Reaching for normalcy

There seems little to be gained from adding greatly to the reams of copy that have now been written about Covid-19 and its impact on financial markets. In our view, 'unprecedented' is a superlative that gets bandied around too frequently by the financial commentariat. When studying the past 18 months, however, it is really the only word that fits the job. The pandemic, and the ensuing response from policy makers, caused both: the deepest global recession since the Second World War; and then possibly the fastest economic expansion on record.

Central banks responded to the crisis by flooding financial markets with liquidity on a jaw-dropping scale, dwarfing the actions that were taken in the aftermath of the global financial crisis (GFC). At the same time, governments directly stepped into the economy in a way that has never been seen outside of wartime. In total, governments added c.US$20 trillion to their collective debt burdens in 2020 in their efforts to mitigate the impact of the crisis, equivalent to 21% of global GDP.

Looking at the big picture, these policy actions have worked incredibly well. A massive wave of company defaults and job losses has been averted and the global economy has been spared unimaginable damage. Even with all this support, the World Bank estimates that the pandemic has pushed 120 million people into extreme poverty. It beggars belief to think what that figure might have been without the massive interventions that were undertaken.

It is natural to want to dwell on the past 18-months, given how utterly extraordinary this period of history has been. Nonetheless, as investors, our main task is to look forwards not backwards. While they can seem clinical at times, financial markets are forward-looking machines. They generate prices for assets today, based on the best understanding we have of how the future is expected to unfold. The events of the past 18-months have been tragic, but from a market pricing point of view, and absent a vaccine-resistant strain of Covid-19 arriving, the main drivers for security prices today are much more typical market concerns. Indeed, if we were to bottle up the past 18 months and set it to one side, what is interesting is that many of the 'post-Covid' debates that are beginning to appear in the market today, look remarkably like the angsts that troubled both bears and bulls before Covid began. Once again, interest rates seem about as low as they could possibly go. Once again, markets are wringing their hands over how soon they will rise, and by how much. At the time of writing, the two fiercest debates in the market centre around whether we have hit 'peak growth', and whether the current uptick in inflation will prove transitory or longer lasting. In other words, markets are back to pricing the bread-and-butter issues we leave them to contend with day-to-day: economic growth and inflation expectations.

It is important to take stock and note that while markets may have moved on to more anodyne concerns, for most of us, our everyday lives are still dominated by the pandemic and its repercussions. As is often the case with financial markets, this is a development that can seem rather perverse. Yet, to the extent that financial markets are often the best predictor we have about what the future holds, it offers a wonderful hope to all of us - the prospect of normalcy sitting just a little further along the horizon.

Performance of the investment portfolio in FY2021

We finished FY2020 pleased to have avoided a loss in the wake of the Covid market crash, and incredibly excited about our prospects for the year ahead, given the extraordinary amounts of value we were seeing within our portfolio and across our universe. We wrote extensively at that time that our ability to unlock this value should be largely independent of how broader markets were going to unfold. Consequently, it is very pleasing to be able to report a banner year for the Company, both in terms of absolute investment returns, and in the success of our discount capture strategy. For FY2021, GVF's adjusted pre-tax NTA[1] increased by 29.2%, a figure that rises to 30.2% if we include the benefits of franking credits the company received during the year. By far the biggest contributor to these returns was

[1] 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

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the Company's discounted capture strategy, which generated gross returns of 24.9%. To put the result from our discount capture strategy into context, when we launched GVF we set a target of generating 5% per annum of market outperformance from our approach. In today's brutally efficient financial markets, aiming to outperform any market by 5% a year should be an audacious goal. Prior to FY2021, GVF had generated 6.2% per annum of outperformance over the Company's six-year life. While as investment managers we will always want to have delivered more, this was a result we were greatly satisfied by. In contrast, in FY2021 we generated as much market outperformance - measured in discount capture terms - as we achieved in the preceding four years combined.

Several important factors came together during the year to drive this success. The first was our commitment to always staying light on our feet at a portfolio level. When the crisis first struck, the short duration of the portfolio and the embedded catalysts we have for releasing value meant we were very quickly able to begin recycling the portfolio into a new, much more exciting investment universe. Combined with our ability to draw-down on low-cost borrowing lines when we need them, the Company was able to deploy large amounts of capital relatively quickly into deeply dislocated markets. The final leg of the success came from the lessons we had learnt during the GFC. If investing is the art of balancing risk and reward, we saw vanishingly small risks in the prices we were paying for the distressed assets we were buying. Having been through a similar cycle in 2008/9, we were also highly confident in our ability to unlock large amounts of value from these securities, regardless of broader market conditions. Thus, while we were using more leverage than GVF had ever deployed before, the absolute risk in the GVF portfolio was, in our view, as low as it had ever been. At the same time, the return targets we were going after had never been higher. This combination of factors led us to aggressively pursue the opportunity set we saw in front of us, including asking the GVF Board for permission to temporarily increase the limits on leverage the Company has in place[2].

Looking back on FY2021 now, it is easy to conclude that most investment strategies made healthy returns, principally riding the coattails of the enormous levels of government and central bank support. However, this high-level analysis misses an important distinction. It was not until November 2020 that we had confirmation there was a working Covid-19 vaccine, and it was not until after this development that higher-risk assets generated most of the returns they ended up posting for FY2021. In contrast, in discount capture terms, GVF had some of its best ever months before the November turning point in markets. We were able to unlock large amounts of value from our holdings before markets began to run, and then continued to do so after the point when risky assets began to shoot ahead. While this might seem like nuance to highlight, we believe it is an important point to emphasize. We set out that the value we unlock from our discount capture strategy is largely independent of what broader markets do. If the vaccine had taken longer to arrive, or if a stimulus-supporting Democrat party had not won both the White House and the Senate, it is easy to envisage risk assets following a radically different path in the latter parts of FY2021. In contrast, and pleasingly, we consistently unlocked large amounts of value across the entire year, regardless of which way the market wind was blowing at the time.

For FY2021, GVF's adjusted pre-tax NTA increased by 30.2[3]% exceeding global equity market returns[4] (+28.2% in A$ terms), despite the fund running with an average equity market exposure of just 44% throughout the year. They also comfortably exceeded global credit market returns[5] (-3.2% in A$ terms), with the company holding an average credit market exposure of 22% through the period. GVF did not suffer a single down month (in A$ terms global equity

[2] The Company announced in September 2020 that the Board had approved an increase in the maximum level of borrowings that the Company may utilise, from 15% to 20% of net asset value. This increased limit was for one year, after which time the Board shall review its effectiveness and merit and may extend or vary.
[3] Including the value of franking credits received.
[4] As measured by the MSCI All Country World net return index.
[5] As measured by the Bloomberg Barclays Global High Yield Index.

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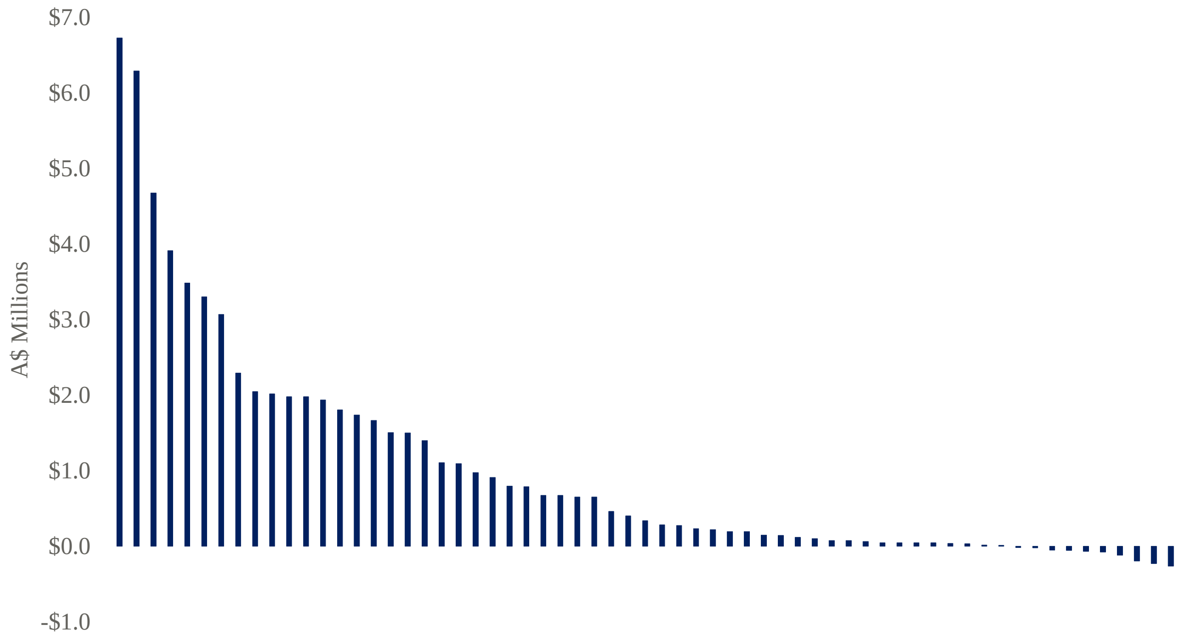
and credit markets had two and seven respectively), while it enjoyed an extraordinary win/loss ratio in terms of its holdings.

The diagram below shows the absolute Australian dollar returns on all investments GVF held through FY2021.

Total return[6] of every GVF investment held in FY2021



The remarkable skew between winners and losers hopefully justifies the considerable 'table pounding' we have inflicted on our shareholders over the past 18-months. While a heavily skewed win/loss ratio has always been a hallmark of our strategy, we doubt we will be able to replicate our FY2021 results again anytime soon.

Notable winners and detractors in FY2021

It is customary in our annual letter to shareholders to discuss the three best investments of the year, and the three worst. Without any hyperbole, this year there seems little to be gained from following this approach this year. Our worst performing trade cost the fund only 0.15% of performance - it is also one of the investments we are most excited about for the year ahead. Knowing that we will not always have this luxury, we have decided instead to selectively discuss two loss making trades, both of which are worthy of a brief analysis for reasons other than their financial impact on the portfolio during the year. Similarly, having discussed successes such as VPC Specialty Lending (VSL) in considerable length in our monthly updates, we will instead selectively discuss three of our best performing investments. In each case, we have aimed to focus on the more recent and forward-looking developments, rather than examining areas we have previously covered. For those who are interested, this discussion of notable GVF holdings throughout the year follows this letter.

[6] 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 31st July 2021.

Outlook

One of the biggest challenges we see for investors today is the lack of real financial pain anybody in the market has felt over the past five years. While the pandemic caused a severe market crash, global equity markets recovered to their all-time high within six-months, a feat that took three years following the GFC, or five years following the 'dot-com' crash.

Over the very long-run global equity markets have delivered total returns of 7.5%[7] p.a. for investors. Looking at the past five years, however, that figure rises to 14.6%. The share market has not been unique in this regard. When viewing recent history, most asset classes have enjoyed a period of spectacular price appreciation – whether it is the Australian property market, or US high-yield bonds. The drumbeat behind these moves has been the relentless fall in interest rates all around the world. It is a truism that as the cost of money falls, the value of assets must rise. What has driven this situation until now has been the near collapse of inflation as a phenomenon in the developed world. Without the need to worry about price pressures like they have in the past, central banks have been free to drop interest rates at the first hint of economic trouble – and then keep them there until some new crisis takes them lower still.

We see two important observations from this recent period of above average market strength. The first is a reminder of the adage "don't fight the Fed". No matter how low you think interest rates have fallen, central banks have shown time and again that they can create new ways to drive them meaningfully lower still. Just because we have vertigo looking at term deposit rates of 0.3% pa, this does not mean interest rates are about to revert to levels we have spent a lifetime accustomed to. It also does not mean they cannot go lower.

Our second observation is guided by a simple question. Is it plausible that higher-risk asset classes, like the share market, can compound at 15% pa into perpetuity? To answer yes to this question would imply a re-writing of our understanding of finance and economics. It would also dismiss the entire body of financial history we have to draw from. The reason long-run returns are substantially lower than those seen recently, is that asset classes move in broad cycles. Periods of below-trend growth typically follow the more exciting times. Over a full investment cycle the two periods average themselves out. There would be very few seasoned asset consultants, or large institutional investors, who would use long-run share market return forecasts of above 8%. Indeed, given the large gains we have witnessed across asset prices recently - and the valuations they now command - many professional forecasters will be assuming low single digit returns for some time to come.

Looking ahead, for financial markets to hold the incredible gains they have enjoyed recently, interest rates need to remain roughly where they are today for years to come. That is an entirely plausible outcome. Yet holding recent gains is different to generating future returns. The latter requires boring fundamentals, such as companies growing earnings, or economies expanding faster than the lofty assumptions already baked into market prices. If interest rates do remain at today's incredibly low levels, and barring some new unforeseen market crisis, expecting single digit returns for most asset classes would seem to be the neutral place to sit.

Against such a backdrop we would expect GVF to perform very well. While the markets we focus on have begun to normalise, the opportunity set for us continues to remain elevated compared to what we typically find. Moreover, even in more 'normal' operating environments, we have been able to demonstrate large amounts of outperformance - over a long period of time now - through a range of different market conditions.

Our more conservative, all-weather portfolio will always struggle to keep pace with periods of very strong share market returns. We console ourselves to this by knowing that a backdrop of ever falling interest rates is not a normal or sustainable state of affairs, and that over the long-run sustained market outperformance of the magnitude we have

[7] As measured by the MSCI All Country World net return index in US$ terms. Returns are from the index's inception on 31 December 1987, through to 30 June 2021. Net returns (excluding withholding taxes) are only available from August 1998, before then gross returns are used.

delivered should compound powerfully for our investors. Finally, and most importantly, we remain deeply respectful of the fact that investors have trusted us with their hard-earned savings. All of which is to say that we will continue to run with our lower-risk portfolio, focusing on unlocking value and generating outperformance, regardless of how the coming year decides to unfold.

The team and I would like to thank all our shareholders for their trust and support throughout FY2021, and for the many kind messages that we received during the year.

Miles Staude
Director and Portfolio Manager
27 August 2021

Appendix - Notable Winners and Losers in FY2021

Amedeo Air Four Plus

Our worst performing investment in FY2021 was our holding in Amedeo Air Four Plus (AA4), a London-listed aircraft leasing fund designed to provide investors with a steady source of long-term income and, eventually, the prospect of capital growth.

With air travel being one of the sectors hardest hit by Covid-19, AA4 was an opportunistic deep value investment that GVF made in May and June 2020 after the shares had fallen by more than 60% in value. At the time of this investment, we were buying shares in the company below its cash backing. The large cash balance the company had was the result of a fortunately timed sale of two aircraft in February 2020. It meant our entry price assigned little to no value to 12 underlying aircraft that AA4 owned, or the long-term leases it had in place for them.

AA4 was one of GVF's most profitable investments in FY2020, as the shares rebounded relatively quickly after our purchases at deeply distressed prices. During FY2021, the vast majority of AA4's large surplus cash balance (£100M) was returned to shareholders, which substantially de-risked our original investment. The company also paid two dividends, funded by the company's lease income from Emirates. Adjusting for those distributions and the large capital return, the company's share price drifted a little lower over the year, and the position detracted 0.15% from total portfolio performance.

Despite the stagnant share price, the outlook in our view has improved fundamentally since last June. We attribute the share price weakness to selling pressure from several of the company's original investors, for which AA4 has become too small, too 'messy', or incompatible with their income mandate since regular dividends have recently been suspended. Besides the obvious positive - that we now have several approved vaccines and visibility on when air travel can return to some semblance of normality - Emirates' cash position has been bolstered by a US$3Bn injection from the Dubai government. Every one of AA4's eight leases to the airline continues to be paid in-full, and in-line with the original terms.

Based purely on the Emirates leases, we estimate that the company has the capacity to pay dividends that would represent a yield of almost 20% on the year-end share price. Moreover, even after the large initial capital return, roughly half of the company's current market capitalization is still covered by its cash balances. As such, we continue to believe AA4 offers a highly compelling and asymmetric risk/reward profile. It is not without significant risk, however. As such, we have sized the position modestly within GVF, and only after underwriting the investment based on very conservative assumptions. At the current share price we believe there is a substantial margin of safety embedded in the investment, while there are plausible future scenarios that could see the company's share price more than double over the coming 12 to 24 months.

Secured Income Fund Plc

The second loss making investment from FY2021 that merits a discussion was our holding in Secured Income Fund Plc (SSIF), a London-listed direct lending closed-end fund that focuses on small and medium-sized enterprise loans. SSIF has an interesting business model of lending directly to SME companies, a sector that has struggled to get capital since the GFC, and hence offers appealing rates of return. Having invested at an attractive discount to asset backing, our thesis for the trade revolved around a restructuring of the company. However, a series of high-profile problems at a much larger sister fund that the manager ran led to a serious de-rating of the manager's brand in the market, effectively ending the restructuring event we had been looking towards. It seemed clear to us at this point that the fund had little future, given its small size and the problems surrounding its sister fund, which was weighing heavily on broader sentiment. We therefore began an active engagement process with both the board and the manager – one that resulted in a new director we nominated joining the board and the company announcing a formal winding down process. SSIF has always enjoyed a much stronger lending model than its problematic sister fund, and up until recently had traversed the crisis with no meaningful impairments, while still distributing the high rate of interest its lending book generated. In the final months of FY2021, however, it announced some modest write-downs relating to loans it had made to the UK film sector. The film industry is being hit particularly hard by the pandemic due to the blanket closure of cinemas. While these write-downs are a little disappointing, the fund had already returned a third of its capital back to shareholders before they occurred, and we expect most of the outstanding capital to be returned over the year ahead.

Our holding in SSIF detracted 0.07% from our portfolio performance in FY2021. While the loss itself was not material to GVF's returns during the year, we believe it is a good illustration of our ability to effect corporate change when it becomes necessary to protect our investors' interests.

Third Point Investors Ltd

Our most successful investment in FY2021 was our holding in Third Point Investors Ltd (TPOU). TPOU is a London-listed feeder fund, which invests all its capital into an US$8Bn dollar master fund run by Third Point, a well-known New York based hedge fund group. TPOU invests across a range of asset classes, but it is better known for employing shareholder activism strategies, notably at high-profile companies such as Nestle and Sony. Despite the manager purporting to be a shareholder advocate - and a specialist in advising companies on how to improve their stock market rating - TPOU has suffered from one of the worst discounts to asset backing the London market has seen over the past decade. The fund began FY2021 trading at a 26% discount to its asset backing and we, along with several other exasperated shareholders, engaged heavily with the board, manager, and fellow shareholders throughout the year. In response, the board announced a fresh strategic review, a development we initially had high hopes for. Concurrent with the board beginning to take the discount problem seriously, the manager - whose investment performance had been lacklustre for some time - also delivered one its best years, with the underlying fund enjoying investment returns of 54.4% for FY2021. Combined with the discount on the fund tightening from 26.1% to 11.5% over the period, GVF enjoyed total local currency returns of 84.9% on its investment. TPOU was one of GVF's largest holdings through FY2021 and as such the position added 3.6% to total portfolio performance.

As an aside, positive returns of this magnitude (+84.9%) illustrate one of the interesting features of our strategy – the powerful compounding effect that occurs when a large contraction in a fund's discount occurs at the same time as a significant move in the fund's underlying NAV. Said another way, we aim to provide our investors with two sources of returns, the returns that come from the underlying assets that we have bought cheaply, and then the second source of return that comes from unlocking value from these holdings. These two sources of return are not additive, but rather compound together. This is how GVF has enjoyed an 84.9% gain from holding a listed fund that generated a 54.4% investment return, while its discount contracted by 14.6%. The returns we have generated on TPOU this financial year are extreme examples of this compounding factor at play. It does, however, demonstrate the significant potential that exists from combining two separate sources of investment return together in the manner that we do.

Returning to TPOU. The fund's discount began to tighten once the (under pressure) board announced it was undertaking a new strategic review. We were initially optimistic that this might result in real changes at the company, however the 'shareholder consultation' process the board undertook turned out to be something of a sham. The board did announce further improvements, notably a new commitment to a 7.5% discount target for the fund, and two large future capital returns if this is not to be achieved. Despite this, these announcements fell far short of what we believe shareholders in the company wanted. It is also an outcome we view as unacceptable. In July of 2021, GVF - along with other shareholders holding in total 17% of TPOU's outstanding ordinary shares – requisitioned an extraordinary general meeting of the company. This meeting was called to allow shareholders an opportunity to vote on measures that, in our view, will unlock significant further value in the company, and which we believe should have wide-ranging support. Rather pitifully, the board of TPOU has recently rejected the calling of this meeting on obscure legal grounds. Without publicly disclosing what our next steps in this campaign will be, it would be reasonable to assume that we are not about to give up the fight here. TPOU remains one of GVF's largest holdings today and we will be sure to update our shareholders throughout the coming year as the story continues to evolve.

Ellerston Global Investments Ltd

Ellerston Global Investments Ltd (EGI) was an Australian listed investment company (LIC) that held a portfolio of global equities managed by Ellerston Capital. Despite the manager having a good long-term track record, and the fund performing respectably over its six-year life, the LIC itself struggled with a poor market rating. GVF accumulated a very large position in the fund, becoming the largest shareholder on the company's register. We engaged with the board in a constructive manner and were impressed with the directors' commitment to finding an appropriate solution. Ultimately a restructuring was announced which saw the LIC converted into an open-ended trust, a perfectly viable format for this type of fund. Upon the conversion, GVF realised a substantial uplift on its investment with the removal of the large discount to asset backing that shareholders had suffered from.

In our time running GVF, we have been instrumental in a range of similar restructuring events of Australian LICs. While each situation has been unique, most of them have had two important components. A restructuring or liquidation that allows shareholders the ability to access the underlying value of their investment, and a tax crystallization event. The latter is a function of the fact that when a company structure is retired in Australia, the entity in question must realise its entire portfolio for tax purposes. When the pre-tax NTA of such a LIC is greater than the post-tax NTA, this results in a final tax payment to the ATO and the creation of franking credits in the process. In the case of EGI, the strong investment performance from the manager meant there was a large tax payment necessary as part of the fund's restructuring. This, in turn, created a sizeable franking account balance for the benefit of shareholders.

Slightly unusually in the case of the EGI reorganisation, these franking credits were transferred to the open-ended fund, rather than being immediately paid out. They then had to be paid out as two special dividends to unit holders as part of the distributions that would be made for financial year 2021. We expect the total value of these franking credits to GVF shareholders to be c.A$1M, half of which were recognised in FY2021 with the balance being received in FY2022.

In terms of the typical performance numbers we report to investors, our investment in EGI added 3.6% to our total portfolio performance. However, if we were to include the value of these franking credits that figure rises to 3.9%.

During FY2021 we were instrumental in several large restructuring events of Australian LIC's, of which EGI was just one. In total, these accrued A$1.5M in franking credits for the benefit of GVF, equivalent to an additional 1% of investment returns for our shareholders. Our primary objective in these situations is always to generate investment returns by unlocking value for the benefit of all shareholders, while the collection of franking credits provides an additional secondary benefit for the Company.

Empiric Student Property

One final notable contributor to GVF's performance in FY2021 was our holding in Empiric Student Property (ESP), a London-listed student accommodation real estate investment trust. We discussed ESP in some detail in our commentary during FY2020. At that time, ESP had been one of our worst performing investments for FY2020, despite being a relatively small position for us.

As we discussed last year, we undertook a forensic analysis of ESP during the depths of the Covid crisis. The UK purpose-built student accommodation (PBSA) sector has several very attractive supply/demand dynamics, including: a structural undersupply of student accommodation beds (one purpose-built accommodation bed for every three students); a desirable destination for the large, and growing international student market; and, currently, a domestic demographic 'bulge' of UK 18-year-olds that will last until 2026.

Despite this, ESP was hit particularly hard during Covid, owing to the way the PBSA business model works. Each academic year the rent roll effectively resets to zero as students only rent their premises for one academic year at a time. In times of strong consistent rental growth this is a positive attribute, as each year the property owner captures all this rental growth. In the event of the global pandemic, however, the business model was particularly hard hit, as property owners potentially faced incredibly low occupancy rates.

As we argued last year, while the pandemic had caused severe short-term disruption to its business, we felt ESP had significant upside potential that could be captured either through a turnaround in operating performance or, alternatively, through the attractiveness of the company's assets to a trade buyer. We spent considerable time 'stress testing' ESP's financials to satisfy ourselves that it could ride out the pandemic. Confident that it was well-placed to do so, we added considerably to our investment during the depths of the pandemic sell-off.

Pleasingly, ESP's share price was up almost 50% over the 2021 financial year, spiking on the news of a vaccine and then continuing to rise on the back of a successful rollout of the vaccine program in the UK. In addition, there were extremely strong university application numbers, with growth of 11% in domestic students and 17% in international students.

While the discount to asset backing has narrowed from more than 40% to just under 20%, we continue to see further upside in the share price. We expect to capture this value once occupancy rates return to pre-pandemic levels – something ESP management is cautiously optimistic about for the 21/22 academic year – and dividends than being reinstated.

The long-term attractiveness of the UK PBSA sector has been highlighted recently through the considerable merger and acquisition activity that has been taking place, with multiple asset purchases being undertaken by large private equity funds. Most relevantly, in July 2021 a London-listed peer of ESP's, GCP Student Living, announced it had received an approach from a consortium advised by US private equity giant Blackstone. This bid came at a 9% premium to the company's asset backing, and a 30% premium to the pre-announcement share price. By comparison, ESP finished FY2021 trading at a 20% discount to its asset backing.

Our investment in ESP added 1.3% to total portfolio performance in FY2021, more than offsetting the 0.7% it detracted in FY2020. We continue to see substantial remaining upside from here.