Financial Year in Review

Given how much Covid-19 dominates our thoughts and experiences today, it seems strange to look back at a time before the virus struck. And while seen through today's eyes the concerns of early FY2020 seem trivial, it's worth remembering that FY2020 has ended much the same way it began – with considerable concern about the economic outlook, and a worry that markets have overextended themselves.

The year began under the shadow of the trade war between the US and China. Escalating actions from both sides had caused global growth to slow and, as FY2020 began, there was considerable concern that this slowdown was gathering pace. Many commentators were actively predicting the end of the longest bull-market in history. Faced with the weighty goal of trying to extend an ageing economic expansion, central banks around the world begun to cut interest rates again, while promising further action was on the way if needed. In hindsight, these preventive measures were highly successful in fulfilling their goal. Monetary easing first moderated and then reversed the growth slowdown, and by the end of calendar year 2019 global growth was accelerating again. For financial markets, this backdrop provided a re-run of the 'Goldilocks' environment that has been a key driver of asset price returns in recent years. Namely, reasonable global growth, falling interest rates and non-existent inflation - with the latter providing cover for central banks to maintain their ever-easier policy settings.

This constructive investment backdrop ended abruptly in January, with an outbreak of a new and severe coronavirus disease reported in the city of Wuhan, China. By February, any initial hopes that the virus outbreak could be contained to China had been shattered. Primarily to take holidays and participate in Chinese New Year celebrations, some five million people were allowed to leave Wuhan before authorities began imposing restrictions on movements out of the city. As March began, it become clear that the virus had spread widely around the world, with the World Health Organisation then declaring it to be a global pandemic. By the end of March, most western governments had conducted abrupt policy U-turns, dropping their initial guidance that the spread of the virus could be managed. In their place a series of drastic social policies were unveiled that were designed to dramatically slow the spread of the virus. These policies were highly effective in slowing the virus, and in doing so, provided healthcare systems with the breathing space they needed to cope with a massive influx of critically ill people. The impact these policies had on economic activity, however, was cataclysmic. The International Monetary Fund estimates that global growth will now fall by 4.9% in 2020, which is nearly an 8% negative swing compared to their growth expectations at the end of last year. Moreover, rich world countries are expected to suffer far sharper contractions than this. Notably, the economies of the US and the Euro Area are forecast to shrink by 8.0% and 10.2% respectively in 2020 – outcomes that will dwarf the economic impact of the 2008/9 global financial crisis.

Unsurprisingly, equities and higher-yielding credit markets bore the brunt of a savage correction in financial markets that followed these events. From peak to trough, global share markets[1] fell by 34%, while sub-investment grade debt[2] fell by 22%, both in US$ terms. Those commentators who had been calling an end to the bull market were finally vindicated, though for reasons that not even the wildest forecaster would have predicted when the year began.

As the scale of this crisis began to unfold, governments and central banks began to announce vast stimulus packages designed to protect their economies. The size of the programs announced to-date are truly jaw-dropping. In aggregate the IMF estimates that rich world countries will borrow and spend $4.2 trillion in 2020, roughly 17% of their collective GDP. On top of this, nearly a further $4 trillion has been created by these countries' central banks through quantitative easing and other unconventional measures. All of this newly printed money has been invested into financial markets, much of it with the explicit goal of supporting asset prices.

Unlike the 2008 financial crisis, the recession of 2020 has been caused by an external shock in the form of a global public health crisis. Typically, we expect recessions to begin from some form of internal shock, usually triggered by rising imbalances in the economic system. The fact that we have had such fast policy responses to this crisis, and on

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[1] As measured by the MSCI All Country World Index
[2] As measured by the Bloomberg Barclays Global High Yield Index

a scale that is unprecedented during peacetime, is almost certainly due to the fact that this recession is nobody's 'fault'. This time around politicians can't be accused of bailing out overpaid investment bankers.

The scale of these stimulus packages has equated to an avalanche of new money being thrust into the economy and into financial markets. The result, unsurprisingly, has been a significant rebound in asset prices and an economy that optically looks terrible, but where, in truth, the majority of the real hardships that recessions bring have yet to be felt.

Thus, FY2020 ended with financial markets recovering much of their lost ground, but doing so against an economic backdrop that is so bleak that it is hard to truly fathom. In the real-world, the worst effects of the Covid-19 recession are clearly yet to come. This is particularly the case in the many countries that have softened the early blow by underwriting workers' pay cheques. This has undoubtedly saved many jobs. It can't, however, save them all. Sadly, as government fiscal largess is wound back, considerable hardship lies ahead in the real economy.

Performance of the Portfolio

FY2020 put the GVF investment portfolio to the test. As regular readers will know, we strive to provide a unique source of market outperformance for our investors, whilst at the same time seeking to protect shareholder capital come what may in the markets. This year, the second part of that proposition – protecting shareholder capital – was greatly tested by the severe market correction throughout February and March.

The year began quite positively for the portfolio, with a number of our important investment theses playing out as hoped. By the end of January 2020, our discount capture strategy was by far the largest component of the overall 9.8% adjusted NTA return the Company had by then recorded. Positive returns from our discount capture strategy represent outperformance over the underlying market returns of the portfolio. Given the see-through asset allocation of the portfolio is typically set quite conservatively, on their own, broad market returns are never expected to add greatly to overall investment performance. Rather, the relatively conservative asset class allocation employed is designed to protect shareholder capital through most market conditions. In turn, GVF then aims to achieve its higher return targets through its discount capture strategy.

February and March presented a real-world test of the sort of event that we spend much of our investment life planning for but hope to rarely see. We have high confidence that, given some time, we are able to unlock considerable amounts of value from the discounted assets that make up our investment portfolio. Over very short periods of time, however, we know that we have limited control over the discounts to asset backing that these securities trade at. This dynamic, of possessing limited influence in the short-term, but having significant control in the medium to long-term, is one of the most important factors that goes into GVF's portfolio construction. During periods of extreme market stress, we expect discounts to widen across the universe that we invest into. We are not afraid of this outcome as unlocking value is the one factor that we know we can control in the market given some time. That the assets we already own at a discount are expected to become cheaper still during extreme market events, does not change the amount of underlying value we ultimately expect to realise. In fact, in many cases, a significant short-term widening of discounts can greatly hurry along the process we are involved in to unlock underlying value.

Instead of worrying about what we can't control in the short-term, we believe the more important exercise is to build an investment portfolio that can both withstand these sorts of events and be able to quickly capitalise on the much more interesting investment universe they typically produce. The chief way we do this is by running our portfolio with a short duration. This means that the portfolio naturally turns itself over very frequently and so, even in distressed markets, we have a steady stream of value realisation events happening. These catalysts serve to both unlock value for us and provide us with capital to reinvest when we want it the most.

The upshot of this is that while our discount capture strategy detracted 10.7% from our returns during February and March, caused by discounts across our universe materially widening for a short period of time, by the end of the financial year we had recouped almost all of that value again. From April through to June our discount capture strategy added 9.3% back to returns, with this performance greatly underpinned by the catalysts that we put into place ourselves to realise underlying value. What has been encouraging about this outcome is not just that we have managed to recoup this lost value relatively quickly, but rather, that we have also heavily recycled the portfolio at the same time. This means that despite the fact that we have now recovered most of our lost ground, the see-through value within our portfolio is now considerably greater than it was before the crash.

Over FY2020 as a whole, the Company's adjusted pre-tax NTA increased by 0.2%[3], with the successful application of our discount capture strategy adding 3.1%[4] (gross) to performance. Thus, despite an incredibly turbulent year where almost all asset classes excluding 'FANG'[5] produced negative returns, the GVF investment portfolio managed to avoid a loss, primarily due to the value we unlocked through our discount capture strategy.

Notable winners and detractors in FY2020

When looking at the key developments within the GVF portfolio over FY2020, the extreme levels of market volatility hide a lot of what took place. A simple assessment of what made or lost money during the period is mostly an analysis of what sectors of the market fared better or worse through the crash. Whilst absolute returns are obviously important, the key measure of success that we use internally is the returns we generate from unlocking value. The basis for this is that financial markets today are generally quite efficient machines. There is a large body of both empirical and academic research that points to it being exceptionally difficult (though not impossible), to outperform the market through active security selection when measured over the long-term. Thus, one of the key pillars of the Company has always been to provide an alternative source of market outperformance for shareholders. We set out to do this by investing into a diversified portfolio of global assets, all purchased at attractive discounts to their intrinsic value. This is then paired with an active, hands-on approach, that is designed to unlock the value presented by these situations. While we press many tools into service in our efforts to unlock value, one of our key differentiators is our strengths in shareholder advocacy, and an ability to successfully employ shareholder activism when needed.

With this in mind, and whilst absolute portfolio returns for the year were minimal, FY2020 was a moderately successful year for our approach. When looking at the worst detractors over the period, these were all driven by an underlying exposure to an asset class that fared poorly through the market crash.

Our worst performing investment in FY2020 was our holding in Polar Capital Global Financial Trust (PCFT), a closed-end fund that holds a portfolio of global financial stocks. This fund has a unique feature which allows all shareholders to exit their holding at the fund's underlying asset backing once every seven years. We were able to accumulate a substantial position in this fund, at an attractive discount to asset backing, before this exit opportunity was scheduled to take place. Further, given the large liquid underling shares PCFT held, we were able to hedge a substantial portion of the underlying market exposure in the trade, which greatly improved the risk versus reward characteristics of the investment for GVF. Financials are a sector that have been hit especially hard during this crisis, with a severe economic recession likely to materially increase loan losses, while falling interest rates will hurt future loan profitability. What drove GVF's loss in PCFT during FY2020 was that we only hedged around half of our exposure to the fund's assets, and that, by chance, the NAV exit opportunity happened to take place in the depths of the crisis, before markets rallied substantially again. Notably, over our entire holding period for PCFT, the investment has generated positive overall returns for GVF. During FY2020 however, our holding in PCFT detracted 0.8% from portfolio performance, with this loss as much as anything a function of unlucky market timing.

While being forced to exit a holding at an inopportune time may, at first pass, seem to be a drawback to our approach, there are two important mitigating factors that are worth remembering. The first is that while we exited our position toward the market lows, we still unlocked meaningful amounts of value in the process, meaning we fell by less than what the market did through this period. Secondly, as discussed earlier, we rely on there being a constant stream of realisations occurring across our portfolio, so that during periods of market stress we have capital ready to reinvest.

[3] Adjusted NTA returns are net of all fees and expenses. NTA adjusted for dividend and tax payments and the effects of capital management initiatives. Source: Staude Capital Ltd.
[4] Source: Staude Capital Ltd.
[5] 'FANG' refers to a small basket of high-growth, high-multiple, technology companies like Facebook, Amazon and Google. Excluding the thirteen stocks widely regarded as comprising this sector, global share markets fell by 2.3% in A$ terms over FY2020.

The capital we received back from PCFT was therefore re-invested at the market lows, into positions that benefited greatly from the following market rebound.

The next notable detractor was our holding in Empiric Student Property Plc (ESP), a London-listed real estate investment trust. ESP owns and operates more than 90 premium student accommodation sites across the UK. Over the past decade, student accommodation has been a powerful investment thematic in countries such as the UK and Australia, which serve as prime studying destinations for many international students. The simple metric that best articulates why this has been the case is the ratio of students to purpose-built student accommodation beds in the UK, which for the 2019/20 academic year stood at 3:1, or 15:1 if first year demand/supply is excluded.

This combination of a shortage of supply and strong structural demand growth has created a fast-growing industry designed to provide purpose-built student accommodation facilities. We invested into ESP during 2018 and early 2019, after the company missed a series of operating targets that caused the shares to sell off to a level where we saw compelling value. Our thesis for investing was twofold. First, we had confidence that an overhauled management team would be able to get the company back on track in terms of its operating goals. Secondly, given how cheap the company had become, we believed that if the turnaround was not successful, the company and its portfolio of properties would likely be acquired by a corporate buyer. During the early part of FY2020, the company began to hit a number of the important operating milestones we were looking for and the shares re-rated considerably. We, in turn, began to exit our position and had sold approximately half of our holding before Covid-19 arrived.

A positive feature of student accommodation in recent years of strong rental growth has been the fact that the rent roll resets at the beginning of each academic year, allowing the owners of student property to fully capture rising rents. However, in the face of the pandemic and associated lockdowns, this left student accommodation particularly exposed, as it risked a potential scenario of zero occupancy due to Covid-19. Therefore, it is no surprise that ESP and its student accommodation peers were hit particularly hard through the market sell-off.

2020/21 revenues for ESP are currently particularly hard to forecast, not least because occupancy depends on the situation at a very particular point in time, being the start of an academic year. We, instead, have focused our efforts on stress testing the company's balance sheet for a series of likely worst-case scenarios, whilst looking through the pandemic to assess what the company should be worth on the other side. Fortunately, ESP moved fast to protect its balance sheet, halting dividends and extending what little debt it had maturing in 2020 to 2024. It also moved quickly to cut costs. Having witnessed the turnaround that the overhauled management team originally achieved; we are confident that ESP should be able to weather the current storm. Moreover, the shares today are trading at a discount of more than 40% to our conservative estimate of the company's asset backing. We therefore have been adding to the position again at these newly depressed prices.

Positively, the early indications are that ESP is filling its beds for the 2020/21 academic year better than we had hoped. As of early May, ESP had bookings for 47% of its total capacity, which compares to a booking rate of 54% at this time last year - albeit these bookings are less contractually binding than they have been in the past. Finally, while the backdrop is clearly uncertain for the sector, there are some positive mitigating factors. A more difficult economic backdrop generally keeps more students in study in the absence of job opportunities. Further, normal 'gap year' activities such as international travel and internships have suddenly become a lot less viable.

While not without risks, we believe ESP has significant upside potential from here that can be captured either through a turnaround in operating performance or through the attractiveness of the company's assets to a trade buyer. In terms of FY2020 portfolio performance, ESP detracted 0.7% from our overall returns.

The last notable detractor for the year was our investment in Henderson Alternative Strategies Trust (HAST), a London-listed investment trust that holds a globally diversified portfolio which spans several different asset classes. After battling with a persistent discount to NAV for many years, the directors of the company announced that they would be calling a shareholder meeting to propose a liquidation of the company and an orderly return of capital to shareholders. We understand these sorts of propositions very well and they often provide very lucrative opportunities for GVF. Our advantage here is that we are able to model in detail the underlying assets held in these sorts of portfolios, whilst also having a great understanding of how long liquidation processes take, and how much they cost to fully execute. Following our due diligence, we built a substantial position in HAST at an attractive discount to the company's asset backing. The loss that GVF recorded in HAST during FY2020 was solely a function of financial markets selling off. From the time we invested into the company through to the end of FY2020, the value of HAST's underlying portfolio fell by 5%, which, while disappointing, was an unsurprising outcome given the correction seen in markets. What is much more encouraging, and which bodes well for the future, was that we were able to add to our holding during the depths of March at discounts that approached 30%.

Our holding in HAST detracted 0.6% from portfolio performance during FY2020, though in discount capture terms it produced a positive overall performance. We continue to hold the position at an attractive discount to asset backing which we expect to realise over the year ahead.

On the positive side of the ledger, our most successful investment in FY2020 will be one that is familiar to our regular readers. Pershing Square Holdings Ltd (PSH) is an Amsterdam and London listed closed-end fund managed by Bill Ackman, a high-profile Wall-Street investment manager. Our investment thesis with Pershing has been consistent for some time. Prior to 2018, the fund had three years of poor performance, which resulted in it trading at a very wide discount to its underlying asset backing. Looking ahead, our belief was that either PSH's investment performance would have to improve materially, or that investors in his fund (including ourselves) would demand action to address such an unjustifiable discount. In FY2019 the first of these outcomes prevailed, with the PSH investment portfolio increasing by 21.6% over the year, greatly outpacing general share market returns in the process. While FY2019's returns were impressive, they have paled in comparison to the performance generated in FY2020. Through an almost unbelievably astute instance of market timing, the PSH team decided to hedge their portfolio against Covid-19 risk in late February. They did this by buying insurance against three high-yielding credit indices. As markets then went into free-fall and credit spreads widened dramatically, this hedge paid out handsomely for the fund. The result was that, through February and March, PSH generated positive investment returns of 4.7%. In comparison, the S&P500 index fell by 20% over the same period. For FY2020 as a whole, the PSH investment portfolio increased by an incredible 41%.

While we have maintained a large holding in PSH for some time now, we have actively traded the position over this period, adding value to our holding in the process. We have also successfully invested in the company's bonds, though we recently exited our holding in these.

Despite a stellar investment performance through the market correction, PSH's shares continue to trade at a 32% discount to their underlying asset backing. While we continue to maintain a holding, we have recently reduced our weighting and realised some of our gains in lieu of the many other exciting opportunities we are seeing in the market at the moment. Ultimately, however, we continue to believe that the investment retains the same compelling asymmetrical payoff profile we saw in it when we first invested. In our view, such a large market discount to an underlying portfolio of liquid large-cap stocks is unsustainable over the long-run, especially for an investment firm that styles itself as a shareholder activist. We therefore continue to believe that the size of the current discount provides a significant 'put-option' for investors into the company. If performance does not continue to impress, shareholders' tolerance of the discount to asset backing should be expected to wane very quickly. Our holding in PSH added 1.6% to total portfolio performance during FY2020.

Our next notable positive performer in FY2020 was our holding in JP Morgan Global Convertibles Income Fund (JGCI), a London listed closed-end fund that invested into a portfolio of global convertible bonds. JGCI was very much a straight down the fairway investment for GVF. The underlying investment thematic for JGCI - exposure to global convertible bonds – had fallen out of favour in the market, and the fund had been battling with a stubborn discount for a number of years. At a headline level however, this discount had never been allowed to get too wide, primarily due to the actions of a vigilant board who had committed to buying back shares if the discount to NAV exceeded 5%. In defending this target, the board bought back approximately half of the entire share capital over a four year period. To our eye, there was now insufficient demand to maintain JGCI in a listed fund structure, while the pace of the board's buyback program was unsustainable for much longer. Thus, our assessment of the situation was that this listed fund no longer had enough market support to continue in its current form. We built a sizeable position in JGCI, which culminated in us owning 7% of the outstanding shares in the company. In July 2019, and with minimal engagement from ourselves, the board announced that they would bring forward plans to liquidate the company and return capital back to shareholders. GVF subsequently exited its investment through the liquidation process. During FY2020 our investment in JGCI added 0.8% to total portfolio performance.

Finally, Amedeo Air Four Plus (AA4) was an opportunistic deep-value investment the fund made in May and June. AA4 has a simple business model. It aims to provide its investors with a high level of income and the potential for capital appreciation, by owning and leasing twelve widebody aircraft to Emirates and, to a lesser extent, Thai Airways.

With air travel one of the sectors hardest hit by Covid-19, the shares understandably came under significant pressure as, first, Thai Airways sought some accommodation from its lessors, and then Emirates asked for assistance too. In the meantime, the company's board took the prudent step of suspending the dividend to preserve capital which, while understandable, triggered further rounds of selling from income orientated investors.

While this all paints a particularly bleak picture, what made AA4 an exciting opportunity to us was the very large amount of cash sitting on the company's balance sheet. This cash had appeared due to a well-timed sale of two of its planes to Etihad in February, just before the crisis struck. Thus, in the depths of the market sell-off, we were able build a position in AA4 at a price approximately equal to the company's cash backing. In effect, at that time, the market was assigning little or no value to the underlying aircraft that AA4 own, or to the long-term non-cancellable leases that the company has in place for its fleet. This has set up a very asymmetric trade for us, where we have a large cash buffer beneath us and a number of scenarios under which the potential value of the company is a multiple of the current share price. Furthermore, once the situation with Thai and Emirates is better known, we expect the company will be in a position to distribute at least some of its excessive cash balance, thereby de-risking the investment.

Our holding in AA4 added 0.5% to total portfolio performance during FY2020 and still continues to offer very attractive upside value.

Outlook

The big debate in finance today is whether investment markets have detached themselves from economic reality, or whether, in fact, they correctly reflect a new reality – one of unprecedented levels of government support, and a near-zero interest rate world with no end in sight.

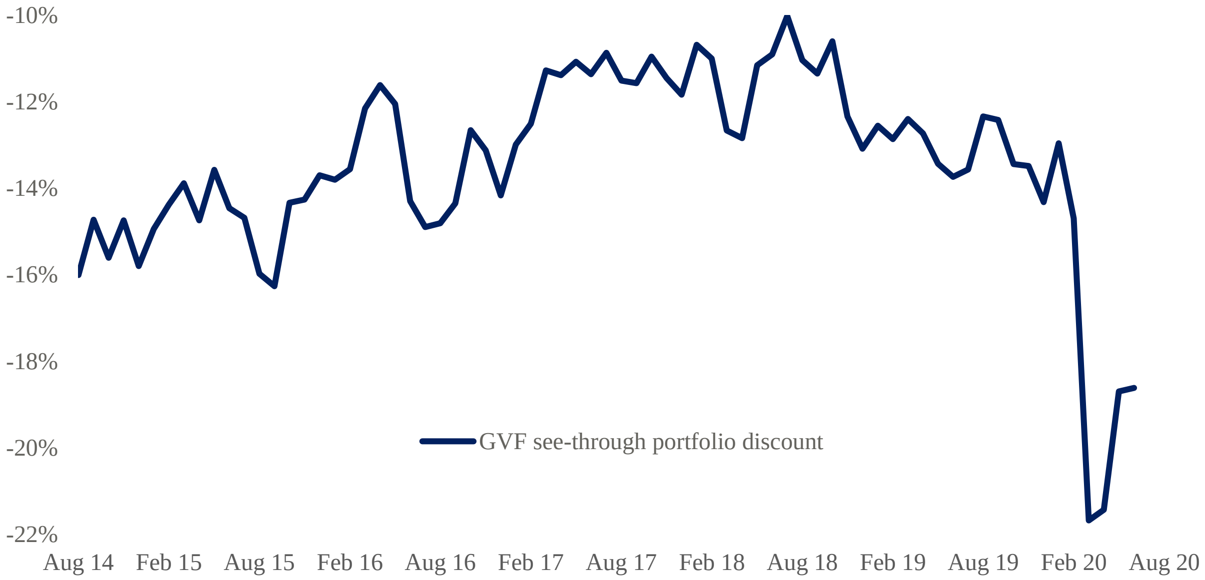
The primary driver for increasing asset prices during the final years of the recent bull-market was not stellar economic growth, or companies greatly growing their underlying profitability. Rather, investors became willing to pay substantially higher valuations for the same financial assets. The driver for this investor largess was falling interest rates, a topic we discussed in detail in January.

Looking at the dramatic re-bound in asset prices since the Covid-19 crisis struck, one thing is clearly apparent again: markets are not rallying because companies are growing earnings, or because the economy has stepped it up a gear. In fact, once again, it is the complete opposite of this. An incredibly bleak economic outlook has forced interest rates yet lower still. Today, the yield on a 30-year US government inflation-protected bond is -0.5%. That is, the real interest rate you receive for lending money to the US government today, for a period of *thirty years*, is negative.

It is a truism that lower interest rates justify higher financial asset valuations. Taken to its extreme, if you assume that interest rates are zero in any financial model, the calculated valuation you will receive is infinity. For many investors these concepts start to look like financial alchemy, a view that is hard not to have sympathy for. And while we may still be someway yet from quoting stock prices in terms of '∞', the challenge investors face today is that broad market returns are poised to be hyper-sensitive to the future direction of interest rates for the foreseeable future.

Against this backdrop we believe the proposition for GVF over the year ahead is both very exciting, and relatively insulated from the debate over whether markets have run too far too fast, or still have further yet to go. As we have discussed in our recent monthly reports, the extreme levels of market volatility seen this year have created large dislocations across our investment universe. For us, this means that the underlying value propositions we hunt out around the world are considerably more attractive now than we typically find.

The result of this is that the GVF portfolio today is pregnant with significantly more value than we are accustomed to. To illustrate this point, the chart below shows the see-through value within the GVF investment portfolio over the six years since the company's launch. Historically, the see-through discount across our portfolio has ranged between 10 and 15%. This historical range has been a function of our relative weightings to the two areas in the market that we unlock value from over time: the relatively narrower discounts on the trading opportunities that we exploit, and then the much wider discounts on the deep value propositions we find where we are looking to unlock through our own actions.



What has us excited about the outlook for the GVF investment portfolio today is that the discounts we see now in both of these key hunting grounds - trading opportunities and deep value propositions – are much wider than we typically expect. Importantly, given time, our ability to unlock this value is independent of what broader markets may, or may not, do next.

The team and I would like to thank all our shareholders for their continuing support throughout FY2020 and especially for the many kind messages that we received during the year.

Miles Staude
Director and Portfolio Manager
21 August 2020