VALOR ASSET MANAGEMENT

Valor October 2020 Newsletter

> "Smart people are a dime a dozen. What matters is the ability to think different... to think out of the box"
>
> *Walter Isaacson*

The Market Remains Elevated

We continue to believe that the general level of markets remains elevated for most to achieve a reasonable return. The current level will likely provide lower returns than previous averages suggest. Perhaps we may see another more than a decade period of no returns that occurred after the dot com bubble?

Despite the general excessive stock prices, we remain invested in fantastic business that are either below or well below their fair value in our assessment. We strongly believe we are well positioned for the coming 5, 10 and 15 years. Those that avoided the folly of the dot com bubble did well in the 2000 to 2003 bear market.

We are likely in another dot com bubble in terms of how disconnected the financial market is from economic reality as a result of the impact of Covid19 in our opinion.

Those who believe that you can pay any price for a stock may be in for a rude shock. Sadly, history has been brutal for these types of operators. They do well for a few years, and then they wipe out decades worth of hard earned savings.

The profitability of a company is the most important piece of the investing puzzle. Only 13% of all recent IPO's have been profitable. SPAC listings may be worse. There are countless companies that are growing revenues at high rates, loss making and trade at prices that suggest they will become the next MasterCard. Few will.

This time is unlikely to be different. History does rhyme.

Berkshire

Berkshire's 12 month share price performance of a negative 5% return, in AUD term, has been disappointing. However, the underlying business is still performing well but its share price has not reflected that. One key asset is Apple, with their stake in Apple being approximately 43% of Berkshire's entire stock portfolio. Since the start of 2019, Berkshire's holdings in Apple have ballooned in value by over 150% or $55 billion in absolute dollar term. The enormous rise in Apple's stock price is increasing the value of Berkshire. Berkshire's share price will eventually follow.

With approximately $147 billion in cash, the company remains a fortress. The safety of the business with these levels of cash is unparalleled. We remain extremely confident in the future returns of Berkshire and are comfortable with it being the anchor for our portfolios.

If Berkshire buys back more stock or does a big acquisition, the share price should rerate significantly higher.

At approximately 10 times operating cash flow after cash, Berkshire is not expensive.

Alphabet

Alphabet has shown its resilience over the last year. The business continues to grow and with multiple segments such as its cloud offerings, YouTube, Android and Google Maps with significant upside, we see a long runway of growth still ahead for Alphabet.

The less certain, yet enormous upside potential of Alphabet's 'other bets' continue to be discounted by the market. Whilst the value of these other bets is unknown, we do not believe they are being fairly valued by the market.

Again, like Berkshire, it has a fortress balance sheet with around $130 billion in cash.

Facebook

Facebook continues to grow solidly. As expected, advertising slowed during Covid19, however we expect this to pick up over the coming years.

Instagram remains one of the most powerful branding tools ever built. The "Influencers" trend on Instagram is unlikely to slow down and remains exceptionally powerful for growing brands. The flywheel network effect moat of Instagram is strong.

User numbers for Instagram and WhatsApp remain strong and we expect them to continue to grow.

With approximately half of the worlds internet users regularly engaging on a Facebook app, the power of Facebook's advertising revenues will likely continue to increase.

Ambev

Beer volumes took a hit during Covid19's induced lockdowns in South America. Canada remained steadier.

Due to this weakness, we have been able to purchase Ambev at very depressed prices. The commanding positions of the brands that Ambev owns is obvious with their economic returns over the last few decades. We expect that these brands will remain strong for many years to come. We also expect Jean Jereissati, CEO of Ambev, will use excess cash and cash returns to add to the brand stable, which will further increase their dominance in their respective markets.

The weakness of the South American currencies is a large driver of Ambev's stock price. We expect that stronger commodity prices may have a very positive feedback loop for Ambev. It would increase GDP in these countries and thus beer consumption and at the same time, increase the currencies of these nations leading to a significant rise in Ambev's share price.

Purchasing Ambev during this cyclical low should provide very solid returns over the coming years.

The balance sheet is exceptional with net cash of approximately $2billion. This contrasts to other beer companies with stretched balance sheets.

Safran

Safran has proved its resilience throughout the Coronavirus crisis.

With passenger numbers recovering in a number of countries, the profits and cash flows of Safran should recover strongly in the coming years. Notably, China already has higher domestic air travel than pre- Covid level.

The approval by the European regulator for the 737 Max to operate again is a big step in Safran's future earnings potential.

We expect double digit earnings growth for the next decade for Safran. This upside potential is not reflected in its share price.

Gold

Before Coronavirus, we had an ambivalent attitude to gold.

Our views changed when the central banks embarked on an unprecedented monetary and fiscal stimulus policies to take on and try to reduce the impact of the crisis early on.

Our gold holdings have done very well. Our view on gold is simple. It is less worse than a number of other assets.

In a world of race to the bottom by central banks, gold provides a reasonable protection for our portfolios as a buffer against the worst-case scenario.

We will continue to own the gold and gold stocks as a hedge against extreme levels of monetary operations. We expect it to remain volatile, yet generally uncorrelated to a number of our other positions.

Xplore Wealth take over

Xplore Wealth has received a take-over offer by Hub24. We are happy to exit this position with the takeover bid valuing Xplore at 203% premium to its closing price on Tuesday.

The management of Xplore could have gone on a holiday for 5 years and done a better job. The entire managed account space has grown at nearly 40% over the last 5 years as the new breed of platforms stole market share from the old generation of WRAP platforms. Every managed account company **except** Xplore Wealth has received their fair share of this growth. This is not a winner takes all industry.

The management issued more than double the number of shares to buy loss- making Linear and the transaction wiped away much of the value of the business. It was one of the worst acquisitions we are likely to see.

The Hub24 take-over offer is part cash and part scrip. Hub24 shares are at a fairly rich premium. Their issuing of new shares to buy a far cheaper business will be accretive to their earnings, but whether we want to own at this price is not obvious.

Rolls-Royce

Singapore has thunderstorms on a regular basis. It is common knowledge for a pilot flying into Singapore to hold some extra fuel. Occasionally there are thunderstorms which are not on the forecast. The pilot can hold until the thunderstorms clear or they can divert to Kuala Lumpur, pick up more fuel and then come back to Singapore. The longer the pilot delays the decision to divert, the less fuel they have at Kuala Lumpur. If a pilot delays the decision to divert, they risk approaching minimum fuel reserves. At minimum fuel reserves, you can’t have anything go wrong.

This regular story of thunderstorms and management decisions is highly applicable to Rolls-Royce. Rolls **had** one of the best businesses in the entire world. The difficulty to compete with Rolls for long haul engines has led to a duopoly that has lasted for decades.

The unprecedented Coronavirus challenges forced Rolls to raise capital to be able to continue their operations. Raising capital would not have been an issue for Rolls if they had made the decision early. Due to management incompetence, they delayed the decision. This uncertainty has sent the share price down and the amount of shares they need to issue is now considerably higher. The future return on invested capital is now a fraction of what it could have been.

The management of Rolls have kicked a home goal. The management likely had vision of the company's issues early in the crisis. The power system segment weakness and the over hedged currency costs would have been clear to them for months. They should have raised capital earlier. By delaying, they waited until the share price was at a critical level and the amount of capital they need to raise became larger than their market capitalisation. They did the equivalent of delaying the decision to divert and getting down to below minimum reserves. Management put the company on its knees and they were forced to raise capital under duress.

The future returns on capital are now insufficient for us to remain owners.

Looking forward

We remain confident of solid future returns, whilst at the same time expecting poor returns from the general share markets. We can suggest this is possible due to previous bubbles where "new technology" stocks traded at prices that required a vivid imagination for the company to grow into their lofty valuations. We are near a junction today.

Just as there were winners who survived and thrived after the dot com bubble, there will be winners today. How long will their prices take to recover? Using history as a guide, we estimate it may be over a decade. We prefer to avoid stocks which could take a decade or more to get our money back.

> "The parties were bigger, the pace was faster, the shows were broader, the buildings were higher, the morals were looser, and the liquor was cheaper"
>
> *F. Scott Fitzgerald, The Great Gatsby*

> (The roaring 20's was just after the Spanish flu of 1918. We remain optimistic)

Stay safe from the Team at Valor.