Quarterly Perspectives

Q3 2023

Dear clients, partners and friends,

In the face of heightened geopolitical turmoil, the fact remains that market volatility is still driven by the perceived risk of interest rates remaining higher for longer because of a stubbornly robust economy, in particular in the US.

This contrasts with Bloomberg's monthly survey of economists in December 2022, who placed a two thirds probability on a US recession in 2023. Economists invariably get it wrong because forecasting typically assumes that what happens next in the economy will be some kind of extension of what's already happened – a linear process.

Another way to put it is that there are too many variables to contend with in macroeconomic forecasting. We therefore subscribe to the view that it is simpler (if not always easier) and therefore generally safer to focus on the fundamentals of companies and to gauge their ability to compound their earnings over time.

The notion of compounding is one that we want to embed in our organization. It is generally associated with financial investments, where your initial investment earns a return, and over time that return also earns a return, and so on, creating a powerful compounding multiplier. However, we believe that the power of compounding also applies to many aspects of life and as far as our business is concerned, consciously thinking about compounding in the following areas can make us better as a team:

Knowledge: Learning compounds over time. The more you learn, the more you can build upon that knowledge. Continuous learning leads to expertise and a deeper understanding of various subjects. Warren Buffett describes his work day: 'I just sit in my office and read all day'. This is the reason behind our book reviews at the end of this newsletter – to instil a culture of reading and learning that avoids noise.

Skills: Practising a skill consistently leads to improvement. Regular practice compounds your abilities, making you more proficient over time. This is the 10,000 hour principle popularized by Malcolm Gladwell in his book Outliers. Our goal is to create and nurture a culture of mentoring and responsibility which embraces high expectations but where we can learn from our mistakes.

Relationships: Building trust, understanding, and positive interactions with others can compound the strength of relationships. Small gestures, kindness, and transparent communication both internally and externally can lead to stronger and more meaningful connections over time. We develop meaningful relationships with clients and investment partners and want to always be viewed as a reliable, thoughtful and trustworthy partner.

The keys to harnessing the power of compounding are consistency, patience and a long-term perspective.

We passed our fourth anniversary milestone in July, with a team of 28 and a similar number of client groups. We are also delighted to welcome Neamul Mohsin to our Advisory Investment Committee. Neamul is Deputy CIO at Oxford University Endowment Management and we look forward to our further engagement with him over the coming years.

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
13 October 2023

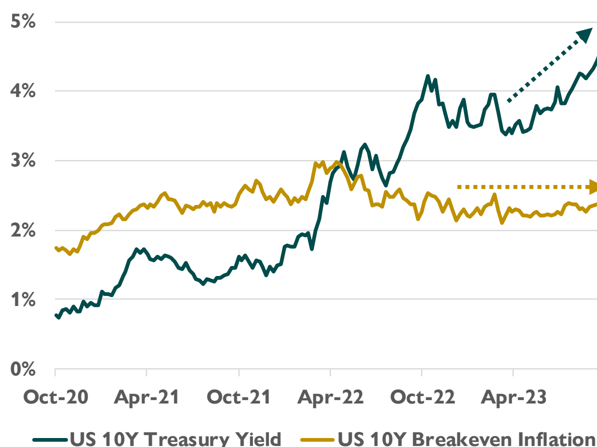
CIO Review

Taking stock

Three and a half years ago, the benchmark 10 Year US Treasury Bond hit an all-time intraday low yield of 0.31%. It ended September at 4.57% and subsequently (before pulling back this week on safe-haven flows and more dovish Fed commentary) moved up further to touch a peak of 4.89%, its highest level since August 2007 – a different era, before the Global Financial Crisis and the 'new normal' of sluggish growth and depressed interest rates which followed. The exuberance of the first half of the year was followed by a more muted third quarter as investors digested a combination of still resilient economic data and these surging bond yields, which increase the discount rates applied to investment assets while also putting pressure on levered corporate and household balance sheets. Global equities and the S&P 500 both softened some 3.3% during the quarter, to end September up 10.5% and 13.1% respectively for the year.

Various factors likely contributed to the rise in bond yields, although not perhaps the most obvious one; long-run inflation expectations remained virtually flat even while yields were rising:

Figure 1: 10 Year US Treasury Yield rising while inflation expectations remain flat

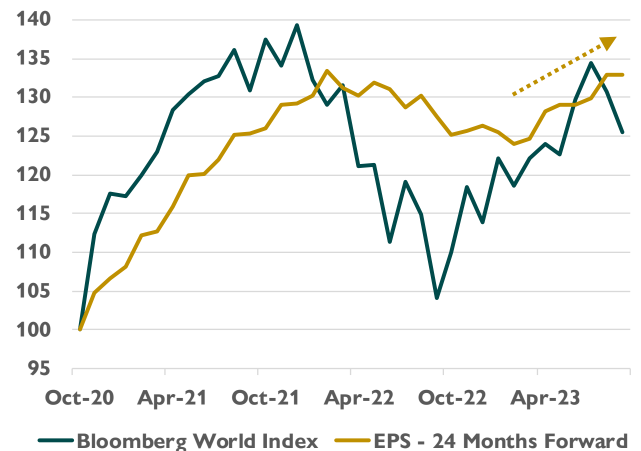


Source: Bloomberg, October 2023

First was the persistent hawkishness of the Fed, whose messaging resulted in markets all but cancelling their former expectations for rate cuts in the next 12 months. However this is not the full picture, given that longer rates moved up more than shorter, more policy-sensitive maturities. The second factor then is that longer-term growth expectations are improving, and a 'soft landing' scenario is becoming priced into the bond market. On top of these drivers may be added technical factors such as the loosening of the 'yield curve control' policy in Japan (where higher yields on Japanese government bonds have resulted in significant repatriation flows of capital out of US Treasuries) and an increase in the 'term premium' that investors demand to hold longer-dated bonds as both the volatility of those instruments and the size of the US fiscal deficit have risen.

In line with these rising discount rates and the improving longer-term growth outlook, the pullback in global stock prices (by some 9% from their July peak to recent trough, and some 6% as we type) was driven by falling valuations rather than expectations of weaker earnings. The price/earnings ratio of the MSCI AC World reduced from 18.6x to a low of 17.4x (both somewhat below the 25 year average of 19.4x) even as estimates for global earnings per share over the coming one, two and three year periods remain firmly on an upward trend.

Figure 2: Earnings estimates continuing to rise as global equities pulled back



Source: Bloomberg, October 2023

This impact was most striking for the 'Magnificent Seven' tech stocks highlighted in our last quarterly, whose historic P/E ratio came down by 15% (from 46x to 39x) even as analyst consensus increased yet further and now projects their earnings to double over the coming three years.

As rates rose during the quarter, longer duration bonds (to which we continue to have no exposure in portfolios) were hit particularly hard; for example the 'TLT' iShares 20+ Year US Treasury Bond ETF has lost some 11% this year, with most of the decline occurring since rates really took off in mid-July. Credit risk, however, has performed well through the year and spreads are indicating very little

concern about the underlying resilience of corporate borrowers. Senior loans (which have floating rate coupons and hence very low rates duration) are up some 9% year to date, while high yield corporate spreads at 4.5% remain well below the 6%+ peak reached in the middle of year and close to their 10 year average level.

Portfolio Performance and Activity[1]

Growth portfolios were modestly down during the quarter, generally capturing around two thirds of the market movement. For the year to 30 September, liquid Growth portfolios are generally up in the high single digits and are comfortably ahead of peer benchmarks. Those with a material exposure to private investments have lagged given that those holdings are slower to mark.

Since Eighteen48's inception in July 2019, our Growth composite return (which includes 40% in an actual private equity portfolio) remains above 9% per annum net of all fees. On a compounded basis this implies a total return which is approximately three times higher than that of wealth management and large multi-asset fund peer groups, which have annualised below 4% in aggregate over the same period.

Research activity on the marketable funds side has been focused on bolstering our 'reserve' bench of global equity managers (a focused group of managers we underwrite and monitor to the same extent as our owned managers) as well as on specialist strategies in the activist space, where we are evaluating several managers whom we consider to be truly exceptional and who have shown the ability to add real value to their portfolio holdings.

Within private funds, we are evaluating re-ups in several of our buyout names as well as several new candidates with an Industrials focus where we have historically had relatively limited exposure. Within private credit we are looking to complement our recent commitment to a sponsor-backed direct lending strategy with a manager which focuses on lending to non-sponsor backed businesses (i.e. with no private equity backer) which has similar target returns (i.e. low to mid-teens with significant cash distribution) but somewhat different risk drivers. We are also evaluating other niche credit strategies including healthcare royalties. Lastly, on the growth and venture side we continue – with invaluable introductions from our Advisory IC members and our broader peer network of institutional investors – to build out our relationships with leading managers in both the traditional mid-stage VC and bootstrapped growth spaces, located across the US from west to east coasts and within Europe.

Revisiting China

The greatest disappointment in portfolios has been direct China exposure (to which we generally hold some 2-4% in portfolios), which has fallen back again after the strong rally in late 2022. Our most widely held China manager is down 10% year to date, following a decline of 19% last year. It has fared considerably better than the MSCI China Small Cap Index this year (down by less than half as much as the index) but a combination of falling valuations across Chinese equity markets, and some portfolio holdings which turned out to be more macro-exposed than the manager expected, has generally led – depending on entry point – to an unsatisfactory outcome so far.

It is a truism of investing that all positions will never perform at the same time, but that does not make it less frustrating when individual holdings – and even small ones – are marked down over a protracted period of time. In such a situation we should always re-underwrite the rationale for owning the position with an open mind, in the context that – from a decision making perspective – the opportunity set *from here* is the most important factor in that process.

With that lens, it is difficult to make the case for selling here, given both the extremely low valuations on offer (e.g. the China fund noted above is trading at c. 8x P/E ex cash, compared with 13x at the start of 2021 – itself far from excessive and in line with the portfolio's long-term average) and the pervasive negativity towards the region. The most recent Bank of America Fund Manager Survey showed that the 'avoid China' theme has become consensus among surveyed investors, with 'short China equities' shown as one of the two most crowded trades (the other being 'long big tech'), and a net zero percent of investors expecting stronger economic growth in the next 12 months – a sharp fall from 78% in February, and even more pessimistic than 12 months ago while China was still suffering its strict COVID lockdowns. These data points suggest that a great deal of selling pressure has

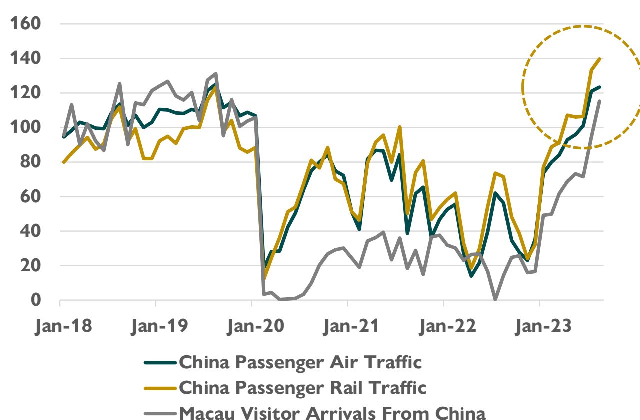
[1] *Past performance is not a guide to future results. There is no guarantee that investment objectives will be met. Composite returns are shown after fees on a notional $100 million portfolio.*

already occurred.

The time when investors should rationally quit a position when valuations and sentiment are already this low is when the fundamental investment thesis is clearly broken. The negative news flow provides an explanation for why prices are where are they are, but being already widely known, offers little clue as to where stock prices will go in the future. For that, one must look at the data itself. Here, despite the well-publicised woes in the property sector, there are actually quite striking signs of underlying recovery from bellwether corporate results and commentary as well as broader consumer data.

In Q2 of this year, Alibaba's China retail revenues grew by 13% from a year before; at Tencent, payment revenues rose by 15% while online advertising revenues – often seen as a leading indicator – surged by 34%. The qualitative messaging from companies as diverse as L'Oréal and Mastercard is also encouraging; L'Oréal CEO Nicolas Hieronimus recently noted that, while not at the speed everyone had hoped for, the Chinese market is nonetheless "really picking up". The recovering consumer is also evident in travel data, with Chinese rail and air traffic returning rapidly over the last few months to levels near or above their pre-COVID peaks:

Figure 3: The Chinese consumer is on the move again



Source: Bloomberg, October 2023

Perhaps most importantly, earnings per share in the portfolio of the China manager noted above grew at 30% for the first half of the year, even after removing several outliers to the upside. There are clear signs that consumers are spending again and that smaller, consumer facing businesses with excellent products are able to grow rapidly into China's enormous middle class consumer market (and increasingly export to a global one) despite projections for longer-term GDP growth running at 'only' 3-5% compared with 5-7% in the recent past.

As part of our riskier 'Specialist' allocation, Chinese exposure has been sized much smaller than exposure to Global Equity managers – typically in the region of 2-4% of portfolios overall. We consider that this is an appropriate weighting given the risks of investing in the region but also given the increasingly attractive fundamental opportunity set and hence projected returns from today.

Looking Ahead

Will the major central banks manage to engineer a 'Table Mountain' scenario, where rates peak and then remain at a moderately high plateau for some time? Or will persistent growth and inflationary pressures force policymakers to raise them to a 'Matterhorn' – a sharper, but potentially shorter, shock? The magnitude and duration of the rate peak are inherently unpredictable; however, as commentator John Authers recently warned, the greatest dangers are often faced on the descent rather than the climb. The history of the last five decades indicates that real life has generally thrown up a rates path which is more craggy and formidable than the symmetrical mountain peak of the imagination, with rapid spikes up and down which are more representative of the underlying tectonic power of financial markets.

We as investors must brace ourselves against missteps on the descent, while recognising that the near-term outcome may be either worse or better than the market currently estimates – and that the long-term destination is almost always worth the journey. In concrete terms, this is all about thoughtful preparation in order to forestall impulsive reaction further down the road. It means building portfolios which are carefully calibrated to the specific risk tolerances of each of our clients; rebalancing exposures rigorously within those targets; retaining enough liquidity to take advantage of any market drawdowns; and having sufficient diversification within portfolios such that everything is not always moving in the same direction at the same time.

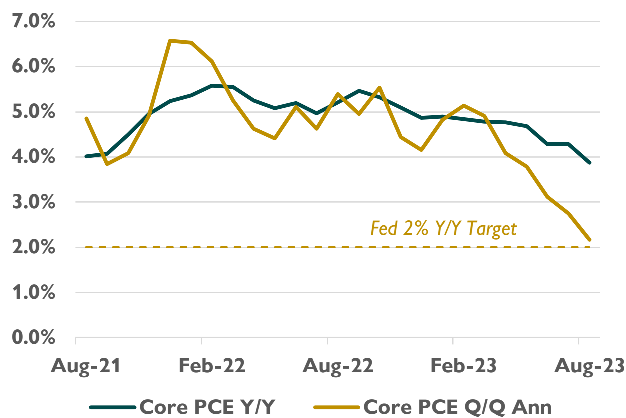
In this context, the tension between what constitutes good or bad news continues. The most recent US jobs report last week indicated that US employers added 336,000 jobs in September, the highest quantity since January and almost double Wall Street expectations. In broad brush terms, a strong labour market and consumer spending are good news for the economy and corporate earnings; while the consequent pressure on the Fed to hold interest rates 'higher for longer' pushes bond yields higher and is hence bad news for borrowers and for

equity valuations. The tension between these two forces is creating considerable short-term uncertainty, especially around high profile data releases.

The positive nuance in the latest jobs report was that wage growth fell slightly to its lowest level (4.2%) since June 2021. The increase in wages during the last quarter has now fallen to 3.4% on an annualised basis – a level which according to Oxford Economics is consistent with the Fed's 2% inflation target, after adjusting for 1.5% productivity growth. There are clear signs in the jobs data that – with excess savings depleting and juicier salaries on offer – workers are now returning to the labour market in scale, relieving the pressure on wages from the recent dearth of supply.

This encouraging inflation picture is evident in broad inflation measures too. The Fed's preferred 'Core PCE' measure is now back below 4% year-on-year and, on a faster 3-month annualised basis, is already almost on target, suggesting that the sequential pressures on prices have eased significantly.

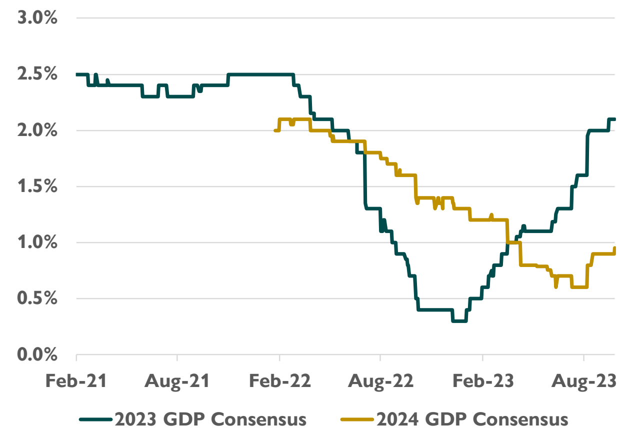
Figure 4: Early indications that inflation is trending down towards the Fed's 2% target



Source: Bloomberg, October 2023

At the same time as inflation is falling, the growth outlook continues to improve. The Fed's 'GDPNow' model is projecting GDP growth to be above 4.5% (perhaps excessive, but at least in the right direction). The consensus estimate for US GDP growth in 2023 has been revised steadily upwards since Q1, from close to recessionary levels to above 2%. Even forecasts for 2024 have recently begun to be revised decisively upwards.

Figure 5: Estimates for US GDP growth are being revised upwards



Source: Bloomberg, October 2023

That said, the 2024 forecasts remain low in absolute terms and the Bloomberg survey of strategists still places the odds of recession at a little over 50%, albeit off their peak two-thirds probability in January. All else equal, the chances of a 'soft landing' have improved – but risks to that outcome continue to abound, whether from further strikes, shutdowns or policy error, or external factors such as oil prices or an escalation of geopolitical turmoil such as we are seeing, tragically, between Israel and Hamas currently.

In particular, the current level of real interest rates (i.e. the Fed Funds Rate net of annual consumer price inflation) represents a significant tightening of financial conditions. This is well illustrated by Goldman Sachs's financial conditions index which – after the extremely easy conditions of 2020-22 – is indicating the tightest conditions for 12 months (measures above 100 are considered restrictive):

Figure 6: Financial conditions are quite restrictive

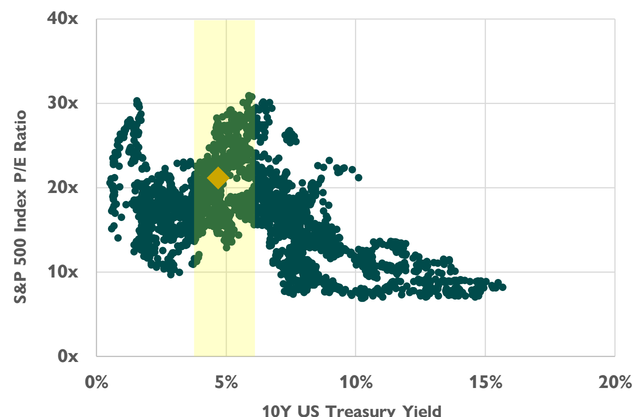
Source: Bloomberg, October 2023

On the positive side, this aggressive policy response reduces the likelihood of a resurgence of inflation down the line. Herein lies the greatest difference in policy approach from the mid-1970's to today; even as the second wave of inflation built up from late 1976 to its 15% peak in 1980, real interest rates were allowed to average just 0.2%; today's much more restrictive levels of almost 2% were not reached until October 1979, when inflation was already back over 12%.

On the other hand, real interest rates approaching 2% – compared with a 30 year average of zero, and the Fed's estimated 'neutral' level of 0.5% – could pose a material threat to economic growth in the quarters ahead, especially if negative impacts exhibit a greater degree of lag than expected. Recent comments from Dallas Fed President Lorie Logan and Fed Vice Chair Philip Jefferson have emphasized how the rise in real yields is, in the latter's words, "doing some of the hard work for us"; Jefferson went as far as stating this week that: "we believe we have reached that fabled sufficiently restrictive level" in rates (a comment which markets greeted with no small enthusiasm). The word 'believe' is key though – in dealing with actions which have both unpredictable impacts and lags, there is a lot of room for error. While a recessionary misstep is certainly possible, however, the current data – and the Fed's explicitly data-driven approach – suggest for now that any downturn is unlikely to be particularly deep or systemic in nature.

Turning to the broad opportunity set, index valuations continue to look quite reasonable, with global equities trading at 17.7x as we write, some 10% below their 25 year average and with EBITDA margins which have also returned to near their long-term averages. While the S&P 500 Index of US equities remains above its long-term average at 21.2x, valuations look more reasonable on an equally-weighted basis which strips out the impact of the largest constituents – which as we have previously discussed, active managers have the option but not the obligation to own. On this basis US equities are trading at 17.3x earnings – not historically cheap, but certainly not extended. Lastly, while 10 Year Treasury yields in the 4-5% range can be disconcerting after a long period of much lower yields, the following chart shows that we have been here before: in fact P/E valuations of 15x to the mid-20s and above have commonly existed alongside 10 Year Treasury yields in the region of 4-6%, from the early 1960s right through to today:

Figure 7: Valuations are historically consistent with current bond yields (1954 – Present)



Source: Bloomberg, October 2023

After rising to quite bullish levels in July and early August, sentiment measures have returned to cautious levels. Individual investors have turned net negative on the market, albeit not to the extent that they were during most of 2022. The Bank of America Global Fund Manager Survey showed average cash levels which are still relatively elevated at c. 5% – again, cautious but not extreme. Lastly, while investors continued to buy stocks and bonds during Q3 (flows of $28 billion and $35 billion respectively) by far the greatest fund flows went into money market funds ($239 billion, or 8.5 times the flows into equities). Together, these factors paint a picture of an environment which – somewhat as we are seeing in index valuations – is characterised by caution, if not extreme pessimism.

From a bottom up basis – on which we put by far the greatest weight – we caught up recently with one of our core external global equity managers who provided some clear data around the ongoing theme of normalisation at corporate level. Aggregated across his portfolio, the latest quarterly results showed revenue growth of 9% (exactly in line with his fund's 10 year average), cash flow margins of just over 20% (also in line with his fund's 10 year average) and – counter to the prevailing narrative in the financial press – valuations which are somewhat below the fund's 10 year average. Moreover, his portfolio companies are also seeing a marked improvement in operating margins – with EBIT growing faster than sales for the first time since Q4 2021 – as the upward pressure of costs (both input and wages) is contained while revenues grow at a good clip. His base case expected return on the portfolio (which has generally proven conservative in the past) is currently 10% and he has recently been able to add a new holding in a market-leading consumer and commercial services business with

high and stable returns on capital which he projects could generate 12-13% compound returns from here.

Microsoft CEO Satya Nadella was questioned in August about how his company was navigating the economic uncertainty of the post-COVID world. His response was thoughtful and instructive. He reminded his audience that we are returning to a more normal economic environment and that 'mostly the world looked like this' before the 'aberration' of the prior ten years; and he concluded: *'we all as businesses have to be accountable for how we manage in that environment'*. In other words, rather than complaining about the challenges posed by higher interest rates and inflation, companies (and indeed investors) need to recognise that this is the environment in which we are operating, and use every tool at their disposal to make the best of that situation. From a corporate perspective this has recently often involved a renewed focus on profitability through both cost control and pricing optimisation.

As ever the backdrop provides us with plenty to worry about, and the ongoing process of adjustment back to a more normal world of higher inflation and interest rates may not be accident-free. But the solution is to keep focused firmly on the long-term prize, be prepared to take advantage of opportunities if they arise, and continually re-underwrite our conviction in our managers and owned companies that they are all equally giving a good account of themselves during this time of readjustment.

Edward Clive

Chief Investment Officer

Sixteen02 Global Equities

The Institutional Share Class (US$) returned 24.6% as of 29th September 2023 versus the MSCI ACWI return of 10.1%.

During the third quarter, there were no outright new purchases nor sales in your portfolio.

Figure 8: Five Largest Holdings as of September 2023

1	Alphabet Inc
2	Eli Lilly and Company
3	NVIDIA Corporation
4	Salesforce, Inc.
5	ServiceNow, Inc.

Holdings shown in alphabetical order

Tale of Two Themes

Americans are getting stronger. Twenty years ago, it took two people to carry ten dollars' worth of groceries. Today, a five-year-old can do it.

– *Henny Youngman*

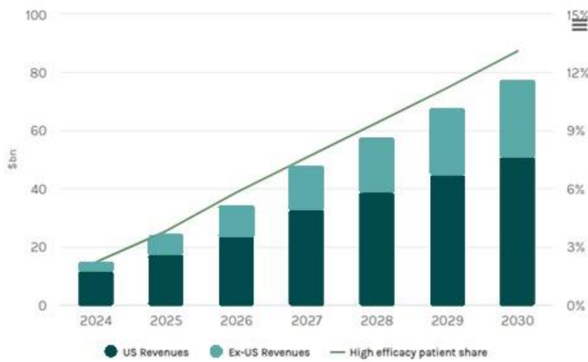
Although they have been gaining momentum since 2022, obesity drugs came to the fore in August after **Novo Nordisk** published the results of a key study.

To set the stage - GLP-1 (Glucagon-like peptides) class of drugs, are used to treat diabetes and have been in use since 2005. The newer version of these drugs, such as Wegovy (by Novo Nordisk) and Mounjaro/ Tirzepatide (by **Eli Lilly**), have shown higher efficacy in helping with weight loss, in addition to demonstrating best-in-class results in controlling diabetes. For example, Wegovy, has been shown to help with weight loss of up to 15% while Mounjaro in the 20%+ range – and indeed closer to the approximately 25% weight loss typically achieved with highly invasive bariatric surgery. Obesity is a chronic disease and creates serious health conditions such as cardiovascular (CV), kidney, liver complications and sleep apnoea, to name but a few. Despite its pervasiveness, it is not recognised as such globally. Even in the US, the debate is ongoing about whether obesity is a chronic disease. The current cost of these drugs means that reimbursement is not widely available for patients.

In August, Novo Nordisk released the results of their study which showed Wegovy reducing major adverse CV events (heart attack, stroke, cardiovascular death) by 20% in patients with established CV diseases. This is the first study to show a CV benefit of obesity medication and a

positive development for the industry, as it is likely to result in the expansion of reimbursements in the US for those drugs. More studies are in the pipeline including one from Eli Lilly which could expand reimbursement possibilities in the US.

Figure 9: Market for obesity drugs to reach $77bn by 2030



Source: Morgan Stanley Estimates

Before we initiated a position in Eli Lilly last year, Morgan Stanley estimated that obesity drugs could quickly become a top-12 global therapy growing from approximately $2.4 billion to a circa $54 billion category by 2030. Today, this estimate stands at $77 billion, an uplift of approximately 43%. Eli Lilly and Novo are two players with most efficient formulation of GLP-1s. The dual usage of GLP-1s in the treatment of diabetes and obesity is likely to drive significant earnings growth at Eli Lilly for many years to come.

Given this backdrop, Mr Market went into a frenzy on picking out the industries that could well be affected should these drugs be widely adopted. One of the purported beneficiaries is even the airline industry! Heavier aircraft must work their engines harder to keep aloft, which means more fuel is burnt. If obesity drugs help shed the weight of passengers, it could mean significant fuel cost savings for the airline sector globally! One estimate suggests that a single US airline could save up to $80 million in annual fuel costs if average passenger weight drops by approximately 4.5kg. Maybe airlines will offer access to obesity drugs in their frequent flier programs?

Similarly, the food, beverage & restaurant industries could also be affected. A recent survey noted that patients taking GLP-1 medication cut back on the consumption of confections, sugar drinks and baked goods more than other food items. Recently, Walmart Inc also confirmed that it saw a slight pull back in overall basket size from people taking the weight loss drugs.

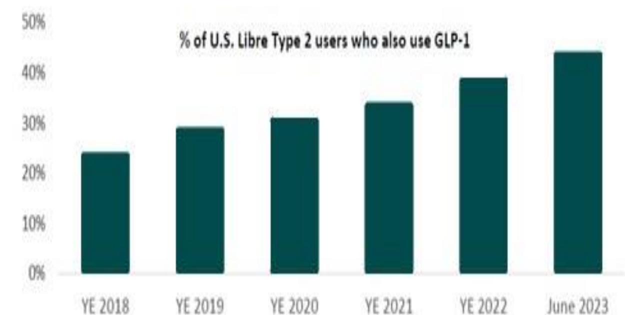
Following suit, Mr Market also took a dim view on the prospects of CGM (Continuous Glucose Monitoring) sensor markers such as Dexcom (part of the Sixteen02 portfolio), Abbott and insulin pump makers such as Insulet. Fewer obese people mean a lower TAM for these companies as they may not develop severe forms of Type-2 diabetes.

There are approximately 537 million diabetic patients globally, approximately 64 million of which require insulin. GLP-1 drugs cannot cure diabetics and in fact are often used in combination with insulin to treat some of these patients (nearly since 2005). CGM penetration is still low in this population, with **Abbott** and **Dexcom** having just over 7 million patients using their sensors globally.

CGM is considered a companion treatment in the fight against diabetes. In the US, it is normal for an endocrinologist to prescribe a GLP-1 treatment together with CGM because it helps with dose titration while lowering the risk of hypoglycaemic events. For patients, it promotes greater accountability and durable behavioural changes. For example, after an indulgence of confections, a CGM wearer is likely to receive a warning for a hyperglycaemic event. He/she may decide to take a walk in the park and/or avoid such foods in the future. This data is also utilised by the endocrinologist.

Abbott which has a significant presence in the US retail pharmacy channel (covers approximately 280 million people) recently released analysis suggesting that CGM adoption is unhindered by GLP-1 penetration in the US. It also suggested that sensor adherence is higher for those who use GLP-1 and vice versa. Based on different data sets, Dexcom and Insulet made similar observations. Hence, we believe that further data and strong execution will ultimately turn the sentiment around on Dexcom.

Figure 10: Abott data suggests that CGM usage is unhindered by GLP-1 adoption



Source: ABT Presentation; Libre is the name of Abott's CGM sensors

Another Sixteeen02 holding, **Boston Scientific**, a medtech player that helps with the treatment of cardiovascular complications among others, was

unaffected by the GLP-1 frenzy. It held its investor day in September and upgraded its growth outlook well above market expectations. BSX now expects to grow revenue 8-10% per annum over 2024-2026 while expanding margins and improving free cash flow conversion. These targets position BSX as one of the top growth firms in the med-tech space.

In the Gen AI landscape, monetization and pricing models began to emerge with **Microsoft** and **Alphabet** announcing subscription-based pricing for their Gen AI tools. Microsoft unveiled a $30/user/month pricing for its Microsoft 365 Copilot – this is a 53-83% uplift compared to the price charged on its most common enterprise tiers (E3, E5). This implies over $135bn of estimated incremental opportunity that Microsoft can pursue in the coming years. Following this, Alphabet also announced $30/user/month pricing for its version of co-pilot, called Duet AI.

Figure 11: Pricing for AI Tools – Microsoft & Alphabet

Plan	Price (User/Month)	M365 Copilot Pricing (User/Month)	M365 Copilot Pricing Uplift
Microsoft 365 Business Standard	$12.50	$30	240%
Microsoft 365 Business Premium	$22	$30	136%
Microsoft 365 E3	$36	$30	83%
Microsoft 365 E5	$57	$30	53%

Source: Microsoft, Press

Meta on the other hand, is taking a different approach to benefit from the Gen AI opportunity. It is pursuing an open-source approach in which its large language models such as Llama are available at no cost. This allows the developer community to iterate rapidly on the model and build applications on top. This is already evident as there are over 7,000 derivatives of this model since its release in July!

At the Meta Connect event, Meta showed off Meta AI, an AI assistant, which can respond to real time queries. In addition, there will be at least 28 chat bots that will have distinct specialities and personalities and will be embodied by cultural icons or influencers including Snoop Dog, Tom Brady, Kendall Jenner. All of these tools will be available across Meta's platforms (WhatsApp, Instagram, and Messenger) as well as its hardware offerings such as mixed reality device, Quest 3, and Ray-Ban smart glasses.

Initially these tools will be freely available, but in our view, once adopted at scale across its 3 billion+ daily active userbase, it could provide interesting monetisation opportunities. Meta AI and the whole host of 28+ chatbots provide an interesting segue into a social graph-based search opportunity that could be monetised in a number of ways. The tools will also improve engagement across these platforms as well as ROI for Meta advertisers.

It has been almost a year since the release of ChatGPT, and it is astonishing to see how quickly this space has grown in strength. Given the cost savings and productivity benefits, Gen AI will likely proliferate across industries beyond tech - dramatically propelling demand for compute for years to come.

As the market narrative is slowly transitioning away from a soft-landing scenario, volatility in equity markets is more pervasive, driven by macro headlines rather than micro fundamentals. Such environments generally bode well for the patient investor to upgrade constituents in the portfolio, and we see no exception this time.

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Private Investments

Nineteen01 – Private Funds

As we make the final investments in the second vintage of our Nineteen01 programme, it seems an appropriate time to look back on how the programme has developed in the four years since we launched Vintage I, the first in the series, in December 2019. The reference to the year 1901 is a reminder of what is regarded as the first ever buyout deal, when JP Morgan acquired Andrew Carnegie's steel empire for $480m, about $15bn in today's money. It was merged into nine other steel companies to form the United States Steel Corporation which still exists today as U.S. Steel. (See https://www.ussteel.com/about-us/history for a more detailed history.) The name Nineteen01 is therefore a constant reminder to us that successful investing requires a long-term perspective – even more so in private markets – and we will continue to exercise patience and discipline as we implement our systematic approach to putting client and partner capital to work.

Since starting the programme at the end of 2019, we have made commitments to 26 funds from 18 different managers ranging from West Coast US to Singapore, with

strategies spanning Buyout, Growth and Venture. In addition, we have completed 15 direct co-investments alongside a mix of existing managers and independent sponsors in the US and Europe. The bulk of our capital has been allocated to the developed markets of North America and Europe and we have also made one commitment to an Asian-focused fund. Overall the programme remains very young, but Vintage I should be almost fully called and invested by year end.

This four year period has certainly been eventful. It has encompassed the COVID pandemic, the war in Ukraine, the tech correction and the return of inflationary headwinds. The beauty of the commitment and drawdown model is that the underlying funds have continued to put capital to work throughout this period, benefiting from dollar cost averaging and the ability to be opportunistic during periods of lower valuations. Our philosophy has remained the same since the outset: to generate attractive returns for clients through a relatively concentrated portfolio of high quality managers, supplemented by the premium returns that can be generated from selectively co-investing in high quality businesses that are being acquired at attractive multiples using conservative capital structures.

What is notable already about the programme is the wide range of companies that we have exposure to. The Vintage I portfolio now has exposure to over 1,100 companies (admittedly 900 of them from the two venture secondaries funds, and a further 140 development stage biotech companies). Geographically, the portfolio is invested predominantly in North America and Europe but we have investments as far afield as New Zealand (an elderly care home business), Australia (luxury fashion[2]) and Brazil (food distribution). Investments are as esoteric and varied as pest control in China, Bytedance (owner of TikTok), the National Stock Exchange of India, the leading crypto exchange in Korea and the Orangetheory Fitness franchises in Michigan, Illinois, Utah and Missouri. In the world of sport we have stakes in the commercial arm of the Women's Tennis Association as well as the French and Spanish football leagues. No sports teams as yet, but they may come. In the world of esports and gaming we have already seen an exit with portfolio company Scopely acquired for $4.9 billion by Savvy Games Group. There are positions in large public companies such as Datadog ($30 billion market cap), Roblox ($18 billion) and ZoomInfo ($12 billion) as well as large private companies such as TKE, a top 5 global elevator manufacturer, acquired in 2020 for €17 billion. We have also benefitted from stakes in three early stage drug development companies that have been sold this year to Eli Lilly and Novartis, two of which at valuations in excess of $1 billion.

These are the higher profile and more exotic companies in the portfolio. The majority of the portfolio consists of small and mid-sized US and European businesses in areas such as software, healthcare, business services and logistics, IT, consumer, leisure and food and beverages. The exposure is very different to typical public market portfolios with their heavy weighting to the six 'MATANA' big tech stocks[3], banking and insurance, utilities, energy, mining and materials. With the exception of Bytedance which one should probably categorise as 'big tech', one investment in an Indian bank and the co-investment in German lender Aareal, the Nineteen01 program has almost no exposure to any of these sectors. Instead, the exposure is weighted towards smaller, faster growing companies which are less capital intensive and therefore generate higher returns on invested capital. It bears no relation to any public market benchmark and is designed to generate significant out-performance of public markets. We expect this to continue regardless of the rising cost of debt or temporary closures of the public markets as an exit route. After four years the programme is shaping up nicely and we expect that the range of interesting and innovative companies outlined above will ensure that in both relative and absolute terms the returns generated will be accretive to portfolios.

In terms of new investment activity, we further built out the venture portfolio during the quarter with the addition of the following two funds:

Elephant Partners V

In August we made a commitment to Elephant Partners V, a 'boot-strapped venture' fund focused on minority investments in fast-growing, capital efficient software and internet companies, predominantly in the US. Elephant is an example of a hard to access manager that is largely closed to new investors and was introduced to us by one

[2] *Please do take a look online at Zimmermann which has become Australia's first billion dollar fashion label following its sale to Advent International.*

[3] *Refers to Microsoft, Apple, Tesla, Amazon, NVIDIA and Alphabet. Meta should arguably also be included.*

of our investment committee members. This type of warm introduction, which often leads to privileged access, is exactly the reason that we spend so much time and thought in appointing members of our advisory committees. In-demand managers are in a strong position to choose their investors and in Elephant's case the manager was looking to broaden its LP base by adding a small number of high quality new investors with a long-term commitment to building the relationship over time. Insightful, 'warm' introductions such as this are very additive to the programme, particularly in the Venture and Growth space, and there are a number of other cases where we are similarly nurturing new relationships.

But other than the strong endorsement from more than one of our senior advisors, what was it that we liked about Elephant? The manager was founded in 2015 by Jeremiah Daly, previously at Summit and Accel, and Andy Hunt who co-founded online eyewear retailer Warby Parker. The team is small, with 12 investment professionals based in New York and Boston seeking to back fast-growing, founder-led businesses where they are the first institutional investor. Target companies will have at least $3 million in annualised sales and will have achieved cashflow breakeven from less than $10 million of invested capital and where Elephant's capital is likely to be both the first and last round of capital raised by the company. Elephant's young and hungry team is matched only by the resourcefulness, drive and ambition of some of the founders that we spoke to during our diligence and we are excited about the dynamic and interesting companies that we will gain exposure to through this fund which is sized at $800 million.

StepStone VC Secondaries Fund VI

This is the third investment we have made in StepStone's (formerly Greenspring's) venture secondaries programme. Fund IV, which was the very first commitment made by Nineteen01, has performed very well and we see the current environment for acquiring secondary positions in venture funds and directly in companies as being even more attractive than it was then. StepStone's close relationships with high quality venture managers and the venture team's deep knowledge of venture-backed companies gives them a real edge in diligencing and winning deals in this space and, relative to the secondary market for buyout funds, venture is much less competitive and less well understood. While secondary market discounts for buyout funds are currently in the 10-15% range, venture pricing is at a 35-40% discount to NAV. We expect that this will enable the fund to build a diversified portfolio of companies with significant growth potential at very attractive entry multiples.

Charles Magnay

Head of Private Fund Investments

David Schofield

Investment Manager, Private Investments

Nineteen01 – Direct Private Opportunities

The third quarter saw us complete our third new investment of the year and our fifteenth co-investment since launch in 2020 as we invested in the take private of Sureserve Group, the UK's leading provider of outsourced gas boiler compliance, repair & maintenance, and energy transition services to social housing providers alongside a top tier emerging manager. With a 22% share of a market growing at a 6% CAGR, backed by long-term inflation indexed contracts and protected by regulatory barriers to entry and additional upside from a fast-growing transition services business, we believe this type of company fits well in our portfolio of high quality, non-cyclical assets. Further, at an acquisition multiple of 7.4x LTM EBITDA and less than 7x pro forma for an upcoming add-on, we believe the valuation is compelling for a business that grew revenue and EBITDA by 17% and 55% respectively to September 2023 Y/E and is budgeted to grow top and bottom line by double digits in FY 2024.

We remain pleased with the performance of our portfolio which as of Q2 has average EBITDA margins exceeding 20% and LTM organic revenue growth of 19%. Similarly, the current environment continues to generate significant levels of deal flow, as the fly-wheel effect of our independent sponsor and emerging manager outreach efforts over the last 3+ years and our growing reputation among intermediaries as reliable, fast-moving co-investors combines with opportunities generated by our IC and network and offered to us by the funds backed by our Nineteen01 programme.

Oliver Mayer

Head of Direct Private Equity

David Schofield

Investment Manager, Private Investments

What we have been reading …

VC – An American History *by Tom Nicholas*

In this 2019 book Tom Nicholas, Professor of Business Administration at Harvard Business School, examines the historical roots of the Venture Capital industry in the United States. The book starts, rather unexpectedly, with a study of the US whaling industry in the 18th century, which is presented as the start of 'long-tail' investing in the US and as an industry with many similarities to VC – both in the 'lay system' used to incentivize crews and in the returns profile of the various whaling agents of the time.

The book then weaves through the 19th century, tracing the genesis of risk capital through the early backers of scaled textile manufacturing processes in New England in the 1810s and 1820s, the railway networks in the 1850s and of inventors like Westinghouse and Edison in the 1880s. As figures such as Andrew Mellon created vast fortunes, they formed holding companies which behaved much like modern VCs, with Mellon's Union Trust vehicle acquiring stakes and taking board seats in emerging companies such as the Gulf Refining Company and Union Steel, the latter of which delivered a 40x return for Mellon in four years when sold to JP Morgan's US Steel in 1903.

As Nicholas moves into the 20th century two distinct strands emerge, in the form of government-backed VC vehicles and family investment entities. An excellent profile is given of American Research and Development ('ARD'), established in 1946 and traditionally seen as the first VC firm, and the impact of its 1957 investment of $70,000 in Digital Equipment Corporation which delivered over $350 million in proceeds and legitimized 'long tail' investing. Through its uncompetitive incentive structures, ARD resulted in the creation of several successful GPs as investors gradually spun out. Alignment remains as critical a part of the underwriting process today as it ever was. That notwithstanding, between ARD, Small Business Investment Companies, defence industry spending and the creation of the GP:LP structure, it is clear that we have a lot to thank the US Government for in the creation of the modern VC industry.

In parallel, the account of the growth and increased sophistication of family investment entities created by figures such as Henry Phipps and Lawrence Rockefeller makes for excellent reading and creates a clear link with 'modern VC' as Phipps' Bessemer Trust forms Bessemer Venture Partners and Rockefeller's aviation funding entity evolves into New Enterprise Associates or NEA.

As the book moves to more contemporary events and Nicholas' source material changes from archives to interviews with venture capitalists the reader is somewhat left with the feeling that the author has become seduced by the charisma and wealth of his subjects. Tellingly titled an 'American' History, Nicholas' unwillingness to acknowledge that any other country has succeeded in building a start-up ecosystem fails the sniff test. Similarly, after an interesting account of "the big bubble" of the late 1990s and the excesses and conflicts of interest that were rampant during the period, the conclusion that "it took the wastage of a bubble to fund the exploration that would yield Amazon and eBay and Google" feels like a cop-out tailored for a future career on the Sand Hill Road speaking circuit.

The biggest question left unexplored is the extent to which the luminaries of Venture Capital profiled in and interviewed for the book are genuinely creating value or simply riding the coattails of entrepreneurs with skills and ideas that would have resulted in the same extraordinary companies being built regardless. This is presented briefly as Larry Ellison's view and then ignored. After such a nuanced view of early venture capitalists and their interactions with entrepreneurs, it is disappointing that a founder reading only the second half of the book would probably feel altogether superfluous in the process of company building.

Perhaps unsurprisingly the author is at his strongest when contrasting the differing investing styles of three Silicon Valley legends: the People focused Arthur Rock, the Technology focused Tom Perkins and the Markets focused Don Valentine. The page turning series of case studies telling the story of wildly successful investments in Fairchild Semiconductor, Intel, Apple and Tandem (and also failures such as Diasonics) demonstrates what all three investors agree – a combination of the right People, Technology and Market provides the ideal conditions for an outstanding company to be created.

David Schofield

The Intelligent Investor *by Benjamin Graham*

And last but not least, our thanks to Theo Berryer, who joined us for this summer's successful internship programme, for a refresher on the timeless wisdom of Benjamin Graham:

The Intelligent Investor by Benjamin Graham conveys a fundamental message that successful investing doesn't necessitate extraordinary intelligence, insider knowledge, or sheer luck. Instead, it emphasises the need for a rational approach and emotional discipline. Warren Buffett refers to this book as the best investing book ever written.

Graham's core principle is that a stock isn't merely a ticker symbol with a price tag; it represents ownership in a business. He introduces Mr Market and his irrational behaviour, leading to a stock's true value diverging from the price he offers. Frequently, Mr. Market becomes overly optimistic or pessimistic, leading to over- or under-pricing. Graham advises investors to buy stocks they'd comfortably hold, regardless of Mr Market's price fluctuations. However, for investors who can keep their heads cool, Mr. Market presents an excellent opportunity to purchase a company for a bargain.

According to Graham, there are two types of investors: the passive and the active. Most people are better suited for the defensive strategy due to limited time for investing. Passive investors should maintain portfolios with a mix of bonds and stocks. Being an active investor and outperforming the market is more demanding, requiring patience, discipline, and a thirst for learning, as it's surprisingly easy to succumb to Mr. Market's pricing fluctuations.

Graham emphasises the pivotal role of price for active investors. As company profits are finite, the price investors pay should also be finite. The market often overvalues rapidly growing or glamorous companies and undervalues those with less appealing prospects. Intelligent investors should prioritise current valuations over uncertain future earnings. Additionally, he strengthens the importance of scrutinising annual financial reports when analysing a company.

Graham challenges the conventional wisdom that risk and reward are always correlated. He argues that the price and value of assets can often be disconnected. Therefore, an investor's expected return depends on their effort and intelligence rather than the level of risk they accept. Passive investors typically receive lower returns, while active investors, exercising intelligence and skill, can achieve higher returns.

In summary, *The Intelligent Investor* offers several invaluable lessons. First, investors should disregard Mr. Market's extreme mood swings, viewing his fluctuations as business opportunities. Second, passive investors should create diversified portfolios. Third, active investors should put in time and effort before making an investment decision. Fourth, investors should insist on a margin of safety. Lastly, Graham challenges the notion that risk and reward are always correlated, emphasising the importance of intelligent investing.

Theo Berryer
Summer Intern

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