

[View this email in your browser](#)

FRAZIS

• CAPITAL PARTNERS •

March 2020

Coronacrisis

If you were forwarded this you can subscribe to our updates [here](#), and past letters can be found [here](#).

Dear investors and well-wishers,

The fund contracted 6.2% in February, roughly in line with global markets (ASX200 fell -7.7%), leaving us up 5% year-to-date. The February end date excludes much of the recent turmoil.

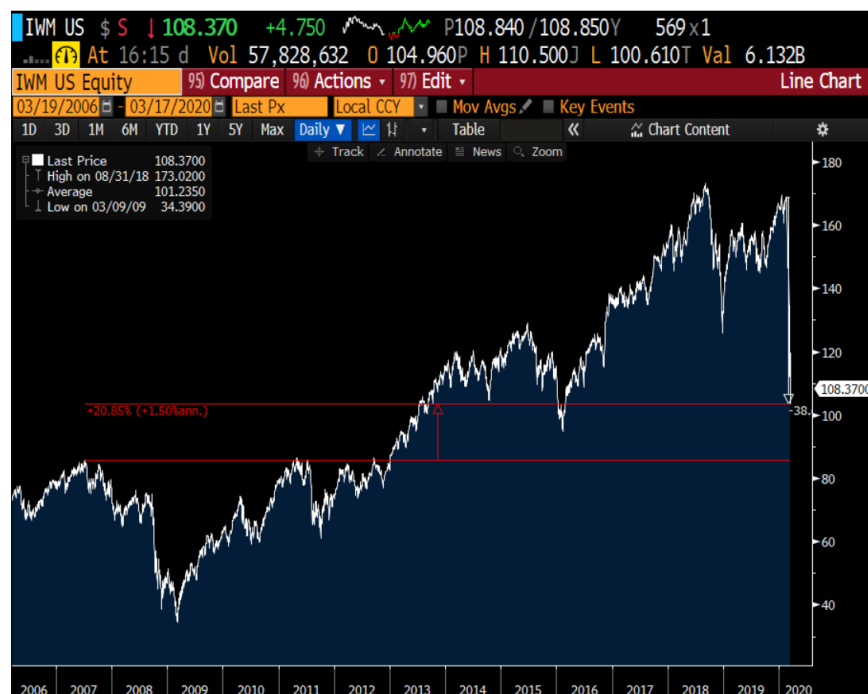
Historic moves in markets, combined with intense concern for friends and family has made this a tough time for all of us. A heartfelt thank you and all possible respect to the doctors and nurses on the front line facing this epidemic.

A quick review for the history books

This was the fastest US bear market in history, *exceeding* a prior record set in 1929.

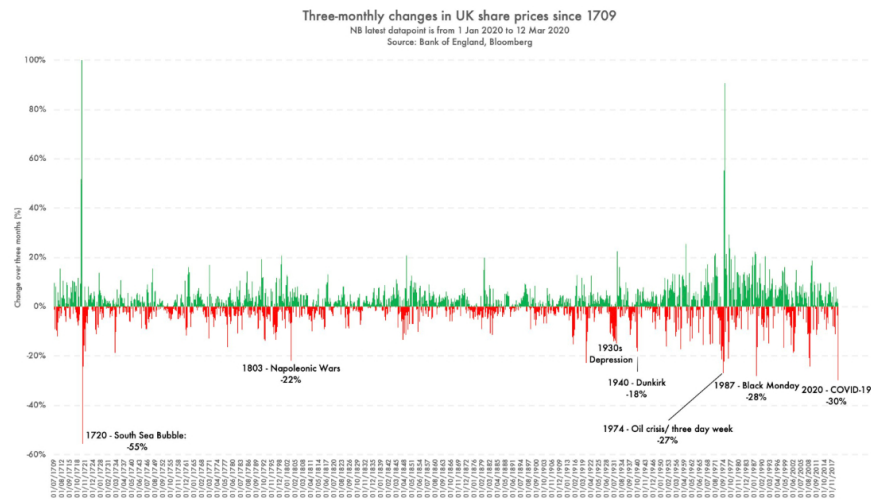
By some measures sentiment is worse than those in the depths of the Lehman collapse. Monday 17 March was the worst day for the ASX 200 on a percentage basis than any of October 2008, which was scary enough for those who remember it.

US small caps have passed through the lows of 2018 and are now at levels last seen in 2013.



Small caps have only annualized a 1% return since 2006. Reminds me of 2009, during that brief period when the ten year return of the S&P500 was negative.

The year-to-date move in the United Kingdom to March 12 was greater than any sell-off since the South Sea Bubble in 1720, which troubled the fortunes of no less a figure than Sir Isaac Newton. Three hundred years ago.



Alpha Pro Tech (APT) is a US microcap that makes surgical equipment. It has the same ticker as Afterpay, so has been a constant irritant since early 2017.



For a brief moment, this was one of the hottest assets on the planet. Sometimes, the things you need most are right in front of you.

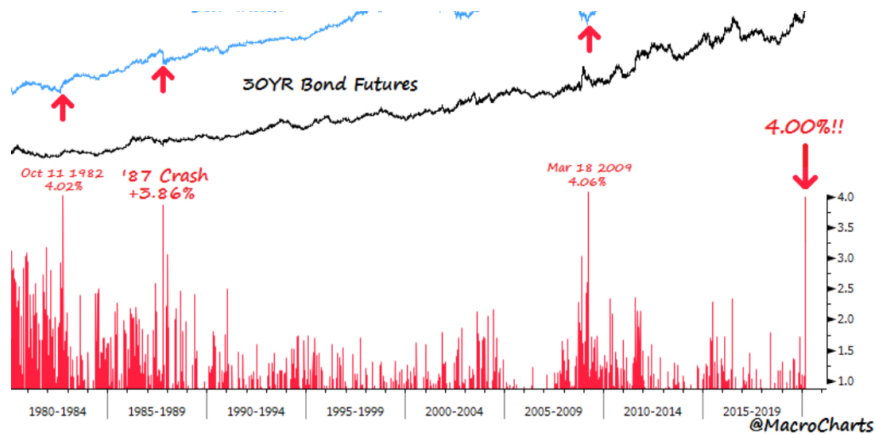
Early in the month, a sharp fall in fuel demand and an ill-timed price war between Russia and Saudi Arabia caused one of the largest falls in crude prices on record - and the record includes some fairly significant geopolitical events. Energy producers aren't as large a component of high yield indices as they were in 2015-2016, but are still significant borrowers.

As are airlines, hotels, and cruise ship operators. This is a perfect storm for corporate credit, and losses there are going to lead to capital flight and hesitancy to lend which affects everyone else. Fortunately, this is a part of the market where traditional financial tools can help the most. And when this virus passes, we will all take those holidays we just cancelled. Revenue for these industries has collapsed... but demand is building up. Probably a good distressed play or two out there, for those in that game.

It's also helpful that our strategy is focused on capital-lite technology and the life sciences. The life sciences has been hit hard by the changing winds of sentiment, but our portfolio companies have plenty of cash to ride this through.

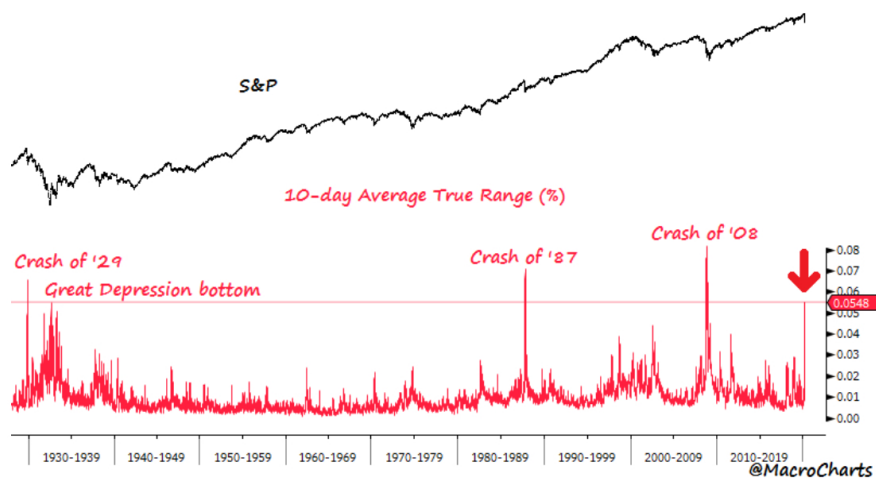
To give a sense of the level of panic, (which you may have felt first-hand), the bond moves last week were extreme on a multi-decade time-frame. This may be an unpopular view: but these kinds of moves are very much in line with multi decade market lows:





The chart above covers multiple wars, >10% interest rates, high inflation, low inflation, multiple recessions, hedge fund collapses, and regional catastrophes.

When panic gets this high, it generally pays to buy.



I sourced these two charts [here](#).

The market is now pricing in a virus-induced recession.

This may be an unpopular view right now, but pandemics are temporary shocks. There will be harsh economic consequences, but the worst will pass with the virus. Flights will be rebooked, restaurants refilled, and staff rehired.

Pandemic scares are quite common - it's very rare they turn into an international emergency of this scale. SARS, MERS, Ebola, Swine Flu, Bird Flu, these are just the ones I can remember. It's unusual for a virus to strike such a destructive balance: a long incubation period, mild symptoms for most, yet deadly progression for so many.

Most financial crises come from within finance. They're internally generated, usually in some odd speculative corner. The textbook cure comes from within finance too: the restoration of financial confidence through concerted Government and central bank support.

This is a different beast. It's the fear of a virus that is grinding economic activity to a halt. Travel, tourism and in-store retail are being hit hard, perhaps harder than ever before, and these industries employ a lot of people.

There are good and bad features of the current situation worth noting.

First, the bad: much of the global population is moving into self-isolation, and the resulting fall in production may exceed the deepest depression.

But second, the good: This virus will be tamed, or in the worst case scenario, will flame out of its own accord.

Which means today's market pricing offers an incredible long-term opportunity.

It's very possible that at the end of 2021 many of our portfolio companies will be twice the size, and trade on substantially higher valuations than those induced in the current market panic.

Quality high growth companies advanced 200% to 400% at the back end of 2009 and 2018, and it's not unreasonable to expect them to do so again. This sell-off was steeper and the panic more severe, so the rally may be similarly strong.

The juice here is worth the squeeze.

Strategy

You're probably wondering what changes we've made. We have noted broad liquidations and moves to cash amongst many of our peers. In short, we're staying invested.

However, we have taken advantage of the dislocation to buy rockstar businesses with explosive growth, incredible customer loyalty, in market leading competitive positions. We are focusing all new purchases on core companies with net cash, and positive free cash flow.

The high growth quality names have largely held, despite big drawdowns. We bought Afterpay at around \$4.3. In the midst of the sharpest consumer and credit shock since the GFC, it is still trading around \$20.

We don't hold leverage, and we don't have any shorts or funky derivatives.

These may have paid off substantially over the last couple of weeks. but having traded them for many years, the complexities and risks associated are not worth those rare occasions when they pay. We are close to fully invested in the highest quality businesses we can find with explosive growth and widely loved products. Most of the people I know who've made real money did it by holding assets for decades, either businesses or real estate. None of these fortunes would exist if they sold up every time there was good news, and the price went up, when there was bad news, and the price went down. Yet this is standard practice in public markets.

Selling into a panic and hoping to buy your stocks back at lower prices simply doesn't work. And if it works this time, there's no guarantee it will work the next. It's not a sustainable strategy.

We are positioning the portfolio to be the single best way to play a rebound in global asset prices, which will certainly come. And perhaps quite soon. Opportunities to buy brilliant, high growth businesses tend don't stick around long.

We are not going to panic and sell our long term investments *this* time, and you can rely on us not to panic and sell our long term investments at *any* time.

There is only one strategy we are confident will work over the next 40 years. And that is to stay invested in the best possible companies we can find.

Virus

I can't help but make a few comments. There is plenty of talk of exponential curves on the twittersphere.

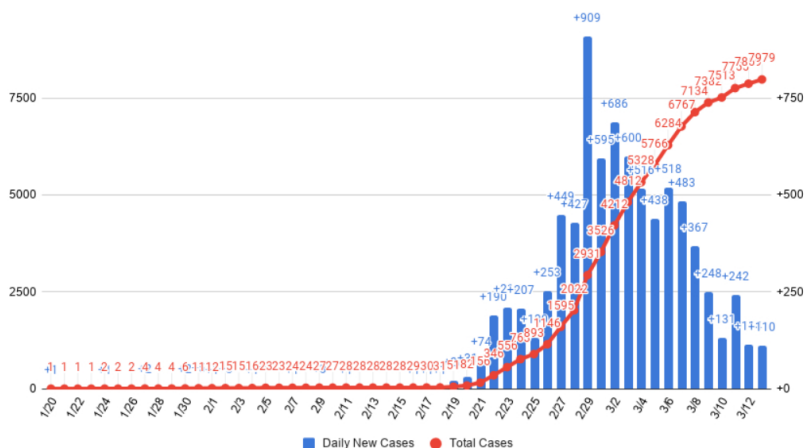
In biological systems there is *always* a negative part of the equation. Things in nature don't grow exponentially forever. It's like that first year uni problem, where you're asked to calculate the growth of E Coli in a dish, then realise that it won't take long for it to cover the whole world. The point is this same one: real things don't grow exponentially forever.

The worst case scenario, that the virus spreads unchecked, actually means that it will be over sooner, rather than later. But that hasn't been the experience seen in countries like South Korea, which peaked after a couple of weeks:

COVID-19 Cases in South Korea

10000

+1,000



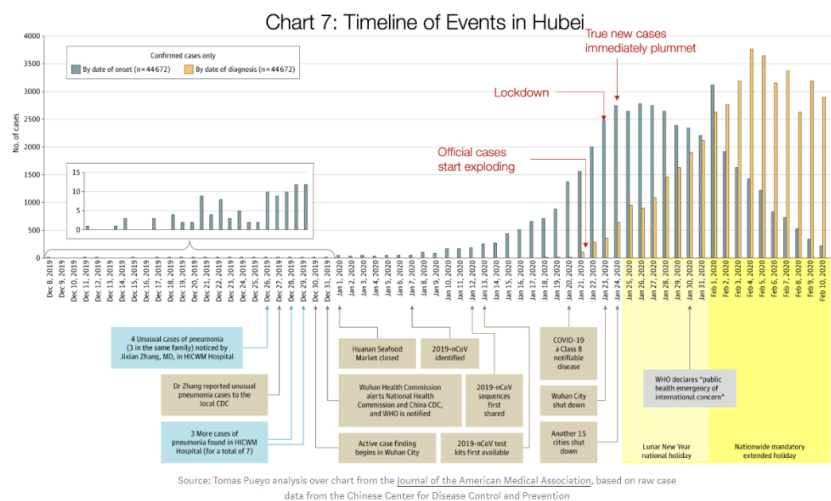
Italy is currently ground zero. But even there new cases have stabilised after barely a week in isolation.

This virus hits hard, hits fast, and goes fast. And also appears manageable.

Major cities like Shanghai and Beijing, with large-scale population interchanges with Wuhan long before the Hubei was locked down, have been almost entirely spared. So has Taiwan, Hong Kong and Singapore.

In these countries there is systematic use of masks, regular temperature checks, wide-scale testing, and enforced isolation of those who are exposed. Instead of a total lockdown, those who are exposed are quickly pulled out of the population.

This is what effective epidemic management looks like:



The lockdown quickly halted new cases (blue/grey), even though recorded new cases continued to rise, as these cases were infected prior to lockdown.

We are at that moment in countries with lockdowns, which now includes Italy, France, Spain and to a lesser extent, much of the rest of the world. New cases are rising but they have probably already started falling.

Science

There is promising news from the life sciences. The trials of Gilead's Remdesivir will read out in early April. That is not far away (though with markets limit up or limit down every day it may feel like a long time!)

South Korea is apparently using chloroquine, a cheap off-the-shelf antimalarial, with considerable effectiveness. Again, we may have robust data on that within weeks. French study with 24 people showed that 75% of those who were treated with hydroxychloroquine recovered in 6 days, vs 10% for the control group.

Our portfolio company Moderna's mRNA vaccine has been injected into the first patient volunteer. In 2009, it took the scientific community 260 days to develop a widely

volunteer. In 2009, it took the scientific community 200 days to develop a widely available vaccine for swine flu (actually, multiple vaccines). We are vastly more advanced today, and the need is far greater.

The best case scenario is that safety is established in a dose escalation study completed in a few weeks, after which a large Phase 2 / 3 trial can commence. Given the urgency, this might involve vaccinating large numbers of people. There is some precedent for this in Ebola, where after safety was established, the trials themselves involved vaccinating large numbers of people on the front line. Safety shouldn't be an issue, as Moderna uses mRNA rather than a random toxic molecule.

One of our favourite current companies, Twist Biosciences, is doing a brisk trade helping scientists sequence the various coronavirus strains.

Many, if not most, in the Western World who catch this coronavirus will have access to at least one of these experimental treatments.

So what happens next?

Markets have repriced 30% down across the board. Small caps indices as I write are just shy of -40%. Banks in Australia and around the world (certainly Europe!) have repriced lower than they were in the GFC, despite having significantly more robust capital positions, ample liquidity and certain Government support.

There is a sharp smell of fear in the air. There has been a huge move to cash amongst speculators and long-term investors alike. Fast-growing businesses with net balance sheet cash that are likely to have no long-lasting damage from the coronavirus have been marked down 30%, 40%, and in many cases 50%. Are you a buyer or a seller?

Vol-targeting strategies have reduced their equity exposure to a minimum. Momentum funds are likely to be max short. There has been an enormous rush to cash and Government bonds.

What do you think will happen to the shorts, the cash on the sidelines, and market pricing, once case numbers start to decline? Or when one of the many vaccines in development is proven effective? While record stimulus floods the market?

When markets look safest, they tend to be most dangerous. I vividly remember the statistics of 2017 stating it was the longest low vol period on record. The years since have been ... stormy. The converse is also often true.

There is a certain kind of justice in markets. Those who keep their nerve when times are tough, and supply capital when it is needed most, play a valuable role - and are generally richly rewarded. This time is likely to be no different.

To summarize, there are five reasons for optimism... which are similar to those I wrote about in January 2019.

1. The virus will pass through vaccine or its own accord
2. Record fiscal and monetary stimulus, with rates at zero. You won't earn a return unless you put your capital to work.
3. Record short positioning and a flight to cash
4. Sentiment at record lows, by some measures worse than the peak of the GFC
5. Dramatically reduced valuations

I've attached some work I did on one of my all-time favourite companies, Twist Biosciences, available [here](#). The firm combines inkjet printing and silicon manufacturing to miniaturize the entire process for synthesizing DNA. This is a foundational technology of the life sciences, and Twist is the market leader, growing revenues at a rate of over 80%.

Twist has built two high-tech businesses from scratch, and has two other businesses in development

1. Manufacturing DNA to order and selling it to synthetic biologists
2. Genetic sequencing, which is one of our best tools for defeating this virus. There's a good chance every virus sample is sequenced and the entire evolutionary

a good chance every virus sample is sequenced and the entire evolutionary trajectory mapped out. (Next generation sequencing requires synthetic DNA probes).

3. Drug development, developing highly specific libraries of antibodies, which would offer new drug candidates for all kinds of diseases - with no small relevance to the issue of the day.
4. Finally, their fourth project is straight out of science fiction: using DNA as storage instead of magnetic memory. DNA has several interesting features, I encourage you to have a read if you want to find more.

This is a little out of date as I wrote this late last year, but on the plus side, you'll be very pleased to know there is no mention of coronavirus.

Please get in touch if you'd like to have a chat, we're very much open for business.

And stay safe out there.

Michael

+61447559606

If you'd like to invest with us in companies like PolyNovo and Avita (**before** we send them out to the mailing list!), you can access our investment portal through the button below, or simply reply to this email and a member of the team will be in touch.

Invest

Please feel free to share this note:



Disclaimer

Frazis Capital Partners Pty Ltd is a corporate authorised representative (CAR No. 1263393) of Lanterne Strategic Investors Pty Ltd (AFSL No. 238198). The Frazis Fund is open to wholesale investors only, as defined in the Corporations Act 2001 (Cth). The Company is not authorised to provide financial product advice to retail clients and information provided does not constitute financial product advice to retail clients.

The information provided is for general information purposes only, and does not take into account the personal circumstances or needs of investors. The Company and its directors or employees or associates will use their endeavours to ensure that the information is accurate as at the time of its publication. Notwithstanding this, the Company excludes any representation or warranty as to the accuracy, reliability, or completeness of the information contained on the company website and published documents.

The past results of the Company's investment strategy do not necessarily guarantee the future performance or profitability of any investment strategies devised or suggested by the Company.

The Company, and its directors or employees or associates, do not guarantee the performance of any financial product or investment decision made in reliance of any material in this document. The Company does not accept any loss or liability which may be suffered by a reader of this document.