Quarterly Perspectives

Q4 2022

Dear clients, partners and friends,

Market corrections over the past twelve months may be unwelcome and painful for companies and investors alike but they are a stark and healthy return to reality. The past decade and a half since the 2008 Great Financial Crisis saw gross market distortions exemplified by 'who's-paying-whom' negative government bond yields, eye-watering venture valuations and nose-bleed buyout leverage. Somehow, like that carousing colleague at the Christmas party, it all makes sense until it doesn't – human nature has a heedless way of justifying 'just-one-more'. Investors simply grew too spoiled for too long by an ever-present Fed 'put', thereby mis-pricing risk.

While the morning after invariably brings some semblance of regret, the current chastened environment is scarcely more than normal – US 10 year at 4%, global equities at 16x P/E and high yield bonds yielding > 10% are all in the attractive Goldilocks zone for markets, neither too hot nor too cold. The long-term outlook is attractive. True, the spectre of runaway inflation in the short term must yet be tamed and consequently corporate earnings may yet leg down (suggesting higher pro forma market multiples). However, benchmarking against historically normal market environments suggests that we still have an ample buffer in terms of further rate rises and multiple expansion.

A wise old investment banking MD once said, everything boils down to speed, quality and cost. You can have two but you can't have all three.

- If you want high speed and high quality, then it's going to cost you dearly.
- If you want high speed and low cost, then quality ends up compromised.
- If you want high quality and low cost, then be prepared to wait a while.

The last decade tested the limits of this maxim. Companies could have it all – plentiful, low-cost debt, high valuations, quick growth and ever-present access to all three. The period ahead will likely 'mean-revert' to the essence of the adage. Pick your two as an investor. At Eighteen48, we tend to favour higher quality at a reasonable cost but are prepared to wait. We are definitionally in the long game.

On the organisational front, we warmly welcome our newest colleague and Head of Legal and Compliance, Roya Abrams, who recently joined us from EnTrust Global and with a background at several multinational financial services firms. We closed 2022 with twenty-five talented titans on the field strongly supported by two passionate player-coaches.

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

Julien Sevaux
Tarek AbuZayyad
12 January 2023

CIO Review

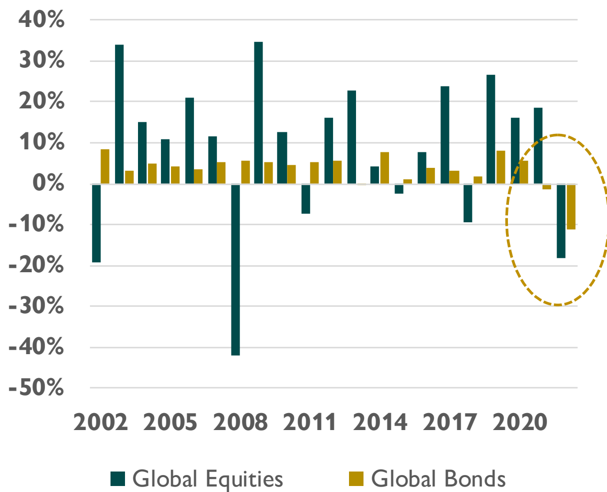
The end of free money

And so the second 'bear market year' of the last three draws to a close. 2022 was a year many would prefer to forget, with its surging inflation, rising interest rates and broad economic slowdown globally; war and the associated energy crisis in Europe; and here in the UK a sense of political unreality with two sovereigns, three Prime Ministers and four Chancellors in only 12 months. The war in Ukraine and unresolved tensions between the US and China remind us after a long period of relative calm that peace, globalisation and financial stability are by no means inevitable or permanent.

While the peak-to-trough declines in risk assets were less severe than during the COVID crisis, 2022 was the most negative calendar year for the equity and high yield credit markets for almost 15 years, with global equities falling by

18.4% and global high yield by 12.7% in US dollar terms. Unlike the 2002, 2008, 2018 or intra-year 2020 market declines, investment grade bonds failed to provide an offsetting safe haven, with the Bloomberg Global Aggregate index ending the year down by more than 11%, after its deepest peak-to-trough drawdown for at least 30 years (-26% between January 2021 and October 2022).

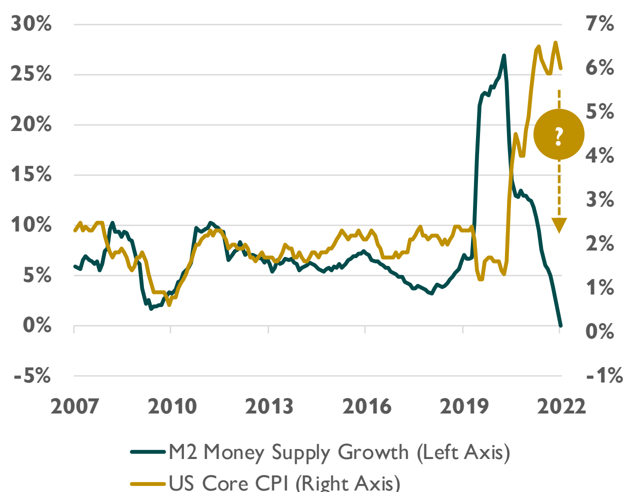
Figure 1: No protection from bonds this time



Source: Bloomberg, January 2023

The greatest direct impact on markets through the year came from widespread consumer and input price inflation and the monetary policy responses to it (both actual and expected). This **monetary tightening has already had a powerful impact**, with US money supply growth falling back to zero at the end of November – which may well presage further declines in the core rate of inflation:

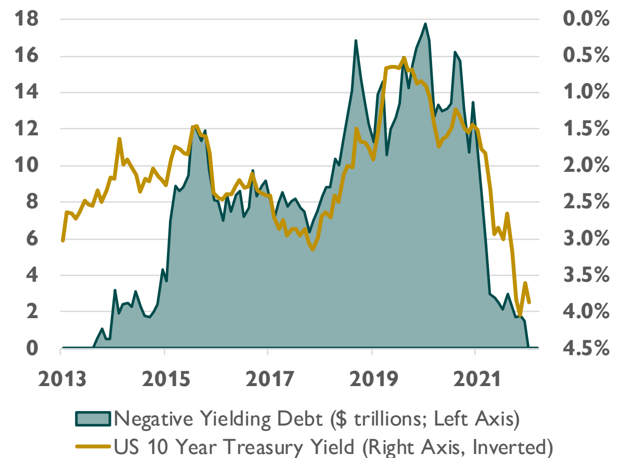
Figure 2: M2 Money Supply growth spike has unwound



Source: Bloomberg, January 2023

Meanwhile the **'ZIRP'** (Zero Interest Rate Policy) **era appears to be well and truly behind us**. As government bond yields have risen across the curve, the stock of negative yielding bonds globally – which rose from near zero in 2013 to peak at $18 trillion in December 2020 – returned to near zero again at the end of last year:

Figure 3: Round trip completed for global stock of negative yielding debt



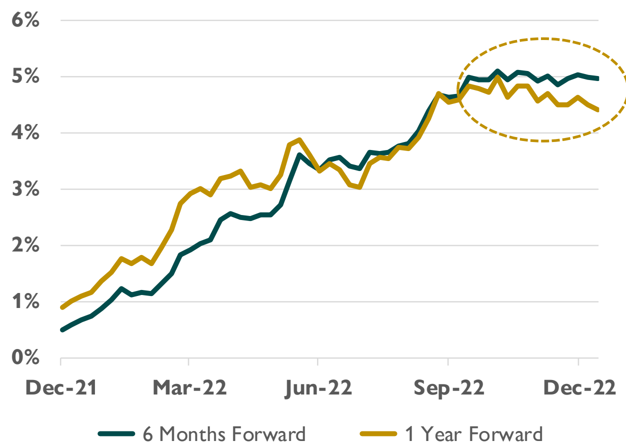
Source: Bloomberg, January 2023

This environment has shined a powerful light on those who in Warren Buffett's famous phrase have been 'swimming naked' – who didn't do the work, or used too much leverage, or bought assets at crazy valuations, or a combination of all three. Meanwhile the collapse of FTX and indictment of Sam Bankman-Fried provided us with a textbook example of what economist JK Galbraith termed the 'bezzle': the 'inventory of undiscovered embezzlements' which proliferate in times of rising markets before being revealed as the waters recede (cf. Bernie Madoff in late 2008). As SBF is carted off from the Bahamas to Manhattan to face US justice, the end of free money could not be more starkly drawn.

Back to the Future?

Last year saw the sharpest increase in interest rates since the 1980s. However with projections for peak Fed Funds rates stabilising over the last couple of months at around 5% (in mid-2023), monthly inflation figures rolling over, and long-term inflation expectations anchored at historically normal to low levels, there are indications that – if by no means over – **the worst of this hiking cycle may now be behind us**. As outgoing Chicago Fed president Charles Evans put it in a recent interview: 'we finished the frontloading, and … the Fed's not that far from where they need to be' *(WSJ, 6 December 2022)*.

Figure 4: Peak Fed rates expectations have been stabilising around 5%



Source: Bloomberg, January 2023

The question now is what degree of damage this tightening will inflict on economies. Monetary policy famously works with 'long and variable lags', as Milton Friedman put it; he compared the risk of overaction by central banks to 'a fool in the shower' – too impatient to wait for the water temperature to adjust as he turns the dial, he alternately freezes and scalds himself as he overcompensates each time. **Central banks face a particular challenge when economic data are as variable and often contradictory as today**.

At the epicentre of the energy crisis, and with leading indicators in contractionary territory since the third quarter of last year, Europe may well already be in recession. That said, the regional outlook has been highly dependent on volatile energy prices and as those subside (European spot gas prices are now 76% off their peak and back to their pre-Ukraine level) some commentators are beginning to foresee a recovery in the coming months.

The probability of a US recession is more contentious; for example Bank of America, Deutsche Bank and UBS all expect a recession in 2023, while BCA, Credit Suisse and Goldman Sachs expect one to be avoided. The strategists' commentary and range of expectations suggest that **if a recession does occur it is likely to be relatively shallow**. This fits with our view on the underlying economic robustness (across the consumer, corporate and banking sectors) in both the US and Eurozone, and the absence of severe imbalances which typically precede deep recessions or systemic crises. Current indications from real-time data compiled in the Atlanta Fed's 'GDP Nowcast' suggest an absence of significant downward pressure for now:

Figure 5: US GDP and Atlanta Fed 'Nowcast'

Source: Bloomberg, January 2023

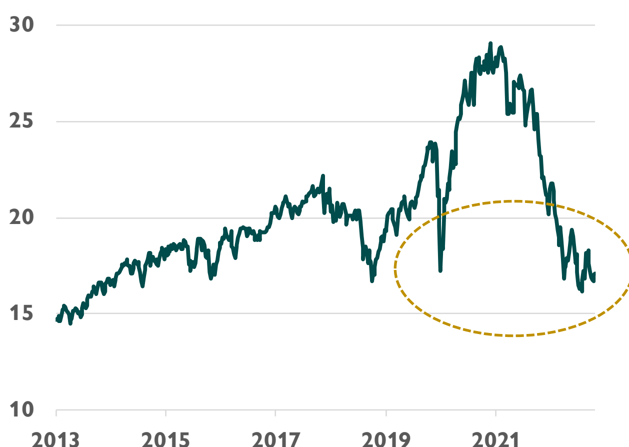
This economic uncertainty **sets the stage for continued choppiness as we enter 2023**, given central banks' clear determination to tighten conditions sufficiently to bring inflation back down towards their long-term targets. Both strong and weak economic data pose challenges. Strong economic data (and especially employment data) imply upward pressure on price and wage inflation, meaning that even more restrictive interest rates may be required. On the other hand, weak economic data (or better news on inflation) are liable to be front-run by equity and credit markets pricing in a 'dovish pivot', loosening financial conditions (via higher stock values and lower borrowing costs) and again implying that more restrictive rates may be required.

In line with a slower overall backdrop, corporate earnings expectations have been revised down quite materially from their highs (e.g. global EPS estimates for 2023 have declined by some 9% from 12 months ago). However, there is a broad consensus among Wall Street strategists that consensus earnings are still too high. 'Bottom-up' estimates (i.e. aggregated from underlying company models) for S&P 500 EPS in 2023 are currently c. $225 per share, implying growth of 9% through the year. (Such estimates almost always start too high and are revised down as the year progresses.) However, many strategists are forecasting index EPS well below that level: for instance, Bank of America expect $200, Citi Wealth Management $186, Deutsche Bank $195, JP Morgan $205, and UBS $198. We do not have an edge in predicting where earnings will end the year in the US or globally, but it is clear that earnings which are flat or up to 10% below last year's levels (implying flat to negative real EPS growth over the last two years) should not come as a surprise.

The good news is that these risks have been widely telegraphed and **equities and bonds have pre-empted macro weakness quite substantially** (even if one can never be certain that they have done so fully). We highlighted the depth of negative sentiment in our last quarterly and it is still the case that bulls are few and far between; the latest Bank of America survey shows that the vast majority of respondents expect weaker growth next year and that allocators continue to hold elevated cash levels and have moved to be overweight bonds for the first time since the Global Financial Crisis. This caution continues to be reflected in individual investor surveys and hedge fund manager positioning.

This widespread negativity has also been reflected in the valuations of equities and high yield bonds. At their lows in October (from where they recovered by c. 10% to the year end), global equities were down 26% in USD terms, while global high quality equities were down some 30%. Using the S&P 500 Index for comparison (as this has the longest price history) the median drawdown in non-recessionary periods post-World War II has been -21%, while the median decline of all major bear markets over that period has been -28%. At the October 2022 market bottom, global equity P/E valuations had fallen to their 7th percentile of the last 30 years and high quality equities were valued below their COVID trough level – close to where they remain today.

Figure 6: Historic P/E valuation of MSCI AC World Quality Index below its COVID trough



Source: Bloomberg, January 2023

The short-term outlook is as unpredictable as ever, but it certainly looks as if the drawdown of 2022 'priced in' a mild global recession based on historical analogues.

In this context, investors need to balance the possibility that central banks keep conditions restrictive for longer with the fact that **risk assets are a lot cheaper, prospective long-term returns are attractive, and it will be impossible to time the bottom of the market when it comes**. We do not think this is an environment for heroics but equally it is generally a bad idea to reduce risk at low levels, and our portfolios are designed to perform within clear risk parameters which are appropriate to each mandate.

We leave the last word to one of our core global equity managers, who considers what we are seeing at corporate level as being closest to a 'normalisation' of revenue growth and margins back to pre-COVID levels, following the post-COVID surge in demand. His portfolio businesses continue to report 9% organic revenue growth in aggregate and profit margins which have fallen back to their 2010-20 average levels following super-normal returns in 2021. Now that the market has fully adjusted for the impact of higher interest rates (which he considers to account for c. -15 percentage points of portfolio return, an estimate which our own calculations support) his conservative growth projections imply 10 year portfolio returns from here which are higher than from the depths of COVID, and comfortably into double digits.

Portfolio Update and Activity

There were few places for allocators to hide during 2022. The traditional 'Balanced' 60/40 portfolio (allocated 60% to global equities and 40% to global bonds) fell by just over 15% in US dollar terms during the year, not far behind the 'Growth' 75/25 equivalent which was down 16.5%. Early indications of wealth management peer group returns suggest similar returns for Balanced and a slightly worse outcome for Growth portfolios.

While a number of portfolio holdings are still to price, we expect that **our core endowment-style Growth mandates including private investments will be down in the single digits for the year**, while portfolios which have more restrictive liquidity constraints will be closer to the peer group returns. Three key factors have affected returns across the various mandates.

Firstly, the level of private investments, which have been relatively resilient through 2022 to date. We provide a detailed update on our private equity activities below, but it is worth addressing briefly here the question of whether this resilience is real or illusory. Much has been written recently about the 'failure' of private equity managers to mark down their portfolio holdings in line

with public markets. It is worth looking back at the prior market crises of the last 25 years – which we consider likely to have been of equal or greater severity than the one we are currently experiencing – to see how private equity marks have moved compared with public equities. (We focus on buyout as this comprises the large majority of our 'in the ground' exposure to date.)

The worst case was a 'beta' of 0.59 during the Global Financial Crisis of 2008, when global equities fell by 49% peak-to-trough and buyout funds were marked down by 29% (all on a quarterly basis, in line with standard private equity reporting). Meanwhile the average beta of buyout funds to global equites through the TMT collapse of 2001-03, the Global Financial Crisis of 2008 and the COVID crisis of 2020 has been exactly 0.50. At the end of 2022 global equities had fallen by 18.4%, which therefore implies a maximum drawdown in buyout of some 9%. Meanwhile buyout NAVs have already been marked down by some 6% to the end of Q3 2022 (Preqin data). One can argue about the extent to which private equity managers *should* mark down their holdings more aggressively (and one might contend that public markets can correspondingly overshoot) but, absent material further equity market weakness, history suggests that a washout in private equity valuations is unlikely.

Secondly, our focus on high quality equities was a detractor from performance this year. As interest rates – and hence discount rates – rose, assets with a greater proportion of their cash flows further in the future were hardest hit. Unprofitable technology equities and crypto assets – which have *all* their cash flows in the future – were hardest hit (e.g. Cathy Wood's high profile ARK Innovation ETF and Ethereum both down 67%); followed by large cap 'growth' stocks (MSCI AC World Growth Index down 29%); followed by high quality stocks (MSCI AC World Quality Index down 24%). We hold very little exposure to high growth businesses (and where we do so directly, it is through a manager who takes a highly fundamental, long-term approach and eschews leverage). Meanwhile our core global equity managers, with their broadly 'quality growth' approach, performed in line with these benchmarks with an aggregate return of -25%, but behind the standard global equity index over the calendar year.

We believe that this underperformance will prove temporary and remain convinced that **investing in high quality equities which can compound their own intrinsic value at above-market rates is the best route to compounding portfolio value over the long run**. We have often shown that such stocks have outperformed the global equity index on a rolling seven year basis some 90% of the time over the last three decades – and by an average of some 3% per annum. Coming into the year with high quality stock valuations elevated but not extreme, our expectation was that a portfolio of high quality equities should still be able to outperform the global equity index modestly on a 7+ year time horizon. Following the price movements of the last 12 months, we expect that outperformance could be quite material from here (and with higher absolute returns for both).

The third factor was the mitigating impact of our Specialist and Diversified Return managers. Our Specialist managers – which we expect to generate higher returns than core global equities over time, but in quite different ways – generated significant alpha **and outperformed our global equity composite by some 15% year to date**. Of special note were positive absolute returns from our concentrated Industrials long/short manager and a combined return of -14% across our two China managers – an area which few would have expected to outperform global equities before the plethora of supportive policy announcements in the last couple of months. We believe that these funds still have substantial embedded value, despite the country risk premium and hence relatively small sizing in portfolios.

Meanwhile our Diversified Return strategies – which we expect to have beta to equity markets of just below 50% as a group – recovered strongly in Q4 to end the year down 5% in aggregate, capturing only around one quarter of the market drawdown. Over the last five years these managers have returned 9.5% per annum in aggregate, compared with 5.2% for global equities, while exhibiting significantly lower volatility – illustrating the **value of these strategies during more volatile market environments**.

A negative calendar year is never satisfying but as we discussed in our Q3 2022 letter, periodic mark-to-market losses should be seen as the (no less painful) 'cost' of being a long-term investor. We examined MIT Endowment's 15 Year Review (a period over which they placed in the top 1% of the Cambridge Associates endowment universe) in our Q2 2022 letter and repeat what we consider perhaps the most important passage here:

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.

Instead of trying to predict where markets are going in the short term and selling (cheaper) assets into volatility, we believe that portfolio managers should focus on three key areas at times of market stress like this.

First, **knowing what they own** – carrying out forensic analysis of managers and underlying holdings in their portfolios to make sure that they have the conviction to stick with them or even add through weakness. Second, **ensuring sufficient liquidity** to meet the needs of capital calls and distributions (where required) and to permit efficient portfolio management and rebalancing as appropriate. This is especially important in portfolios which have a significant percentage invested in private investments. Third, **optimising the portfolio** by rebalancing into risk where portfolios have become underweight or by adding opportunistically to areas which are particularly attractive on a risk-adjusted basis.

These are the tenets which we have followed through the year. Alongside our regular programme of monitoring and engagement with our external managers, portfolio management activities outside of private investments were focused in four areas.

First, we rebalanced broad portfolio risk in marketable holdings very incrementally – partly reflecting ongoing capital calls in many portfolios as private investments were built up and which kept portfolios close to target risk levels, and partly reflecting caution around the economic and policy backdrop.

Second, we switched several hedge fund holdings to more liquid variants during the second and third quarters, where we considered the improvement in optionality more than offset the slight reduction in projected returns.

Third, we added to our biotech positions in the middle of the year at levels which our two specialist managers felt represented extremely attractive value on a variety of metrics. Since then we have seen a marked increase in M&A activity in the sector (reflecting the value in the development stage businesses on which our managers focus) and fund returns of +17% and +25% respectively.

Last, we opportunistically bought into a credit fund in early November which has exposures globally across high yield and senior loans. We have not owned high yield assets for our core Growth mandates for many years but following the increase in short-term rates and widening of spreads during 2022, we considered this portfolio to be very attractive on both an absolute and risk-adjusted basis. With a gross yield to maturity of c. 14%, even our downside case involving a 2008-style pattern of defaults and recoveries over the coming five years should result in net returns in the region of 9-10%. In addition, the floating rate nature of the senior loans results in a portfolio with interest rate duration of only c. 2 years overall, meaning that it is relatively insulated from macroeconomic volatility. We consider that this is an excellent opportunity to add exposure to portfolios in a risk-controlled way.

Looking ahead, new research efforts in marketable assets are focused on areas which higher rates have made attractive or which require less market directionality in order to perform well. These include a credit long/short manager with strong institutional backing; a global mid-cap activist strategy which span out of one of the leading global large cap activist managers; and a global equity long/short manager with low net equity exposure and a focus on less crowded sectors such as transportation, industrials, real estate and (until recently) energy, which has annualised at 10.5% over almost a decade with only 10% correlation to equities.

On the private assets side, the team continues its programme of selecting (and reupping with) outstanding buyout and growth managers – on which, more below. Alongside this we are – with the invaluable help of our investment committee members and other senior advisors – actively building out relationships with leading venture capital managers which until the recent downturn were 'hard closed' to new investors, but which are now opening discussions very selectively with potential long-term partners. As ever, we prefer to lean into market weakness in the expectation that the coming years will throw up some terrific opportunities in this space. Lastly, we have renewed our focus on private credit strategies where the opportunity set has become increasingly attractive through the year.

Are we 'Perma-Bulls'?

Following the volatility of 2022, many commentators and strategists have been quick to call the death of 'buy and hold', presumably in favour of a much more tactical approach to markets. (We have been here before, generally following other major market sell-offs such as 2001, 2008 or 2020). It may feel to our long-term partners as if we are a stuck record on risk assets and out of sync with this changing paradigm. We explain below why we believe that – especially at the moment – 'buy and hold' is the right approach for a long-term *investor* seeking to compound their returns over multi-year periods, even if it may not be appropriate for a *speculator* who seeks (whether explicitly or not) to profit from calling shorter-term price movements.

Firstly, 'buy and hold' (by which we mean remaining invested in markets in general, even if portfolio composition might change) has a very long history of success despite recessions, wars, pandemics and other trials along the way. Professor Jeremy Siegel (of the Wharton School of the University of Pennsylvania) shows in the updated edition of his *Stocks for the Long Run* that, including dividends, US equities returned 8.4% nominal / 6.9% real from 1802 to 2021. (Even after the 20% decline in H1 2022, the real return falls only slightly to 6.7%, such is the power of compounding). The asset class returns over this more than two century period can be summarised as follows:

Table 1: Comparison of long-term asset class returns from 1802 to 2021

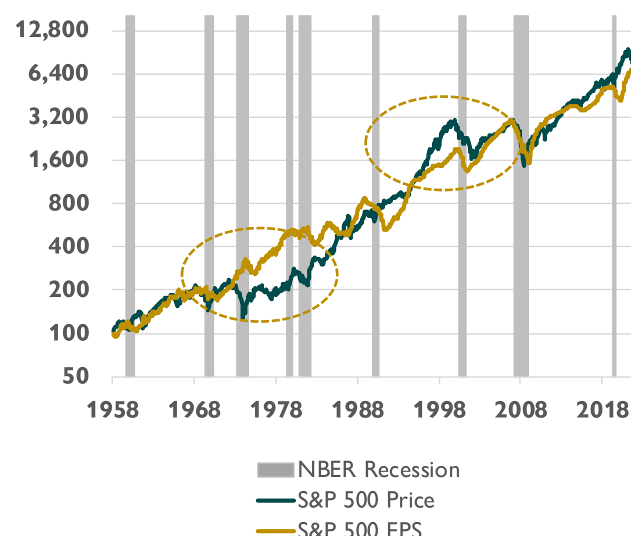
Asset Class	Annualised Return	Ending Value of $1,000
Equities	8.4%	$54 billion
Bonds	5.0%	$50 million
Bills	4.0%	$5.6 million
Gold	2.1%	$94,000
Inflation	1.4%	$23,000

Source: Jeremy Siegel, Stocks for the Long Run (2022)

Over this admittedly long period, equities have outperformed bonds by more than 1,000 times! Why is this possible? The answer is that – for those operating in the context of good corporate governance and the rule of law – corporate equity is simply the **best claim available on the growth in an economy over the long term** and the structural ability of talented management teams to innovate and allocate capital effectively.

That is not to deny that periods of lower or even negative returns exist. Stock prices follow earnings growth, but they can deviate materially (in either direction) at certain points along the way:

Figure 7: S&P 500 Price and Earnings Per Share (Logarithmic Scale)



Source: Bloomberg, January 2023

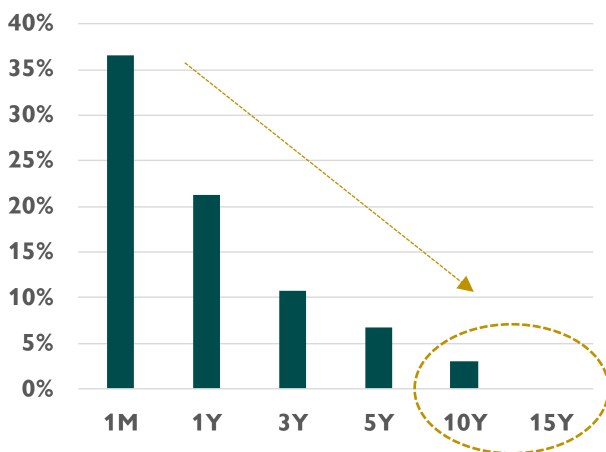
The chart above shows two important things. First, that earnings per share (shown in gold) have grown by c. 6.5% per annum with a remarkable degree of consistency over the long run, despite no fewer than nine recessions in this illustration; and second that there have been periods – and quite long ones at that – in which headline stock indices (shown in green) have not really gone anywhere. However, while price returns should match earnings per share over the long term, total returns to investors have actually been much higher over time as they include the impact of dividend income. While for example the price level of the US index rose by just 1.6% per annum during the turbulent 1970s, the total return including dividends was 5.9% per annum. (Note that if a greater proportion of capital had been returned to investors through share buybacks than via dividends, as today, price returns would be higher and dividend yield commensurately lower.)

To the complaint that this return lagged the 7.4% rate of consumer price inflation through that decade, one might question how much gold (+30% per annum, although barely ahead of inflation over the very long term) an investor can realistically hold in their portfolio. In the end, receiving a return of 5.9% is better than not receiving it, and one cannot wish into being higher returns than those which the market provides. For those who hung on for another 10 years the story was very different, as the

1980s rewarded patient investors with annual returns of 17.5%, far ahead of 5% inflation and the -3.3% return from holding gold.

In short, the longer your time horizon the greater the probability of positive equity returns. For investors with a greater than 15 year time horizon, there has never been a negative return in the post-World War II period, while for those investing over 10 years, negative returns have occurred only a tiny minority of the time:

Figure 8: Incidence of Negative Returns by Holding Period, S&P 500 Index



Source: Bloomberg, January 2023

Furthermore, over that same 10 year time horizon, there was a strong chance of generating attractive performance, with a 75% probability of returns in excess of 7.5%:

Table 2: Return probability on a 10 year time horizon, S&P 500 Index from 1945 to today

Annualised Return	Probability
> 0%	97%
> 5%	87%
> 7.5%	75%
> 10%	57%
> 15%	28%

Source: Bloomberg, January 2023

In fact the only incidences of negative returns came from investments made in the 22 months around the peak of the TMT Bubble in 1999 and 2000, when global equity valuations were about double what they are today and even businesses like Johnson & Johnson traded at 35x earnings; it would have been an unlucky (and somewhat reckless) investor who put all his money to work in stocks in such a brief and euphoric period.

Second, while recognising that there will be periods of below-trend (as well as above-trend) returns, we remain convinced that **predicting these periods and profitably trading around them is fraught with challenges and certainly not part of our skill set**. Take the last couple of years. Should an investor have exited a portfolio of high quality stocks when they exceeded a valuation of 25x P/E following the COVID crisis? On the surface, it would seem logical, with high quality and broad index valuations both elevated in absolute terms and in or near their top deciles of the prior decade. In practice however the picture is generally less clear cut: valuations can stay high for long periods of time, while growing earnings can unwind elevated valuations with limited impact on price. The latter is what we have experienced since mid-2020, as rising rates have driven the P/E valuation of high quality equities down by over 30% from 25x to 17x, while investors have still generated a decent positive return as earnings growth more than offset that decline.

Figure 9: High Quality Equities still positive following 25x P/E valuation

Source: Bloomberg, January 2023

This is by no means to suggest that returns from 14 July 2020 will always be positive, nor that this was the best time to buy such stocks. However, what it does illustrate is that this was not obviously a good time to throw in the towel, given that even after the sharp declines of last year the index is still up 13% (or 5.0% annualised) from that starting point and has not (yet) fallen below it.

Lastly, our focus on high quality businesses gives us greater confidence to be long-term investors, as long as the expected returns on at least a 5+ year time horizon

are attractive. There is often (if not always) a trade-off between lower growth and greater predictability (e.g. businesses such as Procter & Gamble or L'Oréal), and higher growth with slightly less predictability (e.g. PayPal or Adobe). Nonetheless, the resilience of these businesses relative to their 'value' peers and the index in general enables us to look through challenging environments in the expectation that their businesses remain securely capitalised and are likely to exit the inevitable downturns – when they inevitably come to an end – with lasting efficiency gains and enhanced competitive positioning.

We have always liked Larry Fink's maxim that investors should be short-term pessimists but long-term optimists. The challenge for long-term optimists was well described by Professor Siegel:

Optimists on the market are regarded as Panglossian, well-intentioned, but simple-minded prognosticators who push feel-good forecasts with no appreciation of the risks found in history nor the actions of malevolent governments, corporations and other destructive institutions … [while] those who present a pessimistic view of the future are often assumed to possess special insights, which make them more believable.

The merchants of gloom get to sound clever (and generally get a lot more airtime) but predicting ten bear markets out of every five and shifting in and out of the market seriously impairs the ability to compound capital at really attractive rates. We unashamedly lean towards optimism and a belief in the power of human ingenuity to innovate and create value over time. We are happy to accept that we have no special insight into the next 'black swan' event to face humanity, but we do have confidence that we will ultimately find a way through it. The history of more than two centuries indicates a powerful tailwind to this approach for those with the patience to exploit it.

Edward Clive

Chief Investment Officer

Sixteen02 Global Equities

The Institutional Share Class (US$) returned -32.6% for 2022 versus the MSCI ACWI of -18.4%.

Table 3: Five Largest Holdings as of December 2022

1	ASML Holding N.V.
2	Mastercard Incorporated
3	NVIDIA Corporation
4	Thermo Fisher Scientific Inc.
5	TSMC

***Holdings shown in alphabetical order*

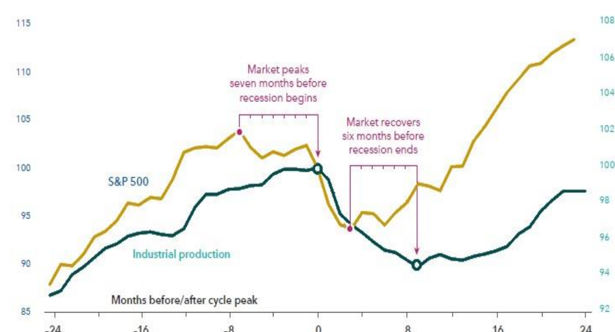
A number of variables worth understanding more deeply have driven this relative and absolute underperformance.

At the last FOMC meeting in 2021, the Fed expected a median rate of 0.9% by end 2022 and a peak rate of 2.1% by 2024 which they thought would be sufficient to control inflation. Fast forward to today, the Fed ended 2022 at a median rate of 4.4% and expects a peak rate of 5.1% by 2023! In response to this rapid hiking cycle, Mr Market compressed multiples, punishing some areas of the market more severely than others. A rolling bear market ensued with several, painful corrections, followed by prolonged rallies, which created an illusion that we are finally out of this malaise!

On a sector basis, software was one of the hardest hit in the portfolio. Despite hefty headwinds in the form of a strong dollar and skyrocketing energy costs (especially at the cloud hyper-scalers), these companies are on track to deliver or beat their guidance for 2022. Separately, the payments and healthcare sectors enjoyed robust earnings growth and relatively less multiple contraction as they continue to benefit from global re-opening.

Whatever the economic scenario for 2023 may be, it is important to bear in mind that all recessions and bear markets eventually end, and history suggests that stock markets could rebound about six months before the economy does.

Figure 10: Stocks have been leading the economy



Source: CG

At a fundamental level, the focus is now on earnings as investors try to envisage what a recession may mean to different companies and in what form or environment these companies will find themselves post-recession.

Most of the companies in your portfolio are beneficiaries of a strong secular trend, if not multiple such trends. They are disintermediating existing legacy players and continue to win market share. For example, **Amazon** is still benefiting from penetration of e-commerce (which is circa 22% of US retail sales versus >60% in some countries such as South Korea, China), and transition to cloud. **Adyen, PayPal, Visa & Mastercard** are still riding the secular shift to electronic payments, while **Taiwan Semiconductor (TSMC)** and **ASML** are benefitting from the diffusion of semiconductors into all aspect of life. **Nvidia** benefits from emergence of big data and artificial intelligence & machine learning use cases: ChatGPT & DALLE-E are recent example of such use-cases that have real ramifications in the business world. History suggests that such secular trends do not dissipate due to the market cycles and often emerge stronger post cyclical correction.

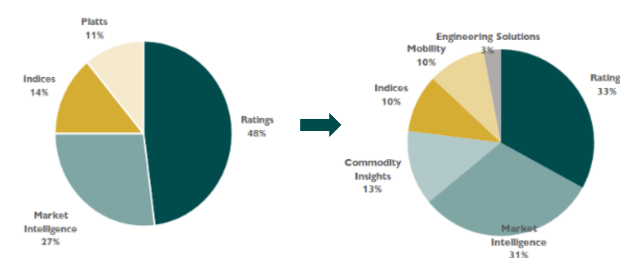
Secondly, the management teams are rapidly responding to the changing environment. They are refocusing and re-prioritising their opex and capex to meet new challenges. For example, last week **Salesforce** announced that they will accelerate head count reduction and rationalise their real estate portfolio. We estimate the proposed actions have brought forward margin expansion of as much as 500bps by about two years, strengthening our original investment thesis even more. We expect similar aggressive moves from other portfolio companies too. Given cash rich balance sheets and attractive valuations, opportunistic acquisitions may serve to strengthen moats of a number of our portfolio companies. All in all, we expect our portfolio companies to generate relatively better earnings growth in 2023 and emerge much stronger than before.

In the fourth quarter, we utilised the bear market drawdowns to our advantage and increased our existing holding in **Nvidia, ASML** and **TSMC** as we felt that these names were washed-out both on earnings expectations and multiples. Similarly, we added to some of our software names such as **Service Now** as it continues to execute well, and its valuation is even more attractive. We initiated a position in **Eli Lilly** and then added to it as we grew more confident of its product cycle and execution. We remain interested in a few other names and look forward to discussing them in future letters.

S&P Global – Toll Booth Operator

Financial market participants and many of our readers are aware of Standard & Poor's (S&P) brand which traces its roots to the 1860s. However, many may not be aware of the critical role it plays in global capital markets, especially after it completed the acquisition of IHS Markit, another data assets provider.

Figure 11: Business mix pre & post-merger



Source: SPGI

At its core, SPGI owns unique and vast data sets spanning capital markets (equity, credit, private companies and ESG), commodities (oil, iron ore and used vehicles). It manages over 4 trillion data points, ~57 million publishable documents on CIQ Pro and covers 50m+ private companies.

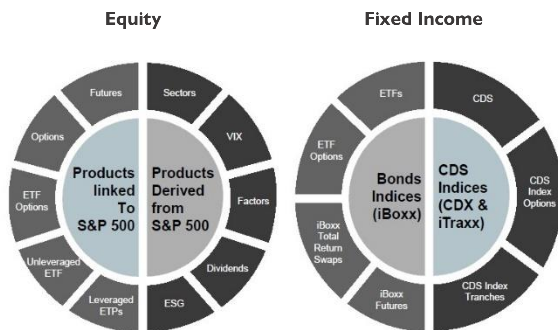
It has built a strong ecosystem around these assets by embedding the data sets within critical capital market use cases, creating strong distribution platforms (such as CapIQ) and a strong customer base (99% of US Fortune 500 are customers).

The Credit Rating business is the largest for SPGI. Corporate debt issuers that don't obtain a credit rating are "penny wise, pound foolish". In the absence of a rating, an issuer often incurs an additional borrowing spread between 25bps and 50bps. This additional cost lasts throughout the life of the debt issuance, whereas the

cost of the debt rating is a one-off fee of 5-6 bps (unless the issuer opts for continuous monitoring). The rating market is essentially a duopoly in the US with SPGI and Moody's commanding circa 40% and circa 35% market share, respectively.

The Indices business is the market leader and a one-stop shop for a variety of capital market assets. It underlies the most liquid financial product in the market for both equity and credit. Some of its well-known global brands are S&P500, The Dow, VIX, iBoxx, CDX & iTraxx.

Figure 12: S&P Indices based financial products

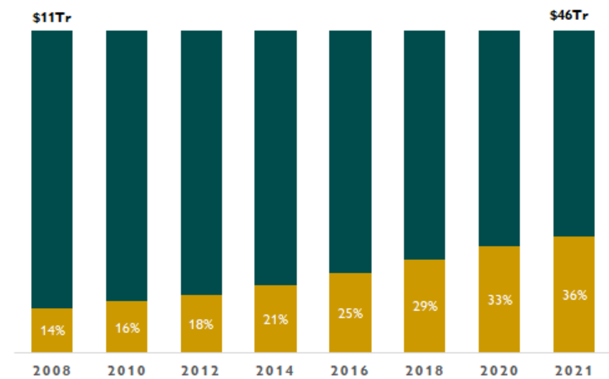


Source: SPGI

The less familiar businesses are Commodity Insights and Mobility. Almost 70% of the global crude oil transactions are conducted by prices provided by Platts, owned by SPGI. This pricing assessment also covers other commodities including agriculture, iron ore, natural gas, shipping and so on. With the IHS Markit merger, data coverage extends both upstream and downstream, further reinforcing SPGI's indispensability to users. The Mobility segment is a leading provider of actionable data and insights into vehicle production volumes, performance metrics and consumer demand trends. It is a key beneficiary of ongoing electrification trends and the shift to buying vehicles online.

SPGI is at the intersection of multiple secular drivers and high growth end-markets. First is the trend from active to passive investing. Approximately 36% of global investible assets are allocated to passive products today compared to 14% in 2008. ETF AUM is expected to double by 2026 with high growth in several segments such as sustainability, traditional equity and factor investing.

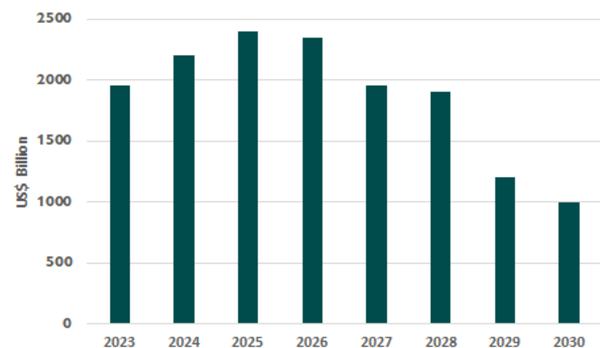
Figure 13: Passive AUM penetration has been increasing



Source: SPGI

Secondly, the ratings business is likely to benefit from emerging markets, especially in China, where turmoil in the real estate sector has accelerated demand. Furthermore, SPGI is penetrating more deeply into new asset classes such as cyber risk, sustainability, and climate change. Even if we were to assume that no growth materialises, one should note that circa $2 trillion of corporate debt that is rated by SPGI comes up for refinancing each year, creating natural recurring demand and indeed on increasing amounts.

Figure 14: c.$2T corporate debt rated by SPGI matures each year for the next 6 years

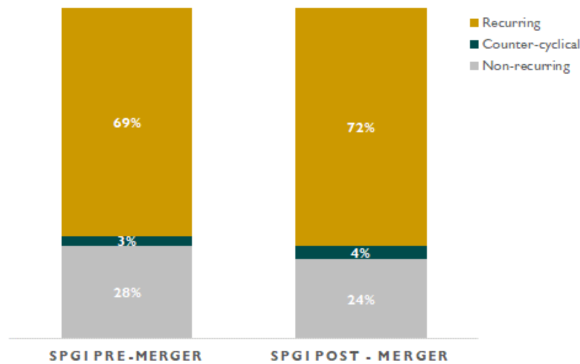


Source: SPGI

SPGI thereby has a highly recurring revenue base. Post-merger, circa 72% of the revenue is generated from subscription products that drive revenue for its customers, such as the Platts or Indices. Another 4% of revenue is counter cyclical revenues that are based on the energy price and indices volatility. Only 24% of the revenue is based on transaction volumes. SPGI converts circa 40% of these revenues into free cash flows and has a target to return 85% of it to shareholders. Given secular growth aspects and progress it has been making to generate synergies from the merger, we anticipated SPGI

to compound its earnings at mid to high teens rates over the long term.

Figure 15: Highly recurring revenue base



Source: SPGI

Chandan Khanna

Portfolio Manager, Sixteen02 Global Equity

Nineteen01 Private Investments

Nineteen01 – Private Funds

We have had a busy quarter on the private fund side, with our Nineteen01 programme making commitments to JMI Equity XI and ECI 12 and approving a commitment to a US mid-market buyout Fund XI for Q1 2023. Summaries of JMI and ECI are provided below.

JMI Equity Fund XI

In October we made a commitment to JMI Equity XI ('JMI XI'), a growth orientated fund focussed on taking large minority stakes in established North American B2B cloud software companies with proven business models. The firm was founded in 1992 and runs a single strategy from offices in San Diego, Baltimore and Washington DC. Today the firm has 54 employees including nine investing Partners and is led by Managing General Partners Harry Gruner (co-founder) and Peter Arrowsmith who have been with the firm for 30 and 26 years respectively. Unlike many peers, JMI is often the first institutional capital in the companies it invests in and works with founders seeking an operationally involved partner to take their company to its next stage of growth. JMI XI is a $2.1bn fund and expects to make investments in c.20 underlying companies.

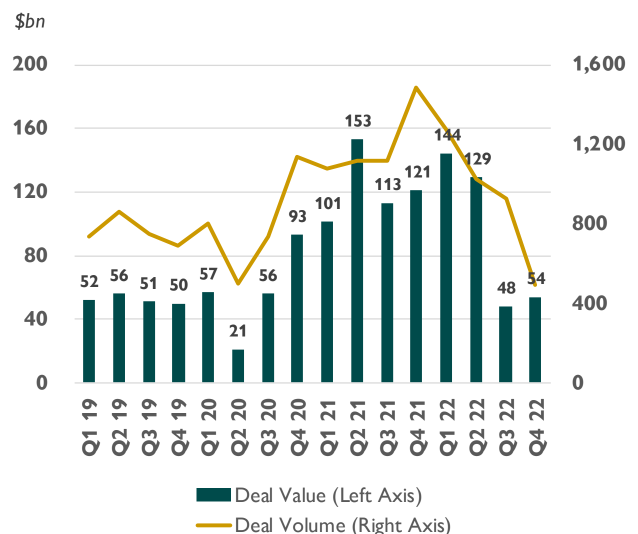
ECI 12

ECI is a UK buyout manager which invests in market-leading, high growth UK mid-market companies in tech enabled sub-sectors that exhibit high degrees of resilience. In December we committed to ECI 12, which has a £900m target size. ECI was founded in 1976 and today the team of 29 is led by a group of four Managing Partners, Sean Whelan, David Ewing, Chris Watt and Tom Wrenn who have an average tenure with ECI of 21 years. The firm is employee owned and manages a single strategy from offices in London and Manchester. Fund 12 will continue ECI's strategy of partnering with founders to acquire majority stakes in 12-15 £30-300m EV companies that have high revenue visibility, low customer concentration, high EBITDA margins and a leading position in one of ECI's ten established sub-sectors.

Private Equity Market Overview

The fourth quarter saw a continuation of the slowdown in PE dealmaking which began in Q3, as debt, particularly for mega-cap deals larger than $10bn, became difficult to come by and amid reluctance from sellers to exit at a perceived 'market bottom'. Looking at the chart below, the pace of US buyout dealmaking has certainly normalised during the second half of 2022, something which is hard to see as a negative after the frenzied activity of the prior 18 months. Deal volume fell 39% in H2 vs H1 while deal value fell some 63%, as the closed syndicated loan market made mega cap deals effectively impossible during the quarter.

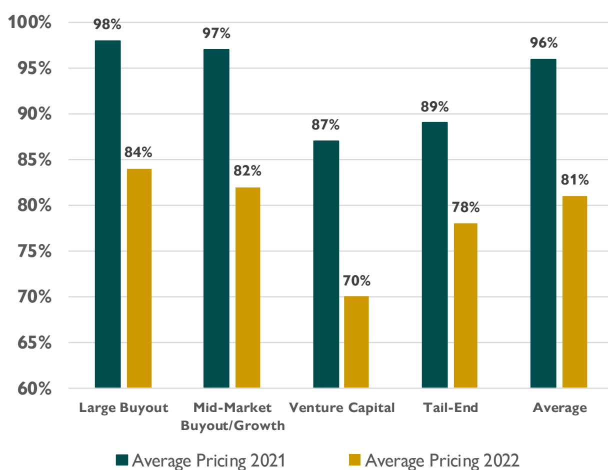
Figure 16: US PE Buyout Value



Source: Preqin, PwC

This reduction in deal-making has continued to mean a slower pace of distributions for LPs, with data from Triago for the last six years showing aggregate PE fund distributions at their lowest level as a percentage of committed capital since 2020. At the same time new capital calls (which include repayment of fund facilities used for earlier deals) continued at a pace second only to 2021. This net PE cash draw, coupled with relatively steady PE buyout valuations, has worsened the so called 'denominator effect' and forced many large allocators into secondary sales, pushing prices down by some 15 percentage points (see chart below). This should create opportunity for secondary funds, whilst serving as a valuable reminder about the dangers of over-optimistic cash flow modelling and pitfalls of excessive overcommitment strategies.

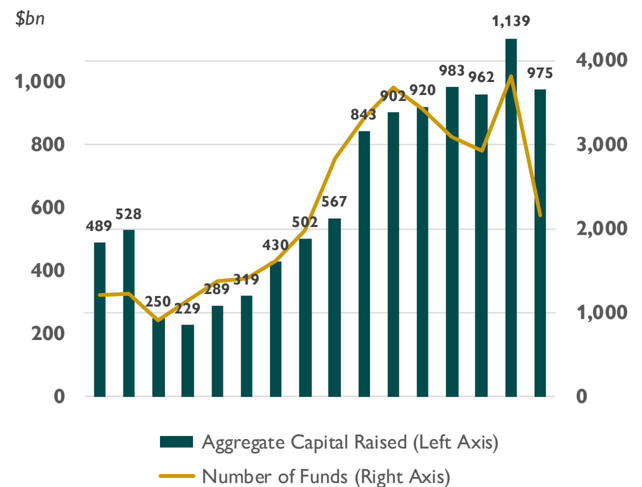
Figure 17: Secondary Market Pricing by Fund Type (% of NAV)



Source: Triago (2022 data to December 12th)

Despite the exit of some large allocators from the market, PE fundraising in 2022 remained in line with pre-2021 highs at $975 billion. It is notable, however, that the number of funds raised fell by more than 40%, consistent with our view that many managers will be forced to stay in the market for longer than they would have hoped, or disappear for good as capital becomes scarcer and more discerning and allocators focus on fewer manager relationships. This trend is clear in the remarkable fact that some 23% of the total $2.0 trillion in PE dry powder now sits with 25 managers (S&P Global).

Figure 18: Private Equity Fundraising since 2007



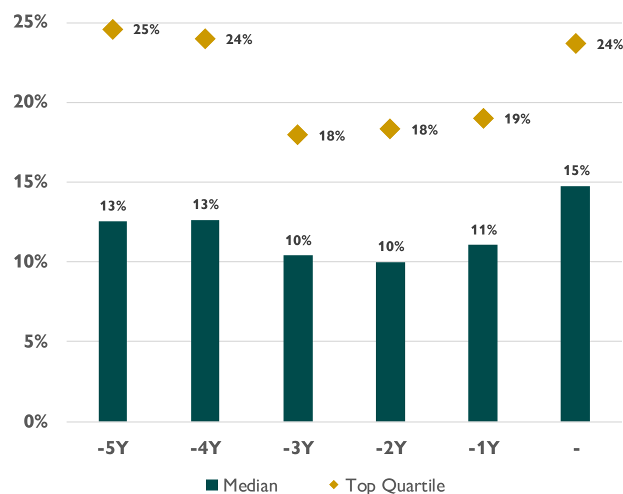
Source: Preqin

Reports of Private Equity's (impending) demise are greatly exaggerated…

Given the fall in public markets, the relative resilience of PE valuations and strong, if slowing, fundraising environment have led to much talk this quarter that PE will inevitably deliver poor returns to investors from here as rising interest rates send debt costs higher and valuation multiples lower, whilst earnings growth slows or even turns negative. We think this view unfairly tars all GPs with the same brush and instead see a more nuanced picture where manager selection will matter more than ever, as outcomes become bifurcated between GPs that have relied on abundant cheap debt, EBITDA adjustments and multiple expansion and those that add real value to portfolio companies.

Looking back at PE performance over the last four decades, through a range of interest rate, inflation and growth backdrops, gives us confidence that the fundamental advantages of Private Equity investing – extended time horizon, manager alignment and operational value-add – will continue to drive the long-term performance of talented managers regardless of what the coming quarter, year or cycle has in store.

Figure 19: PE Performance by Proximity to Recession: Strongest for Recession Vintages



Source: Preqin, based on analysis of all PE funds with vintage years 1980 to 2009; recessions determined based on NBER methodology (1980-82, 1990-91, 2001, 2007-09)

Two messages come out clearly from the chart above. First, the robustness of both median and top quartile PE performance across vintages. Selecting only average funds from 'unlucky' vintages two to three years prior to a recession (meaning virtually all capital will have been deployed in years where entry valuations were higher and sold into a recession or early recovery) would still have delivered a 10% net IRR – doubling capital every seven years. Top quartile manager selection, meanwhile, has delivered truly stellar returns regardless of economic cycles. Those managers with the discipline to avoid overpaying or gearing up excessively at cyclical peaks, and the ability to identify sectors and companies with staying power, improve operating efficiency, hire high quality management teams and effectively execute strategic acquisitions, have doubled investor capital every ~4 years through economic cycles since 1980.

Secondly, in PE as in public markets, we believe it pays to be 'greedy when others are fearful' and lean into recession vintages where managers can deploy capital at lower valuations during a period of revenue and EBITDA headwinds and potentially achieve a boost to returns from multiple accretion at exit. The median fund from these vintages has delivered ~15% net IRRs, doubling investor capital every 5 years and performing better than funds invested in the five years prior to the recession.

We believe the 2022 and 2023 vintages may prove to be particularly strong as managers benefit from the sell-off in public markets and complete more take-private investments, particularly at the smaller end where private debt markets remain open and all-equity deals are possible. The growing divide between the fundraising 'haves and have nots' may also mean that those managers sitting on the $2.0 trillion of dry powder begin to find some motivated sellers from weaker (or less lucky) counterparts whose own fundraising processes need a boost from selling their winners.

In summary

In our view, the key differentiator of PE fund performance through cycles is how disciplined managers are in deployment during the peak years pre-recession and how operationally engaged they are, both when things are going well and when companies face challenges. We look for managers that do not get swept up in euphoria and push leverage to meet minimum returns or compromise on business quality to meet deployment targets. Managers, and investors, that take a long-term view and focus on true business building rather than financial engineering will outperform by pressing the fundamental advantages of the longer time horizon and 'free call option on cash' that the PE model provides. As for the rest, the end of the era of easy money may prove a deserved and overdue turning point.

Charles Magnay
Head of Private Fund Investments

David Schofield
Investment Manager, Private Investments

Nineteen01 – Direct Co-Investments

In Q4 2022, we approved an investment in Aareal Ag, a take-private led by Advent International and Centerbridge Partners. Based in Wiesbaden, Germany, the business is comprised of three divisions: a landlord enterprise resource planning software business (Aareon), a commercial real estate lending business (CRE lending), and a payments processing business.

We found this acquisition particularly interesting for several reasons. Firstly, Advent had already secured a position in Aareon in August 2020, well ahead of launching the take-private, creating a clear due diligence advantage as they had significant knowledge of the asset and had begun implementing their value creation plan, which we would benefit from. Aareon is also a clear market leader in its category, with the number one or two position in several European markets and provides a

critical service that has proven very sticky but represents a low cost for the client. The fragmented, growing market also leaves significant scope for further growth, both organically and through acquisitions. The lending business, meanwhile, is a low LTV, first lien, senior lender to high quality sponsors, backing well-known assets in key cities in Europe and the U.S. The business has low-cost funding sources but lends at market rates, making it well positioned to benefit from increasing interest rates. Lastly, the attractive entry price relative to peers (a function of the difficulty that public markets have in pricing conglomerates and investor aversion to anything perceived as a 'bank') created what we believe is a compelling risk-reward for us as investors. Although completion is pending regulatory approval in Germany, the business recently released Q3 YTD earnings which were 50% ahead of our full year forecast.

Our existing portfolio continues to trade well. We were happy to return capital to our investors in ClimateCare after the business completed a dividend recapitalization, repaying circa 1.2x cost. Despite recuperating all our invested capital, our economic ownership of the business remains the same and we continue to see significant upside (to which we are now exposed at effectively zero cost). In the just over two years since September 2020 when we made the original investment, ClimateCare has tripled EBITDA and become one of the global leaders in carbon credit services. The business continues to show strong growth and improve its earnings visibility by signing multi-year contracts, which we expect to positively impact valuation.

We continue to see attractive opportunities across both established and new sponsor relationships and have remained highly selective, with more than 60 opportunities reviewed in detail during the quarter. Our focus will continue to be on companies that exhibit durable, through-cycle growth characteristics, are backed by high quality, well-aligned sponsors and are not reliant on excessive leverage to deliver attractive returns.

Oliver Mayer

Head of Direct Private Equity

What we have been reading …

The Power Law: Venture Capital and the Art of Disruption *by Sebastian Mallaby*

Penned by famed *Washington Post* and *Financial Times* columnist Sebastian Mallaby, *Power Law* is a masterful chronicle of the history of modern venture capital from its auspicious beginning with the Traitorous Eight in the 1950s through to the 'deca-corn' riddled peaks of the 2020s. Mallaby researches and highlights all the milestones along the way — companies and characters, fireworks and flame-outs. *Power Law* is a 'must-read' for anyone seeking to understand the asset class today as the work helps decipher modern venture's core portfolio construction logic — the quintessential fly-wheel effect that when executed well results in amplified compounding (a relative change in one variable sees a proportional and relative positive change in another variable).

All the VC titans (Sequoia, Kleiner Perkins, Benchmark, etc) have understood and capitalised on this self-reinforcing phenomenon and thereby extracted significant excess returns over the public and private markets creating an aura of unassailable oligopoly. Notably and satisfyingly however, none has climbed the mountain by exactly the same path. Some like Sequoia built expansively — both internationally and downstream into later stage growth and public markets — while others like Benchmark steadfastly stuck to their early stage roots in the US. Perhaps one of the most salient and topical takeaways from Mallaby's work is that disproportionally many of the best investments were made during the darkest periods — a harbinger of hope for an industry beset with many a challenge today.

Tarek AbuZayyad

The World for Sale: Money, Power and the Traders Who Barter the Earth's Resources
by Javier Blas and Jack Farchy

Just as Ben MacIntyre's true spy histories equal or outdo most fictional creations (and for those who have not read *The Spy and the Traitor*, we cannot recommend it highly enough), so Javier Blas and Jack Farchy document an industry and its often colourful participants which would feel scarcely plausible in a work of fiction. *The World for Sale* charts the development of the commodity traders from the early adventurers forging links between the

Soviet Union and the West in the aftermath of the Second World War, to the secretive successor firms which emerged in the 1990s, and finally to the giant trading businesses of today – Vitol, Glencore and Trafigura in oil and metals; Archer Daniels Midland, Bunge, Cargill and Louis Dreyfus in agricultural commodities. The early buccaneers are brought vividly alive: characters such as Marc Rich, who fled from the US to Switzerland following indictment on 65 criminal counts, never to return; and the mercurial John Deuss, the 'epitome of the freewheeling trader', who mixed with Iranian ayatollahs, Arab sheiks and Soviet bureaucrats, and who from his base in Bermuda (and two private jets) lived a life which would put a Bond villain to shame.

The impact that these traders had on the geopolitics of the last century is perhaps the most staggering lesson of this book. Across the Soviet Union and post-Soviet Russia, the Caribbean, apartheid South Africa, former communist Europe, and latterly Africa, the trading firms are never far from the action and not always on the side of the angels. Blas and Farchy do not shy away from the more nefarious historic activities of these companies, whether involving briefcases of cash and fixers in Baghdad, or Trafigura's shameful disposal of chemical waste at an open dump in Cote d'Ivoire in 2006 which resulted in a fine of $198 million to cover clean-up costs and compensation for the 95,000 victims who had fallen ill as a result.

Transparency and governance have certainly improved in recent decades and Swiss companies are no longer allowed to put 'facilitation fees' through their P&L as tax deductible expenses. And while the major oil traders continued (under existing long-term contracts) to ship oil from Russia through its Baltic and Black Sea ports long after the start of hostilities with Ukraine last year, they will also play a critical role in facilitating the import of some 200 million tonnes of LNG which Europe will need over the next decade in order to phase out Russian gas. Given their ubiquity and importance to the very plumbing of the global economy, the implication of this book may be that – as the Catholic theologian Monsignor Ronald Knox explained of his reluctance to visit Rome – 'He who travels in the Barque of Peter had better not look too closely into the engine room.'

Edward Clive

Eighteen48
PARTNERS

Important Information

Eighteen48 Partners Limited ("Eighteen48") is authorised and regulated by the Financial Conduct Authority (FRN: 823699). Its registered office is at Montpelier House, 106 Brompton Road, London, SW3 1JJ, UK. Eighteen48 is registered in England and Wales as a Private Limited Company (company number 11593850) and its VAT registration number is 328827571.

This document is intended for professional clients only and is not intended for distribution or redistribution to retail clients. This document is not directed at any person in any jurisdiction where (by reason of that person's nationality, residence or otherwise) the publication or availability of this document is prohibited. In the United Kingdom this document is only being provided to those persons to whom it may lawfully be issued under The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 and/ or Chapter 4.12 of the FCA's Conduct of Business Rules, as appropriate.

This document is provided for informational purposes only. Nothing contained in this document constitutes investment, legal, tax, accounting, regulatory or other advice nor is to be relied on in making an investment or other decision. This document is not intended to be taken by, and should not be taken by, any individual recipient as investment advice, or a recommendation to buy, hold or sell, or an offer to sell or a solicitation of offers to purchase, any security, investment fund, vehicle or account. Such offer or solicitation will be made only on the basis of separate marketing materials, which will be sent to prospective investors separately. If you are in any doubt about the contents of this document, you should obtain appropriate professional advice before making any investment decision.

While Eighteen48 uses reasonable efforts to obtain information from reliable sources, the information contained in this document has not been independently verified and no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the timeliness, validity, fairness, accuracy, completeness or correctness of the information or opinions contained herein. Eighteen48 and/or any individual named or referred to in this document are under no obligation to update or keep current the information contained in this document and shall have no liability whatsoever (whether in contract or tort, for negligence or otherwise) for any loss, costs or damages whatsoever arising from any use of this document or its contents to the fullest extent to which such liability may be excluded or avoided by law.

Any performance data or comments expressed in this document are an indication of past performance. Past performance is not indicative of future results and no representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided.

Statements contained in this document that are not historical facts are based on current expectations, estimates, projections, opinions, assumptions and/or beliefs of Eighteen48, taking into account all information currently available to it. Such statements involve known and unknown risks, uncertainties and other factors, and undue reliance should not be placed thereon. Certain information contained herein may constitute "forward-looking statements", which can be identified by the use of terminology such as 'may', 'will', 'should', 'expect' etc. or the negatives thereof or variations thereon or comparable terminology. As a result of certain risks and uncertainties, actual events or results or the actual performance of an investment may differ materially from those reflected or contemplated in the forward-looking statements. We undertake no obligation to publicly update or review any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by applicable law.

This document is subject to copyright with all rights reserved. You may not reproduce (in whole or in part), transmit (by electronic means or otherwise), modify, link into or use for any public or commercial purpose all or any part of this document without our prior written permission.