Eighteen48 PARTNERS

Quarterly Perspectives

Q4 2021

Dear clients, partners and friends,

We trust that you enjoyed a welcome respite with friends and family over the holiday period, Omicron woes notwithstanding. The last twelve months feels, as is often the cadence in life, like 'two-steps forward, one step back'. While the most recent variant marks a speedbump on the road to recovery, the underlying medical data continues to reaffirm a positive trajectory.

The last year has also marked substantial progress for Eighteen48 across Wealth Management, Sixteen02 and Nineteen01. We ended the year at over double the assets under management we started with and grew our ranks to 21 outstanding individuals. It is this defining element that we accordingly pay tribute to: our performance has, is and will always be predicated on our people.

An investment paradigm we are prone to proselytising is 'jockey', 'investment thesis' and 'deal economics' – the 'who', 'what' and 'how much' of investing. Each variable is important but perhaps none more so than 'jockey' in early stage businesses and indeed in the financial services sector where judgment is everything – judgment about managers, asset classes, businesses, valuation, deal terms and even psychology.

We have 19 exceptional contributors at Eighteen48 and two enthusiastic player-coaches rooting on the team. In the words of Michael Jordan, 'talent wins games but teamwork and intelligence wins championships'.

We warmly welcome our two most recent partners on the field, John Baron and Rola Hage-Ali. John takes on the mantle of CFO and worked with us in the same capacity for many years at Stanhope Capital. Rola spearheads the ever-important Legal and Compliance domain and most recently spent eight years at Credit Suisse. Welcome aboard!

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

17 January 2022

CIO Review

Play it again, Uncle Sam

Writing one year ago, it was difficult to believe after the travails of 2020 that global equities had ended the year up 16%. It would have been equally hard to imagine at the same time, with P/E ratios in the high 20's and amid quite valid concerns about the durability of the recovery, that 2021 would do even better, with global equities up 19%, once again led by US large cap equities up 28%. High yield credit spreads narrowed further to end the year around 3.5%, not far above their pre-COVID lows.

Stock market performance was driven by a **powerful recovery in earnings**; estimates for US large cap earnings per share were revised up by some 30% during the year – in line with the price performance itself – and actual results have beaten Wall Street estimates by an average of 17% over the last 6 quarters (vs. the typical and mysteriously consistent level of 3-5%), exceeding even the recovery from the global financial crisis in 2009-10. Once again we were reminded of the power of staying the course and the truth of JK Galbraith's dictum: 'We have two classes of forecasters: those who don't know – and those who don't know they don't know'.

Conversely, it was a torrid year for most fixed income investors as market participants worried about the extent to which higher growth and inflation could lead to higher interest rates ahead. Long-dated US Treasuries lost almost 5% through the year (having been down some 15% at one point), dragging down investment grade credit (with its seven year rates duration) to a 3% loss. Full duration high yield credit fared somewhat better for most of the year as spread tightening offset the negative impact from rates duration, but still ended the year around flat. **Long sceptical of the very low rates offered on government bonds**, we had no exposure to these longer-duration government or corporate credits. Outside 'cash plus' strategies, our fixed income exposures (where these are held for lower risk 'Balanced' mandates) have been concentrated entirely in short-dated and floating rate high yield strategies, which returned between 3% and 7% for the year.

Our core equity managers performed well as a whole in 2021, which was notable given that there was precious little 'growth' or 'quality' tailwind through the year as a whole. One core global manager, who holds a portion of his portfolio in more cyclical, reopening-linked stocks, lagged by several percentage points as the omicron variant weighed on businesses in sectors such as airlines and payments. Periods of temporary underperformance are a fact of life in active management (on which, more below), and we remain sanguine – especially when this comes from a manager we know very well and have invested with for more than a decade, and who remains exceptionally well-aligned with his investors. As Terry Smith, the founder of Fundsmith, aptly wrote of the Tour de France in 2012:

There's at least one vital lesson for successful investment from the Tour. It will be run for the 100th time next year, yet has never been won by a rider who won every stage, and it never will.

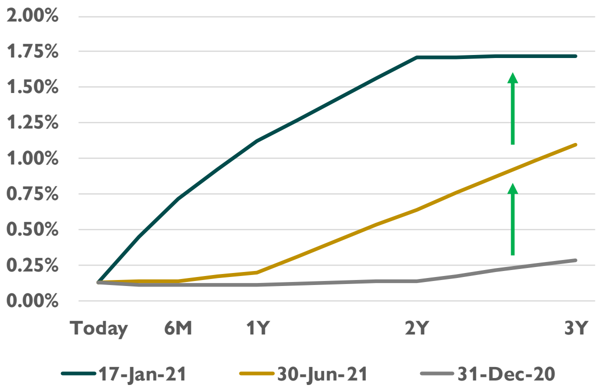
– Terry Smith, FT, 23 November 2012

No doubt the tables will be turned in due course and leadership will shift from the green to the polka dot jersey. And then back again. Of course, long-term returns are what matter and our confidence in the outstanding bench of managers we have built up over many years remains undiminished.

Removing the punchbowl

The greatest challenge facing markets today (aside from any further COVID-related disruption) is the tightening cycle which we are now clearly entering. The majority of economists expect the Fed to have ended its QE programme by the end of March, and the market is now pricing in at least three US interest rate rises during 2022, with the Fed Funds rate reaching almost 1.75% in two years' time. This is significantly higher than expectations at the start and middle of last year.

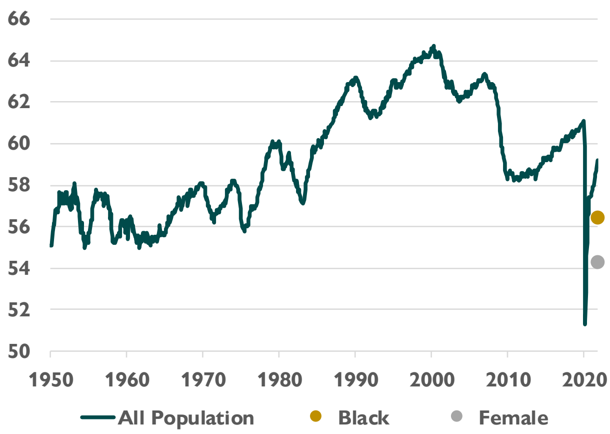
Figure 1: Market Implied Fed Funds Rates



Source: Bloomberg, 17 January 2022

The ingredients certainly seem to be in place for the Fed to act: soaring inflation, an almost full recovery in the unemployment rate, and buoyant lending markets. Subject to Galbraith's caveat earlier, however, **we believe there are good reasons to think that policymakers are likely to proceed with some caution from here**. The first is that longer-term inflation expectations remain well anchored; in fact even as US CPI has touched 7% year-on-year in December, expectations for inflation between 5 and 10 years in the future (the '5Y5Y Forward CPI Swap Rate') remain around 2.5% – below its average for the last 15 years. The second is that the headline US unemployment rate (which at 3.9% has fallen right back to its early 2019 level) reflects only part of the picture: it excludes the large number of people who are not currently looking for a job, as well as those currently doing part-time jobs who may want full-time ones. Powell's Fed focuses equally on this bigger picture, and the data suggest that there remains plenty of slack, both relative to the early 2000's and societally:

Figure 2: US Employment Ratios



Source: Bloomberg, 17 January 2022

Last year saw mixed messages from the bond market and the equity market, with the former suggesting a return to the sluggish 'new normal' of the 2010s, and the latter much more optimistic on the growth outlook. Bond markets perhaps get excessively credited with prescience at extremes: the US 10 Year yield peaked in 1981 at 16% almost two years *after* inflation had begun its long slide back down to below 5%. It seems quite possible that it has been behind the curve (no pun intended) once again.

We continue to believe there is a **good chance that growth exceeds such muted expectations in the years ahead**, unhampered by the post-2008 headwinds of consumer and bank deleveraging and widespread government austerity, and additionally propelled by the $2.3 trillion or so of excess savings in the US alone (equivalent to some 11% of GDP in consumer 'dry powder'). Growth which replenishes the workforce could well have the additional (and somewhat paradoxical) benefit of relaxing many of the supply bottlenecks which have intensified the inflationary pressures of recent months. That is in no way to diminish the likelihood of bouts of market volatility ahead as concerns about interest rates ebb and flow, or the risks to speculative 'long duration' equities whose intrinsic value lies far in the future and which are therefore especially sensitive to rises in discount rates.

While active with existing and new managers on the private investments side (on which, more below) we have added no new liquid funds during the last quarter. **We would expect given our long-term approach to be adding one or two new liquid funds per year at most** in the future. We are however close to completing our investment and operational due diligence on a US-based equity long/short manager to add to our 'Defence' stable. We expect this manager to do well over time in a very different way to our other managers, both generating attractive absolute returns and adding value at the portfolio level. Watch this space.

Ten million monkeys

We are unashamed advocates for active fund management. This may seem quixotic given the underwhelming record of the active management industry as a whole. According to S&P Global, 83% of US large cap funds underperformed the S&P 500 Index in the 10 years to 30 June 2021, while 85% of European equity funds underperformed the S&P Europe 350 over the same period.[1] The chart below shows that global active equity managers in aggregate have underperformed the standard global equity benchmark by 1.85% per annum over the last decade – notably, by more than their fees.

Figure 3: Active Managers vs. Global Equity Index

Source: Morningstar, to 31 December 2021
** Morningstar EAA Global Large-Cap Blend Equity*

Because of this underperformance, many capital allocators have chosen to divide the world into those markets in which they consider alpha is generally available and those in which it is not, and to focus their active exposure on the former. We certainly agree that there are specific markets with greater 'inefficiency', in which larger numbers of managers may be able to outperform, or indeed in which very highly skilled managers may be able to outperform by a greater margin. This forms part of the thesis behind our 'Offence' allocation to what we call Specialist Funds within portfolios, in areas such as biotech, technology, emerging markets and small caps.

Where we differ from the naysayers is that even in developed market large cap equities – where we focus some two thirds to three quarters of our long equity exposure – we consider that there exists a **relatively small number of outstanding managers which have the ability to outperform over long periods of time**. These managers are often difficult to access, capacity constrained, and unavailable to 'retail' investors for structural reasons.

Note that we are not here talking about the actual returns of investors in active funds, who generally compound the underperformance described above through injudicious market timing decisions or overtrading. A cautionary example comes from the returns of Peter Lynch's Magellan Fund from 1977 to 1990. While the fund itself achieved an extraordinary 29% annualised return, Lynch himself calculated that the average investor in his fund made only around 7% return over the same period – selling when the fund had a setback, and piling back in as performance returned, having missed the recovery in the meantime.[2] Regular readers will know where we stand on the power of 'time in the market'.

The following factors have reinforced our preference for active management over the years.

1. *Investor psychology (the right kind)*

While greed and fear cause the disappointing outcomes described above, a far more positive psychological impact can come from the fundamental support of **knowing what you own**.

It can be difficult to add to risk assets when markets are falling – especially when you have no possible handle on the prospects for the hundreds if not thousands of stocks held within passive equity indices. In these environments we have found that the ability to underwrite a concentrated portfolio of stocks – both via our internal equity team and through open and detailed discussions with the outstanding external fund managers we partner with – is extremely helpful in strengthening the conviction to rebalance portfolios by adding exposure. The discussion becomes less about where the market might be heading in the coming months (who knows?), and much more about the **resilience of the owned portfolio companies and their fundamental operating and return prospects** in the years ahead.

2. *Limitations of passive indices*

Professor Burton Malkiel of Princeton University heralded the era of passive investing when he claimed in 1973 that: 'A blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts'.[3] The same year, Wells Fargo and American National Bank launched the first S&P Composite Index Funds. In 1974 John Bogle founded low-cost behemoth Vanguard Investments, which today manages over $6 *trillion* in passive strategies.

Passive funds have a number of advantages: low fees and costs; generally excellent liquidity; style consistency; transparency; and – by tracking benchmark index returns – a reassuring absence of career risk for the wealth manager! If most active managers underperform their benchmarks after fees, the argument goes, then why attempt to outperform it at all?

We describe in the next section certain factors which we consider indicate a higher likelihood of manager outperformance. But first it is worth examining the nature of the passive benchmark itself. In particular, **the market cap weighted index is a momentum machine**: always owning more of a stock as its price rises, and owning less as its price falls. The S&P 500 ETF investor would have had her largest exposure to the Consumer Discretionary sector at the height of the 'Nifty 50' bubble in the early 1970s; to the Energy sector (a peak weight of 30%) in the early 1980s following the Yom Kippur War and Iranian Revolution; and to the Technology sector (a peak weight of almost 35%) at the height of the TMT Bubble in 2000. The Global ETF investor would have held as much as 44% in Japanese equities in 1989. From this peak it took international investors in Japan some three decades just to break even.

While Malkiel posited that a monkey could outperform the 'expert' stock picker, a number of academic studies have since shown that **the same monkey can also outperform the passive index with a high degree of consistency over the long term**. Using 100 randomly generated 30-stock portfolios, a team from Research Affiliates found that the monkeys outperformed the market cap weighted index by an average of 1.6% per annum over the period from 1964 to 2012, with a 96% success rate.[4] Going 9,999,900 better, Professor Andrew Clare of Cass (now Bayes) Business School tracked the performance of 10 million random (and more diversified) portfolios from 1969 to 2011.[5] **The proportion of these random portfolios which outperformed the market cap weighted index rounds to 100%**.

An adherent of Modern Portfolio Theory (MPT) might retort: 'So what? Of course these returns should be higher. By having smaller weights in the largest index names, these random portfolios have a higher exposure to small cap and value factors. The monkeys are therefore taking on more risk in order to generate that additional performance.' There are several counters to this. First, even accounting for slightly higher market sensitivity (beta) and volatility (standard deviation), the average *risk-*

adjusted returns of both Cass and Research Affiliates' portfolios were superior to the passive index. Second, the team at Cass illustrated that – counter to the claims of MPT – the more volatile index deciles actually tended to have *lower* returns than less volatile deciles. It appears that higher returns are not necessarily compensation for investors taking higher 'risk' after all.

Lastly though – and most importantly – we consider that **metrics such as beta and standard deviation are poor indicators of the true riskiness of a business**. The volatility of large cap global banks was lower than that of global small cap equities in the five years prior to the global financial crisis (banks 13.3% vs. small caps 14.9%). However at their worst point global banks stocks had shed some 75% of their value, and as of today are no higher (including dividends) than their 2007 peak level – while small cap stocks have almost trebled. Who would rather have owned 'lower risk' large cap bank stocks through that period?

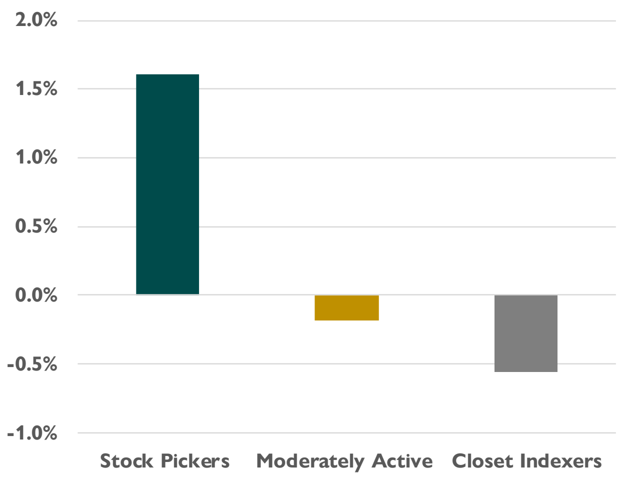
3. Active Share, etc…

If random 'monkey' stock selection outperforms over the long term, is it possible to identify managers who, by virtue of having portfolios which are also very different from the benchmark, might be able to do the same – and critically (given that the unfortunate monkeys above were working for free) might be able to do so net of fees?

A landmark in this mission came in 2009 with what Yale academics Martijn Cremer and Antti Petajisto termed 'Active Share'.[6] Their insight was that **the more different a portfolio is from the benchmark, the more likely it is to be able to outperform that benchmark over time**.

Petajisto analysed 1,124 US mutual funds over the period 1990-2009 in an updated 2013 paper.[7] After excluding those funds which exhibited the highest tracking error (indicative of managers generating their returns through exposure or timing bets rather than through stock selection), he found that those funds which exhibited the highest active share outperformed materially. Assuming a total expense ratio of 1.0% for the active managers, the impact would be as follows:

Figure 4: Net annual outperformance by manager type



Source: Petajisto (2013), Eighteen48 Partners cost assumptions

The impact of this outperformance (which was shown by Fidelity Investments research in 2014 to have exhibited impressive persistence through time, especially in weaker market environments)[8] can be very significant. Assuming a market return of 7% per annum, an investor in an index fund charging just 0.05% would have grown $10 million to $38 million. Even at a much greater annual cost of 1.0%, **the same amount invested with one of Petajisto's Stock Pickers would be worth $53 million, some 40% higher**.

Alongside high active share (which our equity managers, being fundamentally driven, relatively concentrated and benchmark agnostic, all exhibit) there are other factors which are likely to have some bearing on performance over time.

(a) Fees are clearly impactful. High fees can provide a significant headwind to performance over time, and the compounded effect of this can be significant. That said, we generally caution investors against fixating too much on the absolute level of fees (the so-called 'look-through TER') and instead recommend a focus on **appropriate fees for the strategy and manager quality**. It would be easy to construct a passive portfolio with an extremely low look-through TER; but our expected long-term returns for this portfolio would be meaningfully lower than for the actively managed portfolios we generally build despite the differential in fees.

(b) A long time horizon and its corollary, low portfolio turnover, are factors we generally look for in our managers. High portfolio turnover not only incurs greater costs for investors but can also be indicative of a shorter-term, more trading oriented style of management which is less likely to outperform over the long term. Cremers and Pareek (2015)[9] found that, among high active share portfolios, only **those in the top quintile by holding period (average holding period in excess of two years) outperform the index** on a risk adjusted basis – but they do so significantly, by over 2.0% per annum net of fees.

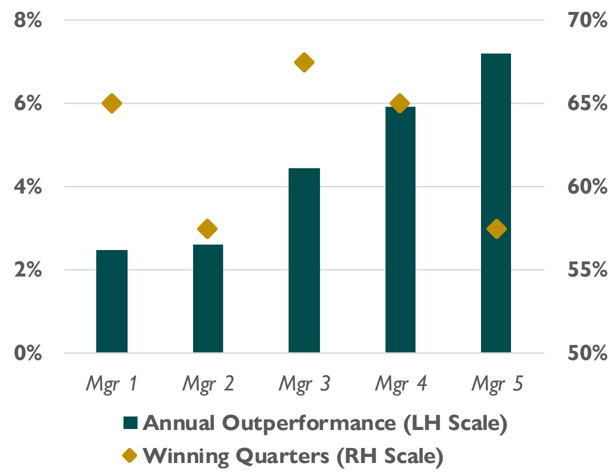
(c) Finally, **portfolio concentration**. We build concentrated portfolios for our clients, and we prefer fund managers that do the same. While concentration itself does not guarantee superior returns, it does create higher *potential* for outperformance than portfolios which are over-diversified. Higher concentration indicates higher conviction in each portfolio holding; and it allows the manager to focus their time more fully on individual positions, and not get distracted by (or complacent about) smaller 'tail' positions. It allows successful positions really to move the needle for investors in those funds. There is an interesting body of research here but perhaps the key data point comes from Emory University research in 2006: over their approximately 25 year measurement period, 'concentrated managers outperform their more broadly diversified counterparts by approximately 30 basis points each month, or roughly 4% annualized'.[10]

Conclusions

Putting this all together, we consider that **funds which are truly 'active', which exhibit low portfolio turnover and high concentration, which charge appropriate fees, and which – we would add – are managed by independent managers with a high degree of alignment with their investors, stand a good chance of generating meaningful outperformance of passive funds or ETFs for patient investors**.

Investing in active managers can require patience and resilience. Leadership is far from consistent over shorter periods of time such as quarters rather than multi-year periods. Our 'Core' equity managers, to which we allocate the majority of our equity capital, provide an interesting case in point. We have owned these funds within client portfolios for between 7 and 17 years. While each has gone through periods of underperformance, the overall results have been outstanding.

Figure 5: Outperformance vs. Winning Quarters



Source: Bloomberg, Managers, Eighteen48 analysis

What the chart above shows is that while these managers have outperformed by between 2.5% and 7.2% per year over the last decade (for total returns ranging between 36% and 128% greater than the index), **no fund has outperformed the global index in more than two thirds of calendar quarters during that period**. In fact, the best performing fund overall (Manager 5 above) had the joint lowest quarterly success rate of below 60%!

For most investors (and indeed allocators with excessive scale, lack of access or other limitations), we agree with Warren Buffett that:

Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.

– Berkshire Hathaway Annual Letter, 1997

But for those who have the time, resources and access required to source, diligence and build relationships with the outstanding few, and the patience and conviction to partner with them through both the flat-out sprints and the grinding hill climbs, we are convinced that the long-term results will continue to speak for themselves.

Edward Clive

Chief Investment Officer

Sixteen02 Global Equities

What's your Portfolio's IQ?

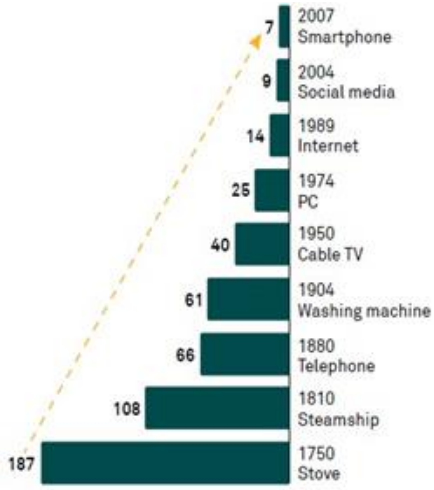
During the Christmas break we had a chance to watch the Christopher Nolan movie *Interstellar*. There comes a scene when a group of astronauts depart from their mothership (left manned by a colleague) to investigate a planet that is orbiting closer to a black hole. After several 'hours' they return to the mothership only to find an old man – who was none other than the colleague they had left behind! This scene was a masterpiece in that it portrayed the impact of time dilation as postulated by Albert Einstein's theory of relativity – yes that famous equation $E=MC^2$!

Clocks seems to run slower closer to high gravitational forces (such as black holes) or when objects travel at speeds closer to that of light. So, a several hour stint on the planet was equivalent to decades on the spaceship resulting in a differential in aging!

The parallel on earth made us wonder, what could help slow the "clock" of our portfolio companies so that they age slowly, and prolong their growth in this disruptive environment – just as the gravitational force of the black hole did to the age of the astronauts visiting the planet?

Today, new products and technologies emerge and permeate markets, our daily lives, and the broader economy at an astounding rate. As shown in the Figure 6 below, it took almost 66 years for the telephone to reach a 50% market penetration whereas it took just 7 years for the smartphone to reach 50% penetration. This phenomenon is exerting significant pressure on companies as they race against the clock to adapt and thrive.

Figure 6: Years from Market Entry to 50% Penetration



Source: Greenwich Associates

So, in this disruptive environment, we find that a quality company enjoys many structural attributes that helps extend the duration of its growth versus the competition (i.e., akin to slowing down the clock). Our past quarterly missives have touched on a few of these factors and attributes.

In July 2021, we discussed how operating in a structurally advantaged industry helps with long term compounding as it reinforces significant reinvestment opportunities (remember Mark running a shop in Zuckland vs Jeff running a shop in Penguin land?)

In the same letter we talked about management quality and its ability to spot and prudently allocate capital to high return opportunities.

In October 2021, we mentioned two "metamorphic ants" in our portfolio – ThermoFisher and Abbott Laboratories – with a focus was on resilience in the face of adversity and how they went about acquiring it.

However, we observe that the common denominator among all is 'innovation' and therefore it is important to keep an eye on your portfolio's Innovation Quotient (IQ)!

Innovation may mean different things to different people: finding new ideas that others don't see, providing a similar outcome in a less expensive and more efficient way, creating an intelligent process/approach to solve a problem, etc.

The aforesaid companies and many others in our portfolio are all highly innovative – **they invest heavily in various resources – tangible & intangible assets, human capital, etc – to build the necessary capabilities well in advance, so that they can swiftly respond to a market**.

A company discussed in fair detail in our very first letter in January 2021, ASML has invested significant capital for more than a decade that has helped establish a 'quasi monopoly' moat – newer and better tools to shrink semiconductor production.

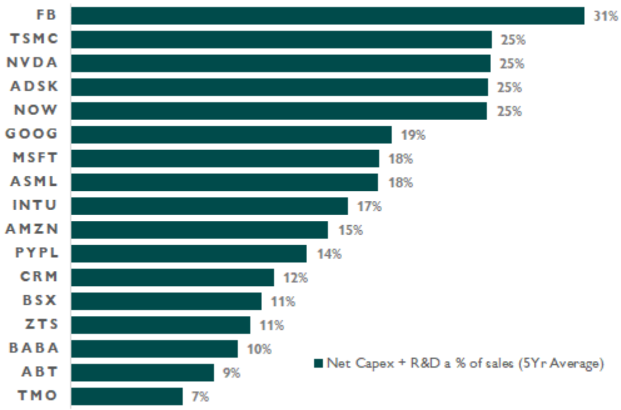
Another of our portfolio companies is Taiwan Semiconductor Manufacturing Company (TSMC). It is the largest foundry company in the world and fabricates high-end chips for most of the leading fabless semiconductor companies such as Apple, Nvidia, MediaTek, etc.

After investing heavily for many decades, it has become the leader in chip fabrication and consequently displaced even Intel. Due to tighter integration with customers, TSMC is in a privileged position to know its customers' (such as Apple's) product pipeline, years in advance. As a result, it can take the risk of investing heavily and out innovate its competitors to meet the future demand of its customers.

In the above-mentioned cases, the investments and the outcomes are broadly measurable. Heavy investment in research & development (R&D) as in ASML leads to large numbers of patents and a technologically superior tool. Similarly, heavy investment in capital expenditure (capex) results in capacity increases at TSMC and other tangible assets in the form of manufacturing facilities, warehouses, and the like.

The table below shows the average R&D and net capex as % of sales, as a proxy for this innovation edge.

Figure 7: Sixteen02 Portfolio Reinvestment Ratio Remains High



Source: Sixteen02

However, what is very hard to measure and generally expensed away in the P&L is investment through operating costs (opex), such as hiring & retaining data scientists and programmers. This spending also contributes to innovation as it creates newer processes and 'know-how' within a company, the impact of which would only be felt years later.

Amazon is a good example of this dynamic. When it built an e-com platform, it invested heavily into the server infrastructure, technological architecture and, most importantly, the human resources that enabled the development of scalable software and hardware. Years later, these investments led to the creation of Amazon's cloud platform, AWS, now one of the most profitable businesses within the company.

Similarly, Amazon also managed to build a highly profitable advertisement business, which is the third largest in terms of revenue, using the very resources and capabilities that it built within the e-com business. In essence, Amazon was able to leverage its investments in R&D, capex & opex to bring out additional, value accretive businesses that would have been missed by anyone who was solely watching valuation multiples.

This is increasingly the case with many high-quality companies since, for competitive reasons, they often disclose minimal information about their opex investment line, R&D focus, etc.

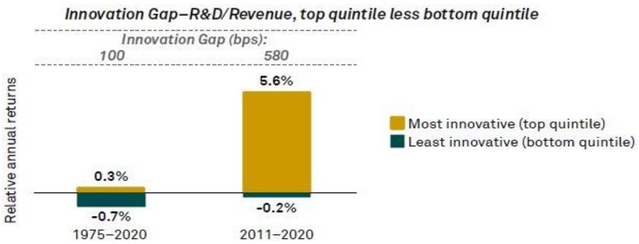
Innovation is not, however, without risks as there is no guarantee that all the R&D, capex and opex investments translate into prolonged growth at the firm. Similarly, newer technologies may face regulatory obstacles or may fail to displace old ones.

We focus all our energy in understanding a company's business model, reinvestment opportunities and most importantly following them and the sector for some time, so that we can clearly understand the innovative edge of a company.

So does the market reward this innovation?

The answer is a resounding 'yes'. Innovative companies do outperform the market over the long term. As shown in the figure below, over the past decade companies in the top quintile in R&D/revenue spending outperformed the market by 560 bps in annual returns as compared to bottom quintile companies.

Figure 8: Innovation Outperforms



Source: Greenwich Associates

In conclusion, our focus is to find those gems that can effectively 'slow down their clock' relative to their competition and extend the duration of their growth, which invariably means that they will help in compounding your capital for a longer period!

A futuristic and thought-provoking quote we heard from one of your portfolio companies' CEOs in November 2021 is:

The virtual world will be larger in economics than the physical world.

– Jensen Huang (Nvidia CEO)

The future is full of possibilities for your portfolio companies.

Chandan Khanna
Portfolio Manager, Sixteen02 Global Equity

Nineteen01 Private Investments

There are two questions that clients invariably ask when they are considering committing to a private equity programme. And the word commitment here is important because it is just that, a long-term commitment, not something that can easily be increased or reduced at will as in public markets. The two questions are invariably along the following lines: (1) Is now a good time to invest in private equity? and (2) Isn't there too much money in the asset class? While I would love to respond that these are myths that must be debunked, they are both good, rational questions for clients to ask and I offer some thoughts as follows:

Is now a good time?

For those who are conditioned to investing in public markets, who are used to having the ability to over-weight or under-weight specific companies, sectors or geographies, to shift allocations, to hedge, to sell short or just to take advantage of valuation anomalies, this question is often top of mind. The desire to adjust portfolios as valuation opportunities arise can be overwhelming – daily liquidity and price transparency offers just that possibility. But get the timing wrong and you enter at too high a price or sell too low.

To build a successful private equity funds programme, this mindset has to be put to one side. The very nature of 'committing' to a blind pool fund means that the day you decide to invest in the asset class you put no money to work. There is thus no buy and sell decision, just a commitment to provide capital to a manager when they find an attractive investment opportunity. A decision to invest in a single private equity fund is therefore a decision to drip feed capital into underlying companies over a period of generally up to five years, and a decision to develop a broader PE programme provides even more diversified exposure over a longer time period. The issue around timing is therefore really a non-issue as a portfolio builds up so gradually over time that investors are not 'buying in' at a particular point in time and are therefore not making a market timing decision. In summary, there is never a bad time – and it is never too late – to start, but your deployment rate must be consistent and your horizon sufficiently long-term.

Isn't there too much money in private equity?

There are $11.4tn of assets under management in private markets, broken down as $8tn of net asset value ('NAV') and $3.3tn of dry powder (i.e. capital waiting to be invested). Private equity accounts for $7.7tn of this ($6.3tn if double counting of funds-of-funds and secondary funds is excluded), of which $5.5tn is NAV, spread across many thousands of underlying companies.[11] These sound like big numbers, and of course they are, but this is approximately the same value, **for the entire private equity industry**, as the market cap of the world's two largest companies, Apple and Microsoft (let's ignore Saudi Aramco for now), or just 6% of the capitalisation of Bloomberg's global stock market index which is $98tn. The median market cap of a constituent of the S&P 500 is $34bn, **over 50 times as large as the average size of one of the 8,424 buyout deals completed in 2021** (which was $607m) and also more than twice as large as one of the largest buyouts ever completed, last year's $34bn acquisition of Medline Industries by a consortium of Blackstone, Carlyle and Hellman & Friedman. In the UK, there has only ever been one private equity backed takeover of a FTSE 100 company (Boots, which was acquired by KKR in 2007).[12] And despite the high level of PE-backed M&A activity in the UK in 2021 which reached $631bn, the average deal size was still less than $100m. Private equity exposure is, by definition, exposure to businesses at the smaller end of the size spectrum and the runway remains huge.

In summary

Investors must want to be in this asset class for the long-term and make a commitment to allocate capital consistently across multiple vintages, riding out both the good and the less good years. Our overriding task is to select high quality managers with a record of investing successfully through cycles, and to make direct investments into long-term growth businesses that can enhance the returns from the funds we select. In summary, we believe that a commitment to the asset class is likely to be well rewarded with outperformance of public market equivalents over the long term.

Nineteen01 – Private Funds

We wrapped up the investment period for Nineteen01 Private Investments I during the quarter and have begun deploying capital for the second vintage, for which rolling closes are underway. As a reminder, Nineteen01 Private Investments II is divided into a Core sleeve which is focused on buyouts and a Growth sleeve which is focused on venture and growth. Both vehicles will be at least 75% invested in funds and up to 25% in direct investments. Nineteen01 II Growth made its first two fund commitments during the quarter to Dragoneer Opportunities Fund VI and Axiom Asia Opportunity Fund – our first commitment to an Asian private equity manager in these programmes. A short summary of each is provided below.

Dragoneer Opportunities Fund VI

In October we made a commitment to Dragoneer Opportunities Fund VI ('DOF VI'), a manager that we also invest with through their flagship public / private fund. Dragoneer is a growth-oriented investment firm with over $25bn in asset under management across public and private equities with a particular focus on technology-enabled businesses. It manages a $10.8bn hybrid flagship fund, Dragoneer Global Fund II, and raised $3.8bn for its sixth private fund, which will make investments in private companies alongside the flagship fund. Dragoneer is led by its founder Marc Stad and has 46 employees operating from a single office in San Francisco.

DOF VI will invest in high quality, growth-oriented, private companies characterised by defensible competitive positions and robust financial models with a focus on capital preservation. Dragoneer takes an opportunistic approach to investing in exceptional growth businesses worldwide with sustainable differentiation and superior economic models at entry points when they are priced to offer compelling returns with a margin of safety. In terms of sectors and geographies, Dragoneer's private investments are focused principally on North America and China and in companies focused on Software, Internet and Financial Services. We believe Dragoneer is an exceptional investor in later stage growth companies, regardless of whether they happen to be privately held or publicly listed, and are excited by the opportunity to access high quality, fast-growing private companies through this vehicle.

Axiom Asia Opportunity Fund

In December we made a commitment to Axiom Asia Opportunity Fund ('AAOF'), a secondary direct fund managed by Axiom Asia to acquire privately held positions in Asian growth-stage companies on a secondary basis. Axiom Asia was founded in 2006 by a team from the Singapore sovereign wealth fund GIC, and over the last 15 years has grown to become one of the leading private equity fund-of-funds managers in Asia with $8bn under management and a team of 50 operating from offices in Singapore, Taipei and Shanghai.

Axiom expects to invest in c. 15-25 companies with equity cheques of between $10-40m. Target companies will typically be fast growing businesses in the region, particularly in China, in the Technology, Consumer and Healthcare sectors and will usually be owned by private equity managers known to Axiom and may well be existing assets in Axiom's portfolio. 70% of capital is expected to be deployed in Chinese growth companies with the remainder invested across Korea, Japan, Australia, India and the rest of South East Asia. A small proportion of the Fund will be invested in buyout assets, principally in the more mature markets of Japan and Australia. AAOF closed on $330m and had made four investments at the time of final close in China, New Zealand and South Korea.

And finally . . .

Last quarter we highlighted that we had made an investment in Level 5, a first time fund focused on the health & wellness space in the US. We mentioned that it was a relatively unusual investment for us given it is an emerging manager and our primary focus is on backing established, blue chip groups with proven track records. One of the attractions of Level 5 was that they had already made investments in four platform businesses and some near term realisations were expected. We were naturally delighted when in December Level 5 portfolio company Restore Hyper Wellness announced a $140m investment led by General Atlantic. While Level 5 will continue as an investor in the company, it did sell some shares as part of the new round meaning that investors, including Nineteen01, received proceeds amounting to 24% of the capital called by Level 5 to date. While we are happy to be long-term investors in businesses, it is also rewarding to receive capital back quickly, in this case just five months after the commitment was made. Happy New Year indeed and many congratulations to Chris and the Level 5 team.

Nineteen01 – Direct Co-Investments

In Q4 2021 we invested in Benhauer, a European cloud based marketing automation platform based in Poland. The company's platform ('SALESmanago') is used by e-commerce retailers to run mission critical marketing campaigns aimed at winning, retaining and upselling clients. The strategy is to expand in Europe to become a European champion marketing automation SaaS platform. We backed SilverTree, a fundless sponsor that specialises in software, technology and tech-enabled business services in Europe and the US. Perwyn, a private equity investor backed by the Perrodo family, owns 50% of he investment and is a co-controller with SilverTree. The investors also include several well-known Advent partners and the CEO of one of Advent's most profitable investments, Rafał Brzoska, who will sit on the Board.

We are pleased with the existing co-investments (Engineering Ingegneria Informatica, Thyssenkrupp Elevators, ClimateCare, Xpath and Gruppo Florence) which continue to trade well.

Charles Magnay
Head of Private Fund Investments

Oliver Mayer
Head of Direct Private Equity

What we have been reading …

The Key Man *by Simon Clark and Will Louch*

Written by Wall Street Journal duo Simon Clark and Will Louch, *The Key Man: How the Global Elite Was Duped by a Capitalist Fairy Tale* is both an edge-of-your-seat crime thriller and sobering tale of moral bankruptcy.

The authors' work chronicles the rise and fall of Abraaj Capital, a once preeminent emerging markets private equity firm, and its dynamic but dubious founder Arif Naqvi. From humble beginnings, Naqvi built the firm into a regional and then global darling with over $13 billion in AUM on the imprimatur of combining noble and profit-seeking 'impact investing' with the developing wold. Deals ranged from utilities in Pakistan to industrials in the UAE to healthcare in Uganda.

Naqvi's reputation as a benevolent capitalist and philanthropist captivated the Davos set and many a capital allocator in the West, including the Bill & Melinda Gates Foundation. However, the firm was increasingly teetering on shaky foundations due to the Icarian hubris of its iconic founder. Not one to be held back by such earthly issues as proper fund governance, distribution waterfalls or expense caps, the authors implicate Naqvi in a well-orchestrated and fraudulent manipulation of limited partners' funds. One Abraaj fund would often loan drawn (but not yet invested) LP funds to plug accounting gaps in another Abraaj fund or indeed to the GP itself for lavish professional (and personal) spending above and beyond its management fee entitlement. Carrying values of portfolio companies were blatantly massaged for fund-raising purposes. Distributions on older vintages lagged what was indicated to LPs. All along the way, there was a string of disgruntled employees and partners.

As with so many similar characters, Naqvi presumably believed it could all eventually be put right by his myth and magnetism – he was 'doing good'. However, a whistleblower to the Wall Street Journal and various LPs who couldn't reconcile the real detail of their and the funds' statements eventually brought the charade to an ignominious end.

A scintillating read, *The Key Man* is a vivid reminder to LPs of the need to be ever vigilant and inquisitive – all that glitters is not gold – but it is also a tragedy for all to learn from, as the firm need not have ended up this way were it to have pursued a normal course of growth; there are no shortcuts.

Tarek AbuZayyad

Money *by Jacob Goldstein*

Provocatively subtitled 'The True Story of a Made-up Thing', Jacob Goldstein takes us on a whistle-stop tour of the development of money 'from Bronze to Bitcoin', challenging us along the way to think closely about what the money we have in our bank accounts, wallets or even digital wallets actually is.

Money has taken a variety of forms over the centuries: from proto-money such as cattle, cowrie shells and sperm whales' teeth; to physical money such as gold, silver and bronze coins, or less conveniently the monumental stone disks of Micronesia; to paper money, whether backed by precious metals or not; to digits in a bank ledger; to decentralised 'cryptocurrencies' such as bitcoin which are gaining traction today. Goldstein illustrates how this development was far from linear. China moved early from coins to physically backed notes and then remarkably – under Kublai Khan in 1287 – to paper money with no backing, rather like today's – before the subsequent Ming dynasty swept it all away, dragging the country back into an idealised agrarian past in which the average person was poorer than their ancestors 200 years before. The lesson though was a profound one: 'people in China had figured out that paper money worked not because it was backed by silver and bronze, but because everybody agreed paper could be money'.

It is sobering to think that it took the Western world until the 1970's finally to kill off the idea that money had to be backed by bars of shiny metal, a construct which led among other things to the worst depths of the Great Depression as the Fed actually *raised* interest rates in 1931 in order to prevent the outflow of gold from its coffers. The gold standard lives on conceptually not only in the nostalgia of the American alt-right but also more problematically in the construct of the European single currency, with its tendency – well explained by the author – to crucify its weaker member states upon a cross of blue (with apologies to William Jennings Bryan).

Goldstein traces the development of financial infrastructure, from retail banks to central banks to 'shadow banks' and the once-mighty investment banks of recent times. The growth of the modern monetary system brought its share of scandal and scoundrels – not dissimilarly to the world of digital assets as it matures into a more institutional asset class – such as John Law's Banque Royale and the giant Mississippi Company fraud which are vividly described. It also, more positively, brought about an immense rise in general prosperity as capital could be deployed more efficiently and productivity took off.

The book ends with a survey of digital forms of money – from the 'radical dream' of David Chaum's DigiCash in 1989 (private but centralised) to 'Satoshi Nakamoto' and his invention of (fully decentralised) bitcoin. One can't help feeling slightly sorry for Laszlo Hanyecz who in the first recorded bitcoin transaction handed over 10,000 bitcoins for a couple of Papa John's pizzas in 2010; the same assets would be worth $435 million today. Goldstein is alive both to the libertarian advantages of a secure, decentralised store of value and also the numerous challenges, both ethical and more structural. Bitcoin may have value, but he argues that it is not yet *money*: for people who wanted bitcoin to become money, he argues, 'the wild rise in bitcoin's value was a disaster'. Maybe it will become so in future, but it will require a far greater degree of stability to transition from a speculative, early-stage asset to a genuine store of value or widely accepted means of exchange.

Above all this book reminds us of the changeable nature of what we as societies collectively agree to be money. 'Whatever money is at a given moment comes to seem like the natural form money should take, and anything else seems like irresponsible craziness.' As he surveys the future possibilities for money (central bank digital currencies among them) Goldstein concludes that only one thing is certain: 'Money will change. The way we do money will look as strange to our great-great-grandchildren as a world where banks print their own paper money with pictures of Santa Claus'.

Edward Clive

Endnotes

[1] *https://www.spglobal.com/spdji/en/research-insights/spiva/*

[2] *Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds in Your Favor*, Spencer Jakab, 2016

[3] *A Random Walk Down Wall Street*, Burton Malkiel, 1973

[4] *The Surprising Alpha from Malkiel's Monkey and Upside-Down Strategies*, Robert Arnott et al., Journal of Portfolio Management, Summer 2013

[5] *An Evaluation of Alternative Equity Indices*, Andrew Clare et al., 2013

[6] *How Active Is Your Fund Manager? A New Measure That Predicts Performance*, Antti Petajisto & Martijn Cremers, 2009

[7] *Active Share and Mutual Fund Performance*, Antti Petajisto, 2013

[8] *Active Share: A Misunderstood Metric in Manager Selection*, Tim Cohen et al., 2014

[9] *Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently*, Martijn Cremers & Ankur Pareek, 2015

[10] *Fund Managers Who Take Big Bets: Skilled or Overconfident*, Jeffrey Busse et al., 2006

[11] Preqin data as at 30 June 2021

[12] Morrisons, which was acquired by CD&R during 2021, had been in the FTSE 100 but was a FTSE 250 company at the time the acquisition was announced.

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