VT Lyndon Fund

Quarterly Commentary 31st March 2020

ContraCapital

What the hell just happened?

We have just endured perhaps the most extraordinary quarter in the capital markets of our lifetimes. As recently as mid-February global stock markets were hitting all-time highs and then, just a month later, many had fallen by a third or more. 'Interesting times' no doubt, just not the most auspicious of ones to launch an equity fund.

The fall in the UK equity market – at its recent trough it was down by -36% from 2020's peak (as measured by the FTSE All-Share Index) – was broadly in line with that of other global stock markets. What was unusual about the fall in the UK equity market, was that having significantly underperformed other countries' markets over the last few years, it had started the year looking cheap, against both its international peers and against its own history. On a variety of valuation measures (including price to earnings ratio (P/E), dividend yield and price to book) the UK market began 2020 in the cheaper half of its history. It is very unusual indeed for the equity market to fall sharply when it is not richly valued against historic norms.

Indeed, as far back as we have reliable figures (early 1960s for the All-Share Index), there is no instance of the UK equity market suffering a fall of the magnitude we have just witnessed from a below average valuation point. Since WW2 there have been five previous market sell-offs of 30% or more and all of them occurred from a starting point where valuations were stretched. The equity market was demonstrably expensive prior to 1987's 'Black Monday' episode, was eye-wateringly overvalued at the onset of the 2000-2003 collapse that followed the TMT bubble, and valuations were similarly stretched before the Global Financial Crisis of 2007-2009. Even the market rout of the mid-1970s, which played out against a dismal backdrop of the first Oil Crisis, the 'three-day week' and a secondary banking crisis, started with the equity market trading at a rarefied valuation. The recent experience can therefore be safely termed as 'unprecedented', at least in living memory.

As well as being unprecedented, the market's fall has also been indiscriminate, with seemingly little differentiation between those stocks that were cheap at the outset and those that were highly valued. Actually no, that's not quite right, there has been some discrimination between highly and lowly valued stocks during the current episode, just not in the way one might expect. During the sell-off, the more lowly-rated 'value' stocks have, thus far, performed worse than the more highly rated 'growth' parts of the market. And this is after 'value' stocks had been notably weak over the past couple of years and were already trading at abnormally wide valuation discounts to growth stocks.

This recent underperformance of 'value' versus both 'growth' and the wider market has been deeply unhelpful for the VT Lyndon Fund's performance, as our approach is very much a value-biased one. We believe that over the longer-term investors' returns are overwhelmingly driven by the price they pay for their investments, with cheap stocks outperforming expensive stocks. This is very much a long-term approach, though, and it is prone to periods of poor performance over shorter periods. Cheap stocks can (and do) get cheaper, whilst expensive stocks can keep rising for longer than common sense would seem to dictate. Ultimately, though, the elastic snaps back and fundamental value reasserts itself. Very poor periods tend to be followed by much better ones, with mean reversion a powerful force in the markets as elsewhere. As the father of modern investing, Ben Graham, observed: 'In the short term the market is a voting machine, in the long term a weighing machine.'

We are currently very much in a 'voting' phase, during which investor psychology dominates the market, rather than a 'weighing' phase when valuation prevails, and 'value' is not working. From inception on 20th January to the end of March the VT Lyndon Fund is down -30% and, whilst the fund is not formally benchmarked against an equity index, we can note that this was worse than the performance of the FTSE All-Share Index, which was down -26% over the same period.

Losing money is no one's idea of fun and was not part of the plan. However, without wishing to sound too desperate to find silver linings in the darkest of rainclouds, we will observe that indiscriminate market sell-offs generate the largest dislocations between price and value and therefore offer the greatest investment opportunities. The opportunity set is currently rich, which we will discuss a little further below. As a noted investor once said, 'you make most of your money in bear markets, you just don't realise it at the time.'

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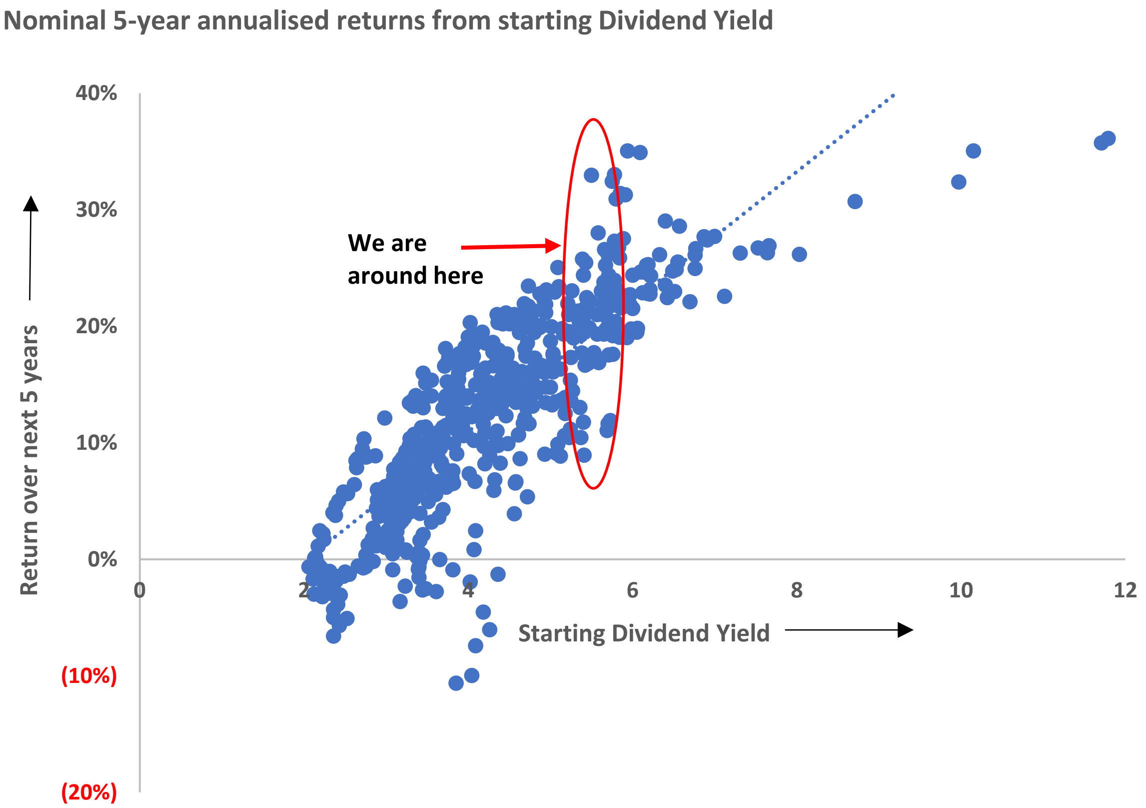
Where are we now?

We do not always succeed, but as investors we do try to remove emotion from the equation, to be dispassionate and therefore indifferent to the 'twin imposters' of euphoria and panic in the markets. Instead, we rely on hard data and historical precedent, what do they now suggest?

Following a small recovery at the end of the month, the UK equity market ended the quarter -26% down for the year-to-date. As we have already observed, the UK market started the year more lowly valued than average, so naturally having fallen by more than a quarter it is now a lot cheaper than average. Notably the UK benchmark index, the FTSE All-Share, currently offers a dividend yield of a little over 5.5%, with this placing the valuation in the cheapest 'quintile' (or cheapest 20%) of history over the last 60 years or so. What sort of return might we expect over the medium term from a valuation point such as this?

As shown in the scatter chart below, if one invested in the UK equity market at any time in the last 60 years when it was trading at a valuation similar to the one currently prevailing and then held for the next five years, you would have invariably enjoyed positive total returns, with this illustrated by the blue dots that lie inside the red ring. The chart depicts total nominal returns, but five-year forward total real returns from current valuation levels have always been positive too.



Source: ContraCapital
Past performance is not necessarily a guide to future performance.

The X-axis in the chart above measures the equity market's dividend yield at the time of investment, whilst the Y-axis shows the returns that were generated over the next five years (on an annualised basis) if you invested at that dividend yield. As can be seen, the greater the dividend yield at the time of investment, the higher the returns received over the next five years have typically been. This is very much as one would expect, as a high dividend yield betokens a low price for the market and, just as with individual stocks, cheap markets tend to offer better returns than expensive ones.

So, historically, investing when the market was offering a dividend yield around the current 5.5% would typically have generated returns of a little over 20% per year over the subsequent five years, or c. 160% in absolute terms. The lowest five year return recorded was 9% p.a. and the highest 33% p.a., or c. 50% and 300% in absolute terms. Clearly, none of

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these figures should be taken as any kind of forecast, but they do frame the historical range when investing at around current valuation levels.

This data is specific to the UK, where the bulk of the VT Lyndon Fund's assets are invested, and conditions elsewhere are rather different. Specifically, we find no such relative cheapness in the US market at an aggregate level, where valuations remain very stretched. Indeed, the performance and valuation of the US market is wholly out of kilter with the UK and also with the rest of the world. For example, at its recent peak the US market had risen by more than +400% from 2009's post-Global Financial Crisis (GFC) market bottom, whilst the comparative trough-to-2020-peak figures for the UK and the World ex-US were +119% and +125%, respectively. This is an astonishing differential in performance.

At the end of Q1, following the sell-off, the US market was still 65% above its 2007 pre-GFC peak, whereas the UK and the World ex-US indices were -16% and -35% (!) below their respective pre-GFC peaks. Furthermore, whilst the UK market did manage to hit a new all-time high during this cycle, the World ex-US has remained well below its pre-GFC levels throughout the 2009-2020 bull market. And somewhat incredibly, the UK and the World ex-US are not only now well below their 2007 levels, they are currently languishing well below the levels they reached at the end of the 1990s, more than 20 years ago.

It might be imagined that the red-in-tooth-and-claw capitalism of the US means that it inevitably outperforms other developed markets, but this is absolutely not the case. If we consider price index data in US dollars going back to the early 1970s we find that the UK and World ex-US indices substantially beat the US over 1971-2008, but have given all that outperformance back and much more besides over just the last dozen years. The quantum of the US's outperformance versus the rest of the world is surely unsustainable and we expect substantial mean reversion lies ahead, with the UK, Europe, Japan and Emerging Markets likely set to outperform the US over the medium term.

This time it's different?

A possible objection or at least a reason for caution might be that, as we have already noted, recent events are at least somewhat unprecedented; so how far can we rely on historical relationships on a prospective basis? It is often tempting to believe that current problems, whatever they may be, are not only unique but somehow uniquely bad, more intractable than problems faced in the past. This is evidently false, but once we can view historical woes in the rear view mirror and know that we came through them safely intact, that they weren't in fact the end of the world, it is all-too easy to diminish just how bad or uncertain they felt at the time. To diminish both their actual and perceived severity.

And clearly, no shortage of Very Bad Things has afflicted the globe, the international economy and the capital markets over the last century or so. We have had two World Wars, with the first one followed by the Spanish Flu pandemic that killed at least 50 million people; the Great Depression (global GDP down perhaps -15%); the Cold War with various regional crises and wars; the Oil Crises and stagflation of the 1970s; runaway inflation, sky-high interest rates and a big recession in the early 1980s; a UK housing bubble and consequent crash in the late 1980s (house prices fell c. -40% in real terms); the global TMT bubble of the late 1990s and its aftermath; the US housing crash and consequent Global Financial Crisis of 2007-2009.

As was famously remarked, 'history does not repeat, but it often rhymes' and, whilst none of these historical episodes was quite the same as the current circumstance, some were clearly more perilous, more existential than SARS-CoV-2. Without wishing to be platitudinous or glib, we got through previous catastrophes, both natural and man made, and we will get to the other side of this too. Any conclusion that old rules and relationships no longer apply should be treated with extreme caution; a very high evidential bar is required to validate such a contention. John Templeton, one of the most successful investors of all time observed that the four most expensive words in the English language were "this time it's different."

On a practical level we have little choice but to rely upon precedents and relationships that have held historically, as the alternative is to operate in the dark without a map. A more specific quibble to the use of dividend yield as a valuation tool might be that many companies have already announced cuts to their dividends and more will inevitably follow. However, this is not a new phenomenon and was common in previous periods of economic stress, with aggregate dividends down by c. 30% over 2008-2010, for example.

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The valuation signal provided by dividend yields is not pure, but it is as good a measure as we have. The level of the market's current dividend yield has a strong explanatory power for its future returns and, unlike earnings-based metrics, it is a stable and robust measure of value. Earnings-based measures, such as the P/E ratio will often give unhelpful readings at the bottom of cycles, as profits can fall even more sharply than share prices, meaning that on spot profit multiples the market can look expensive at the very bottom.

The market is cheap, cheap shares are even cheaper

This sounds like a statement of the bleedin' obvious, which it is, but it's also something a bit more subtle than that. At all times the stock market is populated with both highly and lowly rated shares, but what differs markedly over time is the extent to which the highly rated parts of the market are more richly valued than the lowly rated bits. The textbook example of an especially wide valuation differential between the highly and lowly rated parts of the market was the late 1990s, when TMT (Technology, Media & Telecoms) stocks traded at dizzying multiples, whilst 'old economy' companies that actually made money languished on derisory valuations. After that bubble burst, the market leaders fell abruptly back to earth and the previously neglected laggards performed strongly, with many rising whilst the overall market fell sharply over 2000-2003. The result, of course, was that the valuation spread between the highly and lowly rated segments of the market (or between the 'growth' and 'value' buckets) narrowed substantially.

Following the significant underperformance of 'value', both in the period prior to the sell-off and again during it, we are now in a market that is analogous to 1999 in terms of valuation distribution. The dispersion in valuations within the market stands at historically wide levels, with cheap stocks unusually cheap versus expensive ones. It has been no fun getting here, but 'value' stocks could be set fair to outperform the market over the medium term and, as we have already seen, the UK market itself is on the cheap side of history.

Of babies and bathwater

With the markets in tumult the fund saw an unusually high level of turnover during the period, with the main activity being to add to cheap portfolio holdings as they became ever-cheaper. The biggest additions were made to those holdings that had been most marked down and where we have the greatest confidence they will survive the current crisis intact, or at least not too damaged. In general, the portfolio is populated with companies that are not only lowly valued but possess strong balance sheets, with little or no debt in the capital structure, which should enhance their chances of coming out the other side in a decent position.

For instance, we were able to add significantly to our positions in the builder's merchanting groups, Travis Perkins and Grafton Group, at what we believe to be quite remarkably low valuations. Both were available at less than 5x trailing operating profits or under 4x EBITDA, which is cheaper than they ever got in the 2007-2009 downturn. Not only are these companies cheaper than they were at the bottom of the last cycle, they are financially stronger, with Travis Perkins having little debt (well under 1x EBITDA) and Grafton Group carried a net cash position at the last year-end.

In the same sector but with more risk and lower quality we find SIG plc, a distributor of insulation and roofing products in the UK and across Europe. This is a group that has traded horribly over the last couple of years, but having sold a sizeable business at the end of 2019 it now carries no net debt and yet trades at around 5% of its historical revenues. And this is a group that has historically generated operating margins of 4-6%. A high risk, potentially high reward situation.

At the other end of the risk scale, we added to our existing position in Sainsbury, which is not merely surviving but positively thriving in the current environment. With pubs, restaurants, cafés and most workplaces closed, demand for groceries has inevitably spiked sharply higher, but grocery retailers are not just benefiting from increased demand and volumes. In addition to higher revenues, the big grocery chains will also be making higher profit margins on a per unit basis, as they have essentially ceased any price promotions. And, whilst they will have added some cost by taking on extra staff to meet demand, they will also have saved money by cutting advertising budgets sharply, as there's not much need to advertise when you can hardly keep up with demand as it is. An even bigger reduction in costs was delivered by the government, which has granted all retailers a 12 month business rates holiday. This was really intended to help general retailers, but the biggest beneficiaries have been the food retailers, with Sainsbury set to see a c. £500m saving drop straight through to the bottom line. With standalone general retailers all currently closed, Sainsbury's ownership of Argos, with c. 300 Argos stores located in supermarkets and still trading, must also have be rather helpful.

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Playing much the same theme we also initiated a position in Wm Morrison. Whilst Morrisons naturally does not benefit from the Argos angle, like all of the big supermarket chains it does still sell non-grocery items. More than that, though, where Morrisons does have an edge over its peers is through its uniquely high level of vertical integration. The group produces and processes much of its own food, which will compound the benefits that accrue from the elevated level of demand.

The relatively advantaged position of the big grocers is naturally appreciated by the market, but we do not believe the extent of the boost to their bottom lines has been fully apprehended. Profiteering in a crisis is not a good look, especially when the government has just handed you (an unnecessary) multi-million pound gift, so managements in the sector have been understandably keen to downplay just how well they are doing, talking in cautious tones and emphasising increases in operating costs. This may be a red herring.

Within retail we have also added to our position in Marks & Spencer. As a hybrid food / clothing retailer the group is not so well-placed as the 'Big 4' supermarket chains, but then it is not valued like them either. And nor is it as badly placed as if it were a pure play clothing retailer, but it very much is valued as if it were. Last year M&S generated 57% of its sales from its food business, which remains almost 100% open and where we know sales were up by c. +20% in March, and yet the share price is down more than 50% year-to-date and the group is sitting on a P/E of less than 6x. In addition, the group now owns 50% of Ocado's UK business (with a route to 100% control) and Ocado's share price has been going through the roof recently. It unquestionably has its challenges as a business, but the valuation of M&S looks deeply anomalous to us.

When looking for investment ideas we are often seeking babies that have been thrown out with the bathwater. That is, we are looking for companies that the market has marked down as if they share certain unfavourable characteristics with ostensibly similar, poorly positioned peers, that they do not in fact possess. M&S is predominantly a food retailer (whose stores are still open), but it is being valued like a clothing retailer (stores compulsorily closed), so is something of an example of this, but a purer case is 888 Holdings.

The gambling sector, notably GVC Holdings and William Hill, has been very weak due to the cancellation of sports events, the closure of betting shops and the overhang of the £2 max stake on Fixed Odds Betting Terminals (or FOBTs). In addition, for both GVC Holdings and William Hill these problems have been hugely exacerbated by their stretched balance sheets, which makes it quite probable that rescue equity raisings will be required. 888 Holdings shares precisely none of its peers main problems. 888 is only lightly exposed to sport betting, being mainly focused on casino, with sports, bingo and poker smaller parts of the revenue mix. It is a pure play online business, so the closure of betting shops is a positive rather than a negative for 888, and the group focuses on a recreational, low-staking customer base, so is less likely to incur future regulatory wrath. Lastly but by no means leastly, 888 has a pristine balance sheet, with a substantial net cash position and, at the time of we purchased a holding, the valuation appeared bargain basement. The stock was trading on a trailing EV/EBITDA of well below 4x and a P/E of 7x. We believe that 888 had been sold indiscriminately alongside its more challenged peers and that the valuation represented a significant anomaly.

For the more ESG minded (Environmental, Social and Governance, that is), ContraCapital currently considers gambling companies like 888 to be on the right side of acceptability. Our simple, but unquestionably somewhat subjective taxonomic system, deems a product or service as probably acceptable if it is not unduly harmful when consumed 'in moderation.' So, fast food, gambling and alcohol are on the right side of the line, whilst tobacco and US handgun manufacturers are not. Happy to discuss.

The febrile state of the markets has meant that there have been price dislocations and valuation anomalies everywhere. For example, we have put some money to work in the commodities space, which is likely to be something of a rarity for ContraCapital. Our biggest position here is in Yellow Cake plc, which is a uranium investment company that purchases and stores uranium oxide. For fairly obvious reasons uranium is not freely traded on an open market like other commodities and Yellow Cake is one of the very few ways for investors to access the uranium market. The price of uranium, having been over $150 in 2007, was below $25 in March, which is not a long-term sustainable equilibrium level. The cost of getting the stuff out of the ground is more like $50, so there is currently zero incentive to dig new mines. Indeed, the leading Canadian uranium miner, Cameco, has just shuttered its major site, which is the world's largest uranium mine and is responsible for c. 13% of global output. Supply is therefore already actively tightening and demand is not going away, as nuclear power plants have extremely low operating costs, so they typically remain on at all levels of electricity demand.

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The final piece of the investment puzzle is that Yellow Cake itself has been trading at a perplexing 25% discount to its depressed Net Asset Value. Curiouser and curiouser.

Staying within the realm of commodities ContraCapital have broken the habit of an investing lifetime and recommended some exposure to precious metals, specifically to physical gold and physical silver holding companies. Committed afficionados of gold, so-called 'gold bugs', can be an odd bunch and ContraCapital has not drunk the Kool-Aid nor invested in a new tin-foil hat.

However, the trauma of the last few weeks has seen the UK and many of the other developed economies chance upon veritable forests of magic money trees, with wholesale money printing, direct debt monetisation, 'helicopter money' and many other 'unconventional measures' moving onto the policy agenda. Many nations are likely to do 'whatever it takes' in an attempt to stave off the potential for an economic depression. There is clearly no guarantee that governments and central banks will succeed in reflating the economy, but that is clearly the intent. It is quite possible that after a 40 year disinflationary cycle, which has been brilliant for fixed income returns, we could finally be on the cusp of a regime change, with a shift from disinflation to increasing inflation.

A decent dose of inflation and negative real interest rates would serve as a palliative to many of the developed world's manifest economic imbalances, with excessive debt burdens inflated away and borrowers (the young and poor) benefiting at the expense of asset owners (the old and wealthy). This would be good a thing for intergenerational equity, but should the inflationary genie be released from the bottle, then controlling it thereafter is likely to be far harder than central bankers think. However, before we get to an inflationary environment, either benignly moderate or malignly excessive, there is every chance that we will first take a further deflationary lurch downwards in any case.

The summary is that an unusually unsettled macroeconomic environment is probable and, in such periods of flux, gold and silver are likely to perform well, due to their being perceived as intrinsic stores of value. This would be the historical precedent in any case. We think of precious metals less as investments than as 'anti-investments', which could play a useful role when nothing much else is working.

To make way for the additions to the portfolio we naturally had to tip out some of our existing holdings, where we viewed the risk/reward trade-off as less favourable. One of the areas where we have lightened portfolio exposure is to banks, as we have concluded that the current environment dictates that the steepening of the yield curve that is so necessary to boost banks' profitability is now very unlikely to happen any time soon or even over the medium term.

In addition, the likelihood is for a substantial increase in bad debts from borrowers and also for governments to pressure banks to offer significant forbearance to those borrowers. Whilst this will be a positive for the economy, it will not do a lot for banks' profits. In the UK specifically, Royal Bank of Scotland, still majority-owned by the UK government (62% holding) is liable to come under particularly heavy governmental pressure, with its profitability possibly being sacrificed for the 'greater good' of the economy. Whilst it pains us to sell such a lowly-rated company, we have disposed of the fund's position in RBS.

We have also exited our position in Standard Chartered, an Emerging Markets-focused banking group. At the time of sale the group's share price had held up at least relatively well – it had outperformed the UK market year-to-date – but we believe that this comparative resilience is belied by current prospects for many Emerging Markets, which are likely to be hurt by the sharp rise of the US dollar and the effects of coronavirus on less developed economies could be very unpleasant indeed.

A final and dishonourable mention is required for another piece of trading. We initiated a position in the cruise ship operator, Carnival plc, in February. This investment was wholly congruent with ContraCapital's investment approach, as an awful lot of bad news was clearly priced-in, with the share price having already halved and the valuation had never been lower cheaper in the group's 20 years of publicly quoted existence. The thesis was that here was a global leader (>40% share) in a structurally growing market with favourable demographic trends. Opportunities to buy high quality market leaders such as this, at such low valuations come around but rarely and, typically, they should be taken. Consumers' memories are generally remarkably short and Carnival itself has had more than its share of swiftly-forgotten catastrophes.

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It remains quite possible that this will be another of those times (and bookings for 2021 are reportedly higher than they were for 2020 a year ago), but we are not so sure, and the damage this time could (and should?) be longer-lasting. The management team have hardly covered themselves in glory (sending ships out when Coronavirus was already well-advanced) and, even after an emergency equity raise, the group is not short of debt. In addition, it is not at all obvious why a corporation that pays essentially no tax, has few employees in either the US or UK and does not perform an essential function, should be on the receiving end of any kind of bailout. If current equity shareholders get wiped out, so what? The ships won't disappear, they would just fall into the hands of the group's debt holders. All considered, and in spite of the share price being very much lower than we had paid only a month earlier, we concluded that the risk/reward calculus had deteriorated and we sold out of Carnival at a painful loss.

What happens next?

As recent events have made abundantly plain, we have absolutely no ability to forecast what is going to happen next. However, we do have some views as to what could unfold over the next few years. This may seem a perversity, as forecasting the near future is typically much easier than attempting to predict many years hence, but in investing, the longer the time horizon considered, the further one attempts to see into the future, the greater the degree of conviction we can have in likely outcomes.

This is so because, whilst we have a good sense of the historical returns that different asset classes generate over the long term, over shorter time periods their performance is much more volatile, being prey to the uncontrollable outturn of 'events' and the whims of emotional and capricious investors. As we have just seen. Over the longer term, events and investors' emotions will tend to come out in the wash and returns over longer periods will converge on their long-term average, which is c. 6% real or c. 12% nominal for UK equities since WW2. Against that long-term average, the nominal annual calendar year returns since WW2 have ranged between -52% in 1974 and +152% the following year. So you *really* didn't want to panic out near the bottom at the end of 1974, in what was the worst bear market the UK has seen in modern times. For the UK equity market, the early 1970s were actually significantly worse than the 1930s Great Depression period, a fact that is habitually overlooked by US-centric financial commentary.

So to come back to an earlier observation, from where we are now, with the UK stock market trading at historically cheap levels and with 'value' stocks especially unloved and undervalued, the scene could be well set for decent returns over the medium to long term. In an ideal world, and unlike the Kerryman giving directions to the out-of-towners in the old joke, we *would* like to be starting from here.

This will not provide any comfort, but periodic sharp drawdowns in the equity market, such as the one that got us to our current pass are wholly inevitable. Not merely inevitable, but necessary. To see why this is so, one needs to consider the counterfactual, where equity markets deliver returns that are smoothly and consistently higher than those available on other asset classes, with no sharp downward volatility. To consider such a scenario is to recognise its impossibility, as any asset that offered such high returns without a corresponding level of risk would soon see their valuation bid up to the point where their prospective excess returns were squeezed out. And at such a high valuation level, not only would future returns necessarily be much reduced, but risk would be very greatly increased. That is, if the equity market never crashed, it would not be risky. If it wasn't risky then why would any investor ever buy anything else? So, everyone would buy equities, the market would get hugely expensive and future returns from that point would be destined to be poor. Investors would then either sell, likely causing the market to crash, or be doomed to endure low returns.

The uncomfortable, but in some ways reassuring conclusion is that episodes of extreme market volatility are a necessary price to pay, they are the cost of admission to access the superior long-term returns that equities offer.

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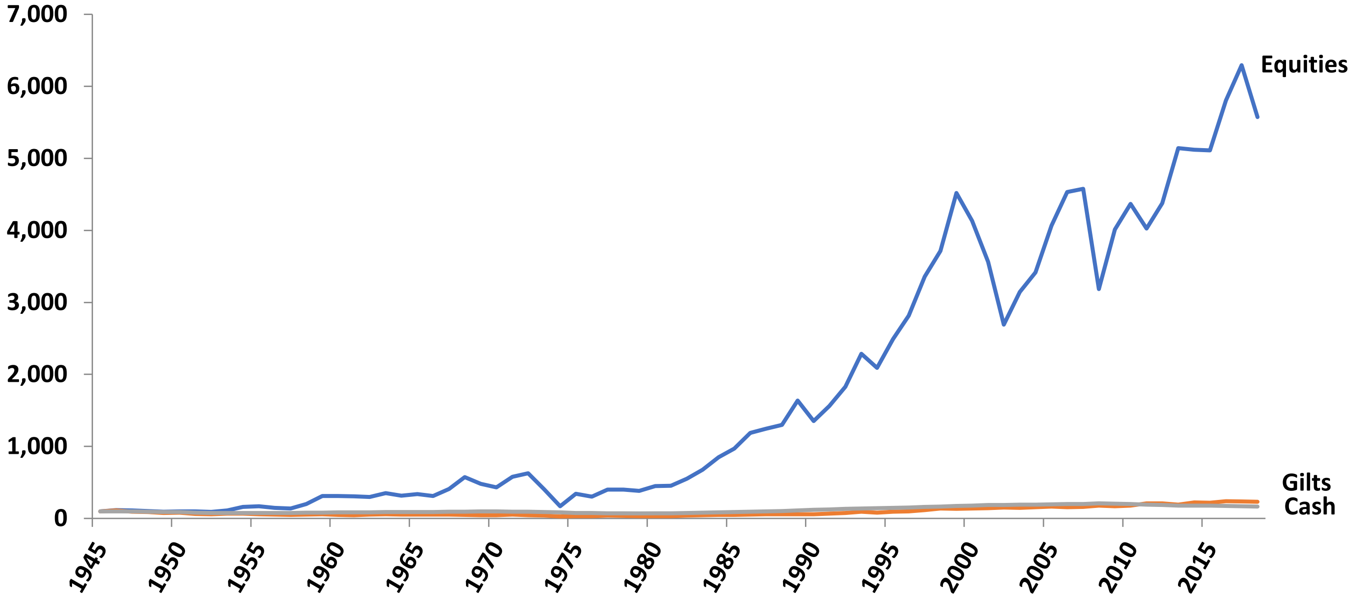
Real returns to UK asset classes 1945-2018



Source: ContraCapital
Past performance is not necessarily a guide to future performance.

Top 10 Holdings at 31st March 2020

Grafton Group	**9.9%**
Marks and Spencer Group	**7.9%**
Travis Perkins	**6.6%**
J Sainsbury	**6.6%**
888 Holdings	**5.3%**
Yellow Cake	**4.6%**
Kingfisher	**4.0%**
SIG	**3.9%**
Citigroup	**3.3%**
Aggreko	**3.1%**

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