# VT Lyndon Fund

Quarterly Commentary 31st December 2021

ContraCapital

**Performance Review**

Having enjoyed a run of six solidly positive quarters in a row, the fund suffered a horrible last three months of 2021, sliding by -6.9%. So, having been up by +16.2% at the end of Q3, the fund ended the year up by just +8.2% (figures cited are for B Accumulation shares). Worse, the fund's poor Q4 was against a backdrop of generally rising equity markets, with the US once again the stand-out performer, whilst the UK equity market was a relative laggard but still firmly up for the quarter.

The fund's very disappointing performance in Q4 was partly attributable to investment style, as lowly rated value stocks once again underperformed more highly valued growth stocks during the quarter. However, unlike a number of recent quarters this was not an especially pronounced effect and rather more costly to the fund's total returns was its overly conservative positioning. The portfolio holds positions in financial derivatives that protect against equity market falls, but in a rising market these were very much surplus to requirements and instead represented a costly drag on returns. They may, perhaps, prove to have greater utility in 2022.

The greatest problem, though, was the most fundamental; holding the wrong stocks. What was especially costly was that some of the worst performers were amongst the portfolio's larger positions, with 888 Holdings, an online gaming group, the most damaging of these. Having been purchased at a very attractive price near the bottom of 2020's Covid sell-off, 888 Holdings has previously been a highly successful investment and this strong performance had led us to trim the position significantly at higher levels back in April. We did, though, retain a sizeable holding, as we believed that there was further upside potential, something that we continue to believe and hence we have recently added back to the position.

During the quarter 888 shares fell by -30%, with this in part reflecting wider sector concerns (peers Entain and Flutter were also down sharply), but 888 was also under pressure for stock specific reasons. The group entered into an agreement to acquire William Hill International back in early September, with this deal having been well received by the market and the shares consequently appreciated strongly. However, in order to finance the acquisition, the group needs to raise around £500m in new equity, with the timing, pricing and precise nature of this raise not yet formalised. This has resulted in a degree of uncertainty and created a technical overhang in the shares that short sellers will have taken advantage of. However, this is a short-term phenomenon that should be resolved soon and one that has left the shares trading on less than 10x operating profits, which looks far too cheap.

Another poorly performing large portfolio holding was Foxtons, the London-focused estate agency, whose weak share price performance has been very much at odds with the on-going recovery in the UK housing market. House prices have rebounded strongly as, even more importantly to Foxtons' bottom line, have housing transaction numbers and rents. Over recent years the vast bulk of Foxtons' revenues and profits have been derived from property lettings rather than sales, which affords some degree of stability to earnings. Housing transactions, especially in London have been so depressed post-Brexit that the sales side of the business has not recorded a profit since 2016, so there is the latent potential for a big cyclical upswing in profitability were sales volumes ever to recover to their previous norms. Whilst we wait the group is utilising some of the substantial net cash on its balance sheet to profitably acquire lettings books from other agents with less robust balance sheets.

Foxtons' problems are predominantly external and cyclical in nature, but the group has also lost some market share over the last few years and shareholder patience with the (extremely well paid) management team is wearing thin. An activist shareholder has appeared on the register and started to make some noise and there have been rumours of private equity sniffing around, which makes sense as the group has a brand and infrastructure that could surely be leveraged much further. The shares are just too cheap and one way or another are unlikely to be this price for long.



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The final exhibit in Q4's hall of shame is Capita**,** the business process outsourcing group that somehow contrives to perpetually disappoint its shareholders. The wheels fell off the group spectacularly back in 2016 and, more than five years later, management appear to still be struggling to re-attach them. Every time that one thinks the bad news is all out of the way and in the past, something else unpleasant seems to emerge. The key problems have been weak revenues and seemingly never-ending working capital outflows. Revenues have now, finally, recovered to being more or less flat over the last year, but perplexing working capital outflows have persisted, which has ensured that the balance sheet has remained stretched in spite of the on-going disposal of "non-core" assets.

The final on-going issue is that the disposal process being pursued by Capita's management has largely generated remarkably, inexplicably low prices. The group has looked potentially exceedingly cheap for much of the way down, if only the bleeding could be staunched and a solid base for growth established. We do continue to believe there is value residing somewhere within the group, but it is well past time that management started to deliver on their increasingly empty looking promises. 2022 is surely make or break.

One of the very few relative bright spots in a difficult quarter was Marks &Spencer, which rose by another 26% after a similar rise the previous quarter. The stock performed very strongly in 2021, with management raising profit expectations multiple times during the year and they have, perhaps, finally broken the group's 20+ year record as a serial disappointer. After innumerable false starts management, under Archie Norman, look to have finally grasped the nettle this time, with root and branch surgery to the group now well underway and the turnaround looks to be real and to have legs. We believe there is much more to go for, as M&S's margins remain very low versus its own history and also against those of its stronger peers. The competitive situation, with many of its most direct competitors having collapsed, looks more benign than for years. The valuation remains undemanding for a recovery play and we continue to believe that M&S is a likely bid target, possibly for private equity, but we also think that Amazon is an obvious owner.

**Outlook**

For now, the investment landscape continues to be dominated by the "financial repression" that is being practised by governments throughout most of the developed world. Interest rates have been held down at rock bottom, near-zero rates (and very far below zero in real terms), which has forced investors who want any chance of maintaining real wealth to get out of cash and fixed income and into equities (and other real assets). The "risk-free" alternative of holding cash or government bonds that offer nominal returns of 1% or less brings with it not so much the risk but the certainty of rapidly diminishing spending power.

Inflation in the UK is currently running at 5.4% on the government's preferred CPI measure, whilst the previously favoured Retail Price Index (RPI) is now at 7.5%. The CPI number is the highest it has been since the current data series began in 1997, with the older RPI at its highest level since 1991. The rate of inflation is set to continue pushing upwards over coming months, as much higher utility bills will start to drop onto doormats from April onwards due to very large increases in wholesale energy prices. Also in April, the economically misconceived and politically inept tax rise announced in last Autumn's Budget will start to bite, with National Insurance increasing by 1.25%. Expect to hear an awful lot more about the "cost of living crisis" as this year progresses.

At the aggregate level wage rises are currently lagging well behind inflation, but we have already seen some very dramatic pay settlements. For example, restaurant workers in Harrods reportedly secured a 25% increase, whilst Franco Manca put wages up by 20% for some of its employees last year. And it can be noted that the RPI measure that the government does not much like talking about, as well as still being used for the UK's inflation-linked government bonds, is also still commonly used in wage-bargaining negotiations. We are not back in the stagflationary 1970s just yet, but with an already tight labour market and rampant RPI, the possibility of an inflationary vicious circle taking hold is surely on the rise.

In such an inflationary environment, equities at least offer the prospect of maintaining real wealth, though their utility as an inflation hedge over the short-term may actually be pretty limited, as inflationary spikes typically sees sharp multiple compression in equity valuations. Equities do, though, represent real stakes in the real economy, the one where revenues are generated by companies, bills are paid to suppliers and wages earned by their workers, so the earnings and cashflows generated by equities do ultimately tend to move with inflation over longer time periods. Fixed income securities and cash do not share these characteristics.



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In the event of a more inflationary outcome, we can also expect that lowly rated “value” stocks will likely fare better than highly rated “growth” stocks. For one thing value stocks have the distinct advantage of starting from the position of being very cheap versus their own history, which is not something anyone could accuse growth stocks of at the moment. More specifically, a recent piece of research from Sanford Bernstein, a research and brokerage firm, shows that lowly valued stocks have historically outperformed expensive stocks handsomely during periods of higher inflation. This very much accords with our expectations and makes intuitive sense.

**David Lynch, Fund Advisor, VT Lyndon Fund, January 2022**



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