

## March 2020 ⋮

Dear investors and well-wishes,

We finished March down 27.8%.

This took us to -24% for the quarter and calendar year-to-date, vs -23% for the ASX200 total return (ASX200 did -21.2% in March). We have had a strong April so far.

Going into the sell-off, our base case was that the virus would flame out in a matter of months. This was at least partly correct - it's only mid April, and new cases appear to have peaked across Europe, Australia and the United States.

We did not, however, predict Government mandated shut-downs of entire sectors in major nations. This took us by surprise, and our results reflect the fact we did not position for this. For this, I apologise.

Nevertheless, we did our best not to waste the crisis, even though at times it felt like we were the only people on the planet on the bid.

Most of the loss was attributed to our two largest positions, Afterpay and Carvana. A sudden stop is close to the worst case scenario for both. While both remain well off their highs, they are well above our purchase price.

During sell-offs like this we all find out what things are really worth. When the chips are down, what will people really pay for a company? What price, if any, will industry insiders and management teams step in? Fortunately, in tech and biotech there was a flight to higher quality names, and part of the portfolio was a beneficiary of this, though we don't own megacaps like Microsoft and Amazon, which have performed best.

We seem to be the most optimistic people around right now.

If asked, how would you describe a perfect situation for equities?

For us, it would go something like this:

- a temporary shock, with early signs that the temporary shock was abating,
- a 30-40% decline across major market indices, with low quality small caps and cyclicals down twice as much,
- a total derisking/move to cash/ increase in short interest by both retail and professional investors alike,
- enormous fiscal and monetary easing. Rates at zero. Cash transfers to businesses and citizens around the world, with a dramatic increase in payments to the unemployed.

Many of these elements were in place at the end of March.

27.8% is the worst month we've recorded. But time shows that high quality technology investments can advance many multiples of this in the years following a crisis. The median organic growth rate across our portfolio is well above the drawdown - so we don't need to rely on sentiment improving and a multiple expansion either.

### Afterpay and Carvana

Given that most of our drawdown was attributable to these two stocks, I'll discuss them in further detail.

These were our largest positions due to their own performance (we avoid trimming positions). Afterpay was up nearly 10x from our purchase price three years ago, and Carvana more than tripled from our purchase price about a year ago.

It's hard to be too upset with Afterpay, given that it's up 5x over a period where many companies have destroyed value. Of all the financial services companies you could have owned globally, you'd be hard pressed to find a better performer.

Having said that, I do appreciate that the majority of our investors have only recently joined us, and suffered the draw-down without the benefit of prior performance.

Looking forward, trends have largely held up, and the firm is a beneficiary of the move from physical to online retail.

We have always taken a firm view that Afterpay is one of the better credit businesses. This is due to the small size of loans (average purchase size of \$150 and average outstanding debt of \$211), rapid turn-over, and steady weeding out of non-payers from the borrowing pool (if you miss a single payment, you're out).

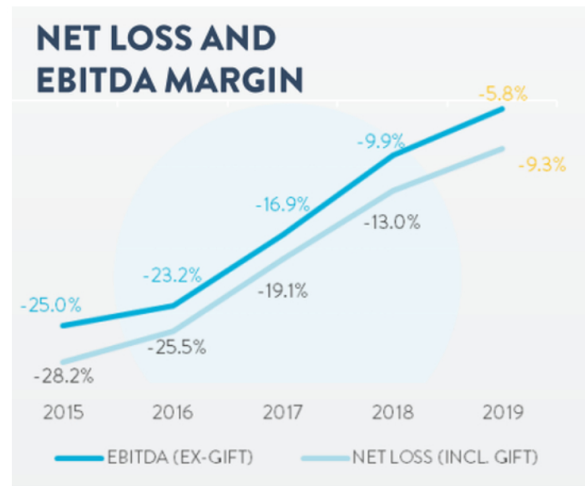
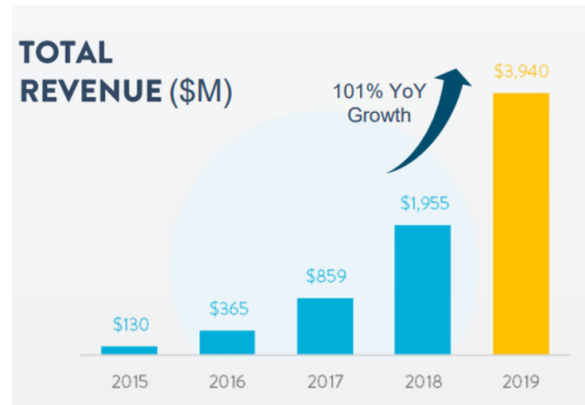
When Afterpay lends a billion dollars over a year, they only ever have a small fraction at risk at any one time. This is very different from the typical start-up lending businesses that blow up in financial crises, as every time they lend, they add to a growing book of long-term loans, often against depreciating assets with poor secondary markets.

No doubt Afterpay war-gamed the GFC and past recessions, and planned to slowly tighten

lending over several 4-6 week cycles as the economy turned. The sudden stop we witnessed in March gave no time to adjust lending.

Fortunately, the lending book turns over quickly, and that period is now behind us. In Australia, Afterpay has started taking 25% of their transactions at purchase, which released a substantial part of their receivables, increased the recovery ratio from any default, and improved the risk/reward of each credit turn.

Carvana was accelerating right up until Feb 2020, building \$4b of revenue with considerable margin improvement. Like many early stage businesses, it was simply bad luck that this happened at a time where they were on their way to maturity before net margins flipped positive.



Carvana's online purchase and delivery-to-your-doorstep is well-suited to the current environment, and we expect them to increase market share, even as the market itself contracts dramatically. They currently have less than 0.5% of the market, and as we have written previously, have a vastly superior customer experience, offering and value.

The firm recently raised \$600 million (above our initial purchase price), with \$50 million injected by the founder and his family, giving us confidence the firm, while exposed to a highly cyclical sector, has the balance sheet to survive this crisis.

With many physical dealerships shut, Carvana may in fact dramatically increase market share from 0.4% over this period.

#### New positions

As you might expect in a sell-off like that, we made a number of new purchases, particularly in software.

Irrespective of recessionary conditions, we expect many US technology firms to perform well, as they are shielded from the direct impacts of lockdowns, and often offer cost savings over traditional ways of doing things.

The trends towards working, buying and selling online have all accelerated. There will certainly be a reduction in corporate spending, and more so than in previous recessions, as IT budgets are larger now than they have ever been. But we do expect the growth trajectory of technology to resume, if from a lower level. Online retail is particularly well placed - even in a weak retail environment - as physical stores are closed around the world. Novel behaviour learned over this period may well stick.

We added Salesforce at ~\$132. Salesforce is a SAAS pioneer and shows the end-game for leading software firms, trading at 6x EV/Sales and 20x EV/EBITDA. The firm has \$8b of net cash and posted a 35% growth rate for Q419. (Throughout this note we will use the most recent organic growth rate. We do understand these firms will post a poor quarter or two, but expect the highest quality firms to resume their trajectory shortly after. The impact on value from a couple of poor quarters is actually minimal, over the long term.)

#### Salesforce



We also added Trade Desk at \$146, a highly profitable internet business with 39% EBITDA margins, net cash, and an organic growth rate of over 35%. This was more than 50% lower than where it was trading only a few weeks previously, and much of that ground has been covered in April. Advertising is under pressure, as it's an easy thing for a business to cut back on. Irrespective of the short term, we expect online advertising will remain a foundational pillar of the digital economy.

### Trade Desk



In Australia we added Altium and bought back Xero. Xero had been a very long-held position of ours and we sold at the high 60s some time ago. It's very pleasing to take the fleeting opportunity to buy it back at lower prices than we sold.

We expanded our investments into e-commerce, adding companies like MercadoLibre that contracted 40%-50%. Pinduoduo has been remarkably resilient, and is up almost 100% from our purchase last year. We reduced the position to purchase high quality companies that dropped 40-50% and have been on our buy lists for quite some time. Luckin Coffee was pitched to us many times, and while it was never our cup of tea, it's a reminder of the risks involved in even the largest companies in China.

### MercadoLibre



There's an old market idea that stocks react to novel issues far more explosively than markets who've seen them before. For example, 9/11 caused a dramatic fall in US equity markets, whereas the 2005 London bombings didn't. This line of thinking suggests that because the English suffered the IRA bombing campaigns in the 90s, they were somewhat vaccinated against terrorist attacks like those of 2005.

I do wonder if the resilience of Chinese equities shows a similar dynamic at play. South East Asia suffered heavily during SARS, which might explain why equity markets were so resilient this time.

We also participated in capital raisings for local biotechnology companies that have so far proven profitable. This is the most rewarding part of the job, as unlike when trading with other funds, in these situations the cash contributes directly to medical research.

broadly we maintained our exposure, but are now substantially more diversified.

## Biotech

We remain optimistic on a vaccine. Swine flu took about 260 days from the first case to million+ manufactured doses, and this time technology is far more advanced, and the need far more urgent.

Moderna had the first vaccine in human trials, helped by their earlier work on MERS. SARS, MERS, and the new coronavirus are all quite similar. This is the third time coronaviruses have jumped from animals to humans in the last 20 years, so it's high time we got a handle them.

Perhaps the reason so many people quote a 12-18 month time frame is that usually, the process is carefully staged and drawn out, as you're dosing very large numbers of healthy people. This is a very different ethical set-up to say, 4th line treatment in a cancer setting, where the bar for experimental treatments is lower. Nevertheless, given the extraordinary commercial need, many steps can be done concurrently, and substantially more financial risk taken.

For example, Moderna's Phase 1 trial will test for safety and an immunological response - but Moderna will push through to Phase 2 and 3 as soon as safety alone is established. The requirement to prove efficacy in animals was skipped entirely. Most likely with substantial Government funding, the firm will kick off the manufacturing process after the vaccine's been proven safe, but before it's proven to work.

The ethics of the current situation certainly allows for a relaxation of the strictest benchmarks of efficacy.

There are simpler approaches too. Moderna's vaccine involves inserting the mRNA that encodes the spike protein, causing human cells to produce it and develop immunity. When the real spike protein turns up with a harmful virus attached, the immune system is ready. Recombinant vaccines also target the spike protein. The spike is an excellent target here, as any mutation in the spike protein will likely to reduce the viruses binding power (some work shows the current coronavirus spike protein binds 20x as tightly as SARS, and this is the part that appears to derive from a pangolin). So a mutation that reduces the effectiveness of the vaccine will likely also reduce the contagiousness of the virus.

Moderna has a true platform: they have 10 vaccines in the clinic that are all based on mRNA. These are likely to all be safe (we are not talking about novel bioactive chemicals), and can be manufactured in the same facility. They are yet to have an mRNA vaccine approved, however.

Oxford researchers are hoping to have a vaccine ready in September, about 5 months away.

Johnson and Johnson has announced they'll soon to begin production of a billion doses of their experimental vaccine. This means again, there will be no manufacturing delay. They are predicting data by December, and first batches ready by January 2021. Derek Lowe gives an excellent summary.

Gilead's early data on Remdesivir looks promising, and we will soon see more conclusive evidence of the effectiveness of hydroxychloroquine, which bizarrely, has become highly politicised in the United States.

Mesoblast has been profitable for us, with an approved treatment in for graft-vs-host disease. This condition pops up all the time, and is highly relevant for the blood cancers and genetic blood conditions that are the topic of so much attention from the gene therapy, CRISPR and immunotherapy communities. Serious coronavirus cases involve a cytokine storm, where the immune system overreacts with often fatal consequences. Given Mesoblast's success in treating this in other situations, the approach has a sound scientific basis. A small study in China suggested the approach has legs, with the usual caveats that the numbers involved were small and there was no proper control group.

Every biotech under the sun is announcing coronavirus programs, but few will attract the support of the necessary institutions and patient enrollment required to prove effectiveness. Mesoblast's study is being run by Mt Sinai in New York, is already enrolling patients, and is based on a well-understood treatment already in the clinic. So for these reasons we are optimistic.

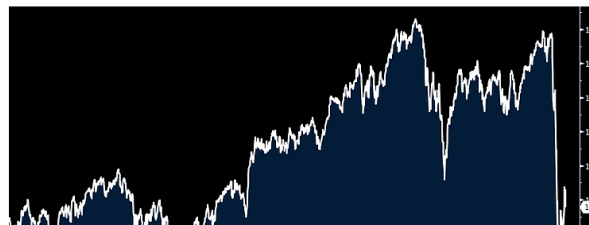
## Outlook

We mentioned earlier that the situation at the end of March was one of the more bullish set-ups we've seen, more so even than January 2019.

Let me go through in more detail.

### 1. Significant falls and reduction in valuation

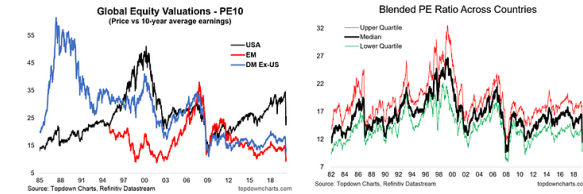
The market is assumed to be of high valuation. But it had already gone sideways for a few years, and some markets dropped to where they were in 2013. As I write this now, after a fairly vigorous rally, US small/mid caps as measured by the Russell 2000 are still down 29% year-to-date and are trading at levels seen in 2014:



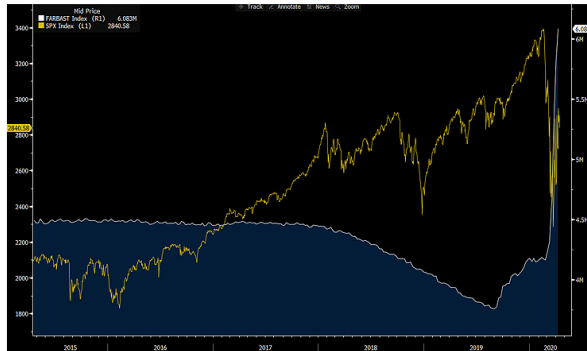


Many years of flat returns from IWM, an ETF that tracks the Russell 2000

Entire industries like financial services have been and remain substantially marked down. These were some of the best performers coming out of both the GFC and Australia's last recession in the 90s.



The exception to cheap valuations is the United States. We may be out-of-consensus here in thinking this is justified, as largely comes from the technology sector, which is investing heavily in growth. We think the US technology sector remains both the most attractive market to invest in long-term, and the most resilient to the current situation. We expect the capitulation lows in March 2020 to hold for many stocks.



S&P500 index (yellow) vs Federal Reserve balance sheet (white)

#### 4. Temporary shock abating.

This is a topic of fierce debate right now, which I don't want to get into. Coronavirus data feels like a Rorschach test where what people see reflects mostly (if not only) on the viewer. Nevertheless, the US, UK, Australia, Europe are all off the positive exponential curve that was so frightening only a few weeks ago. As we mentioned in our last letter, the negative exponential component of the development of biological systems can be just as surprising.

#### 5. Finally, sentiment and positioning.

Sentiment as measured by VIX, put/call ratios, money market funds, and some surveys, reached then exceeded Lehman levels of negativity. That was a pretty bleak time. It seemed as though the entire global financial system was going to collapse. I was living in Europe when there was a similar moment in the early part of last decade. Markets have rallied, but the retail and professional investors I speak to are unanimously bearish, which reminds me a lot of 2010-2015.

This is not to downplay the risks - I'm just highlighting where I seem to be seeing things differently right now.

There will no doubt be second, third and fourth order effects of the mass unemployment we are seeing around the world, and these are going to be bad. But that's a very different question to the direction of equity markets.

In March, there was a terrifying week where the Australian Government bumped up Centerlink payments and queues formed around blocks. It seemed as though business was going to be left to burn and the Government was going to rely on unemployment benefits to keep food on the tables of the newly unemployed.

That was resolved with JobKeeper, which offers \$750/week to full time, part time and many casual employees. This is not perfect. Foreign migrants and students who have lost access to part time work look particularly exposed. There will be substantial political issues down the track, as with all bureaucratic handouts, it's quite arbitrary as to who does or does not qualify (though we will all pay for it one way or another). It's not clear why those who earned less than \$750/week should now receive more.

Nevertheless, it's a remarkable policy that keeps millions of people in jobs that would surely be fired otherwise. It's fair to expect people to stay at home if they're being paid to do so. Market history is actually quite supportive of an optimistic view. Job losses accelerated after the market bottom in both 2000 and 2008/2009. And both of those instances - and other recessions in the early 80s and 90s and indeed the Great Depression - did not involve quantitative easing and helicopter money.

In those scenarios the gold standard, inflation-busting interest rates and austerity dramatically worsened the situation. This time we have quantitative easing, cash handouts to businesses and people, and outright purchases of risk assets.

Supporting markets is not such a bad idea. Over the last couple of weeks, many companies have been able to raise much needed cash due to the confidence these measures instilled. To be ahead of the curve, you needed to sell in February before the crisis unfolded in

marcn. we missed this opportunity, and for that i apologise.

Now, to be ahead of the curve, you need to invest when valuations are cheap, a bearish consensus is near unanimous, new cases are peaking around the world, the Fed is pumping trillions of dollars into markets, and Governments are handing out cash and guaranteed loans to citizens and corporations. Whatever your views are on the wisdom of these policies, best to be on the right side of those flows.

I ran a successful fund from June 2016 to June 2018, then launched our current fund in July 2018 and many of you joined us shortly after. Since then, we've seen two global equity bear markets in less than two years. I certainly concede we were too optimistic in February, but for all the reasons above, believe this is a time for buying companies in technology and the life sciences...not selling.

Markets look risky now, but we are on the back end of a purge where every investor carefully considered what they truly want to own through a recession, and adjusted their portfolio accordingly.

We can't predict the future, but remain optimistic of the five and ten year view from here. The six month view is cloudy at best, but it's crystal clear what we should be doing at times like this over any long term time frame. When looking back on March in 2030, no doubt the leading technology companies at today's prices will look like an absolute steal.

Yours respectfully  
Michael

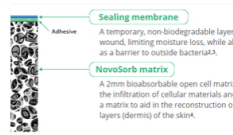


#### Recent Posts

[See All](#)



March 2020 Investment Up...



February 2020: Two invest...



Who wants to dance on Tes...

[Log in to leave a comment.](#)

Contact: [michael@fraziscapitalpartners.com](mailto:michael@fraziscapitalpartners.com)

Frazis Capital Partners Pty Ltd is a corporate authorised representative (CAR No. 1262333) of Lantierne 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 on this website does not constitute financial product advice to retail clients.

The information provided on this website 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 published on the Website 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 Website.

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 on this Website. The Company does not accept any loss or liability which may be suffered by a Website user as a result of any interrupted access to the Website or otherwise as a result of accessing the Website.



[See our Privacy Policy Here.](#)