VT Lyndon Fund

Quarterly Commentary 31st March 2022

ContraCapital

We have just suffered a second consecutive disappointing quarter for the Fund, but let's start with the good news first. All of the good news for the portfolio lay outside of its core U.K. equity holdings, which seems at least a little perverse in a period dominated by appalling international events. Even more perverse, perhaps, is that in spite of the Fund's lacklustre performance we are feeling decidedly bullish on the portfolio's prospects.

Away from the core U.K. equity holdings, the Fund's positions in commodities performed well, with gold, silver and especially uranium generating strong returns in the quarter. As previously cited one of the key rationales for our holding in uranium has been our belief that many western democracies have rashly neglected the importance of energy security (hello Germany) and that a reappraisal of this issue would ultimately result in higher demand and consequently far higher prices for uranium. In Q3 2021 we observed that the U.K. being "so reliant on a single energy source (and natural gas is typically 40%+ of the U.K.'s energy mix), especially one whose price is so volatile and where Russia is so influential in the market, is surely not the best of ideas." We would have preferred if European governments had not been reminded of the centrality of energy security in such a brutal manner, but they do at least seem to have now got the memo. The U.K. government has just published a revised energy security strategy with plans to build eight nuclear reactors by 2030. Given the history of nuclear plant construction, this is clearly most unlikely to happen, but the uranium bull case would look to have legs.

Another area of strength, and one very much related to the rise in commodities was Latin America, where we hold the BlackRock Latin American Investment Trust, which was up by +30% during the quarter. Latin America was the best performing region in the world in Q1, with a stock market very heavily weighted in commodities stocks and also one that has performed abjectly for several years and become exceedingly cheap in the process.

The best performing stock in the portfolio was Bayer AG, a German life sciences group, which rose by +32% after reporting robust results that exceeded expectations and evidenced solid on-going sales momentum, with revenues up double digits in the most recent quarter. Following the strong recent share price performance the shares are still trading at below ten times this year's earnings, which seems far too cheap for the portfolio of high quality assets that Bayer owns.

The Fund's Irish holdings also performed robustly and yet, as already observed, this was another disappointing quarter for the Fund, which was down -7.6% (figures cited are for B Accumulation shares). Moreover, Q1 was a flattish quarter for U.K. equity markets (which were, for once, stronger than most of their developed market peers). So why, with a fairly flat U.K. equity market and non-U.K. holdings performing well, was Fund performance so poor? And why are we feeling sanguine, even optimistic about this objectively unhappy state of affairs?

In terms of explaining the Fund's lacklustre relative performance we can observe that the headline U.K. equity index return is dominated by the performance of the largest companies in the index. The most widely quoted benchmark U.K. equity index, the FTSE 100, is market cap-weighted, so the bigger the company the more effect its fortunes will have on the index. Over the last year or so large cap stocks have performed relatively strongly and consequently so has the FTSE 100, which is constituted of the largest 100 stocks listed on the U.K. market. However, beneath the surface there has been a stealth bear market in the U.K. mid-cap space; at its March lows the FTSE 250 Index of U.K. mid-cap stocks was down well over -20% from its recent peak.

The Lyndon Fund portfolio is primarily composed of mid-cap companies (the median market cap is a little below £1bn) and has absolutely not escaped the sell-off in this part of the market. Indeed, in order to reconcile the poor overall performance of the Fund during the quarter with the solid performance of the non-U.K. bits of the portfolio, it can be inferred that the performance of many of our U.K. holdings must have been (and was) *really* bad. Many of the worst performers were domestically focused stocks exposed to the U.K. consumer, such as M&S (down -33% during Q1), fellow retailer Next (-26%) and the building materials distributors Grafton Group and Travis Perkins (both down -20%).

Following these falls many of the Fund's holdings are now trading at utterly derisory multiples. For example, Wickes Group, a home improvement retailer, has been trading at 4x operating profits or EBIT (Earnings Before Interest and Tax), and this is a well-placed group that is not structurally threatened and has significant net cash on its balance sheet. Similarly, Kingfisher, a DIY retailer with operations across Europe, is trading on 5x this year's EBIT and also has a large net cash position. Grafton Group and Forterra, a distributor and producer of building materials, respectively, are both on less than 8x this year's operating profits and, again, both are in net cash positions.

Perhaps cheapest of all is Vitesco Technologies, an auto parts producer, which trades on barely more than twice next year's forecast operating profit. It too is sitting on a significant pile of net cash. Well actually, no, despite its bargain basement valuation Vitesco is not quite the most lowly valued holding in the portfolio, as ScS Group, a U.K. retailer of sofas and carpets, is trading on 1.5x operating profit and 70% of its equity value is accounted for by the net cash on its balance sheet.

With the exception of the last two companies cited, these are not especially outlying examples, as the weighted average multiple at which the equity portfolio is trading is below 8x this year's and less than 7x next year's operating profit (based on consensus estimates and on a pre-IFRS 16 basis). These multiples would be cheap for a small private company, never mind substantial publicly listed ones, and they also imply negative growth in perpetuity, which is surely a harsh assumption. This is not normal nor, frankly, sensible. As and when the portfolio holdings trade at more typical multiples, we estimate that they offer a potential weighted-average upside to our conservative estimates of fair value approaching 100%. This is not a claim we make lightly and is not something we recall observing before.

Of the stocks mentioned above, we added significantly to our position in Wickes Group, taking it from one of smallest positions in the portfolio to the largest, and we initiated a new position in Vitesco Technologies during the quarter. Wickes Group was spun-off from Travis Perkins last April, since when it has performed well operationally, with consistent upgrades in consensus analyst estimates of profitability. This is in sharp contrast to the share price performance, which headed progressively lower, enabling us to add significantly to the Fund's holding at a valuation of less than 4x EBIT. The shares' de-rating has been perplexing, but can most readily be attributed to simple investor neglect; this is a smallish spin-off that looks to have fallen through the cracks and been allowed to become exceedingly cheap. There is little wrong with the business; it has a strong competitive position (being a price leader in many categories), the sector is not structurally threatened (and has a plausible medium-term secular growth story), the group is well capitalised, has a strong balance sheet and good operational momentum. It also looks like a probable target for one of the private equity houses active in merchanting / DIY, especially if it lingers at around these valuation levels for long.

Vitesco Technologies is what was formerly the Powertrain division of Continental AG, the huge German auto parts producer, with the powertrain being those auto components that lie between the engine and the wheels that produce, develop or assist the driving of the wheels. Vitesco itself is a very sizeable business, with revenues of over €8.3bn in 2021 and c. 40,000 employees across 50 locations worldwide. This is another spin-off, and it was only separated from Continental in a demerger in September last year. The historical performance of the group whilst it was part of Continental was not good, with profitability low and erratic, but the most problematic business lines are being wound down and the group is re-focusing on electrification, where it has already seen some good customer wins and has a multi-year, multi-billion euro order backlog in its Electrification Technologies business.

The Electrification Technologies business is essentially still in its start-up phase and is significantly loss-making ahead of the production ramp-up and this naturally suppresses group profitability and obscures the group's true potential. However, if the losses from the Electrification Technologies division are excluded, then at the €29 per share at which we acquired our position, the group was trading at below 2x the profit generated in 2021. Therefore, one just needs to believe that the Electrification Technologies business is not worth a very large negative number for the group to look exceedingly cheap. If Electrification Technologies is actually worth something, which it presumably is, then the shares are naturally even cheaper. Deriving a valuation of €100 per share or more (so >200% upside) does not require any especially heroic or outlandish assumptions.

The sharp falls in the share prices of Wickes and Vitesco that have enabled us to build positions at very attractive prices were not due to any enduring deterioration in the economics of these businesses. The same is true for the portfolio's other, pre-existing holdings, where rather than anything fundamental having changed, the recent sell-off has merely rendered already cheap stocks even cheaper, thereby further increasing the upside to fair value.

We naturally do not ever enjoy losing money, but the key point here is that we do not believe that the fair value of the portfolio has fallen over the quarter (and that it has likely risen), meaning that the upside to fair value has increased materially. What we have now is a very rich opportunity set with palpably mis-priced securities like Wickes and Vitesco in a portfolio that we believe is pregnant with potential returns. There is consequently the prospect of making good money over the medium term if we hold our nerve.

Identifying mis-pricings is one thing, but predicting when they will be corrected is quite another, and it is easy to envisage things getting worse before they get better. It usually is. Whilst the short-term movements in the financial markets often do not seem to make a lot of sense, they have been making even less sense than usual of late. For example, it is surely odd (and uncomfortable) that after selling-off in the wake of Russia's invasion of Ukraine, equity markets subsequently rallied so strongly that by quarter's end most developed markets were meaningfully higher than where they had been on the eve of the invasion. The MSCI World Index was +5% higher, for example, and the benchmark U.S. index, the S&P 500, was fully +7% above its pre-invasion level. And let's not forget that Russia's full-scale invasion of Ukraine came as a very considerable surprise and has had significant adverse economic effects globally. Inflation and interest rate expectations are both now materially higher than they were a couple of months ago and global growth forecasts are appreciably lower. To say nothing of the disruption in supply chains or the heightened existential risks. The conflict could also still take a turn for the even worse, with a struggling Russia seeking a swift resolution via truly desperate measures.

Partly as a consequence of Russia's invasion of its neighbour, which has further driven up already soaring energy prices, the U.K. is expected to suffer its largest ever recorded fall in real disposable income. The U.K. government's own forecasting body, the Office for Budget Responsibility, now expects real disposable income to fall by -2.2% this year (and not return to pre-Covid levels until at least 2024). A U.K. recession is not yet being forecast, but with higher energy bills alone likely to cost British households an extra £38bn over the next year (about 1.8% of GDP!), one is surely probable. U.K. inflation, as measured by CPI, hit 6.2% in March, but it is forecast to reach 9% and possibly 10% later in the year.

Rising inflation is by no means a solely U.K. phenomenon and outside of the major war in Europe, the other big story for global capital markets was the decisively hawkish turn taken by several central banks, notably the U.S. Federal Reserve. The market now expects that the benchmark U.S. fed funds rate, which was still pinned at zero at the beginning of 2022, could hit 3% by early next year. In the world of fixed income, where little things mean a lot, this would be a seismically huge move. Rates across the yield curve have already shifted significantly, with the U.S. 10-year Treasury yield rising from 1.5% at the start of the year to close to 3% more recently, whilst the U.K. 10-year gilt yield has moved from 0.9% to near 2%.

The impact of higher rates on equity markets has, thus far, been strangely muted. As we have observed previously, the U.S. market has been trading at rarefied valuation multiples for quite some time, with bullish commentators arguing that the high valuations are justified by the very low rates of interest. Now that rates are heading sharply upwards, bulls on the U.S. market are going to need to think up a new story. Well, either that or the market will need to adjust downwards. Such a paradigmatic shift is rather less necessary for global equity markets outside of the U.S., as they are much less stretched. The U.K. equity market in particular is moderately valued, whilst our portfolio (as we may have mentioned) is outright cheap.

David Lynch, Fund Advisor, VT Lyndon Fund, April 2022

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