteen02 portfolio companies have significant founder presence both in terms of their time spent with the firm and their ownership stake.

As highlighted in the January 2022 letter, our companies are innovation-led and re-invest significant portions of their revenue to sustain and expand their competitive advantage.

Figure 13: S02 Portfolio Reinvestment Ratio Remains High



Source: SO2

Listed companies' success is often predicated on a founder's ability to transfer and preserve unique culture or **"owners' mindset"** to generate optimal capital allocation outcomes that result in sustained business performance. We believe this unique blend produces the founders' alpha! Therefore, we think we are best served by aligning ourselves with those founder-led firms who will use this time of volatility as an opportunity to fortify their firms' unique moats.

"A market downturn doesn't bother us. It is an opportunity to increase our ownership of great companies with great management at good prices."

Warren Buffett

Chandan Khanna

Portfolio Manager, Sixteen02 Global Equity

Nineteen01 Private Investments

Nineteen01 – Private Funds

Mind the reality gap … and the calm before the storm

It has been quite a first half of the year in capital markets with the combination of war, shortages of both raw materials and people, and inflation conspiring to force a rethink in public equity markets which were down by 20% in the six months to June. While this has obviously not gone unnoticed in the private markets, we are in that interim period when things have clearly slowed – most notably deal volumes and pricing – but reality is not yet reflected in the valuation and performance numbers we report.

This is partly because of the lag in private equity reporting (we are only now receiving and sending out Q1 numbers), but also the smoothing ability that managers have which tends to mean that reported performance is not as dramatic as public markets either on the way up or on the way down. As a result, we do not expect to have a clear view on the valuation impact on portfolios until after the summer when June numbers are reported.

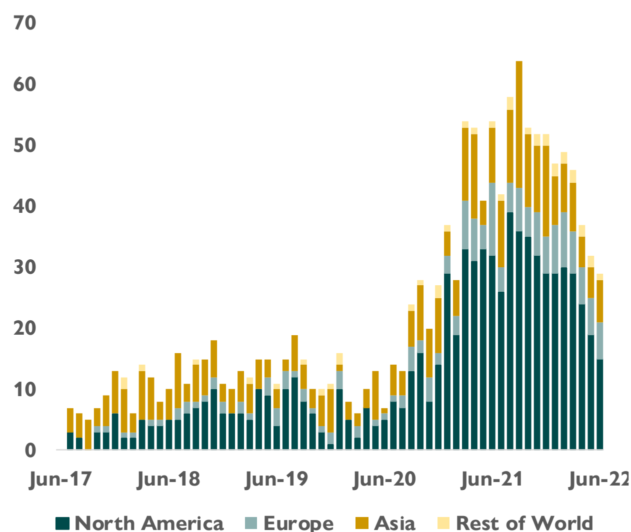
So while the calm before the storm perhaps somewhat overstates things (as we do expect that private valuations, perhaps with the exception of the ultra frothy growth-stage venture investments, will prove to be fairly resilient), we find ourselves in a hiatus period – or reality gap – where private markets are, for a period of six months or so, divorced from public markets. We would highlight the following as some of the key issues that we will be watching with interest in this interim period and beyond:

1. **Inflation**. In many ways inflation is the great unknown. Neither the private equity deal-doers nor their management teams will have experienced a high inflation environment and their ability to navigate it effectively is the big leap into the unknown. It is difficult to speculate how this will play out but clearly there will be an emphasis on, and premium paid for, companies which can demonstrate pricing power. Although price rises are being pushed through across our PE portfolio, which will result in strong revenue growth in 2022, at least in nominal terms, margins will in many cases come under pressure as employee and input costs rise as fast or even faster.

2. **Fundraising**. 2021 was a record year for fundraising at $1.2tn. While some managers will continue to defy market conditions and close funds at or above target (for example Advent International has just closed its tenth fund at the $25bn hard cap), many will struggle. The pace of fundraising over the last 2-3 years has put a real strain on investors and there are very few who are actively seeking to add new names to their portfolio in this environment. As a result, we expect to see some managers close their funds significantly below target, or be in the market for a lot longer than they might have hoped, or delay fundraising until they have returned more capital from their existing funds. It would come as no surprise if a number of managers were to disappear for good but this will be a protracted demise which will play out over the next 2-3 years.

3. **Growth**. Growth funds, usually with significant technology exposure, were the main beneficiaries of 2021's market euphoria and consequently have the furthest to fall. We expect Growth portfolios will take a significant hit over the coming quarters and what currently appear to be stellar track records will be heavily impacted. GPs may look to limit the valuation falls but many new VC rounds are likely to be down rounds (Klarna, for example, is rumoured to be raising new equity at a $6bn valuation, down from $46bn just a year ago) and portfolios with public exposure will have to mark those positions to market. The slowdown in this space is evident in the following chart which shows the number of billion dollar companies (known as Unicorns) created monthly. As an aside, Klarna hit the billion dollar valuation to become a Unicorn way back in 2013.

Figure 14: VC-backed Unicorns Created Monthly by Region



Source: Pitchbook

4. **Existing portfolios**. The great unknown is how existing portfolios will hold up in this environment. While there is little that we as capital allocators can do to influence outcomes here, the health of a manager's existing portfolio will gain extra importance in our diligence. The last thing that we want to be doing is giving new capital to managers who are buried so deeply in the problems in their existing portfolios that they lack the bandwidth to deploy a new fund effectively. As a result, we also are likely to be slightly more cautious in our deployment pace so that we are able to gain a clearer picture of the resilience (or otherwise) of a manger's existing portfolio before making a commitment to a new pool of capital.

These areas of concern are tempered by the following:

1. **Experience**: The leaders of today's private equity industry have seen this all before. While 2009 may seem like an age ago, all of today's Partners and Managing Partners will have had valuable experience of nursing their portfolios through that turbulent period and of the art of deal-doing in a downturn. This gives us confidence in their ability to navigate the current environment successfully.

2. **Dry powder**: The record capital available to the industry to deploy (known as dry powder) currently stands at $3.5tn. This is an extraordinary war chest to invest at these lower valuation levels and we believe that this capital is very well placed to earn premium returns. At this early stage, a prediction that 2021 and 2022 will end up being very good vintages does not seem unreasonable.

In conclusion

While we fully expect a correction in private market valuations in the second half, we do not expect the mark downs to be as severe as in the public markets. If history is a guide, with many exit routes closed, managers will be forced to hold on to assets for longer, and will seek to generate the same multiple of capital over a slightly longer time period at the expense of a few percentage points of IRR. Batten down the hatches, it's going to be an interesting year as the storm approaches and the reality gap closes.

Charles Magnay

Head of Private Fund Investments

Nineteen01 – Direct Co-Investments

In Q2 2022, we invested in two businesses: SI UK, a UK based international student recruitment business, and Modulr, a payment processing platform. We also approved two further investments: Level 5 Be Well, a franchisee to Level 5's pain management business called Restore, and XTEL / Step-Up, a business merger to create one of the leaders in managing and optimising the promotional spend of consumer goods companies.

Taking SI as an example of our investment philosophy: We are investing alongside a fundless sponsor whom we rate highly, having invested with them previously. The business thesis rests on a few core principles: the resilient and growing market for international students coming to the UK for undergrad and postgrad education and universities needing international students from a financial and diversity perspective. The business is one of the two market leaders in the UK and has contracts with 98% of all the universities. Finally, it is a true multi-channel model with students coming online and offline through a network of direct offices, franchisees and channel partners.

The other three transactions follow the same broad philosophy of investing alongside sponsors in whom we have a high level of conviction and in strong businesses at

reasonable prices. This discipline has served us well to date. Looking at the portfolio we remain very pleased with no material disruptions or concerning developments.

Oliver Mayer
Head of Direct Private Equity

What we have been reading …

Oceans of Grain: How American Wheat Remade the World *by Scott Reynolds Nelson*

At a time when Russia is weaponizing oil and grain in its confrontation with the West, the history of wheat and how it made and unmade empires makes for interesting reading. The central thesis is that most wars have been motivated by the drive to access and control a commodity, in particular grain.

Catherine the Great was influenced by the physiocrats, 18th century French economists who believed that the wealth of nations derived from the value of land development through agricultural labour and the export of grain – in essence, food was power. Catherine's plan for growing the empire was centred on a southward, wheat-based land expansion fought mostly against the Turks. It started in the early 1760s and lasted for over a century, bringing parts of Poland and Ukraine into Russian control as well as Crimea. With access to the Black Sea, the Russians built Odessa which by 1807 was the international market for European grain.

Meanwhile in the United States, Thomas Jefferson and Benjamin Franklin were also influenced by the same physiocratic ideas and developed a vison of agricultural colonization of the West and ultimately export of grain. The US Civil War led to a key development which was the design of the futures contracts as we know them for the US Army, arbitrated by the Chicago Board of Trade. Grain production ballooned to feed the troops.

After the war, merchants used the army's infrastructure to develop export markets which coincided with the use of nitro-glycerine and the creation of deepwater ports such as Antwerp and Rotterdam. Ocean delivery was at least thirty times cheaper than land delivery – as a result US grain flooded European market with grain prices dropping by 40% between 1870 and 1900. The lower price of food enticed families to the cities and allowed for the advent of industrialization. The author argues that the resulting social and geopolitical shifts fuelled the outbreak of World War I and the Russian Revolution.

One of the main conclusions of the book is that the death spiral for empires begins with dependence on external food, which leads to capital flight, then financial instability and finally revolution. The current conflict in Ukraine is certainly a painful reminder of the importance of food and energy independence, a lesson many Western leaders seemed to have forgotten.

Julien Sevaux

Eighteen48
PARTNERS

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