# VT Lyndon Fund

Quarterly Commentary 30th September 2020

ContraCapital

A modicum of calm descended on the UK equity market during the third quarter – the FTSE All-Share Index drifted down by -3% in Q3 and the Lyndon Fund was flat – as lockdown restrictions were eased, but Covid-19 remained largely quiescent. However, this relative placidity seems unlikely to last for a number of reasons. Most obviously because, having taken something of a summer break, Covid is definitely back and we look set for an uncomfortable winter. We are now in precisely the situation that, as long ago as March, we were conscious needed to be avoided. That is, we are entering into the colder months when respiratory viruses spread most abundantly with a high level of Coronavirus still circulating in the general population.

Thus far, the UK has suffered the largest economic hit of any major OECD nation (with GDP -21.8% in the first half) and also the highest per capita excess mortality. We have had the worst of all possible worlds. How have we got here? What has gone wrong?

Typically, we at ContraCapital are firm believers in the powerful gravitational pull of mean reversion, but there has been a marked absence of any such mean reversion in governmental competence in the UK. This has had calamitous effects on public health, the economy and the financial markets this year. The result is that being invested in the UK equity market in 2020 has felt like being repeatedly punched in the face by a fat, boorish and overbearing posh man. A man who hasn't the first idea what he's doing, but is supremely confident in his ability to do it. In short, it's not been much fun.

The list of the government's failures is too long to enumerate in detail, but some of the blunders have included: Johnson's making light of the threat posed by Covid; locking down too late; the profound lack of PPE for health and social care workers; dispatching untested, Covid-positive patients back into care homes; Cummings' eye test; flip-flopping over the benefits of masks; the generally dire, confusing and inconsistent messaging throughout. But possibly the most chronically damaging and least forgivable of all the failings of the Johnson administration has been its bewildering inability to set up a functioning Test, Trace, Isolate & Support scheme.

The whole point of a lockdown is to buy time, time in which a competent government would have established a Test, Trace & Isolate scheme that is able to nip in the bud the inevitable post-lockdown sparks of resurgence before they can become a full-scale conflagration. A "world-beating" system was not necessary, one that worked would have sufficed. Instead the three months of lockdown and the subsequent three months of relative calm were wasted.

For example, and quite astonishingly, GP surgeries in England are only now getting Coronavirus testing kits. So rather than being able to get tested quickly, easily and locally, potentially infected patients have often been obliged to travel for hours to a central testing centre. Possibly on public transport. And perhaps to discover that they have run out of tests. Rather than utilise existing local networks and rely on established state expertise, the government instead decided to set up an outsourced, centralised and privately run Test & Trace system wholly from scratch. In the middle of an on-going pandemic. Quite why may remain mysterious, but it can be noted that the chief executive of Serco, the lead contractor responsible for contact tracing, is one Rupert Soames, the Old Etonian grandson of Winston Churchill and brother of Tory Grandee, Sir Nick Soames. And that's Serco, the company that was fined and heavily censured for fraud and false accounting in its electronic tagging contract with the government and whose administration of outsourced probation services was so disastrous that it was terminated years early. The cost of the non-functioning Test & Trace scheme is reckoned to be around £12bn, quite where the money has gone is not clear.

Even if Test & Trace was functioning smoothly, in order for it to be practically efficacious, those that test positive for Covid must properly isolate (or what's the point), which itself necessitates one final aspect, financial support. As things stand, adherence to self-isolation requirements will inevitably be patchy at best. Not only is follow-up from the centralised Test & Trace apparatus often inadequate, but the incentives for many who should be self-isolating are notably lacking. People who should be self-isolating may instead return to work because they cannot afford not to. Statutory sick pay in the UK is £95.85 per week, one of the lowest levels in the developed world. In Sweden, the libertarian right's odd new crush, sick pay is pegged at 80% of a worker's salary.



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The total absence of joined-up thinking in the UK is the inevitable when the government has an economic strategy based around the idea that we need to live with Coronavirus, whilst the health strategy is that we should hide from it. Having no one in the centre prepared to take the tough decisions is how you end up with the worst of all worlds.

The chronic indecisiveness and incompetence at the heart of government have been aggravated by the fact that, rather than focusing all its energies on the Covid-19 response, the Johnson regime has spent much of the summer picking unnecessary fights, ejecting the heads of various civil service departments and needlessly reorganising others. Most absurdly, Public Health England, the body tasked with dealing with pandemics, was scrapped in the middle of the pandemic. Dido Harding has been appointed as head of the replacement body, presumably as reward for making such a success of Test & Trace. Ms. Harding is, of course, a member of the Tory chumocracy, being horsey mates with both Matt Hancock and David Cameron.

Covid is not the only cloud on the horizon; there are a couple of other obvious challenges to serenity in the financial markets. Whatever unfolds in the US over the next few weeks has the potential to cause significant volatility, but whether it will be to the upside or downside remains to be seen. We are also, of course, entering into the end of the UK's transition period out of the EU, with the nature of future relations still up in the air. Expectations of a good or even remotely satisfactory resolution are now set so low that there must be at least some residual possibility of the financial markets being pleasantly surprised by any sort of a deal, however paltry.

Under the circumstances, it's perhaps not desperately hard to see why the UK equity market (and especially the economically sensitive sectors within the UK) have continued to lag. It is worth reiterating, though, that even before the UK's inept Covid response the UK market had already been a significant underperformer, and looked cheap versus both its international peers and against its own history. The good news (sort of) is that following further weakness, UK equities are now trading at their biggest discount to global equities in 50 years and UK "value" stocks are trading at their greatest discount to "growth" counterparts ever.

This is the "good news" as valuation is the main determinant of future returns, with lowly valued stocks and markets outperforming highly rated ones over the long term. And, for all the appearance of bottomless incompetence, there must actually be a bottom somewhere and the UK must (surely) be approaching it. The bottom is the point of maximum pessimism, and it's sure easy to be pessimistic on the UK right now.

The contrast with the US, whose market lies at the other end of the spectrum, both in terms of valuation and investor sentiment, is extreme. The US equity market hit a new all-time high during Q3 and is trading at a P/E ratio in excess of 25x, a level not seen since 2000, at the height of the dot-com bubble. The 20-year average P/E ratio for the US market is 16x, with the longer term average ratio 15x.

By any measure the valuation of the US market is looking stretched and signs of a valuation bubble are now legion. Whilst the market's headline multiple is very high against historical levels, the valuation of some of the most popular "story stocks" are in nose-bleed territory. For example, the video conferencing business Zoom is trading at c. 70x forward *revenues* and now has a market value greater than IBM and, at the time of writing, greater than any UK-listed company.

Tesla, the electric vehicle maker, with a market capitalisation recently in excess of $450bn is valued more highly than Toyota, Volkswagen, BMW, General Motors, Ford, Peugeot and Renault combined. Tesla has barely ever registered a profit and more than all of the meagre profit it generated last year was from the sale of excess carbon credits rather than the sale of cars. But perhaps more head-scratching even than Tesla's valuation is that of Nikola, a would-be electric truck maker that has never actually sold a truck. Nikola was recently valued at close to $30bn, was more than Ford, which sold 5.5 million vehicles last year. Nikola is currently being investigated for fraud by both the US Securities Exchange Commission and the Department of Justice.

Another recent IPO, software business Snowflake, rose by more than +100% on the day it was floated and now sports a market capitalisation of c. $70bn, or 140x its revenues, which are forecast to be a little over of $500m this year. The company is, of course, currently loss-making.



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Valuations and first-day IPO frenzies are deeply redolent of the tech bubble at the turn of the millennium, but perhaps an even more disquieting phenomenon has been the proliferation of “SPACs” (or Special Purpose Acquisition Companies) in the US. These SPACs are investment vehicles that come to market with no assets and no business. The idea is to raise money from investors and then use it to buy into other companies, typically private ones that have not yet been chosen. Given this *modus operandi*, SPACs are also known as “blank cheque” companies, “cash shells” or “blind pools.” So far this year more than $40bn has been raised in the US for these lucky dip enterprises, rather more than was raised in the preceding decade. More than 40% of all US IPOs this year (by volume) have been SPACs.

One of the rationales for SPACs, and almost certainly the dominant one, is that they are able to circumvent the arduous disclosure hurdles that go with the conventional listing of a company. All a SPAC seemingly needs in order to get off the ground is a big-name entrepreneur or financier fronting it, such as the estimable Bill Ackman, and ideally a “hot” area targeted to invest in, such as autotech, agtech or fintech. The money then gets raised, the SPAC listed and you can worry about finding a target later. What could possibly go wrong?

This is all brings to mind the infamous South Sea Bubble era investment opportunity that advertised itself as "a company for carrying out an undertaking of great advantage, but nobody to know what it is." This enticing offer dates from precisely 300 years ago; how things change have changed since 1720! *Plus ça change* and all that. The explosive growth of SPACs is frankly terrifying.

The UK market has, thus far, not been open to SPAC promoters, highlighting once again the extent of the bifurcation in investor sentiment between the US and UK. The recent performance of the US market has so far outdistanced that of the UK and other international markets that the US now accounts for 67% of the MSCI World Index, the most widely used global equity index. We have no idea what proportion of the global equity market the US should account for, but two-thirds does seem an awful lot and we at ContraCap note that during our investing lifetime over the last three decades or so, it has always previously oscillated somewhere around the 50% mark.

In a similar vein, nine of the ten largest companies listed in the global index are now American, with the sole exception being Switzerland’s Nestlé at number eight. But perhaps more startling than the US’s overall dominance of the market is the fact that a single American company, Apple, now has a larger weight in the MSCI World Index than the entire UK market (4.5% vs. 4.1% as at 30.9.2020, source: MSCI). We are old enough to remember when the UK accounted for nearer 10% of the global index.

Another straw in the wind was provided in a recent interview with the famed investor, Joel Greenblatt. He claimed that If you had bought every quoted company in the US with a market cap over $1 billion that was loss-making in 2019 (of which there were 261) you would be up by +65% so far in 2020. None of this makes a whole lot of sense, but yes, we do wish we had had the foresight to have participated in all the fun.

The febrile, overheated state of the US market stands in jarring counterpoint to the state of the wider economy. The disconnect between Wall Street and Main Street has surely never been wider. With the economically insulated tech giants accounting for c. 20% of the US index, some of the US market’s resilience has been justified, but should the US market as a whole really be at an all-time high? Higher than it was before anyone had even heard of Covid-19? It’s hard to construct a persuasive case. It’s not as if the US is tackling Covid-19 in a world-beating manner, on the contrary, the ineptitude of the US’s response is perhaps even greater than that of the UK. There are likely to have been close to 250,000 Covid-related US deaths by election day.

What happens during and after the US presidential (and congressional) election has the potential to significantly disturb the equilibrium of the markets, both in the US and elsewhere. There has been an interesting flip over recent weeks, with the US market seemingly shifting from regarding a Trump re-election as a positive result, due to the likely continuance of low taxes and light regulation, to now seeing a potentially emphatic Biden victory as a benign outcome, as this would bring ‘certainty’. We are currently in one of those phases where just about everything is seemingly good for the equity market; good news is good news and bad news is also good news, as it brings with it the likelihood of further economic stimulus from the Fed. Such Panglossian times typically end abruptly.



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The thing about asset price bubbles is that they last longer and get bigger than you can imagine and then, when their continuance has begun to seem an inevitability, they burst without warning. When the last non-believer cannot take the pain any longer and capitulates, that's the top. We may, of course, not be there yet, with the obvious potential upside surprise being the mass delivery of a safe and efficacious vaccine sooner than currently seems likely. And in the UK specifically, some sort of common sense prevailing with regards to a Brexit deal would naturally be very well received.

More broadly, as and when economies recover from the pandemic and some semblance of normality returns, it is likely that undervalued companies with recovery potential will come back into favour. This year may prove to be the peak year for working from home and, if so, it will be the peak year for the relative growth and earnings of those companies that have benefited from this phenomenon. When the cycle turns investors will want to reduce exposure to those companies where things are as good as they can get and rotate into companies with more cyclical earnings. According to data from Morningstar, a leading provider of financial information, by August investors had poured nearly $50 billion into technology funds, compared to just $1.1 billion in all of 2019. Trends such as these can quickly reverse when sentiment towards sectors changes and the potential rewards for those able to ride out the storm could be considerable once the tide turns.

**Portfolio activity**

There was a subdued level of activity on the portfolio in Q3, with no positions exited and just a single new position initiated, with this a holding in Permanent TSB Group Holdings, an Irish mortgage bank. Permanent TSB Group Holdings is the number three in the Irish mortgage market behind the local, universal banking behemoths Bank of Ireland and AIB. Banks across Europe are trading on very low multiples, but those in Ireland are trading at far lower multiples than in most countries and, within Ireland, Permanent TSB is trading most cheaply of all. The relative cheapness of Irish banks versus those in the rest of Europe appears anomalous, as the pre-Covid Irish economy was in far better shape than most. Demographically, Ireland is set fair for the longer term, possessing a young and growing population, in stark contrast to Germany, Italy and much of the rest of the continent.

After the horrors that the Global Financial Crisis visited upon the Irish economy via an appallingly over-leveraged banking system, Irish banks are now some of the most prudently run in the EU. Irish banks have high capital ratios and 'macro prudential' regulation is notably strict, again due to memories of the dreadful hangover that followed the Celtic Tiger years. Despite this, Permanent TSB Group Holdings is trading at a barely there 0.1x book value, so very little needs to go right for considerable potential upside. One mode of value realisation is the simple passage of time, as the relatively low margin existing back book of mortgages progressively rolls off and is replaced with higher margin new mortgages. Some measure of mean reversion in interest rates also wouldn't hurt. Alternatively, in-market corporate activity, such as a merger with NatWest's Ulster Bank unit would see value realised far more quickly, as this would allow combined costs to be cut very sharply which would totally transform the P&L. A template for this was recently provided in Spain, where CaixaBank has just agreed to take over its smaller rival Bankia, with very large cost savings the primary driver.

**David Lynch, Fund Advisor, VT Lyndon Fund, October 2020**



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