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FRAZIS

• CAPITAL PARTNERS •

Love, Quality and Why We're Different

January 2020 Investment Update

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Dear investors and well-wishers,

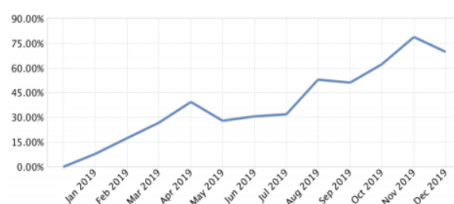
First of all I'd like to sincerely thank you for your support in 2019. I hope your 2020s are prosperous, rewarding, and fun.

Portfolio update

The portfolio contracted 4.0% in December, though more than half was due to currency. This meant we closed the quarter up 12% and the year up 24% net.

Our long only portfolio finished the year up 70%, so in that context it was quite disappointing the fund didn't do better. We've taken those lessons to heart, in particular, to keep things simple and focusing on what we do best. We were too negative at the beginning of the year, and while this was reversed, the damage was done.

Cumulative Return



Our core holdings in Afterpay, Carvana, Pinduoduo and Pointsbet performed very well. We've written extensively about the 30-40% drop in US software and diagnostics names over the last few months of 2019. Already in January we're starting to reap the rewards of increasing our investments in those companies.

We're now concentrated into seven core investments:

1. US software (Twilio, Alteryx, MongoDB, Shopify)
2. Afterpay
3. Carvana
4. Diagnostics (Exact Sciences and Guardant Health)
5. Pinduoduo
6. A small number of high growth Australian smallcaps like [Pointsbet](#)
7. Life sciences (across drug development, DNA synthesis, tissue regeneration and genetic science)

This month we'll answer more of our most common questions and discuss the outlook for 2020. If you'd like our detailed note, please get in touch.

Fund management question #2: What is quality?

The first time I was asked this I didn't really know what to say, it seemed so obvious. You know it when you see it!

You can learn a lot trying to pin down a common phrase like this. 'Quality' is usually ascribed to a long list of factors, like diversity of customer base, recurring revenue, balance sheet strength, cash flow generation, scale, perhaps some discussion of Porter's 5 forces, and so on.

Sometimes these translate into a high-returning investment, sometimes they don't. Many of the highest returning investments don't display any of these.

The answer that has proven most helpful when defining investment quality is whether the customers truly love the product.

Through this lens a multitude of perplexing equity market behaviour starts to make sense, including why companies like Tesla and Afterpay have posted such astonishing performance, against the expectations of the professional investor community.

We owned Tesla many years ago from \$80 to \$200, and wrote about why - and a version of this quality argument - [in 2015](#).

The clue was in the quality: that customer love. For years, Tesla sold every car they could make. Even now, the equity value lies in their ability to drive demand for their current and future products. Other companies may be more efficient at manufacturing, but those are limited by their ability to sell. Other 'high quality' car companies (by our definition) like Ferrari have performed extraordinarily well.

Apple, which we first bought in 2011, also fits this answer nicely. Customers were willing to camp outside for days for the chance to buy new Apple product. Until recently, the stock traded at a steep discount to the market, but there has never been any doubt over the loyalty of the apple fanbase or their willingness to pay up for what they love.

For another example, compare Afterpay to the countless financial start-ups that have tried their hand in this country and elsewhere. It's hard to think of another financial firm that generated so much customer support. This lens of customer love seems to give all the right answers to some of our other questions, and they're often very different to those given by traditional equity analysis. We'd guess this is because customer love gives insight into future customer behaviour, independent of whatever happened last quarter.

In our portfolio the biggest advocates of Shopify, Carvana, Pinduoduo, Afterpay, Alteryx and MongoDB are the firms' very own users.

This expresses itself in software developer conferences, where hundreds of developers improve the platform in an orgy of free R&D. You don't need unique insight into the customer hive mind: the evidence is right there in the rate of customer acquisition and customer loyalty.

The best part is that there are many ways to track loyalty and customer acquisition, so you can constantly test your hypothesis against new data.

There's an important component of this in the life sciences too: many drugs pass all the tribulations associated with regulatory approval, only to fail at the commercial stage. There is a perfect storm brewing in CART and CRISPR right now, as multiple companies are developing treatments to sickle cell disease, beta-thalassemia and leukemia.

Uber

Having ventured this idea to a few friends, Uber came up twice as a counter-example. Isn't that widely loved and also a market laggard right now?

Firstly, it was an incredible investment when customer love was high, one of the greatest VC investments ever. I'd hazard that Uber's value has tracked its customer support quite closely.

Secondly, this also applies to the second part of Uber's business, the drivers. Again there was immense driver support for Uber for many years, but it's fair to say much of that has now dissipated. The company was careless with customers, proved willing to make enemies left right and center, and priced itself in a way to ruin the goodwill of its drivers.

Uber now may need to raise prices twice: first to move to profitability, and second to lift their drivers' earnings. Good CEOs constantly talk about the customer. Uber has squandered much of that initial customer love.

Why do such 'quality' companies outperform?

In short, we believe the fundamental challenge of every business is finding customers and generating revenue. If the customers are there, everything else, from finance to operations, can follow.

The factors driving equity returns lie largely in the future. The enthusiasm of users, customers and clients today is the best guide to what the company might look like in a few years time.

For our next investments, we're going to be looking for the kind of company that customers love so much they're willing to camp on a street. Every investment we make is going to offer convincing numerical proof of a positive answer to this question: Do customers love the product?

Fund management question #3: How are we different?

Perhaps unusually among funds, we have a real answer to this, as many investors seem to explicitly exclude investing in fast growing innovative companies in technology and the life sciences. Specifically, any firm which is growing rapidly, but spending all of that on marketing, will be ruled out by many value investors. These are precisely the sort of fast-growing capital-lite businesses we have built our fund on.

We're all richer for the well-articulated insights of Graham, Buffett and Munger, but avoiding technology, for example, has not been a winning formula over the past few decades, and unlikely to be so over the next 30 years.

Similarly, buying businesses for less than the cash on their balance sheet is a great game if you can do it – but the best investment returns of our generation have not come from these kinds of companies.

Besides, such companies usually have extensive hidden liabilities that are well known to all insiders.

Value businesses are often cyclical, exposed to competition, and can only generate growth by eating significant amounts of capital. Damningly for stock market performance, they're roughly the same business year after year.

Our preferred investments typically look terrible on traditional value metrics, as they are capital-lite and invest above the EBITDA line.

EBITDA

Where did EBITDA come from anyway? You won't find it in Graham's books and Buffett actively argues against it. The meme was apparently coined by John Malone to help raise money. He wanted lenders and equity investors to judge the profits of his businesses before decisions around capital expenditure.

There's strong logic for this that we fully ascribe to.

Today, however, the lite businesses that have the highest returns on invested capital - and can be expected to post the highest stock market returns - often invest above the EBITDA line.

So there is no EBITDA, no profits, and few balance sheet assets.

As an example, MongoDB spent \$205 million on all costs to run the business, so sales, marketing, general and administrative costs. In doing so, they increased their revenue by \$156 million, and this is itself growing at 30% a year. That \$205m investment will almost certainly return more than \$2 billion of high margin revenue.

So how are we different? We've constructed an entire portfolio of businesses that are loved by customers, have the highest returns on capital, but are also explicitly excluded by other investors. There's a good chance you're underweight these kinds of game-changing companies. **Outlook for 2020**

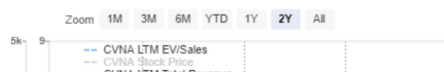
We have a few predictions for 2020.

The Australian slow patch seems to have passed, with real estate rising and retail sales strong. We expect the next move in interest rates in this country to be up, with corresponding increase in the AUD (this time last year we were calling for the next move to be down in Aus and the US - this proved correct).

However, growth stocks are still significantly below their highs. If you take our own portfolio, we are over 25% away from highs seen in September. This suggests to us that there is little exuberance of that scary kind.

Many equity indices are at new highs, but most only moved sideways from Jan 2018 to mid/late 2019, so the spring has been winding for quite some time.

As a visualization of this, Carvana is currently at \$93 (we purchased in February 2019 at \$36, for a 158% return) but the fundamental performance has been so strong that the stock is back to the bottom of the recent trading range:





You wouldn't guess this from the stock price chart.



Carvana share price (blue) and short interest (black)

Some people - at least one of whom made themselves known on twitter - have been short through this entire move.

Short interest is still 35% of the free float, **which comes back to why we're different**: many investors seem to actively bet against the very companies that we think are best, often while still admitting that customers love the product.

We [posted similar metrics](#) for Exact Sciences a while ago, noting that this leading diagnostics firm was trading at the bottom of its typical range. Since then, the stock has rallied hard, but the fundamentals have kept up, so it remains close to the bottom of its historic trading range.

We don't make investment decisions on these kinds of things, but when considering the outlook, it's easy to see stocks at new highs and assume that equals exuberance.

This kind of analysis suggests otherwise.



Left hand chart shows EXAS revenue and EV/Trailing 12m Sales. Right hand chart shows EXAS share price. As you can see, share price has rallied but EXAS is still close to its lows on a multiple basis.

Another example is Twilio, which dropped from almost \$150 to \$91 in the growth sell-off, and has seen continued rising short interest. After a sharp rally this year, many of those new short sellers are already underwater.



Twilio price chart (blue) and short interest (black)

Again, fundamentals have easily kept pace with the increase in share price, so Twilio remains at the bottom of its trading range.





There are similar stories across our portfolio, as our companies are still 20% away from recent highs, but have all reported strong results over the past few months.

Our average portfolio organic growth rate is tracking at over 80%. This will no doubt slow, but it's not unreasonable to expect our companies to be over 50% larger on a revenue basis this time next year. And given the contraction in multiples, stock prices may well follow.

We recorded another podcast discussing some of these ideas with Peter Stevens, available on iTunes [here](#) or desktop [here](#).

We remain fully invested in fast-growing \ companies that customers love across technology and the life sciences.

I hope you've had an excellent start to the year.

Michael

Our fund is available to wholesale clients, and the online form can be accessed using the button below.

Invest

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