# Guardian Fund

## 2021 H1 Investor Letter

Concertgebouwplein 21, Amsterdam
guardianfund.nl

**Alphabet**
Information intelligence and leader in machine learning

**Cloudflare**
Cloud computing network that enhances security and performance

**Crowdstrike**
Cloud-native cybersecurity software

**Elastic**
Enables people to explore, monitor, and analyze data

**Snowflake**
A leader in cloud services

**Palantir**
Software that enables clients to lever their data

**Roblox**
Building the metaverse

**Roku**
Operating platform for streaming to the TV

**Sea**
Gaming, commerce, and digital payments platform

**Shopify**
The leading centralized retail operating platform

**Spotify**
Exploding the audio market

**Square**
Digital financial services

**Stone**
Enabling Brazilian merchants

**Teladoc Health**
Digital healthcare

July 9, 2021

Dear Partner,

Over the first six months of 2021, the return of the Guardian Fund was +16.85%, measured in euros and net of fees and expenses. This compares to +15.25% for the S&P 500 Index, measured in U.S. dollars, and including dividends.

The return of the Knight Tech Fund - our satellite fund founded in 2018 for investors who like to have a highly concentrated investment in a handful of thriving software businesses that are part of the flagship Guardian Fund's portfolio - was +9.76%, net of fees and expenses.

The portfolio of the Knight Tech Fund outperformed that of the Guardian Fund in 2019 and 2020 (net returns of +67.5% and +127.8%) and underperformed in 2021H1. One reason is the higher weighting of Palantir, which we own since before the IPO. Its market value increased significantly in 2020 and lagged in 2021 while operational performance continues to be solid.

## Culture

The past 18 months offered plenty of insights in how ordinary people respond to the arrival of the extraordinary in their lives. Above all, it showed again how important it is to invest only in extraordinary people. The reason those companies are steadily becoming more relevant in a rapidly changing world is because they are driven by the warrior-CEOs who are leading those teams and who seem to be able to innovate faster than competition. They are committed to a long-term mission to show everyone how great their creation is. Those businesses have a soul and therefore quality.

Technology is a constant process of learning and while the world will be using different techniques in the future, the data-driven mindset of the founders is a constant factor and therefore the most important quality. If competition tries to compete with these businesses then the main issue they will have to overcome is not a technology challenge; they have to compete with the talent pool and entrepreneurial culture of ownership that will motivate those people to build extraordinary things. Often these winning teams compete against 'bad' competition, meaning an establishment that cannot possibly compete with the culture, (e.g. Stone in Brazil against the big banks) and this creates the opportunity.

It is clear to us that the culture inspired by Tobi Lütke, Daniel Ek, Forrest Li, Matthew Price, Anthony Wood, Alex Karp, and Jeff Bezos, is the prime driver of investment success in a world that seems to change faster. There is no lack of ambition and this is attracting more talent because these kinds of people enjoy solving hard problems; e.g. Daniel Ek plans to explode the addressable market for audio and Matthew Price, founder of Cloudflare, aims to be the most powerful edge computing network in the world. If they succeed, those businesses are worth multiples.

## Thrivers

The operational performance of the portfolio companies is strong and in several cases surprised us in 2021 H1. For instance, the acceleration of revenue growth at Roku shows how it is becoming the dominant platform in streaming to the TV, thereby connecting users to the content they like and providing advertisers with effective tools to reach people. The greater than 100% revenue growth at Shopify and Sea continues to be impressive. The growth rate will come down yet is likely to stay high for a long time to come.

| revenue growth | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 Q1 |
|---|---|---|---|---|---|---|
| Shopify | 90% | 73% | 59% | 47% | 86% | 110% |
| Roku | 25% | 29% | 45% | 52% | 58% | 79% |
| Sea | 18% | 20% | 100% | 163% | 101% | 147% |

Source: Companies

The high revenue growth and margins indicate the scalability of the cloud-native architecture. Some companies are even growing while producing free cash flows. As owners, we would be happy to delay any free cash flows as retained earnings are reinvested into the business at high expected returns on invested capital while growing the moat. The high net retention rates indicate that the businesses are growing without having to add new clients.

| % | revenue growth | gross margin | net retention rate | FCF margin |
|---|---|---|---|---|
| Snowflake | 110 | 68 | 168 | 5 |
| Cloudflare | 51 | 76 | 123 | -2 |
| CrowdStrike | 77 | 74 | 120 | 39 |
| Shopify | 100 | 53 | NA | 13 |
| Roku | 79 | 57 | 32* | 19 |
| Elastic | 44 | 74 | 129 | -2 |
| Palantir | 49 | 76 | NA | 42 |

Source: Companies

* ARPU: average revenue per user

Marc Andreessen said 'software is a lever on the real world. Software is alchemy that turns bytes into action by and on atoms. It's the closest thing we have to magic.' The dematerialization of physical things across industries is clear and we are seeing some of this magic translated into the earnings of these businesses.

## Roblox

The wonder-tale stories of children's books show us that there are infinite possibilities of stories and worlds. The metaverse, the idea that describes the shared 3D spaces in a virtual universe, is enabling people to create fiction. Over the past six months, we initiated a new investment in Roblox. The firm was founded in 1989 by David Baszucki and Erik Kassel when they programmed a physics lab where students could study how cars would crash.

Today, Roblox has become a leading platform with a mission to build a human co-experience that enables billions of users to play, learn, and build friendships in the metaverse. Recent advances in cloud computing, computing devices, and machine learning, enable the materialization of the metaverse. Take what we have in virtual reality today and fast-forward a few decades. Humans will be able to experience unimaginable things and in a couple of millennia virtual economies are likely to become bigger than the physical trade on planet Earth.

Over the first quarter of 2021, Roblox reported 140% revenue growth, 42.1 million daily active users, and 9.7 billion engaged hours. The opportunity for this platform is massive.

## Palantir

The success of the private sector to innovate in order to help people through the lockdowns and to produce vaccines at record speed at scale has been impressive. The fact that almost every public institution was struggling to be effective no matter how hard some of the people worked, shows the fundamental need of the public sector to become data-driven and invest in data infrastructure.

Government institutions have to partner with enterprises such as Palantir to become digital-native. The public sector will always struggle to attract the most talented engineers as compensations cannot be justified with tax money and therefore this must be a partnership with specialized private enterprises. This is a great opportunity for Palantir especially as it has already shown to be capable of working with demanding and complex public institutions entrusting it to work on the most critical and sensitive matters.

The news section of Palantir's website gives insight in where new business is coming from. The main opportunity is in enterprise software and the faster onboarding time and increased self-service of clients is a positive sign. We believe Palantir is becoming one of the more important global software companies.

In addition, Palantir has quietly become a significant investor, investing well over USD 200 million in eight companies. Thereby, it is following the lead of companies like Tencent, Alphabet, and Shopify of establishing valuable investment portfolios.

## Shopify

It is impressive how fast Shopify is growing its relevance and moat. The decoupling of jobs from location and democratization of participation in the internet-enabled economy is changing lives and business architectures. The modern enterprise is a core with a big partner network of applications around it. Today, any person can lever this network to run a commerce strategy. In his excellent message to Shopify employees, Tobi Lütke, wrote that Shopify is not a family but a team of which the members must perform and will be judged on performance. Now this team can hire any skilled person with internet access regardless of location.

In the payments business (Merchant Solutions) Shopify takes a margin on Gross Merchandise Value (GMV) transacted via the platform. As GMV is growing faster than Subscription Solutions (pricing plans for merchants to access the commerce tools), merchant tools are increasingly becoming a way to grow GMV and therefore the payments business.

On June 15, Shopify announced the strategic move to open up Shop Pay, the excellent checkout system, to all retailers selling through Google and Facebook. As a result, stores that exclusively exist on Instagram (not Shopify) can use Shop Pay for payment processing. The reason for Google and Facebook to agree to this integration is that it drives better conversion of their stores (Shopify claims that checkout on Shop Pay is 70% faster than a typical checkout resulting in 1.72x higher conversion rate) and therefore it enhances Google's and Facebook's core business which is advertising.

Shopify is enabling Google and Facebook to better compete with Amazon. The multi-channel future of commerce is now going to make Shopify's merchant tools even more important; Shopify president Harley Finkelstein said: "You now need to reconcile inventory across eight or nine channels. You now have to handle shipping and fulfillment across eight or nine channels. And so as the complexity increases, the value of using Shopify as the central retail operating system also increases."

About 10% of all e-commerce in the U.S. is going through Shopify (versus 39% through Amazon). On June 29, Shopify announced that they are removing all revenue share on developer's (together earning USD 233 million in 2020) first annual USD 1 million as well as cutting the commission rates from 20% to 15%, which is about half of what other app stores charge. It has become a no-brainer for software developers to create products for the Shopify App Store. This will further grow the quality of the ecosystem.

Environmental issues are on our mind when we do the investment analysis. The space in which we are investing is a net positive force in enabling our species to tackle problems such as emissions. It's worth noting here that Shop Pay is one of the first carbon-neutral ways to pay as Shop Pay offsets 100% of the delivery emissions for every order.

On July 7, Harley Finkelstein said: "The future of commerce is still in front of us. Here's what I mean: if the world of ecommerce was a baseball game – we are still at the hotel. We haven't even left to go to the stadium yet. That's how early we are in the story of ecommerce."

We believe that the valuation of Shopify is fair because it is not just a software-as-a-service business; the platform is becoming a payment business that takes a royalty on global internet-enabled commerce. And as the leading central retail operating software platform the runway of non-linear growth is enormous. We have invested a significant percentage of the portfolios in Shopify because our vision is that this is becoming a USD 1 trillion market value before 2030.

## Spotify

What does the future of audio look like?

To us it seems strange that today the market of music, one of the most universally loved things, is as small as the global market for bananas.

Spotify, with 356 million monthly listeners, is on a mission to provide more monetization options for creators. This is gradually going to increase the size of the market. For example, podcasters now have easy tools to build their business.

One option for podcasters is to use Anchor (accounting for 80% of new shows on Spotify) and determine what is subscriber-only content. For the next two years this service will be free to the creator and from 2023 onwards Spotify will charge a fee of 5% of revenues. This is low and comparable to the 5% Epic Games charges for the Unreal Engine. People are free to use Anchor and it offers tools for example to add video to the podcasts.

Through the Spotify Open Access Platform creators that have subscribers elsewhere will be able to let listeners hear the content on Spotify using the existing login system. It enables the hosts with a subscriber base to distribute using Spotify yet retaining the client relationship.

It has become a no-brainer for creators to use Spotify. Moreover, by becoming an open platform Spotify is moving away from the walled garden strategy that Facebook and Apple pursue. In fact, Spotify is doing things that are hard for Apple to copy as its business model is invested in controlling the garden. The opportunity for Spotify is to find services to provide around its platform just like Elastic does around the open source Elasticsearch or Google around search.

Better software will help the audio market to become bigger. The market for podcasts is much bigger than radio as it will be data-driven and more engaging. Another way to increase the market is to find better pricing tiers. Today, streaming music is one of the cheapest forms of entertainment of all at about 10 cents per hour. Daniel Ek said: "I believe an increase in value per hour is the most reliable signal we have in determining when we're able to use price as a lever to grow our business."

Besides experimenting with pricing tiers, the quality and effectiveness of targeted advertising is getting better and new technology will enable the long tail of advertisers. Then there are other lollapalooza effects coming from for example digital stable currencies enabling many people without access to mobile money, bank accounts, or credit cards, to pay for a Spotify subscription. This will drive conversion from freemium users to premium subscribers.

Better tools to monetize audio may bring back the importance of the entrepreneurial spirit to the music industry. This means making decisions where to optimally spend advertising budgets to be discovered and to measure the returns on ad spend as well as to optimize strategy based on data generated by direct client relationships.

Today, most musicians neither have access to the relevant data nor entrepreneurial incentives to come into action to monetize their creation. I think it will change when creators do not need gatekeepers anymore because they have the tools to be in charge of their brand. We are going to see new strategies to monetize the super fans. For instance, a musician can partner with a TikTok star to use the music with a video, pay Spotify to be included in a playlist, use analytics to plan concerts, sell tickets, share content, merchandise, do podcasts, Clubhouse, YouTube, and all the things we cannot even imagine today yet will be normal in 2030; this month, Sony Music announced a strategic partnership with Roblox to bring Sony Music recording artists into the Roblox metaverse. Over 36 million people watched Lil Nas X performed the first-ever live virtual concert on Roblox including the debut of the hit song Holiday.

Spotify has 158 million paying users which is more than twice as much as the second player Apple with 72 million. Spotify can amortize content creation and acquisition among the large user base and recent moves show that it understands scale advantages and network effects (the former Netflix CFO Barry McCarthy and current co-CEO Ted Sarandos sit on the Spotify board). Recent investments in Locker Room and Green Room mark the start of live audio and social engagement. All of this is creating exclusive and differentiated content that will increase engagement. Already Spotify has relationships with Joe Rogan, the Obamas, the Kardashians, Ranveer Allahbadia, Prince Harry & Megan, many other podcasters and musicians. In a way, the music streaming service has become a client acquisition tool for Spotify's other audio features.

The entire audio ecosystem, including labels like Universal, is going to benefit from a growing pie. Bill Ackman's presentation on his investment in Universal Music Group gives some interesting insights into the music industry. It shows that the number of music streaming subscribers is likely to grow from about 400 million to over 1.5 billion in 2030. The revenue share of streaming as a percentage of the music industry (also digital and physical) will grow from 66% to over 90% by

2030. The share of profit will grow faster as margins are higher. Our expectation is that Spotify is likely to gain a larger share of the growing market.

Spotify is one of the more underrated companies we know. We are either wrong and then the downside is limited or we are going to make a home run owning it. The current valuation reflects that of a commoditized music streaming service which Spotify no longer is. The question is how much and when the value that it is building is going to translate into faster revenue growth. If earnings would positively surprise then the market value will soon be significantly higher.

## The intelligent road ahead

We are living in the historically interesting era in which intelligence is becoming external to the human brain. It is clear that the success of businesses is increasingly determined by their ability to learn and innovate based on its data. Over the past few years, we realized that the most attractive hunting grounds for investments are those where companies can be found that are on the road towards the stage where all advances in technology, particularly machine learning, will lead to hyperintelligent unsupervised learning by software and therefore machines.

Just days ago, Richard Branson announced that he plans to launch to space on July 11, beating Jeff Bezos by days. Early July, China said it aims to send its first crewed mission to Mars in 2033, part of a long-term plan to build a permanent base on the Red Planet and mine resources. The space ambitions of billionaires and nations is here to stay and together with the arm's race in machine learning it is essential in order to dominate our planet system. As the United States is no longer alone in its power to dominate the atmosphere, 'trade wars' between nations are going to be a constant part of our lives. And much will be determined by who can attract the most talented software engineers that develop machine learning.

The most valuable enterprises of the 2030s, 2040s, and beyond, are likely to be driven by self-reinforced learning. This reinforced learning will have to be ultimately governed by humans and how to do this is a current topic. With this endpoint in mind, we can already identify firms that gravitate towards that stage where a network of algorithms is at the core of operations and are optimizing decisions millions of times per day.

The world in which software is writing software and monitoring software has begun. It is already visible in how some players seem to defy traditional gravity that causes growth of more mundane firms to reverse to the mean with increasing size. It took Microsoft 44 years to reach a market value of USD 1 trillion. Then it took 2 years to reach 2 trillion (the GDP of Italy is USD 2 trillion and Brazil USD 1.8 trillion). A person looking at the market value rather than at the underlying business will be forgiven for thinking this must be a bubble. Just a few years ago, the public was impressed by the idea that one of the internet-enabled powerhouses might be able to reach a USD 1 trillion market cap; just like in the early 1900s when it was hard to phantom for the crowd that John D. Rockefellers' Standard Oil would have a market value north of USD 1 billion.

Today, five businesses have a market value between USD 1.0 and USD 2.1 trillion. Having lived through the lockdowns helps most people to grasp the paradigm shift our society is going through. Yet the scale is beyond numbers that most brains can understand. These trillion dollar+ businesses are growing faster than many small companies. Moreover, they are gushing free cash flows and their valuations are attractive; a business like Amazon, producing a USD 35 billion free cash flow in 2020, and growing at a double digit rate, even looks quite cheap.

A portfolio of the USD 1 trillion+ club has a fair probability to 2x in five years because the tailwinds are so strong; the migration of workloads to the modern cloud-native infrastructure is enabling better data governance, monitoring and observability, collaboration, analytics, and adoption of machine learning.

The U.S. and European anti-trust discussions seem to be priced into shares and therefore the downside is limited. A double in five years is basically my personal opportunity cost of capital. Therefore, these powerhouses are the real competition of the active investor. The only reason of existence for any active investor is to outperform the through-the-cycle net return of the S&P 500 or Nasdaq-100 which is being pulled upwards by the thriving internet-enabled leaders.

The common excuse of many advisors for producing mediocre net returns (less than those indices over time) is that they do so with less 'risk' by which they point at less volatility. It is a dishonest message that is taking advantage of the financial ignorance of most people; passively owning the S&P 500 index over time has *zero* risk of a permanent loss of capital and the most likely outcome of a fine long-term return. Therefore, any top down 'risk-on, risk off' strategy or committee discussing asset class allocations, timing and hedging, is *adding* risk. That's the risk to not even get average returns.

Then how do we plan to achieve above average returns over the next decade?

First, our main focus is on thriving digital-native businesses with mid-cap market capitalizations between USD 10 and 150 billion that are building products not 20% better than others but 10x or 100x better. If we invest in the right businesses this focus can help us to outperform the giants. Yet, this is in no way to say that the investor cannot achieve stellar results by owning one of the big tech companies. Note that the top-50 of the S&P 500 index mostly consists of thriving businesses and this is strong competition. Remember that we made a more than 10x return on our investment in Microsoft between 2012 and 2021.

Second, our conviction is that founders make better decisions than managers who have no skin in the game. This drives a better culture, more speed and innovation, experimentation, long-term thinking, and therefore returns. It is possible that the entrepreneurial spirit may dilute somewhat at the huge tech businesses compared to younger companies. Many successful businesses are founded by engineers that previously worked at Amazon, Google, and Microsoft. In case politicians would be successful in breaking up some bigger company (which is likely to be a positive for its investors as for example AWS would have an enormous standalone value), then this would incentivize more talented people to start their own ventures, thus filling the pipeline of future winners and investment opportunities.

Third, approaching investing from the mindset of an entrepreneurial owner is the great hack to achieve attractive returns over time. The worst game to be in is to run a fund that resets every year; because the manager has to constantly find new ideas when some mediocre business reaches full valuation and is unlikely to contribute much to performance from there. In contrast, our portfolio's performance is likely to be inversely correlated with transaction activity. The greatest investment portfolios should drive themselves especially through the most stressful times. A human brain is still much better than a machine in selecting great teams yet is prone to mistakes in trading around the best ideas.

I am convinced that we will grow our wealth significantly over the next five years because the businesses thrive. For those fast-growing companies, possible multiple contraction coming from higher long-term interest rates is far less important than the operational developments. Several of the companies we co-own have the runway to 5x before 2030. Yet be aware that we will have to hold through 50%+ stock declines, short-seller reports, macro-economic pessimism, bubble-talk, six sigma events, specific fiascos produced from within the companies, amongst others. Holding the winners is seldom easy and only seems so with hindsight. I have enormous respect for the investors who owned Amazon since before 2010 and never sold. That is what investing is about. The rest is just trading and therefore likely to be a zero-sum game in the end.

Warren Buffett once told Bill Gates that a ham sandwich could run Coca-Cola. We are looking for the opposite; the founding team and culture is essential because we like to invest in businesses that drive innovation. This focus has an effect on our investment research because the bulk of it has to be qualitative rather than quantitative; the culture, moat, potential earnings power is far more important than anything the observer would be able to conclude based on past numbers. In fact, approaching business with an accounting mindset will put one at a huge disadvantage.

The best way to follow and learn what the teams are doing is to follow them on Twitter and listen to their earnings calls and podcasts. This is where they share what they are building. We like to learn directly from people who work at the companies. Our sources range from conversations with employees to expert networks such as Tegus, which offer a treasure of insights into the culture. This helps us to imagine how society will change over the next ten years.

The investors we respect most are those that, like Bessemer Venture Partners, Sequoia, Tiger Global, Berkshire Hathaway, and Altimeter Capital, have an entrepreneurial 'venture' mindset both on private and public companies. Their returns are driven by owning stellar businesses and not selling them. The businesses that Berkshire Hathaway owns have found a permanent home. It is hard to overestimate the power of this ownership mindset and it's one of the strongest edges one can have.

While some parts of the U.S. economy may seem broken (e.g. education and healthcare), it is hard to not be incredibly bullish on the U.S. venture capital ecosystem. It is a driver of human progress and per capita income because it puts capital in the hands of entrepreneurs with a plan to address some problem and enable them to take a shot. Over the past twelve months great businesses such as Roblox, Snowflake, and Coinbase have become publicly traded. The pipeline of companies coming to the market over the next few years is impressive.

## Miscellaneous

Like always, many of our investors are going to have their temperament tested as owning great businesses seldom is smooth sailing. As we will grow assets under management, we will always continue to focus on working with high quality investors who understand that shares are pieces of ownership in businesses.

Just like over the past decade, the regrets we will have in 2031 are unlikely to be about what we did yet about what we omitted. It's partly hindsight bias yet also the realization of past ignorance. The fact is that today we are missing something big and it is giving us this constant urge to go back on the lookout and read as much as possible, resulting in a classic the-more-you-know, the-more-you-realize-how-little-you-know.

Thank you for your referrals; we are happy to welcome your children and friends as partners. If you are not a member yet, you are welcome to subscribe to the *Sharing Thoughts*, where we share insights that are relevant to our investments.

Hereby, I would like to thank Jacques Kemp, Dirk Lindenbergh, and Peter Jan Rubingh, for their support as members of the advisory committee. Given the new fund structure since 2020, we decided to end the current formation.

In closing this letter, I wish you a nice summer.

Sincere regards, also on behalf of Felicia and Martin,

Georg

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