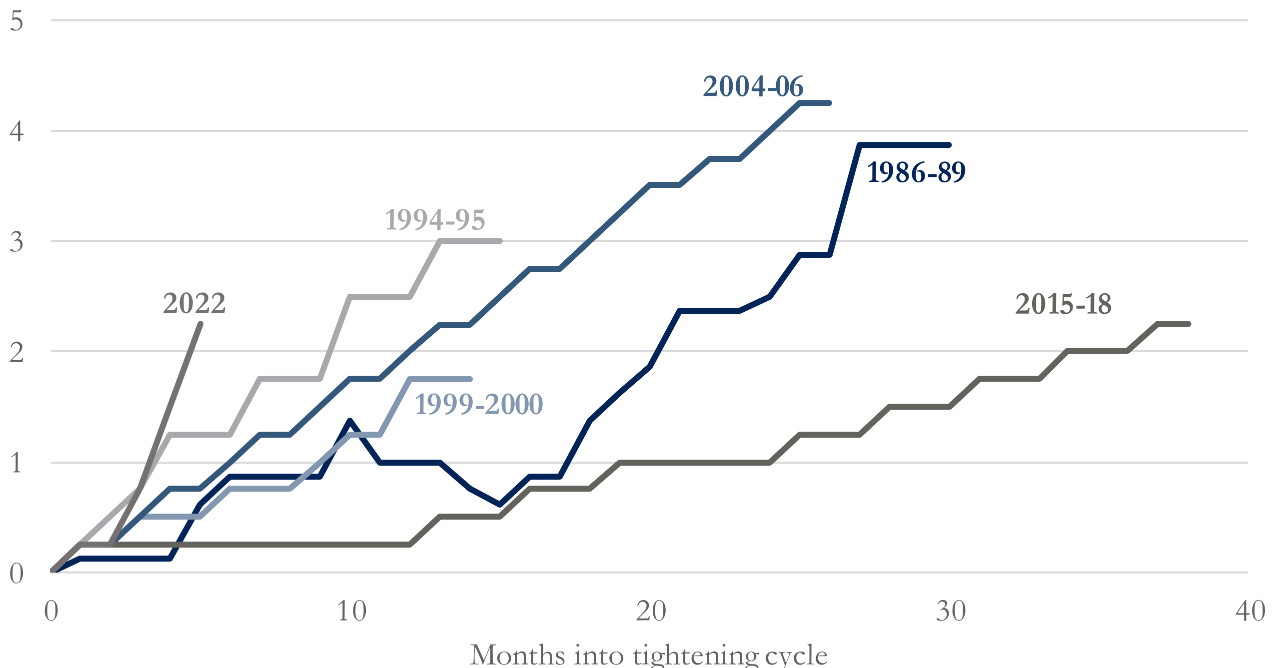
Inflated prices, deflated markets

FY2022 will be remembered as the year that central banks finally took away the proverbial punch bowl. With consumer prices across the rich world rising by more than 9% year-on-year, central banks have begun tightening monetary policy at one of the fastest rates on record. Leading the way has been the US Federal Reserve, which lifted interest rates from 0.25% to 2.5% between just March and July of this year, while guiding the market to expect interest rates to reach 3.5% by December this year, and 4% the year after. Not since before the Global Financial Crisis (GFC) in 2008 have interest rates been that high. Indeed, in 9 out of the last 14 years, short-term US interest rates have effectively been zero, (or said another way, anybody under the age of 35 in the market today has only ever experienced money as essentially being 'free').

Three main factors have led us to where we are. In trying to prevent a complete economic collapse during the Covid-19 pandemic, policy makers erred on the side of too much stimulus, rather than too little. In their defence, worrying about high rates of inflation had become almost an antiquated concern pre-pandemic, while the risk of providing insufficient support during the depths of the crisis seemed catastrophic. Next, the voracious surge in consumer demand that followed this stimulus ran headlong into China's zero-covid policy, which shuttered factories across the country and greatly slowed the Chinese economy - right at a time of peak rich world demand. Finally, Russia's invasion of Ukraine in February compounded already bunged up supply chains and sent food and fuel prices soaring.

The result of these forces has been inflation surging to 40-year highs in many countries. Central banks, which until recently had been behind the curve, (notably the US Fed arguing the problem was 'transitory' throughout much of calendar year 2021), are now duly racing to get out in front of the problem. Cue one of the fastest monetary tightening cycles on record.

Exhibit 1: Cumulative US Federal Reserve increase in target rate % points by cycle[1]



[1] Data sourced from Bloomberg LP, August 2022

For much of recent history, the main driving force in financial markets has been the disappearance of inflation as a real-world concern, and a resulting collapse in interest rates. Investors in shares, bonds and real estate all benefited greatly from the ever-increasing valuations that falling interest rates provided. Even more beneficial perhaps, was the free 'put option' that came with inflation disappearing from central bankers' worry list. Ever since the GFC, whenever the going has got tough, investors have been able to count on policy makers coming to the rescue. The clearest example of this was the price action of higher-risk assets - like shares and low-grade debt - following the avalanche of monetary support that was provided during the Covid-19 pandemic. At a time when economic conditions in the real-world couldn't be worse, investors in higher-risk assets were enjoying incredible investment returns. The market idiom was 'bad news is good news' – what is bad for the economy is good for the investor.

The paradigm of recent years works fine when inflation is low and there seems to be no consequences to cutting interest rates. When inflation is running at 9%, however, and the economy is clearly overheating, it does not. The second half of FY2022 saw a capitulation of the notion that inflationary pressures were transitory, and the start of the sharp tightening in financial conditions discussed above. Unsurprisingly, the highest-risk parts of the investment universe were those that suffered the worst. Over the six-months to June, global share markets fell 20.2%, while high-yield bonds fell 16.7%, both in US$ terms. The pain was worse the further out on the risk curve you were. FAANG[1] stocks, which have been the market darling for some time now, fell 33.4%. Bitcoin fell 60%. Again, both in US$ terms. Moreover, as painful as these losses have been, the resurgence of significant inflationary pressures has removed any near-term prospect of the central bank 'put' that investors have been used to relying on to soften the blow. As we discuss in our Outlook section below, the investing backdrop for the next few years will turn heavily on how quickly inflation is brought back under control, and whether we are ultimately able to return to the unusually low rates of inflation that prevailed between the GFC and the pandemic.

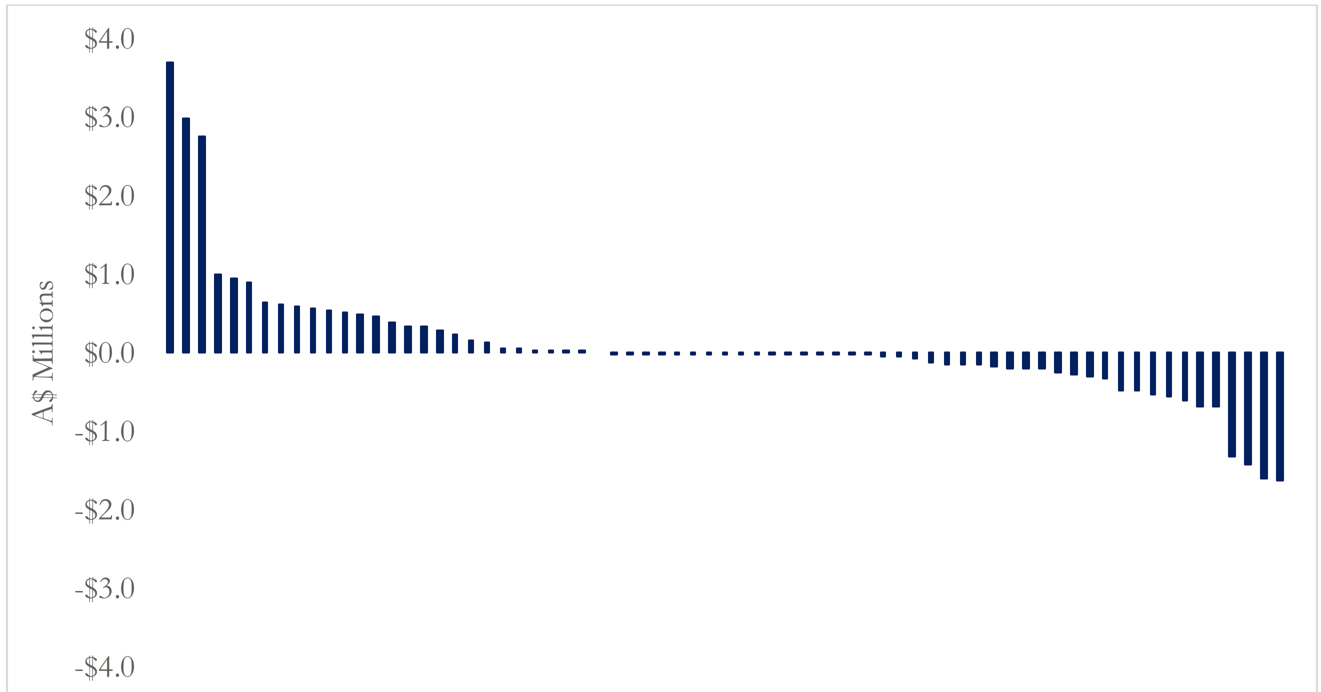
Performance of the investment portfolio in FY2022

FY2022 hopefully represents a good example of the benefit that GVF's unique investment approach can provide to shareholders. In what was a particularly bleak year for most asset classes and investment strategies, the Company generated positive investment returns. Adjusted pre-tax NTA[2] increased by 2.8%, or 3.3% if we include the benefits of franking credits the company received during the year. Once again, the biggest contributor to the Company's returns over the year was our discounted capture strategy, which generated gross returns of 6.1%. The strong performance from our underlying core strategy was thus able to more than offset the losses we incurred from the falls in markets seen over the year.

Over FY2022, GVF ran with an average see-through equity market exposure of 37%, and with an average see-through credit market exposure of 23%. The Company's investment return of 2.8% thus compares very favourably to the returns seen in both global equity and bond markets, which fell 8.5% and 9.5% respectively in Australian dollar terms over the same period.

[1] A well followed share market index of high-growth technology companies
[2] 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

Exhibit 2: Total return[3] of every GVF investment held in FY2022



The above diagram shows the absolute Australian dollar return on every investment GVF held through FY2022. Over the life of the Company, GVF's win versus loss ratio on investments sits at 78% to 22% - a figure the team is quite proud of. In a year like FY2022, where markets fell significantly, it is unsurprising that we fared worse than what we have historically achieved. Indeed, over the year, a simple majority of our holdings recorded some level of loss, with only 39% of the Company's holdings generating a positive return during the period. What that figure does not convey, however, is that our ability to unlock value from our investments can meaningfully offset the impact of falling markets. Said another way, if we are successful in unlocking value, our holdings should fall by less than what the market does. Thus, while more than half of the Company's holdings detracted from performance during FY2022, the relatively mild losses on these positions were more than offset by a smaller number of very successful trades that we held over the year.

Notable holdings in FY2022

It is customary in our annual letter to shareholders to discuss several of the important holdings in the fund during the year. Historically, we have tended to focus on the names that have either made or lost the Company the most money. This year, and going forward, we have decided to amend that focus to concentrate on holdings that we think are the most important for shareholders to be aware of. By and large this should still represent a similar list as before, but it will provide us with more flexibility to focus on the holdings that we think are the most relevant to bring to investors' attention. For example, in a year where markets fell considerably, providing commentary around a position that fell a

[3] Total return by investment shows the gross A$ profit or loss of each investment GVF held during FY2021, including any associated hedging activities related to the particular investment. It also includes the value of franking credits each investment received. These figures exclude the returns from cash balances held in non-Australian currency. Gross returns are before taxes paid, expenses, management fees and dividends paid. Data sourced from Staude Capital as of 30th June 2022.

little less than the market did is, in our view, less helpful than discussing a situation where significant developments may have changed our investment thesis.

In each case, we have aimed to focus on the more recent and forward-looking developments at each investment, especially if we have already covered developments at a holding in our monthly investor reports. For those who are interested, the discussion of notable GVF holdings follows this letter.

Outlook

Inflation will be the key issue that drives asset price returns over the coming few years. Chiefly, whether its rapid reappearance is a short-term phenomenon caused by our response to the pandemic, or whether what we are seeing now represents the start of a new economic backdrop. Rightly or wrongly, investors today are betting on the former. Current market pricing predicts that inflation is about to peak, and that central banks will be able to move back to a more accommodative stance later this year or early next. At the same time, a significant growth slowdown is clearly ahead of us, one that could end in recession. With inflation supposedly peaking and growth slowing, we have seen a reappearance of the 'bad news is good news' thematic. Indeed, one of the key reasons that riskier assets have been rallying from their June lows, is that markets currently expect the US Fed to begin cutting interests rates again in the second half of 2023.

The danger to this consensus view, of course, is that markets have been betting that inflation was about to peak for over a year now, a prediction that has been consistently wrong. There is also a clear divergence between what the market is expecting in terms of future interest rates, and what central bankers themselves expect. Notably, the US Fed's most recent projections forecast short-term interest rates to reach 4% by the end of 2023. In contrast, markets currently forecast that interest rates will end 2023 at 3%. In terms of asset price outcomes, the difference between whether we land at 3% or 4% will be substantial. The market's 3% assumption is based on the view that inflation will peak shortly, and that central banks will therefore be able to cut interest rates next year to soften the blow of slowing growth. The Fed is clearly more circumspect, worrying that inflation will not fall fast enough to allow them to cut rates so quickly. Given the market is pricing in the 3% figure, the burden of proof today lies with seeing inflation begin to fall quite quickly, just to validate current market prices. If it does not, another leg down in riskier asset prices seems inevitable.

As ever, we do not pretend to be able to divine what lies around the corner in terms of market directionality. Our process focuses on investing into a diversified basket of global assets, all purchased at a discount to their intrinsic value, and then seeking to unlock this value for the benefit of all investors. For our particular investment strategy, the silver lining to the recent market correction is that it has thrown up several interesting opportunities for us to invest into at very favourable levels, a development that hopefully sets us up well for the year ahead. Finally, one of the most important guiding principles for the team, is that we remain acutely aware of the fact that the capital we are investing represents other peoples' savings. To the extent we can, our process seeks to mitigate the risk of capital losses through diversification and thoughtful risk management, a discipline we will always adhere to, even if it means foregoing some of the upside during times of very strong markets.

Pleasingly, our process came together as best as we could have hoped during FY2022, with the Company generating positive investment returns despite noticeable falls in most other asset classes. For FY2023, we expect little to change in terms of our approach. We see considerable value embedded within the current GVF portfolio, value we will work to unlock regardless of what markets throw at us during the year ahead.

The team and I would like to thank all our shareholders for their trust and support throughout FY2022, and for the many kind messages that we received from investors during the year.

Notable holdings in FY2022

Amedeo Air Four Plus

Amedeo Air Four Plus (AA4) was the largest positive contributor to performance this financial year as several positive catalysts that we had been anticipating played out. Helpfully, GVF had added to its investment in AA4 at the beginning of the financial year, when it acquired a large block at a substantial discount to the prevailing market price.

At the price at which GVF added to its investment, we felt there was a compelling risk reward: a large cash balance covering almost three-quarters of AA4's share price; the potential to pay a large dividend yield, fully-funded by the company's leases to Emirates, once dividends were reinstated; and the potential for additional upside from the residual value of the aircraft, which we were very conservative in assigning value to – in many cases, predominantly basing this on contractual cash payments that would be made at the end of the leases.

Pleasingly, our expectations were met when in December 2021, after restructuring its leases with Thai (leases which hadn't featured in our return calculations), AA4 announced it would return a significant amount of surplus cash as well as resume the payment of regular quarterly dividends. As a result, GVF realized some of its investment at a large premium to the market price and benefitted from a significant re-rating on the rest of its holding.

Despite this strong performance, the shares today are far from expensive. AA4 pays a 16% fully covered dividend yield, with the potential to grow this. And despite last year's large return of capital, AA4 continues to hold a large cash balance, some of which should be returned to shareholders in due course.

While we have underwritten the investment to what we believe are conservative assumptions, there are scenarios under which actual returns could be considerably higher still. For example, if Emirates extends any of the eight leases, or if a sale of any of the aircraft is completed above our pessimistic assumptions.

On that note, subsequent to year end, there was positive news flow in another UK listed aircraft leasing fund, which could have an important read across to AA4. On 15 July 2022, Doric Nimrod Air One (DNA) announced an agreement to sell its A380 to Emirates (the lessee) at the end of the lease. Net proceeds of this were £25m, which represents a substantial premium to the A380 residual value we are conservatively assuming in AA4. This is despite DNA's aircraft being an older and heavier aircraft than those owned by AA4. News of ongoing delays with Boeing's 777X, and even talk of a possible cancellation (although unlikely) also continue to be positive for AA4, if they increase the likelihood that one or more of AA4's leases will be extended beyond their original 12-year terms.

To be clear, while these offer the potential for additional upside, even if the conservative residual values that we are assuming play out, GVF should still enjoy further returns from here on its investment.

Listed private equity holdings

While overall only a modest detractor from performance, it was a year of two halves for GVF's investments in listed private equity funds Harbourvest Global Private Equity, NB Private Equity Partners, and Pantheon International Participations.

Several times now we have discussed GVF's investment in a basket of listed private equity funds, and our investment thesis which was based on a 'lag effect' for valuations. As a reminder, this was based on both a technical lag – being the delay with which private equity funds report valuations to the listed fund of funds that hold them – and a longer-term lag, with which private equity valuations tend to track public share markets with a delay. As we argued previously, provided the discounts to stated asset backing remained wide, after incredibly strong share market returns like those seen in late-2020 / early-2021, this lag meant you could — in effect — buy today's markets at yesterday's prices.

During calendar 2021, we saw our thesis play out, and for the first half of FY2022 our listed private equity names were amongst the strongest contributors to GVF's investment performance. As our thesis played out, we began selling

down our holdings between November 2021 and January 2022, and across our three key positions we exited roughly a third to a half of each holding during this period at very favourable levels.

With the benefit of hindsight, we should have sold our holdings down more quickly. February marked a significant turning point in markets with the commencement of the war in Ukraine. This came at a time when markets were also grappling with the prospect of rising inflation and interest rate fears.

After underreacting to strong markets in late 2020 and early 2021, and failing to recognize the lag effect, in 2022 we believe the share prices of listed PE funds have overreacted. While some price weakness in these investments is rightly justified – anticipating weaker private equity valuations that will come through in due course – recent discount moves imply private equity write-downs of a magnitude that we view as unrealistically pessimistic. For example, the Q2 2022 marks for the large US-listed private equity managers – useful data points for at least the buyout portion of these funds' portfolios — were, on average, down less than half as much as global share markets.

We have therefore used recent weakness to rebuild our positions in these names at discount levels which we estimate to be close to 40% to net asset backing, using a conservative set of assumptions.

Staude Capital Limited is an appointed representative of Mirabella Advisers LLP, which is authorised and regulated by the Financial Conduct Authority. Mirabella Financial Services LLP is the investment manager of the Global Value Fund and has seconded the investment team at Staude Capital to manage the Global Value Fund.

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