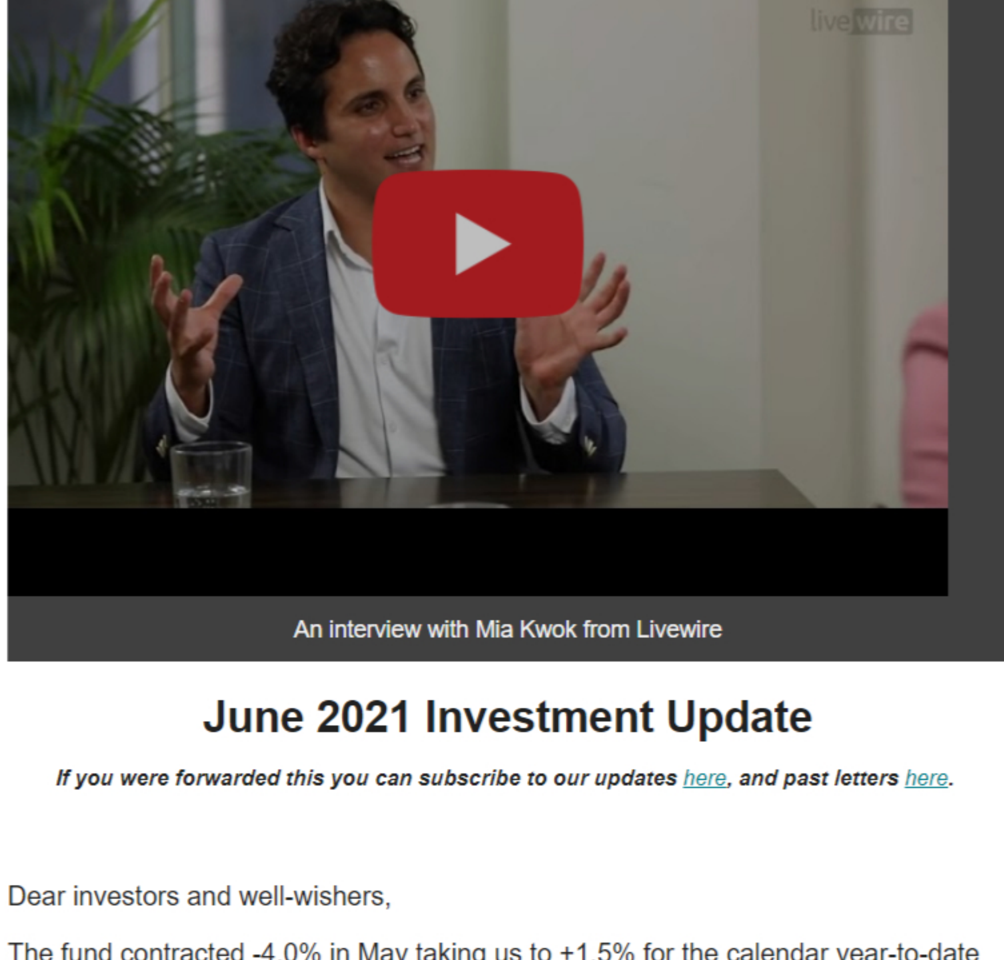


An interview with Mia Kwok from Livewire

# June 2021 Investment Update

***If you were forwarded this you can subscribe to our updates here, and past letters here.***

Dear investors and well-wishers,

The fund contracted -4.0% in May taking us to +1.5% for the calendar year-to-date and a net IRR of 26% per annum. While we are well off our peak in February, we have had a strong start to June and are ahead of where we were at the start of May. Our stocks are almost 50% away from their 52-week highs.

| Net returns | % |
|---|---|
| May | -4% |
| 12 months | 92% |
| Calendar year-to-date | 2% |
| Financial year-to-date | 69% |
| Since inception | 26% |

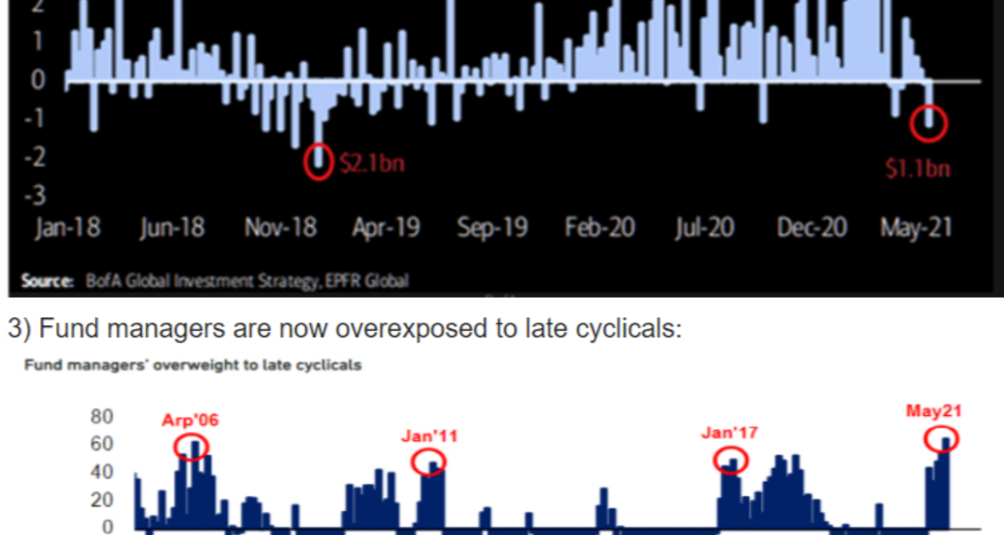
One metric we track carefully is the organic growth rate of our portfolio companies. After the latest reporting season, and adjusting for things like acquisitions, this is now running at 150%, which is higher than it has ever been.

The increase was due to three factors:
1) the fundamentals of many of our companies accelerated,
2) we added to those performing best and winning the largest share of wallet, and
3) we sold out of a small number who were spending too much to grow or missed their numbers.

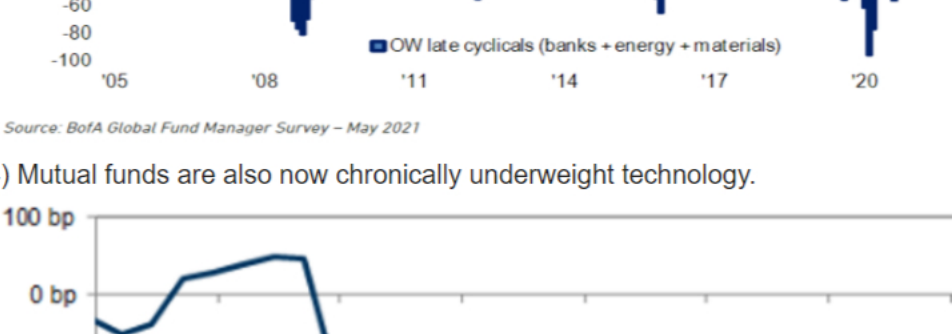
Positioning has also swung nicely in our favour. We have shown these charts before but they are worth repeating as the situation is rare:

1) Professionals have swung from overallocated to technology to *under*allocated:

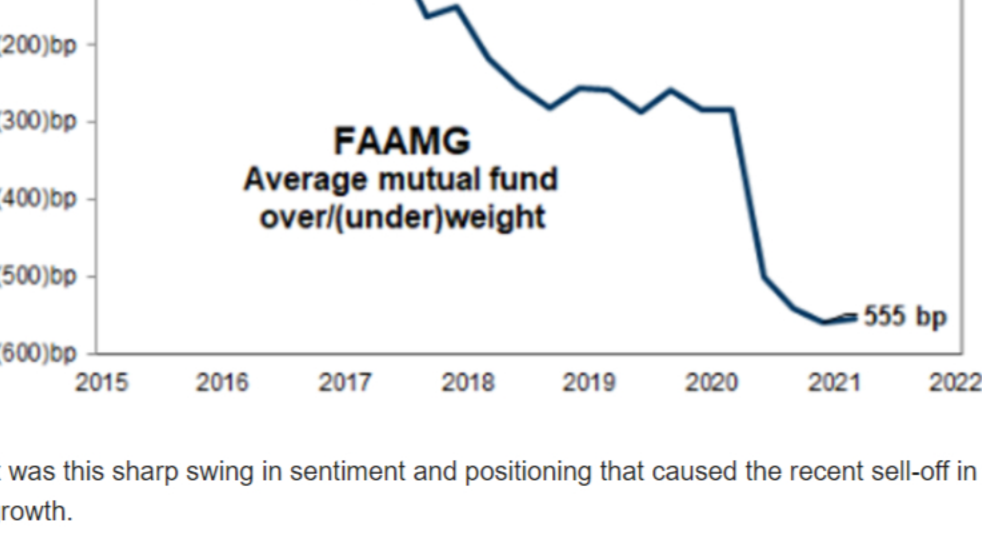
2) This is clear in fund flows as well:




3) Fund managers are now overexposed to late cyclicals:




4) Mutual funds are also now chronically underweight technology.




It was this sharp swing in sentiment and positioning that caused the recent sell-off in growth.

Pulling all that together we now have:
1) accelerating company fundamentals,
2) stocks well off their recent highs,
3) surprisingly negative positioning and sentiment.

I'm often asked to give a heads up when I think it's a good time to allocate. I usually try and dodge the question, but this looks like a decent setup. It's rare that investing in technology is a contrarian thing to do, and these moments can pass quickly.

**Inflation**

This keeps coming up so I'd like to expand on it. It affects our portfolio companies in two ways: valuations and fundamentals.

Valuations are likely to compress, but this is trivial relative to long term growth rates. In fact, stocks can suffer a material 75% multiple contraction and still post exceptional long term returns:

| **IRR** | | 10 year growth rate | | | | |
|---|---|---|---|---|---|---|
| | | 10% | 20% | 30% | 40% | 50% |
| EV/Sales | -75% | -4% | 4% | 13% | 22% | 31% |
| multiple | -50% | 3% | 12% | 21% | 31% | 40% |
| change | -25% | 7% | 17% | 26% | 36% | 46% |
| | 0 | 10% | 20% | 30% | 40% | 50% |

When modelling each portfolio company, we assume a substantial multiple contraction and slow-down in growth.

The most recent US inflation number and suggestion from the Fed that rate rises would be pulled forward was met with a *rally* in growth stocks, giving a price action read on what the charts above already told us: the market is crowded on the other side of the trade (whatever 'crowded' means).

On fundamentals, the first (positive) effect is simply through higher prices. An advantage of focusing on companies with customer love is they all have exceptional pricing power, as seen in some of the blowout results of the late reporting season.

E-commerce platforms obviously transfer price increases through directly. But there's something more interesting going on.

**The coronavirus e-commerce boom of 2020 has morphed into a broader consumer boom.**

This can be seen everywhere from real estate to autos. In the United States, people are selling second-hand cars for more than they bought them new. I can't remember even *reading* about a situation like that.

A second (negative) effect is through higher input prices, which can squeeze mid-supply chain manufacturers in unpredictable and uneven ways. Fortunately, commodity inputs are small cost components for technology companies. The raw ingredients purchased by a pharmaceutical enterprise are trivial relative to its IP, for example. So we are protected there.

A third effect is the impact of higher interest rates on cash flows - particularly relevant for leveraged sectors. Given most of our companies hold net cash, they are actually minor beneficiaries of higher interest rates.

Fourthly, wage costs can be expected to rise, and there are all kinds of data and anecdotes that suggest this is the case today. Staff costs are very relevant for technology companies, but the high cost of each employee is more than matched by efficiency. A salesperson or software engineer can generate very significant revenue compared to say, a retail or factory worker.

Think of a heavily leveraged factory employing thousands of workers, that converts steel and raw materials into widgets for other factories higher in the supply chain. *That* is where inflation hurts. Ironically it is precisely those kinds of companies that have outperformed recently.

**Inflation fears have resulted in a sell-off in rockstar technology companies and a rally in old school industrials. Long term, we know where we want to be.**

Over the last few days inflation has surprised to the upside and the Fed has talked about lifting rates. In a welcome reversal of recent form, this coincided with a strong rally in growth stocks, which shows the dangers of blindly following market narratives, and supports the message in the charts above: positioning is facing the other way.

Our team has done a lot of work on Alzheimer's lately. If you'd like to see it, please send me a message and I'd be happy to share some of our longer pieces. If there's enough interest, I'll send it out to the mailing list.

Finally, I know many of you joined us in mid-February before the recent sell-off. Rest assured we are working hard to set the portfolio for the next leg up, ruthlessly culling companies that aren't performing, and allocating carefully to those that are.

My best guess is the combination of ~150% growth, bearish professional positioning in technology, and a 30% sell-off in growth bodes well for returns from here.

I'll host a webinar with a colleague next Thursday 10.30am Sydney time, please send in any questions or ask live, and register here.

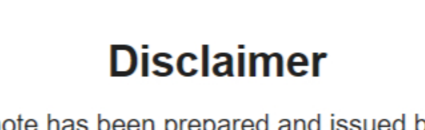
Best wishes

Michael

**Please note:** We are now taking applications weekly, so if applications, funds and supporting documents are received by 2pm on a Friday, the investment will be priced for Friday COB / Monday morning start. We are also available on Netwealth and Hub24.

If you'd like to invest with us, you can access our investment portal and fund documentation through the button below, or simply reply to this email and we'll be in touch.

Invest





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