VT Lyndon Fund

Quarterly Commentary 31st December 2022

ContraCapital

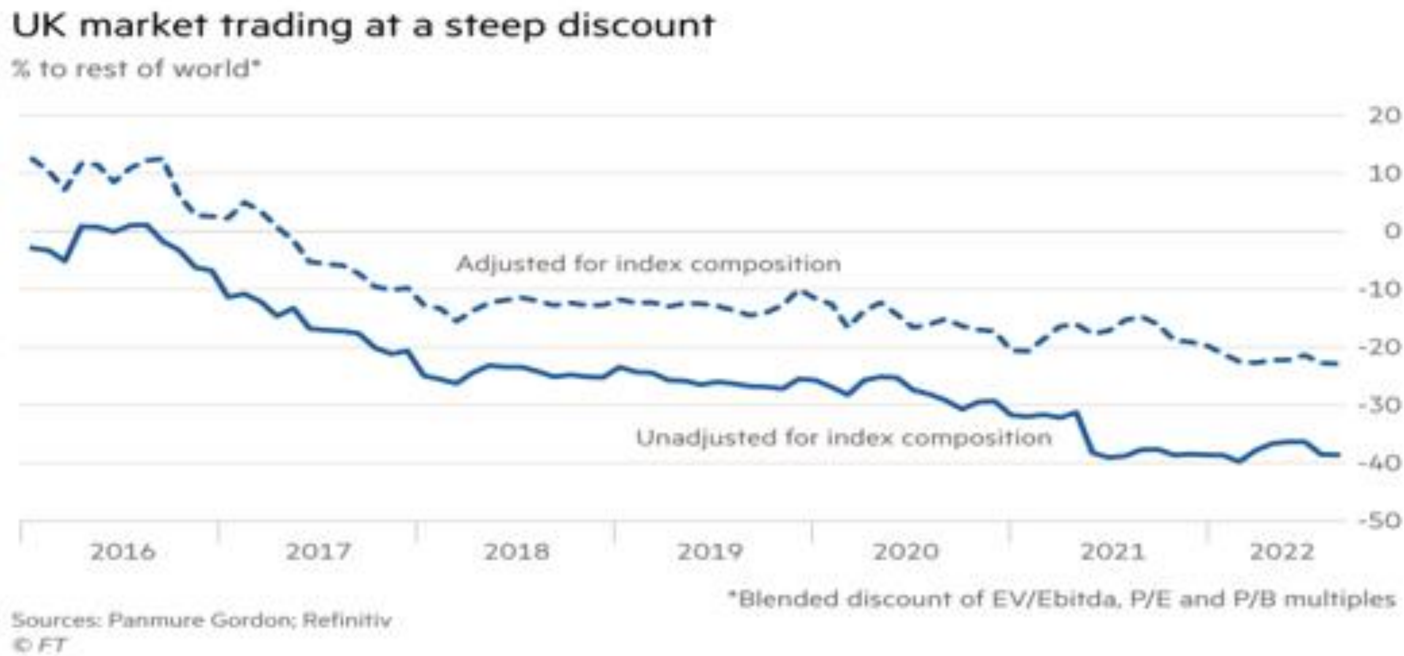
"When pygmies cast such long shadows, it must be very late in the day" – Gian-Carlo Rota

After four consecutive negative quarters, a meaningful rally was enjoyed in Q4, with the Fund up by +11.4% during the quarter. However, the first three quarters of 2022 were so ugly that the Fund was down for the year by -6.0% (all performance figures cited are for VT Lyndon Fund B Acc units).

The turnaround in Fund performance towards the end of the year coincided with a rally in the U.K. equity market in general, but more particularly with an improvement in the relative and absolute performance of mid and small-cap companies. Our portfolio is heavily invested in this part of the U.K. market, as it is the cheapest and most unloved part of one of the cheapest and most unloved equity markets in the world. However, during the previous four quarters the cheapest stocks had remorselessly ground ever-cheaper, with this constituting one of longest and deepest periods of mid and small-cap underperformance in decades, including the largest single quarterly underperformance by mid-caps in at least 30 years at the start of 2022.

The dire performance of U.K. mid-caps inevitably represented a very significant headwind for the Fund, but on a glass at least half-full basis, it also resulted in a portfolio full of exceptionally lowly valued stocks. The single most important determinant of a stock's future returns is its starting valuation, so we continue to believe that our portfolio is replete with excellent prospective returns over the medium term.

In the U.K., equity markets finally bottomed (for now) in mid-October and, as much as one would like to point to exasperation with the witlessness of the Truss administration for driving the fall, and her defenestration for powering the subsequent rally, global markets followed the same pattern and enjoyed similar performance in Q4. The U.K. market remains very cheap relative to global comparators and this is not just because it is a retirement home for tired old companies in tired old sectors. It is true that the U.K. equity market has heavy weights in sectors such as mining, oils, banking and tobacco, which tend to trade at (and deserve) relatively low multiples, but the valuation gap between the U.K. and other developed markets has never been wider. This cannot be reasonably attributed to sector mix, as the U.K. market has not become more heavily weighted in the aforementioned "old economy" sectors over the last five or ten years, during which time the gap has widened substantially (see below). Moreover, if we adjust for the sectoral composition of different markets, the U.K. continues to trade at a very wide discount and one that has never been wider (also below). Why is this?



It almost seems hard to believe now, but at the start of Q4 Truss and Kwarteng were still (more or less) firmly ensconced in Numbers 10 and 11 Downing Street, with the inappositely-styled "mini-Budget" having only been squeezed out a week before. Fun times. This period and the accompanying chaos in the equity and fixed income markets gave rise to a new theory, or at least a new term, to explain the dismal performance of the U.K.'s financial markets. It was suggested that the reason for the U.K.'s low rating was that global investors were applying a "moron risk premium" or MRP for short. Credit for this coinage seems to belong to Dario Perkins, an analyst at TS Lombard, a macroeconomic consultancy, but it was quickly picked up and adopted by the FT, The Economist, Bloomberg et al. Truss may have gone, but notwithstanding the recent rally in markets, the U.K.'s chronically low relative rating remains stubbornly intact. If only there was a clean, elegant way in which we could improve our terms of trade, reduce frictions with our partners, boost GDP and return the U.K. to international good standing as a trusted and reliable partner.

There were no new positions entered into or exited during the quarter, indeed there was no trading in stocks at all, but the Fund closed-out its index hedges in mid-October and so participated fully in the rallying equity markets. Also, we did add a couple of new positions at the very end of Q3, which we did not find space to mention last time. Firstly, there was Essentra plc, a UK-based but global manufacturer of a range of widgets. The group engaged in a mad-cap expansion under a previous CEO during the 2010s, but over more recent years it has been retrenching and focusing on its best business, the Components division. The group's other two divisions, Filters and Packaging, were both disposed of in 2022, so the streamlining process is now substantially complete, but the market does not seem to have properly apprehended the transformation that has been wrought. The new, much more focused and higher quality Essentra continues to trade at the sort of derisory multiple that it perhaps deserved in its previous incarnation as a sprawlingly diverse, albeit small, conglomerate. The group's U.S. peers typically trade at far racier multiples.

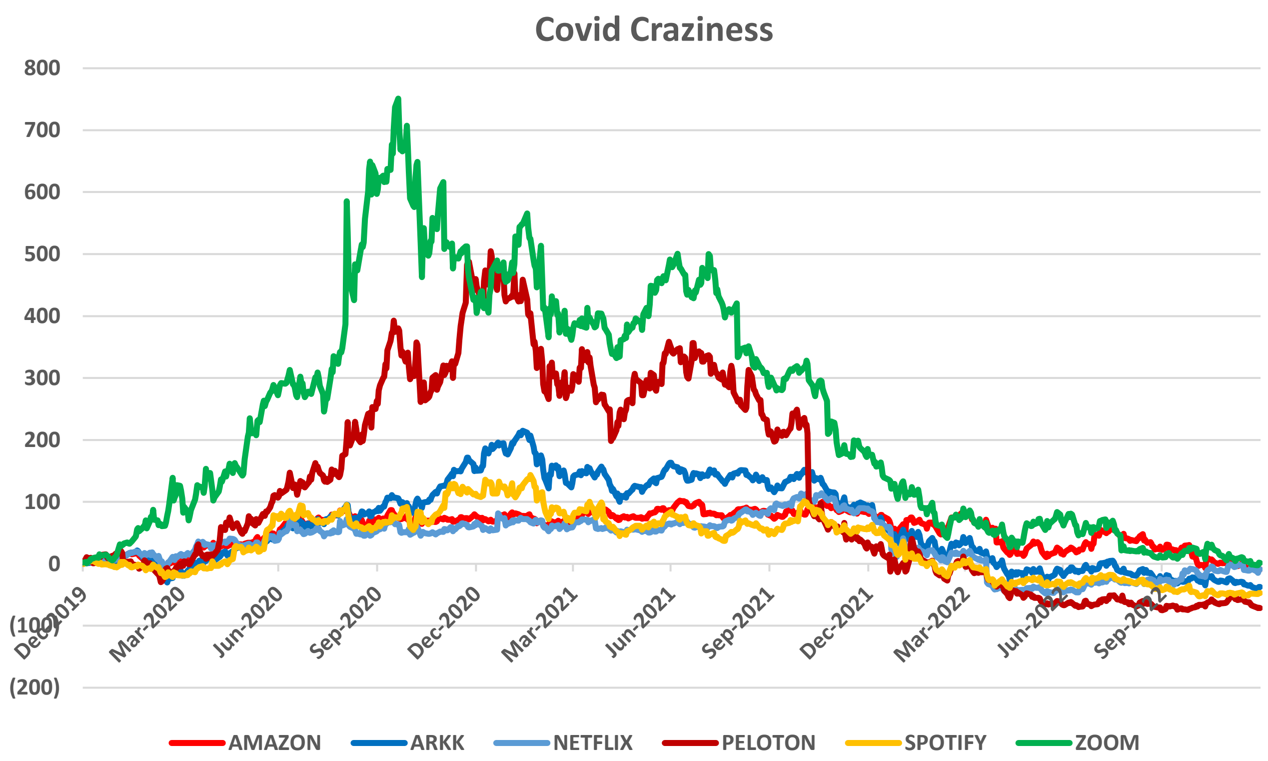
The other, perhaps more interesting addition to the portfolio, was Spotify Technology. Spotify, with 456 million users, including nearly 200 million Premium subscribers, is the world's largest audio streaming subscription service. Spotify is the only audio company that is truly global and is both software and hardware agnostic. It is also the only one of the larger players in the audio space to be solely focused on audio; for the others it's something of an afterthought, and this shows. The audio opportunity is large and the market being targeted by Spotify has expanded hugely over the last few years; it's no longer just a music streamer, with the wider audio space, including audiobooks as well as podcasts, now firmly in the group's sights.

These are big and fast growing markets, with many years of growth in them. Music streaming is growing at 20%+, audiobooks a bit faster than that (maybe mid-20s%) and podcasts an awful lot faster (+45% CAGR 2018-22e). Industry estimates suggest these three markets could quadruple to be worth c. $140bn by 2030 and Spotify is clear market leader globally in music streaming (c. 40% global share of paid subs ex-China) and podcasts (40%+ in US and clear leader in much of developed world), with a nascent position in audiobooks where it is challenging the monopolistic incumbent (Amazon).

The audio market is massively under-monetised at present, with music generating revenues per capita only half what they were at the turn of millennium (in real terms), whilst consumption is well up. Moreover, radio still takes more than its fair share of advertising revenue (perhaps $40bn p.a. globally) and Spotify is well-placed to disrupt and displace much of the radio market. Podcasts have barely been monetised at all yet.

The growth runway is long and yet Spotify, the clear global leader in its key markets, is comparatively tiny in valuation terms. The group's enterprise value as at the year-end was less than $13bn (market cap of $15bn less net cash of $2.5bn), which makes it c. 1% the size of Alphabet or Amazon and little more than 0.5% of an Apple. Now, there is a good reason for this, as the tech titans are insanely profitable and Spotify is not (yet), but the size of the markets that Spotify is addressing, and has global leadership in, offer great and still largely untapped potential. Spotify has the opportunity to perhaps become something akin to the "Google of audio"; the platform where the world goes to find and listen to all manner of audio content. Against this great potential, an EV of under $13bn is really surprisingly small and means that we are being offered an investment with an asymmetric risk / reward trade-off; there is huge optionality here.

At the end of Q4 Spotify was down by nearly -80% from 2021's high of $365 and by more than -50% from the 2018 flotation price of $165.90. This is in spite of the group performing well operationally, with revenues and users approximately trebling since float, with further revenue growth of +22% expected in 2022. Spotify is one of a number of stocks that seems to be suffering from Long Covid, having rocketed skywards during the pandemic, but then steadily deflated as it became clearer that consumers' Covid-induced behavioural changes were not going to be as permanent as many investors had chosen to believe. A representative selection of these Covid beneficiary stocks is shown below and what is most notable is that every single one of them was lower on the last day of 2022 than they had been three years earlier, when Covid was but a small, almost wholly neglected dark cloud on the horizon.

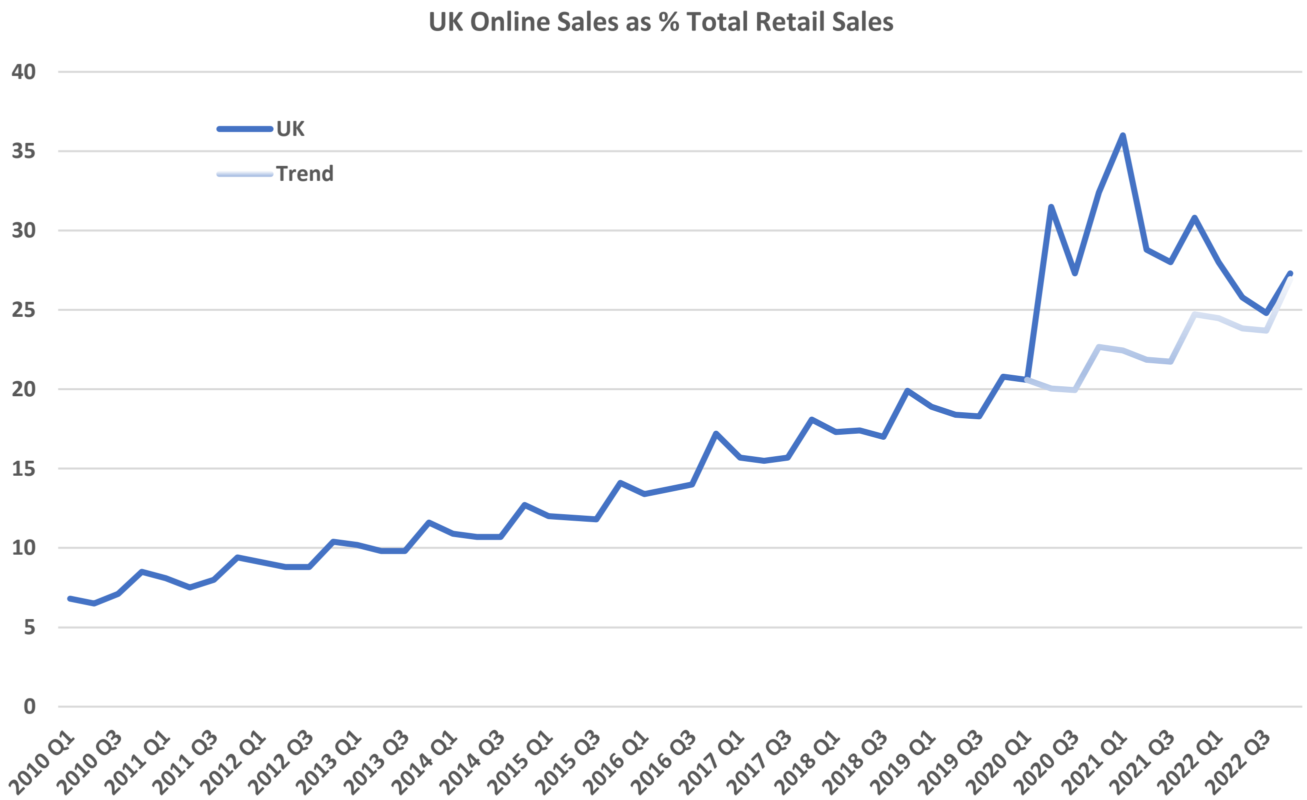


Source: S&P Capital IQ

The best performer within this group over the three year period was Zoom Video Communications, which was down by less than -1% overall, but at its Covid peak it had been up by the small matter of +751%. Amazon closed out the three years down by -9%, from a peak of +102%, whilst Netflix's performance was very similar (-9% and +114%) and Spotify's ultimately very much worse (-47% and +143%). Not nearly so bad as Peloton, though (-71%, down from +505%). Also included in the chart is the performance of the ARK Innovation ETF, a fund that served as the poster child for the bubble in highly speculative and largely profit-free tech stocks over 2020-2021. ARK was -37% over the three years to end-2022, having been up +215% in early 2021.

In many cases the Covid peaks for tech stocks were wholly unjustified and will not be seen again anytime soon or possibly ever (hello Peloton and Zoom). Nevertheless, whilst some of the valuations at the top were positively lunatic, a good measure of the outperformance was understandable and not unreasonable. Underlying the bullishness on the stocks shown above (and many of the other Covid winners) was a widespread belief that the pandemic, rather than changing the direction of travel for well-established secular trends, was instead an accelerant, which served to speed up pre-existing trends and thereby "pulled-forward the future" by five or maybe ten years. The expectation was that once we were out the other side of the pandemic, growth would continue much as before, albeit from the new (much) higher level that we had leapt to. This all seemed pretty sensible, indeed likely in many cases, but it has not typically played-out like this.

To take the most obvious example (and the one for which we have the best data), online sales, having trended inexorably higher at a fairly consistent pace for years, then spiked very much higher after the onset of the pandemic and the attendant lockdown. Online sales accounted for a little over 20% of all U.K. retail sales at the start of 2020 – up from 10% seven years earlier (a CAGR of a little over 10%) – and then jumped to 36% of total retail sales a year later, a 75% increase. This proved to be the absolute peak and since then not only have online sales fallen dramatically as a proportion of total sales (last reported at 27%), but online sales have actually suffered a sustained fall in absolute terms for the first time ever. Remarkably, this data series is now back precisely on its previous trend-line (shown below as the pale blue line), as if Covid had never happened at all. This is data for the U.K., but the U.S. data follows an essentially identical pattern.



Source: ONS, ContraCapital

To be clear, we are absolutely not suggesting that we saw all this coming (we didn't), but as well as being an arresting chart, it is also a fabulous illustration of the danger of extrapolating from a small number of data points, however compelling the narrative may appear to be.

(Source: for all share price and index movements is S&P CapitalIQ and are quoted in local currency unless otherwise noted).

David Lynch, Fund Advisor, VT Lyndon Fund, 29th January 2023

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