VALOR ASSET MANAGEMENT

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The 5 stages of investment through a crisis:

1. Protect capital
2. Net cash companies
3. Recapitalisations
4. Cyclical lows (oil, miners, car companies, airlines & banks.)
5. Property and unlisted assets

It is safe to say that we have protected capital better than most during the initial stage of the Coronavirus crisis. Our portfolios remain positive this financial year. We have largely avoided the first leg down in this pandemic. We may not be at the bottom. No one knows when the market will bottom. What we can know is how previous crises have played out to have a "rough playbook". We are updating our playbook daily depending on different news and market conditions. Most importantly is that we have a model for what we expect so that we are able to invest with confidence if and when we see the expected opportunities. This model is based on what has occurred during previous crises.

Whilst no crisis is ever the same, they all have similar attributes as the saying commonly quoted" History does not repeat itself, but it often rhymes". Bear market rallies are common. It appears we are experiencing one right now, however we won't know until after the fact. We are still seeing a number of businesses that we believe are trading at well **above** their intrinsic value. Excessive optimism remains in some businesses. We don't believe we are at the excessive pessimism stage yet.

Stage 1 – Capital protection

The first stage of the crisis was one of capital protection. It was a risk reduction stage. We sold assets, we shorted the markets, we bought government bonds, we bought gold and gold miners and had a moderate exposure to the US dollar. We are only down single digits from our absolute highs in mid-February. By carrying out the aforementioned trades we feel we have adequately protected client capital and are still up around the mid-single digits for this financial year. We are happy with this result considering the opportunities that we are now faced with.

The first stage of the crisis is actually the most important stage. If you lose 50%, you need to make 100% to get back to where you started. If you lose 75%, you need to make 4 times your money to get back to where you started. I saw portfolios during the GFC which were down 90% and they needed to make 10 times their money to get back to where they were. If you have these large losses, it becomes very difficult to get your money back. If you avoid the majority of these large losses you can significantly outperform over time.

Stage 2 – Net cash businesses

Our investment strategy is not about attempting to pick bottoms, it is all about avoiding permanent loss and having significant upside vs downside risk. There are some stocks which are at or approaching attractive levels due to their cash backing. We are approaching stage 2 – buying wonderful companies with lots of spare cash.

Whilst much of the market may have further downside as their balance sheets and cash flow are insufficient to get them through the coming few years, there are some true gems that are prepared for these types of events. We already own some of them and may purchase more, but there are some which have been on our watch list for **decades** and we may finally get a chance to purchase them.

Some people talk about patience in years. We talk about patience in terms of decades. We have been following some of the wonderful companies on our list since the late 1990's and never invested because they were not in our price range (or we missed an obvious opportunity). This market may present that opportunity and we are ready to pounce.

Stage 3 - Recapitalisations

Some of the world's good companies may need to be recapitalised in the coming year or so (the truly great ones never need recapitalisations). It is only after recapitalisation that we may consider them suitable for investment. Without these recapitalisations, these companies may not survive the worst possible outcome.

We have a good track record of solid gains from companies after they received an injection of capital. Our purchase of Bank of America after the GFC at $7 is one of these. We then proceeded to make multiples on our money over the coming years (trimming along the way) as the stock rose into the $30's.

Just because a company has raised capital does not directly lead to a good purchase. The company must also be undervalued. The recent capital raises by Cochlear and NextDC were done at above what appears fair value and the stocks do not interest us at these prices. Webjet recently raised capital, however we feel that it is a difficult business and it would need to be exceptionally cheap before we made a purchase.

Stage 4 – Cyclical Lows

The old adage, “time in the market vs timing the market” is generally true, however if you invest at the absolute top of a market cycle, it can take up to 25 years to get your money back.

Certain stocks have wild fluctuations between their cyclical lows and highs. These stocks can look like wonderful investments for many years on the way up, however some forget that they are not evergreen companies. We were very vocal warning about BHP in 2011 when iron ore was $180 a tonne. This was, at that time, an obvious cyclical high. Converse to this is the cyclical low points which can create opportunities. The WTI oil price dipped below $20 of late having fallen from highs of $144 a number of years ago. Is this a cyclical low? Many companies won’t survive this level of pricing. Those that do may thrive as capacity is sucked out of the market.

There has been much debate between “growth” investing and “value” investing. This debate is nonsensical. An investment is only an investment when you are buying below fair value. If you pay above fair value you are speculating and it is not an investment, it’s a punt.

In this cycle, so called “growth” companies rose to levels which were beyond comprehension using any rational investment analysis. The use of made up accounting methods, by taking actual costs out to create “made up” earnings, became very common place. For those in the know, we’re talking about “adjusted EBITDA”. Many fell for these tricks. If you avoided pretty much any company touting “adjusted EBITDA” in their earnings reports over the last few years, you will likely protect your money better than most over time. Many of these companies have no cash or cash flow and simply won’t survive a full cycle.

Whilst many value investors were getting caught in relative valuations of cyclical companies versus growth companies, what they failed to realise is that the cyclical companies are often very difficult businesses in tough times. We are now in tough times. The secret to investing in cyclical companies is to look at the range of earnings throughout the cycle. If you are investing in a cyclical company and you are valuing it on depressed earnings, you should do fine. If you are valuing the cyclical company on average earnings and we see more challenging times, some of these businesses can fall **more** than the market. This is where we find ourselves today.

If we see excess capacity curbed, the cyclical companies that survive can thrive in the coming years as demand resumes. This can create multi-baggers off the back of greater than market losses during the initial stages of the crisis.

We have successfully purchased companies at their cyclical lows in the past. We made approximately 65% return in the space of a few months when we bought Ryanair last year. We calculated that when we bought Ryanair it was trading at around its valuation lows for the GFC, despite being near the market top. We sold it successfully and crystallised our gains. We may get another chance to repeat this trade at far lower prices.

Stage 5 – Unlisted Assets

Property

Unlisted assets can have different waves of price falls. Whilst many incorrectly think that property has smaller price movements than stocks, over the very long-term it can have similar ranges, except it is often staged over a few more years. Property in the US bottomed around 2 to 3 years after the bottom of the stock market in March 2009. This creates a wonderful opportunity to those that are asset agnostic.

We do not have any asset bias. If stocks are paying us 10% a year in earnings and property is paying us 2%, we want to own stocks. If stocks are paying us 5% a year to own and property is paying us 10% a year to own, we want to own property. This is the situation we saw in the US in 2012. There were lots of properties that were cheaper than stocks.

Private Equity

There has been a significant trend in recent years to have a significant portion of assets under management in leveraged unlisted assets. Industry super funds and large pension funds around the world have been funnelling trillions of dollars into these vehicles.

> Where there is a popular trend, there is often excess.

Low interest rates and the ability to "smooth out" returns through delayed reporting, combined with "made up" pricing, appears to be a very attractive way to increase returns without theoretically increasing risk. Unfortunately, true risk is not the short-term ups and downs in prices. It is the probability of permanent loss of capital. If you have an asset which is 20% equity and 80% debt, you only need a 20% fall in that asset to lose all your money. This is not a risk to these funds in normal times as they won't disclose to their clients that the asset has actually fallen, however if they are forced sellers of assets, these types of business practices are the naked person when the tide goes out.

Prices for these leveraged unlisted private equity, venture capital, leveraged unlisted infrastructure and leveraged unlisted property rose strongly as interest rates fell. Few questioned how a number of "balanced" funds were achieving over 10% returns in 1% interest rate world. Much of it was done via leverage and hidden risks.

The opportunity in this folly, is that we expect there to be significant forced sales of these assets and we may have the opportunity to purchase assets at fire sale prices. Many of the underlying assets in these vehicles are solid, however they are simply the victims of excessive leverage. Once deleveraged, they will once again be great investments.

We thank you for your support during this period,

Most importantly, stay safe.

The Valor Asset Management Team