EAST 72

QUARTERLY REPORT #16: PERIOD TO 30 JUNE 2020[1]

Performance and net asset value[2]

Quarterly portfolio return: 0.0%

Crazy relativities

On Monday 4 August 2003 – so nearly 17 years ago – in a "past life", I started buying shares in a very quirky funds management company, at that time based in Canberra, at a price of $11.55 per share. It took a while to accumulate a holding because most of the available shares were held by staff or a fledgling investor in fund managers at the time, Ascalon.

Over about a year, we accumulated enough to be the ninth largest holder, and eventually held around 2.8% of the company, at an average price of $12.43 a share for an outlay of just over $300,000. At my entry price, the shares traded at a trailing P/E of 23x, had a market value of $10.8million so that each dollar of funds managed ($300million or so at the time) was valued at 3.6c (3.6%) and the dividend yield – remember the staff were big shareholders – was a reasonable 4.1%.

Fast forward to May 2020. The company is still going strong, and now manages just over $3.92billion, so funds managed have grown at a 17.8% per annum clip through investment return and inflow. This year, the company will earn a net profit of over $7million (before a $2.5million after tax performance fee) over sixteen times the level of fiscal 2003. It is now based in Sydney.

By any stretch of the imagination, that's a very good performance by the business, especially when it went through a disruptive period of "insurrection" by former founder-directors in 2012.

What is now remarkable about this business? Two things. Firstly, seven of the eleven largest shareholders in August 2004 were still in the top 11 shareholders in August 2019, including, perhaps surprisingly, the three key "dissident" founder-Directors who launched an attempted putsch in 2012. All have had the significant benefit of compounding.

Secondly, if we assume that this company was priced similarly to the metrics pertaining back in 2003-2004, with a bit of leeway because of its track record – say 30x earnings, and ~5% of funds under management, the company would have a market value of somewhere around $220million. As a guide, 30x earnings is about twice that of other mature funds management businesses listed in Australia and a premium to the superbly performed Magellan (MFG.AX).

That market value would represent a 21%pa capital return plus the benefits of a generous dividend policy which pays out a substantial portion of earnings each year.

[1] East 72 Holdings Limited (**E72**) provides monthly **unaudited** updates on its company performance and exposure supplemented by a more substantial quarterly note. Readers are referred to footnotes 2 and 13 - 18 explaining the derivation of the numbers. All returns are pre-tax unless stated otherwise. At the current level of net assets, cost imposition is estimated at 0.6% per month over the course of a full year (excluding capital raising related expenses) and is fully accrued monthly according to the best estimates of management. Readers are explicitly referred to the disclaimer on page 11.

[2] Month by month tabulation of investment return and exposures is given on page 10, along with exposure metrics.

On 22 June 2020, the company entered the S&P/ASX 300 index. With index funds chasing shares which are extremely thinly traded, a week out from the end of FY20, the company had a market value of **$1.018billion** – 135x FY20 earnings before performance fees, and the equivalent of 25% of funds managed.

It has pro-forma liquid assets of about $14million, so the enterprise value was just over $1billion. The company is called Australian Ethical Investment Limited (AEF.AX), its shares split 100:1 in 2018, so our entry price in today's terms would be 12.5c; the shares hit $9.09 a week from the end of the financial year, and even excluding the dividend returns, our $300,000 would have been worth.......[3]

It's been a big winner for the reputationally dented IOOF Limited (IFL.AX) who have owned 17% or so since November 2005.

As AEF shares vaulted four and a half fold since the end of March and up nearly 60% from their pre-COVID high, they illustrate - quite spectacularly - the type of "pricing to infinity" which now pervades equity markets, especially in better quality businesses, as well as the distortions brought about by index-type funds[4] and enormous central bank injections of liquidity in the wake of the COVID crisis.

The lunacy of AEF's share price, as one of only many examples of an equity market well out of kilter, is seen when directly sized up against a competitor of sorts, Perpetual Limited (PPT), where we have recently re-opened a position. Perpetual is three businesses: a funds manger with a (past) emphasis on Australian equities using a value style approach, private wealth management with a bias to medium net worth accounts and a trustee, both to corporate and securitised mortgage debt issues, but also managed funds services. On 22 June, for a mere extra $250million over the enterprise value of AEF, you could have (theoretically) bought the whole of Perpetual.

The 2019 financial year was a seminal one for PPT being the first year in modern times where profits from the private wealth and trustee business combined exceeded that of the funds manager; yet the equity market still focuses on PPT's ailing Australian equities funds management business. It's understandable why, because the profits and cash flow from that business have funded generous dividends and takeovers in the two other areas since funds management profits peaked in 2007 at $154million pre-tax. This past FY20, they'll be lucky to do $70million, with current funds managed just above half of the $39billion they were in June 2007 (June 2020: 22.8billion, excluding Trillium).

On a sum of the parts basis, the non-funds management businesses of PPT should earn around $93mn EBIT in the year just concluded; allowing for central HQ costs would give a profit of some $82million. It's not unreasonable to value that at over $900million which means around current prices (slightly above the 22 June levels) we are paying just over $300million for the funds management business.

[3] $22 million
[4] The share price of Tesla rose 61% between 26 June and 15 July, adding $111billion of market capitalisation, largely on speculation of it being added to the S&P500 index

Whilst on any medium term assessment, it looks a bit of a dead duck unless performance turns around fairly soon; the core Australian equities franchise is fourth quartile all the way out to seven years, is suffering net ouflows and was down to an $11billion business at end March 2020. However, the funds management business in total will still pump out $65-$70million of pre-tax profit this year which helps fund a regeneration of Perpetual as a whole.

PPT's first steps in that regard have been to buy a US ESG[5] funds management business, Trillium, with $5.6billion under management for $52million plus staged payments.

So what's the attraction? Firstly, we are not actually paying much for the beaten up Australian funds management business. On my calculations, at around prevailing prices, we are paying the equivalent of about 1.2% of funds under management and an equivalent P/E multiple of around 7.5x; both are fractions of the cohort group which trade at 4%+ and P/E's around 14-16x for the more mature slower growing businesses. Secondly, for the whole company, we are paying a FY20 P/E equivalent of around 12x for the whole company (EBIT multiple of 8.4x). Thirdly, the entire sector is likely to undergo consolidation, and more than one suitor should be interested in one or other of the non-funds management businesses. Finally, around 7% of the shares are sold short – down from 9.5% recently – and given the relatively thin trading due to slabs of the shares being held by retail investors attracted by overly generous dividends, that's an aggressive position.

This is not looking across the valley

It's hard to escape the conclusion that the prevailing equity market environment in the US is the craziest ever seen, with distinct undertones of 1999 and 2007.

There is obvious logic in trying to buy shares of companies when their prices have fallen sharply to below long term fair value and holding for the long term. That is not what we are seeing in the world's largest equity market, and why we are so cautious.

The logic arises from the established fact that a share price, reflecting the value of a company's equity, is the discounted value, in today's money, of all future cash flows attributable to the shareholder. So there are two key things move this equation around: the discount (interest) rate at which future cash flows are calculated back to the present day and the assumptions upon which the estimates of these cash flows rest.

Let's dispense with the easy bit first. Current interest rates at which investors are tempted to discount cash flows – usually calculated as the ten year bond rate plus a risk premium – are about as low as they can likely go, after ten years of central bank experimentation with printing money, yield curve control and all kinds of other Frankenstein-like concoctions, created irrespective of the impact on future generations.

The past eighteen months have seen the US Federal Reserve Board effectively print money to buy US Government debt (via the secondary market)[6] to keep long term yields down. Over recent

[5] Environmental, Social, (corporate) Governance
[6] So called Modern Monetary Theory. If you want the economic debate about this, there is a lengthy, detailed but balanced read by Stephen Grenville, an ex-Deputy Governor of RBA available free at:

times, they have expanded into buying corporate debt to keep the system liquid. Corporate debt of such troubled companies as Apple (last stated (28/3/20) cash net of debt excluding working capital deficit: $104billion), Berkshire Hathaway ($34billion, excluding a $181billion equity portfolio).

As a guide, if you have a standard company growing free cash flow at 5% for five forecastable years, then long term growth of 4%, the net present value of those cash flows at a discount rate of 6% is about twice that of an 8% discount rate. The unforecasted (assumed long term growth) bit – the so called terminal value - depending on your assumptions typically represents 70-80% of overall value in a 5 year discounted cash flow. This rises significantly as discount rates fall.

We've seen that piece. What it does is allow undisciplined growth investors to "hide" their fears at a point further in the future. But what it also does, perfectly reasonably, is where there is a "shock" to a company in the early years, to hold onto the fact that the terminal value will prevent the share price from falling too far. This is especially the case for stable long term assets, such as tollways and airports. Hence, on any major fall, the shares tend to be snapped up aggressively.

However, it's not all plain sailing in the theoretical world. Virtually no matter what the discount rates used, a <u>severe</u> interruption to cash flow in the early years – say a year of -25%, then growth the subsequent year from the lower base of 20% & another year of above trend growth – has around a 15-20% dilutive impact on theoretical value, no matter what the discount rate.

With technology stocks in the US trading above their pre-COVID levels, investors are effectively saying there is no short term downturn in their business, interest rates are staying very low and that long term growth rates will increase. That WILL be the case for some; but for others, less likely.

Consider the five largest capitalised stocks on the US market: two (Alphabet, Facebook) have a 70% - 97% reliance on advertising, which has <u>some</u> degree of consumer sensitivity whilst nearly two thirds of Apple revenue comes from selling devices, not immune from deep (if transitory) recession.

US equity markets still seem to assume very limited dislocation from COVID-19. This <u>may</u> be due to recent economic releases NOT capturing the dramatic increase in COVID infections from ~21,000 per day in early – mid June, up to over 60,000 per day more recently (see chart, next page). These numbers are not reflected in statistics such as non-farm payrolls (the surveys of which are taken in the first two weeks of a month) and upon which equity markets place great store.

The COVID pandemic in the US is remarkable – 1% of the US population has caught COVID; at the time of writing, just less than half have seen an "outcome", and for these folks , one in twelve die. Death rates are falling as knowledge of the treatments have improved, as has the dispersion of the virus away from its concentration in New York back in April. However, the rate of growth remains staggering and out of sync with other developed nations. For example, in UK and Italy,

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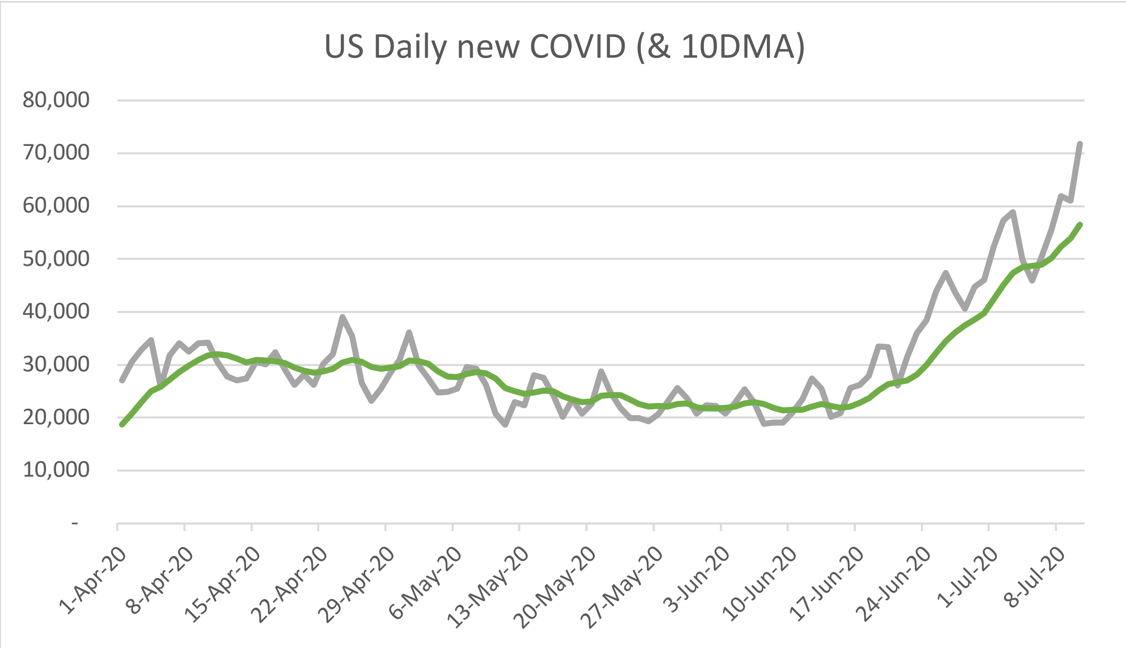
https://www.eurekareport.com.au/investment-news/modern-monetary-theory-and-mainstream-economics-converging/147725 around 105- 107 days after the case numbers passed 100, the compound daily growth rate in cases finally fell below 8% per day . In the USA, after 135 days, it's still above 8% a day[7].



Our focus is on the economic damage caused either directly, indirectly by people not engaging in activities which create economic multipliers (retail, entertainment etc), near term economically damaging measures caused by regulatory shutdowns and then the medium and even longer term ramifications.

This involves multiple levels of thinking. First level is easy; the shops are shut – sell retailers. Second level: sell retail property owners as retailers can't pay the rent. Third level: people work at home more, use "Zoom" so sell office property companies – whose rents may not be being paid anyway, who are usually financially levered and may not be able to repay debt, interest or fund new developments and improvements. Fourth level: the near term psychological impacts. Fifth level: the interplay of all of these on long term habits.

The fourth and fifth level are the most difficult. Things like a temporary increase in the purchase of jigsaw puzzles; a noticeable improvement in the environment; an INCREASE in the price of second hand 'stuff" – cars & computer monitors as folks adapt to WFH.

But how much of this is permanent, rather than transitory, and how long does the transitory impact? We know that if "lockdowns" and closures go for too long, they become permanent. For example, how much of the "support services" for Sydney and Melbourne's CBD will exist in a year's time with far fewer office attendees. The small coffee shop simply won't come back – or will migrate to the burbs.

[7] As a clue 1.08 to the power 27 is 8 (something starting at 1 growing at 8% a day for 27 days); 1.04 to the power 27 is less than 3. So it's reasonable to assume US has had more than twice the cases it should have if growth had been levelled off by proper action. The situation in New York shows this to some degree.

Many of the starting points for these trends are obscured. Accurate economic statistics are blurred by JobKeeper and the US PPP, and are simply not, in our opinion, giving an accurate picture of how deep this slowdown has been.

Of course, there is a bounce of sorts from the low point of activity in March/April when the realisation of pandemic hit home. But to ascribe a "V" shape, is sloppy thinking indeed.

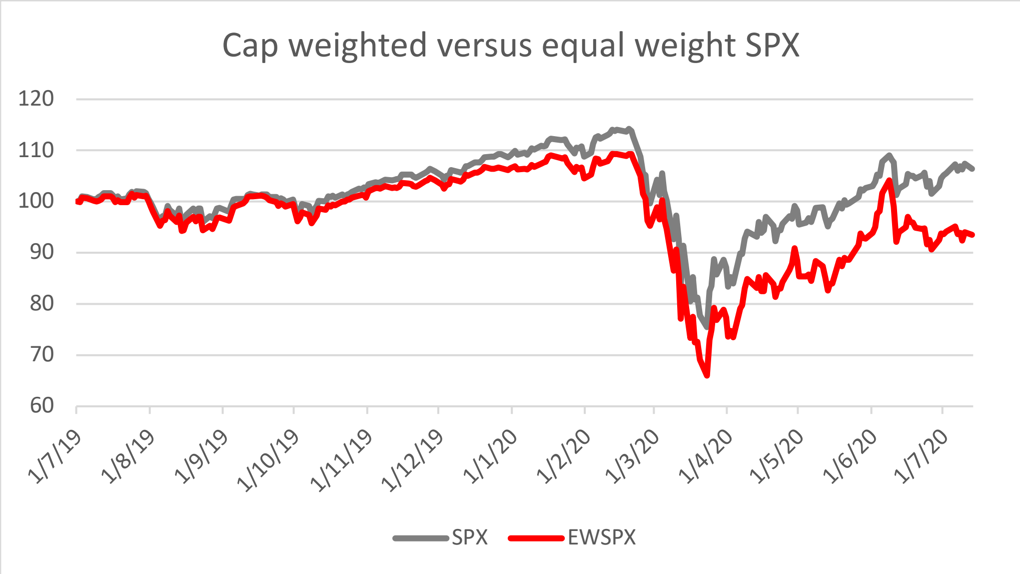
Yet US equity markets are doing exactly that.

Over the past few months, there has been virtually no change to the FY21 S&P EPS estimate of just above 163 - the same level as in FY19. This is despite the not unexpected collapse in FY20 estimates from 172 at the start of the calendar year to ~127 at the current time. A few obvious comments:

- How realistic is it to expect FY21 earnings to equal FY19 earnings given far lower activity for airlines, a lower oil price, likely margin pressure and higher bad debts for financials, potentially higher tax rate if there is a change of President and a consumer whose net worth or liquidity will have been damaged by COVID and where the unemployment rate is likely to still be well above average?;
- Some folks already postulate 2021 earnings being significantly ahead of 2019 as a result of cost cutting in FY20 (without regard to what this does to the wider economy);
- There will be some obvious clean-ups by companies who can put all their bad news into FY20 to report a stronger FY21;
- By far and away the largest contributor to negative growth in FY20 and uptick in FY21 is postulated to come from the consumer discretion sector which makes up about 11% of S&P500, industrials (<8%) and financials (about 10% of S&P500). Make sense but its low quality.

Add into this expensive fundamental picture, some of the madness of retail stock speculation which has occurred from April-May onwards, and which may have reached crescendo levels in early July. When else have an additional 50,000 folks on one platform traded in Tesla shares on one night starting at a price some US$75BILLION more than the world's next largest car company.[8]

[8] On 13 July, 49,192 users of Robinhood took out long positions in Tesla, increasing its popularity on the platform from 408,515 to 457,707 "holders". The shares moved from a prior close of $1544.65 (market capitalisation ~$283billion, to a high of $1775 (~325billion) to close at $1497 ($274billion). Toyota Motor has a market value of $202bn, sells 10.6million cars against Tesla's ~400,000 (COVID affected in 2020).



Of course, as we discussed earlier, what's driving the US market is the perceived high growth technology sector, including the top 5 FAAMG[9] companies accounting for just under 22% of the S&P500. Over the course of a year, S&P500 (a market capitalisation weighted index) has returned 4.6% before dividends; on an equally weighted basis[10], the return has been nearly 12% less at (6.3%). The FAAMGs have returned between 79.6% (Apple) through 48.9% (MSFT), 43.4% (AMZN), 28.7% (GOOG) to 16.3% (FB) in the year to 30 June 2020.

This type of return disparity provides a clear backdrop to the fact that there are a myriad of cheaper companies than the highest quality, but highly priced mega-caps, which we have noted are NOT immune from economic distress. Whilst we are betting explicitly against only one of the mega caps, the fact we have a short position in the cap-weighted index represents an explicit recognition that whatever their strengths, the big 5 look more akin to 1960s "Nifty Fifty" one pick stocks now than at any prior time.

Incorporating some "Coffee Can" investing

In February, an investor based in Pennsylvania, Kevin Duffy, published a wonderful 19 page note[11] establishing what he called a "coffee can" portfolio. This is a portfolio where you make some very careful choices of securities and essentially stuff the "share certificates" in a coffee can, put the can under the bed and leave it for ten years. Mr. Duffy was guided by a paper[12] written in 1984 by Robert Kirby of Capital Guardian Trust in Los Angeles, which laid out four key principals underpinning this style of investing:

- the lack of transaction costs, which were far higher in the mid 1980's than the present day;

[9] Facebook, Amazon, Apple, Microsoft, Alphabet (Google)
[10] Sourced from Invesco S&P500 Equal Weight ETF (ticker: RSP)
[11] Available at www.thecoffeecanportfolio.com
[12] Journal of Portfolio Management (fall 1984) (The Coffee Can Portfolio)

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- his coining of the phrase "active passive" – in other words, you do actually pick stocks (active), but you leave them to gestate for years (passive);
- the difficulty of selling such a product to anyone as an adviser– it takes ten years or so to evaluate, and thereby makes evaluating an upfront fee to an adviser quite difficult; you can, of course, just do it yourself; and
- the big one: the presence of a "multi-bagger" – a security that appreciates many-fold in price amongst the portfolio, because you leave it to do so.

In April I did some self-analysis[13] [14] looking back on some past investment decisions of mine pre-dating East 72. Apart from the crazy anomaly of AEF noted earlier, I did show a very significant opportunity cost by not letting certain investments fully gestate. Some were perhaps surprising as to how they did so well, but others were not.

The analysis certainly rammed home the need to hang on for the very long term to your best investments and not exit after a 50-100% gain, and forego a multi-bagger. The current period of time appears strange with multi-baggers within months (eg. Afterpay) which don't appear justified at face value. I do see scope for some of our existing holdings to trade at multiples of where they are at present and am intent on retaining them and ensuring they have the requisite impact on the portfolio. I should add that not all of them are disclosed in this note.

Portfolio structure

Our top ten long positions in alphabetical order as at 30 June 2020 are:

Berkshire Hathaway Inc	Renn Fund Inc
Boral Limited	Treasure ASA
Gowing Brothers Limited	Virtu Financial
Namoi Cotton Limited/Australian Rural Capital	Xplore Wealth Limited
Prime Media Limited	Yellow Brick Road Limited

Such is the disparity of pricing in equity markets which has left certain types of company's share prices behind, and bid up other perceived growth stocks, we can see a 1999-2000 type situation has evolved whereby not only the current "go-go" stocks fall away but there is significant increased attention on "value" plays, which are so underpriced, there is multiple upside (i.e 100-300%) within their share prices.

Within out top twelve long positions, we can see over 100% upside in five of these holdings from their 30 June 2020 prices, without "pushing the envelope" in terms of either valuation assumptions or earnings forecasts. Whilst two involve discount to asset closures, the others all have hidden value unappreciated by the wider market.

Outside of the larger holdings, this type of analysis has yielded one takeover already in July at 1 75% premium to the end June 2020 price, with the takeover of Powerwrap Limited which we accumulated in May and June at an average price of below 15c.

[13] https://www.livewiremarkets.com/wires/for-want-of-a-coffee-can-on-a-1-1m-portfolio-we-left-7million-on-the-table
[14] https://www.livewiremarkets.com/wires/coffee-can-2-the-25million-sequel

Our portfolio structure has been refined and reflects these facets of:

- A market priced with some badly awry shorter term parameters;
- Speculation previously noted; and
- Our own capabilities and the "coffee can" philosophy

At 30 June 2020, we had a net long equity exposure of only 14.5% reflecting our view that equity markets are utterly out of sync with sensible valuations or reasonable earnings expectations over FY21 into FY22.

During the last quarter, we sold four of the Top 10 holdings at end-March:

- Alphabet on the basis that its price is becoming harder to justify as advertising revenue growth will inevitably slow;
- JP Morgan as ultra-low interest rates cramp its margins, bad debts are rising and trading profits (hwoever hefty) are transitory in magnitude;
- Exor on the basis that the cancellation of the sale of reinsurance allied to a slowing of automotive sales will dull growth in NAV – we want to return at some stage; and
- L1 Long Short Fund where we were able to take advantage of a spurt in performance allied to a narrowing of discount to NTA, to collect a 66% gain over the end-March price. Who said LIC's are boring?

However, the composition of our 14.5% net exposure is significant. Our gross long position of 126% of equity is comprised of 73% smaller companies and 53% larger stocks. We have offset the larger stock positions with short futures and index derivatives equivalent to 83% of equity and put options equating to a further 5%. That gives us a net negative exposure to larger companies of -35%. In addition, we have specific short share positions equating to 24% of equity across ten individual securities, all of which are sensibly sized.

Conclusion

Our portfolio performed reasonably well through most of the June quarter, given that we were deliberately underinvested for much of the period via hedges. We stepped up our short positions towards the end of June when equity markets rallied. Some end of financial year tax loss selling in Australia saw some of our smaller company positions marked down, and on paper, we gave back a <u>significant</u> portion of the quarter's notional gain in the last week of the month.

We are positioned for equity markets to retrace some of the gains made in the past quarter, as COVID continues to hamper economic recovery and heighten gearing, and with an expectation that future (not 2020) earnings prospects remain rather worse than currently anticipated.

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STATISTICAL APPENDIX: QUARTER & FYTD TO 30 JUNE 2020

1. Monthly performance, exposure and NAV

	Investment return[15]	Cost imposition[16]	Net Return[17]	R12 Return	NAV/share pre tax (c)	Gross Exposure[18]	Net Exposure[19]
30 Jun 17				46.6%	35.5	276%	-6%
30 Jun 18				-18.8%	29.0	278%	81%
30 Jun 19				-25.8%	21.6	395%	0%
30 Jun 20							
				R12 return			
31 Jul 19	(1.8%)	(0.7%)	(2.6%)	(24.7%)	21.1	413%	-13%
31 Aug 10	(7.9%)	(0.6%)	(8.5%)	(26.0%)	19.3	416%	-15%
30 Sep 19	0.9%	(0.6%)	0.3%	(26.4%)	19.3	415%	-31%
31 Oct 19	0.6%	(0.7%)	(0.1%)	(25.7%)	19.3	429%	-55%
30 Nov 19	(2.4%)	(0.8%)	(3.2%)	(27.8%)	18.6	440%	-76%
31 Dec 19	(4.4%)	(0.6%)	(5.0%)	(23.4%)	17.7	446%	-106%
31 Jan 20	(18.6%)	(0.9%)	(19.4%)	(43.3%)	14.3	475%	-142%
29 Feb 20	(13.5%)	(0.9%)	(14.4%)	(50.4%)	12.3	305%	218%
31 Mar 20	(41.5%)	(0.5%)	(42.0%)	(70.0%)	7.1	339%	56%
30 Apr 20	(0.6%)	(0.6%)	(1.2%)	(70.8%)	7.0	246%	67%
31 May 20	4.7%	(1.0%)	3.7%	(69.7%)	7.3	185%	122%
30 Jun 20	(4.0%)	(0.6%)	(4.6%)	(67.9%)	7.0	238%	15%

2. Equity exposure as at 30 June 2020[20] (as % month end pre tax shareholders funds):

	percent	exposures
LONG	126.2%	21
SHORT	(42.0%)	12
FUTURES	(64.6%)	
PUT OPTIONS (delta adjusted)	(5.1%)	
TOTAL	237.8%	33
NET	14.5%	

[15] Change in market value of all investments – cash and derivatives – after interest charges, dividends receivable, dividends and fees paid away divided by opening period net asset value and time weighted for equity raisings

[16] All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings

[17] Calculated as 2 (above) minus 3 (above)

[18] Calculated as total gross exposures being nominal exposure of all long and short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[19] Calculated as total net exposures being nominal exposure of all long minus short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[20] Figures may not sum due to rounding

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