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Letter to investors, Q4 2021

Performance

The Master Account, in which I am personally invested alongside SMA clients, returned 3.9% net in Q4 2021, as reported by our fund administrator. As of December 31, 2021, the top ten positions comprised approximately 69% of the portfolio, and the portfolio held under 3% in cash. Following three years of running ACML, we are now almost fully invested. Approximately 12% of the portfolio is invested in what I consider smaller/more speculative names, with the vast majority in what I believe are robust, profitable businesses with long runways to compound in value. I expect to have approximately 5% of the portfolio in cash once I redeem some SPAC investments. Once that is deployed, I would have to sell existing positions to finance any new investments and be convinced these new ideas present more compelling opportunities for our capital.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020	4.6%	18.4%
2021	13.9%	28.7%

ACML performance is net of fees and standard costs.

The constant barrage of financial and other news reminds me of Billy Joel's song "We didn't start the fire." He rapidly mentions 118 significant political, scientific, and cultural events spanning the first 40 years of his life. (Apologies if you are not familiar, see link here: https://www.youtube.com/watch?v=eFTLKWw542g). The song refers to Chinese politics, Edsels (a failed futuristic car brand), civil liberties, foreign debt, the Suez Canal, Sputnik, polio vaccines, and Afghanistan. Likewise, in three short years, we have been inundated with news of China/US relations, highly valued Electric Vehicle companies, civil rights, Quantitative Easing/rates, supply chains and the Panama Canal, the billionaire space race, Covid vaccines, and Afghanistan.

The markets have flip-flopped between fear and optimism several times in reaction to news of shutdowns, reopening, new Covid waves, potential inflation, stimulus checks, and "growth vs value rotations." For example, just one quarter ago, fast-growing and mostly unprofitable software companies commanded some of the highest valuations in history until talk of interest rate hikes quickly knocked their legs from under them, with many of these companies drawn down 50-80% from their highs.

The S&P500 has continued to track higher, driven by the FAANMG companies, which now make up 21% of the index (and Tesla). Since 2013, the FAANMGs have appreciated 4.5 times the rest of the S&P500, masking a wide dispersion of results amongst individual companies.[1] While the index ended the year within 1% of its all-time high, one fifth of its companies ended over 20% down from their individual highs.

Of course, none of this is new; markets (over)react to news as fear and greed dominate sentiment. As Mr. Joel said, "We didn't start the fire, but when we are gone, it will still burn on, and on, and on ... ." I have always believed that a long-term approach grounded in some basic principles allows one to profit from any temporary dislocations, making it easier to tolerate market gyrations. I, therefore, spend my time trying to understand high-quality companies run by capable operators who are focused on creating value for shareholders.

[1] https://www.yardeni.com/pub/faangms.pdf

I recently enjoyed reading “The mission the men and me” by Pete Blaber, about lessons he learned as a former commander of the elite Delta Force. I wasn’t sure what to expect and was curious about the decision-making process of someone faced with, in a very literal sense, hostile life and death situations. I was please to find a sensible and thoughtful approach that is broadly applicable to everyday life and business.

A key point of the book is “when in doubt, develop the situation” by which he means take the time to build context. Mr. Blaber advocates taking time to recognize life’s patterns, saturating one’s mind with facts about the real-world situation, then allowing time for ideas to incubate before executing decisions with creativity and courage. “Instead of indecision, going off half-cocked, or doing nothing, we understand that time is an ally that allows us to actively build context and uncover the options hidden from those who create ‘traditional plans’ based on limited information that’s frozen in the past – before most options and opportunities have availed themselves.” This resonates with the idea of investors taking time to investigate a business to develop a more detailed understanding of its operations. We can then make better decisions, especially during times of stress or volatility, where we neither ignore nor overreact to news but assess our options with an open mind. Moreover, owning companies for extended periods allows us to develop a more nuanced understanding of their operations through different market conditions.

The book vividly illustrates the need to build tacit knowledge from “the guy on the ground” - people interacting with the environment. It makes the point that generals sitting in air-conditioned control rooms thousands of miles away from battle do not always have the tacit knowledge or rich context to make decisions. Similarly, as public investors, we are removed several steps from the day-to-day operations of the companies in which we invest. When debriefing a captured enemy combatant to gain rich contextualized context on Al Qaida, Blaber writes “the main thing I focus on when assessing someone’s credibility is his or her motivation. Family, patriotism, revenge, and self-preservation are the motivations that are most often correlated with credibility.” A key element of our investing style is to “ride along” with aligned operators and outstanding capital allocators. We try and assess the motivations and level of alignment of company executives and infer their incentives through, for example, their record of actions and compensation. As Charlie Munger says, “show me the incentive, and I’ll show you the outcome.”

Using a painful example of a battle gone wrong which cost lives in the mountaintops of Afghanistan, the book rails against defaulting to tired old strategies, in this case, the military’s reliance on heavy-lift helicopters to deploy troops behind enemy lines, which “alert any and all enemy personnel occupying a target to the approaching assault force,” resulting in a deadly ambush. Instead, it advocates relying on innovation, adaptation, and audacity and gives some entertaining examples of the team’s ingenious plans. It would seem in both combat and business; winners develop creative solutions “instead of being forced to default to the status quo.” They also have the “flexibility to adapt to uncertainties instead of avoiding them because they weren’t part of the plan” and “the audacity to seize opportunities, instead of neglecting them due to risk aversion and fear of the unknown.”

I am pleased with the differentiated portfolio we have assembled, comprising companies that in my view, embody many of the attributes mentioned above. In the next section I highlight a few examples of how aligned managers are not afraid to take creative and bold steps to create long term value for shareholders. While it sometimes takes the market a while to fully credit our companies, we can use “time as an ally” to allow prices to catch up with their intrinsic value.

Discussion on a selection of portfolio positions with an average weight over 1%:

Positions with an average weight of over 1% of the portfolio throughout the quarter were: Alphabet Inc., Amazon Inc., Brookfield Asset Management Inc., Burford Capital Ltd., CarMax Inc., Colfax Corp., Countryside Properties Plc., Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., IAC/Interactivecorp, KKR & Co Inc., Liberty Broadband, Naspers Ltd., Oaktree Acquisition Corp. B, Pershing Square Tontine Ltd. Prosus NV, Tencent Holdings Ltd., Trebia Acquisition Corp., VanEck Vectors Gold Miners and Junior Gold Miners Etfs, Wandisco Plc, and Wayfair, Inc.[2]

[2] There is no assurance that any of the securities discussed herein will remain in an account’s portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See “Disclaimers” at the end for more details.

Alphabet and Amazon – update

Alphabet and Amazon are well known and largely understood by investors. One doesn't always have to turn over an obscure rock to profit in this business, and good investments are sometimes plainly visible. Nevertheless, I still find it helpful to analyze them on a sum-of-parts basis, as this highlights how they have used their scale to expand beyond their core operations, which will help power their continued growth despite their size.

Alphabet has a dominant position in online advertising with one-third market share and is growing at double-digit percentage rates off a large base. Alphabet uses its prodigious cash flow to finance approximately $8bn in operating losses in its cloud and "other bets" divisions. Given the roughly $90bn it generates in the core advertising/serviced business per year, it can well afford to do so. The entire company was worth approximately 22x the core business alone at year-end. This valuation does not include Google Cloud, which generates $18bn in revenues, growing 48% per year. Google Cloud could be worth over $300bn[3] in a few years if it catches up to Amazon AWS's 30% margins. In other bets, Waymo, the self-driving unit, last received funding at a $30bn valuation, and Verily Life Sciences has raised $2.5bn to date to invest in healthcare data science. Should their moonshot investments in quantum computing or nuclear fusion ever work, it would be difficult to estimate their impact on the world. In the mean time we can enjoy that growing cash flow.

Amazon has been singularly effective at developing logistics and technologies to solve its own pain points in its original first-party retail business and then building those solutions into fast-growing and higher-margin profit centers. Amazon Web Services (AWS) came out of an effort to efficiently scale up Amazon's infrastructure to support its retail growth and provide a platform for third-party merchants.[4] In doing so, Amazon realized it could offer on-demand compute services to third-party developers. Today AWS generates almost $60bn in revenue, growing at 38% per year, with 30% operating profit margins. The first-party retail business generates approximately $240bn in revenue at 3% margins; meanwhile, the third-party business generates roughly $100bn of fees at around 30% margins. Amazon's latest growth area is in selling advertising services to merchants, with revenues of $30bn, growing at 70% per year and margins of approximately 30%.[5] In July, Andy Jassy, who built AWS, took over as CEO, and it seems he inherited a company with plenty of growth still ahead.

Exor NV - update

Exor signed a definitive agreement to sell its reinsurance subsidiary PartnerRe to Covéa for €7.8 bn, with an expected closing in 2022. The companies first signed a tentative agreement in 2020 before Covéa used Covid to negotiate the price. However, Exor held firm and revived the deal at the original valuation a year later. Moreover, Exor and Covéa/PartnerRe will invest jointly in Exor-managed funds, presumably giving Exor a stream of high-quality fees – a classic example of "synthetic leverage."

Following the deal, Exor will be in a uniquely attractive position to create value for shareholders, with a market capitalization of approximately €19bn, comprising €9bn (or 47%) in cash and stakes in Ferrari, Stellantis, CNH Industries, and private assets worth a combined €35bn. The last two numbers add up to materially more than the first, which speaks to the very deep discount the market is attributing to the holding company.

Unsurprisingly, analysts at Exor's recent investor day asked questions regarding buybacks to close the discount. Exor, however, has earmarked only €1bn on debt reduction and buybacks. Instead, its primary focus is on acquiring good businesses in the healthcare, luxury, and technology sectors to grow its net asset value (NAV) per share over the long term. Given Exor's record of compounding NAV per share at 18.7%,[6] I am optimistic about the significant optionality this could present.

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[3] Assume $18bn revenue grows 30% pa for 4 years, 30% cash flow margin, 20x multiple

[4] https://techcrunch.com/2016/07/02/andy-jassys-brief-history-of-the-genesis-of-aws/

[5] Amazon does not disclose all these segmental numbers in this level of detail, so I have made some estimates

[6] Company investor relations page https://www.exor.com/pages/investors-media/net-asset-value-nav

Fairfax, Inc. - update
Fairfax, in contrast, is focused on what management view as a steep undervaluation of the company. Even though it gets little notice from the market, Fairfax's growth formula is intact, with record earnings of almost $2.5 billion in the first nine months of 2021 and book value per share growing 20% in the third quarter. These results were driven in no small part by investment portfolio gains and a 25% growth in gross premiums written, which benefited from a continuing "hard market" in which premiums rates escalate and underwriting standards tighten.

In 2020 Prem Watsa personally bought $150m of stock, an impressive demonstration of his conviction in the company. Fairfax also bought back 1.4m shares or approximately 5% of shares outstanding. More recently, in Q4 2021, the company sold 10% of its insurance subsidiary, Odyssey Group (which accounts for only 20% of Fairfax's total assets[7]) for $900m and subsequently bought back 7.4% of parent Fairfax's shares for $1bn. In my view, this is clever and value accretive capital allocation by a founder with a lot of skin in the game.

IAC, Inc. - update
IAC's strategy is to direct resources opportunistically behind portfolio companies demonstrating traction, in the form of funding and managerial talent, frequently using cash flow from slower growing but profitable subsidiaries to fund fast growers. It typically spins them out, once sufficiently developed, as separate public companies. This "anti-conglomerate" strategy, as Barry Diller has described it, catalyzes the partial elimination of a Holdco discount with each separation. For example, when SAAS companies commanded very high multiples last year, IAC accepted venture investment on attractive terms ahead of spinning out Vimeo.

IAC capitalized on DotDash's recent solid revenue growth and margin expansion this year by purchasing Meredith for $2.7bn in cash. At first, I worried that buying an old-school print media business was a step backward. However, after listening to the deal presentation, I became more encouraged by the company's rationale. Meredith has strong brands and extensive independent content, which allows it to monetize its long-standing relationships with advertisers through premium display advertising. DotDash, on the other hand, owns challenger brands but has better optimized its content for the online world. For example, it performs better on high-yielding performance marketing (converting clicks directly into purchases/transactions). In addition, it has fast-loading sites with good user interfaces (which dramatically improves ad effectiveness). With the significant overlap between DotDash and Meredith in the home, food, health, beauty, and travel sectors, IAC sees the opportunity to take leadership positions in these categories and significantly ramp up online advertising performance. From this perspective, the plan is in keeping with IAC's long-standing core strategy of investing in offline-to-online transitions. Sometimes the "guy on the ground's" situational context enables them to see better opportunities than we can as passive investors.

Oaktree Acquisition Corp. B - update
In December, Oaktree Acquisition announced its intention to acquire Alvotech, a leading pure-play biosimilar platform. Interestingly, the parent Oaktree Capital has invested in Alvotech for three years, so one would expect it has highly diligenced the opportunity. A biosimilar is a biological product that is highly similar to and has no clinically meaningful difference from an existing approved biological. Biologicals are large complex molecules that have become the standard of care for many difficult-to-treat conditions. Eight of the world's ten highest-selling medicines are biologics, and the market is large, expected to grow 10% per year to a $555bn market by 2026. The biosimilar market is expected to grow to an $80bn market. The business case for biosimilars is that they are significantly cheaper to produce and should save the US healthcare system over $100bn over the next five years.[8]

Alvotech has 7 biosimilar products in its pipeline. The most notable is a biosimilar to rheumatoid arthritis treatment Humira, the world's best-selling pharmaceutical product with $20bn in annual sales. Alvotech receives milestone payments from partners to finance the development of its products and a cut of revenues following successful

[7] Page 17 of 2020 shareholder letter. https://s1.q4cdn.com/579586326/files/doc_financials/2020/q4/Letter-to-Shareholders-2020-(Final).pdf
[8] Oaktree Acquisition Corp B transaction presentation transcript

commercialization. Notwithstanding the risk inherent in biotech companies, these alternative funding sources align nicely with the type of businesses I seek.

The company forecasts $800m in 2025 revenue at 60% EBITDA margins, which could make it worth $7bn-$9bn using comparable multiples. This would be 3-4x Oaktree's acquisition price of $2.25bn. While this is clearly at the more speculative "high skew" end of our portfolio, there are several factors that make this a potentially attractive risk-reward, sized appropriately. Alvotech's founder previously built three pharma companies, including one that he grew to $2bn in revenues and generated 50% annual returns for shareholders. Furthermore, the management team brings deep knowledge of the development process, with collectively 17 successful biosimilar approvals. Together, they have built a pure-play bilosimilar development platform and established a top-tier network of commercial partners (TEVA in the US, STADA in the EU, and Yangtze River in China). Finally, on December 12, the European Commission has approved the use of Alvotech's Humira biosimilar in the EU, bringing it a step closer to commercialization.

Wandisco, Plc. - update

At long last, Wandisco may be getting some traction. In October, the company finally gained General Availability on Microsoft's Azure cloud, opening the pipeline for enterprise adoption of their data migration solution. Then, in the last few weeks of December, the company announced three deals, one each via Amazon AWS, Google Cloud, and IBM.

The Google deal is notable, given the sheer amount of data involved. Bosch has entered a "Commit to Consume" contract valued at a minimum of $6m over five years to replicate over an exabyte of automobile sensor data to the Google Cloud. The deal allows for increased consumption, potentially growing to $10m-20m in revenues. An exabyte is 1,000 petabytes, and 50x the 20-petabyte deal Wandisco agreed previously with AT&T. Importantly, WANdisco's Fusion product was 25x faster than Google's product, which at least underscores Fusion's technical superiority in the very large data segment. Finally, this "internet of things" deal expands the target market beyond the original Hadoop server migration market.

While this is a great start, Wandisco needs to book significantly more revenues to prove the investment thesis. Therefore, I continue to monitor the company's progress.

Wayfair, Inc.– new position

I initiated a starter position in Wayfair, the online furniture retailer. I have been following the company for a few years but had refrained from pulling the trigger as the company had not been profitable. I wanted to see how the company executed its ambitious logistics plans. Wayfair has been a big beneficiary of Covid, as people focused on their homes and home offices during lockdowns, and the company posted a little under one billion dollars in Free Cash Flow in 2020 (after subtracting share-based compensation). In the fourth quarter, Wayfair's stock declined 40% from its high as the market began to worry about the potential short-to-medium-term impact reopening might have on demand for furniture, which I felt presented a decent opportunity to initiate a small position. (With the benefit of 20-20 hindsight, waiting a few more weeks would have been better!)

The furniture market has a few key characteristics. While 60% of goods sold are commodities (think paper towels, e.g. Bounty, and batteries, e.g. Duracell), and 20% are groceries, 10% are fashion, and 10% are home goods.[9] In contrast to commodities, shoppers in home goods are searching for unique, personal items. Shoppers like to browse and get inspired, and text searches alone are less effective in describing, say, a particular type of sofa one hopes might fit in a living room. Moreover, most furniture is unbranded and produced by a fragmented industry of small and medium-sized businesses across the globe. Therefore, an aggregator such as Wayfair has a significant negotiating position (classic Porter's 5-forces).[10] Finally, furniture is bulky, heavy and prone to damage, which is challenging for traditional online delivery logistics. For example, 30% of Wayfair's products are too big to be shipped by FedEx or UPS.

[9] https://www.joincolossus.com/episodes/73227114/shah-developing-every-skill?tab=blocks
[10] https://hbr.org/1979/03/how-competitive-forces-shape-strategy

To fulfill consumer desire for uniqueness and variety, Wayfair offers its 31m unique customers 22m different products. For example, it provides 7,000 different bedroom layouts to inspire its customers. To achieve this variety, Wayfair partners with 16,000 suppliers. Wayfair focuses on customer acquisition and interaction, marketing, and merchandising. It employs 4,100 customer service associates to provide as high-quality a service as possible. The suppliers concentrate on product development, design, manufacturing, and quality control.

Wayfair has invested heavily in logistics to handle the complexity of shipping so many goods from so many different points of origin. Firstly, it established warehouses in China and Vietnam close to suppliers (the International Supply Chain operations). Wayfair is now a top 30 importer to US by volume, benefitting from volume discounts and the ability to combine less than container loads into one container, further saving on transport costs.

Next, Wayfair established CastleGate, its fulfillment network, in which suppliers pay Wayfair to manage their inventory (which requires a high degree of trust). By gaining more control of the logistics process, Wayfair can "forward position" products, shipping them to warehouses closer to end customer locations, using its algorithms to predict demand. CastleGate speeds up delivery to two days or less vs. over four days from standard drop shipping and reduces the number of touchpoints, shrinking costs and minimizing damage and returns. CastleGate currently handles approximately one-third of total volumes. Products within CastleGate feature higher in search results with a "2-day delivery" badge, which can lead to a 130% uplift in sales.

Finally, the company has built the Wayfair Delivery Network specializing in large item delivery. WDN handles 90% of large parcels in the middle mile and 70% of large parcels in the last mile. Overall, Wayfair has three main competitive advantages. Firstly, it has achieved household brand status in the US, Canada, and the US. Second, it has network efficiencies as millions of customers attract suppliers, and more suppliers provide product variety which attracts customers. Third, Wayfair has economies of scale as one of only a handful of companies handling global logistics for bulky items. Given that logistics cost 20% of each revenue dollar, this advantage should grow as the company grows.

Amazon is frequently brought up as a legitimate competitive threat, and so I have spent some time reading transcripts of interviews with former employees of Wayfair, Amazon, and IKEA. The general view of these "guys on the ground" is that a specialized player such as Wayfair should be able to create more efficient logistics for bulky items than a generalist. For example, a customer would ideally receive a rug, sofa, table, and desk lamp from disparate manufacturers in one delivery, so that the rug can be laid down before the other heavy items are assembled. Traditional delivery logistics are not optimized for this level of coordination and give Wayfair a point of differentiation as it improves its offering.

At $14bn, Wayfair generates substantial revenue yet makes up only 2% of the global home goods market. The company believes it has the potential to 8x this by 2030 as both the overall market grows from $840bn to $1.2tr and more buying shifts online, from the current 20% to closer to 50% as is found with more traditional e-commerce. While these numbers seem optimistic to me, I'd note that if the company merely maintains its current share of online home goods sales (historically, it has taken up to 40% of online growth), it would generate $60bn in revenues by 2030. With scale, margins should improve (as the company demonstrated could happen in 2020). Management estimates long-term cash flow margins of over 10%, I use 8% after share based compensation, which results in a cash flow number approximating $5bn, compared to the year-end market capitalization of roughly $20bn.

The company still has a few things to prove; for example, that customers will consistently return for repeat purchases and not "churn" away. The company spends the equivalent of one year's worth of gross margin per customer and needs customers to come back to be reliably profitable. Management points to the 70% of revenues that come from repeat purchases as indication that customers return to, for example, purchase ancillary furnishings after buying a central item of furniture. Still, it is a metric I will continue to follow.

Overall, I believe Wayfair has a good chance of being one of a handful of major global online furniture players, run by forward-thinking founders who were bold enough to invest in differentiated logistics over many years. As a result, it is well-positioned to ride the growth in online furniture sales. Wayfair generates $1bn in revenues from

Canada, Germany, and the UK, and $1.5bn from a growing B2B offering (a sub-market with no dominant player), which provide further avenues for future growth.

Gold mining ETFs

I sold the junior miner ETF and consolidated proceeds into the majors ETF. This was both to harvest tax losses and consolidate our portfolio, as the two ETFs track reasonably well to each other while the majors are less volatile.

Samer Hakoura
Alphyn Capital Management, LLC
January 2022

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