Geometrica Fund

Investor Newsletter – February 2020

We seek asymmetric investment opportunities informed by the coalescence of rigorous fundamental analysis and alternative data discovery.

The Geometrica Fund aims to deliver outstanding returns to unitholders via highly targeted investments in the global mid-cap equity universe.

Overview

This monthly note is different to the regular ones. Things are quite busy now. But in the interest of keeping our co-investors informed, here it is.

Net of costs, the Geometrica Fund closed the month of February -0.34% or negative 34 basis points. NTA at month end was $0.9884 (Founders Class – Lead Series).

In the same month, the S&P/ASX200 Index closed down -8.2% whilst the S&P500 Index fell -8.4%.

Gross exposure at month end was 66.3%, a ramp up from 37% the prior month, driven by rapid growth in our single stock short book. Net exposure at month end was 24.7%.

During February our longs cost us money whilst our shorts began printing it, a trend that has continued into March as we write.

FX was also an important factor as the AUDUSD depreciated; we had our US equity holdings unhedged for currency and converted a large portion of our AUD cash into USD as Quantitative Easing by the RBA loomed on the horizon as a probability and a structural USD shortage became clear.

In managing through this crisis, our goals are simple:

1. Protect and preserve capital.
2. Position to benefit from the ultimate recovery.

Without a robust investment process these goals are little more than pipedreams. Without a robust process you fail the first goal which makes the second more challenging.

We are all ensnared in this crisis. We can begin to dimension the first order impacts of Covid-19 but the ultimate consequences lie ahead and are largely unknown, entwined as they are in our methods of response and their own circularity.

In time it is likely that there will be a vaccine or hard-won herd immunity, but the immediate future will bring human suffering and a sharp and sudden economic contraction.

Hard economic stops on a global scale are almost unprecedented. This crisis is likely to transmit rapidly via multiple channels to the broader economy.

Contextualising this as a simple viral outbreak from which markets can harmlessly rebound may prove optimistic. This is morphing rapidly into a major economic crisis. There are so many unknowns.

Events that surprise, seemingly from left field, always occur during a crisis. Short selling bans, market closures, counterparty failures, rolling bankruptcies, broken business models or even busted sovereign credits are some of the events we may be forced to navigate in the days ahead.

Crises tend to require a mental pivot from the status quo in order to survive. Our investment process demands a framework from which to work; without it, in an episode such as this, you're rudderless. Our framework in this case continues

to be understanding the mathematical progression of Covid-19.

Guided by our framework, we assessed what we owned during February for vulnerability to the effects of Covid-19 and its leveraged impacts. This resulted in the dispassionate ejection of some stocks we owned, where very recently we saw large upside. The world has changed, if only for a period of time.

When the facts change so too should our views. Corporate Travel Management Limited (Ticker: CTD.AU) was a case in point – we owned it but when the facts changed we threw it to the wolves: Rule #4 – "*No matter how much you know about a stock, it owes you nothing*".

In some instances, we sold more shares in these stocks than we owned, flipping them from longs into shorts where we thought they would be materially affected as Covid-19 continues its exponential march across the globe. Five stocks fell into this bucket and at the time of writing we have retained four of them as shorts (we had our stock borrow recalled on the fifth). Some of them might become longs once again in time, with considerably more upside than before given the large valuation and earnings resets that are in motion. Two bites of the cherry are better than one. Three is a distinct possibility.

Our short book, predominantly in US and Australia, remains heavily focused around stocks with significant downside exposure to Covid-19. To rattle off a few of our short exposures:

- Quick service restaurant chains that have direct property lease liabilities, low operating margins, financial leverage and thus extreme sensitivity to any revenue declines.
- Casino operators in areas with structurally weak revenue trends, high operating and financial leverage.
- Banks exposed to the onslaught of Quantitative Easing, deposit spread and asset yield compression, loan growth decay, NPL formation and risk of dividend cuts.
- Capital equipment manufacturers selling their wares to consumer facing industries.

All of these shorts were placed into the US and Australian markets before the notion of large-scale outbreaks in these markets had really entered the popular consciousness. Covid-19 is extremely contagious and extremely mobile.

The net of our long book review and short selling activity is that we are now left with a far more robust portfolio. And we are sitting on a considerable pile of cash.

Our additional long opportunities will come in a series of waves. The safest upside exposures initially will be largely devoid of significant exposure to Covid-19 and will be compounders where there has simply been a valuation derating; we own a few of these already in small size and will add to these positions as the opportunities arise. In the early phase we think this is the safest way to play.

The path of recovery for individual companies is likely to be highly differentiated depending upon their primary exposure, and other considerations such as financial leverage.

The GFC exit saw multiple companies with delayed recoveries where massive upside ultimately eventuated. This is the truly rich opportunity set for stock pickers, but we need to navigate the worst of this event first.

We all know that at the nadir of a crisis there are typically wonderful opportunities to be had. This was certainly the case in March 2009. *“Buy when there’s blood in the streets”* is the exhortation. But the first condition is that blood must be spilled for the bargains to begin to appear. The trick is to make sure that figuratively, it’s not too much of your own.

It would be difficult to assert today that the entire market is screamingly cheap when viewed through the lens of history. Companies with the structural capacity to grow their earnings as a compounding function on incrementally higher margins remain generally hideously expensive; they’re mostly cheaper than at the start of the month but generally not on any longer-term view.

But that’s often how it works, the biggest bargains are less obvious.

We are currently beginning to nibble on longs where on a 6 to 12 month view it is very likely that there is asymmetric upside. Part of the calculus here involves managing our gross and net exposure.

Our portfolio settings are conservative, as are our business settings regarding counterparty risk and the health and wellbeing of our team, who since the start of March have been working from home.

At the time of writing we are running a small net short exposure, principally in Australia and the US. Remembering that a week feels like a year in markets right now, this has seen our strong relative outperformance of February continue into the first half of March.

But you can’t eat relative performance when its flat or slightly negative. The goal in the period ahead is to make money.

In that regard our framework of tracking the mathematical progression of the outbreak continues. Recognising that a market is not an economy, this should provide us the best indicator, barring unforeseen secondary impacts, that we are approaching a market bottom from which a profitable exit and an economic recovery are reasonably likely.

Covid-19

Covid-19 is an unfolding human tragedy; one that is evolving globally at an exponential rate.

SARS, which ripped through Hong Kong and parts of Asia in 2003, was cited multiple times in research we saw in January and the earlier part of February as the applicable analogue for Covid-19, with the implicit hope that it would all be over swiftly: another tradeable opportunity to once again “*buy the dip*”.

Yet two crucial facts set Covid-19 in an altogether different league to SARS. To quote from a respected economist recounting the existential fear that gripped epidemiologists during the initial SARS outbreak in Hong Kong back in 2003:

“*…there were two key fears [during SARS];* ***that the virus was airborne*** *and that* ***carriers were infectious while asymptomatic.*** *In the end, neither proved to be the case.*[1]” [emphasis added].

We know now that Covid-19 is highly contagious via airborne transmission and that carriers are infectious whist asymptomatic. SARS is not the analogue we had hoped it would be. The uncomfortable reality is this thing is closer to the Spanish Flu than SARS.

The other dynamic of Covid-19 is its high R0, or basic reproduction number, with consensus on the

[1] Wigram Capital

underlying R0 settling at around 2.5 in the medical community.

Meaning that each infected person on average will pass the virus to a further 2.5 people. The process of transmission for Covid-19 is thus exponential.

Given the absence of symptoms whilst a carrier is contagious, case numbers are thus dramatically under reported at this point in time. As testing ramps up, we'll see an over-reporting of actual cases versus underlying formation, which in turn will likely spur an increasingly urgent policy response.

We are on the cusp of a rapidly accelerating increase in identified cases in the US and Australia. Observable R0, that is the reported R0, exaggerated in a real time fashion as it is by increased testing in the US and Australia now exceeds that of Iran and multiple US States have real time R0 above Italy.

The pattern of development in Asia has been that until what we might regard as draconian containment measures are adopted and accepted by a populace, the quantum of underlying cases grows at an accelerating rate, an exponential progression.

The implication of unchecked growth in Covid-19 cases is that given a small proportion of suffers require access to medical equipment in short supply, a large sudden influx would result in insufficient capacity of said life-saving equipment. The math of fixed capacity versus exponentially increasing demand in this context is ugly.

Policy makers face an invidious choice: prioritise life or the economy. As the crisis deepens nearly universally, if incrementally, they appear to be shuttering economies in order to save lives. It ultimately becomes an easy choice.

But because the underlying driver is exponential, so to is the policy response, and thus so too is the damage wrought upon the economy.

Meaning the economic contraction has some way to go. In an interconnected economy, the lockdowns required to halt the spread of the virus may have crippling effects. Automotive producers, involving complex and international supply chains, are now shuttering production due largely to component shortages. We are aware of retailers with dwindling stocks. Of landlords exposed to lower retail sales via increased symmetry in their share of turnover rents, both positive and negative around a threshold. Of consumer companies watching their revenues fall off a cliff whilst they remain exposed to the fixed costs of their business.

A large part of how the second order effects will play out involves credit. Credit, and its ongoing provision, is the grease that keeps the wheels of a modern economy spinning.

In this regard the monetary and fiscal policy responses to date will soften the real economic blows to come and delay the risk of outright liquidation, but they cannot stop the progression of disease and so they cannot stop the first order economic contraction.

Until we can see that case influx is slowing, we are unlikely to become more sanguine.

But the case population should ultimately resemble a parabola. At least in the initial wave.

Perversely, the pernicious thing about Covid-19 is that it has a far lower mortality rate than say, Ebola. Ebola kills so fast it's difficult for a carrier to spread it. The flip side of Covid-19's exponential progression is that the event should play out over a few months – left unchecked everyone gets exposed to it relatively quickly.

There are likely to be complications to the notion of a clean recovery, such as secondary waves of infection as was the case with Spanish Flu that we will need to carefully navigate. But provided we can sidestep the landmines and provided policy makers can avoid outright sustained economic retrenchment, this ultimately becomes a significant investment opportunity. We earnestly want to capitalise upon this.

Gary, James and Ben.

19th March, 2020

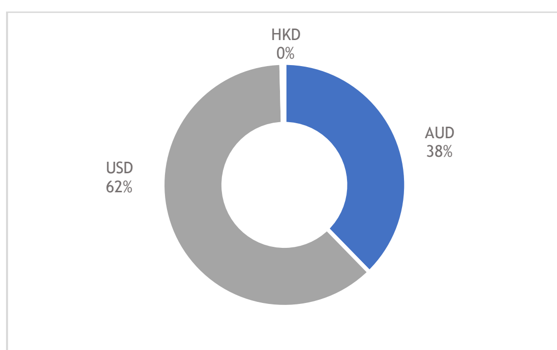
Geometrica Fund

Investor Newsletter – February 2020

Fund overview (Alpha Units)

Fund	Geometrica Fund	Investor Eligibility	Wholesale only
Structure	Wholesale unit trust	Minimum Investment	A$250,000
Mandate	Global long short Mid-cap focus	Fees	1.5% management (+GST) 20% performance (+GST)
Gross exposure range	0 - 200%	Benchmark	RBA Cash Rate
Net exposure range	1 - 100%	High water mark	Yes
Single stock long limit	15% at cost	Liquidity	Monthly
Single stock short limit	5% at cost	Admin & custody	Mainstream Fund Services
Buy / Sell Spread	Nil / 0.25%	Platforms	Ausmaq

Currency allocation



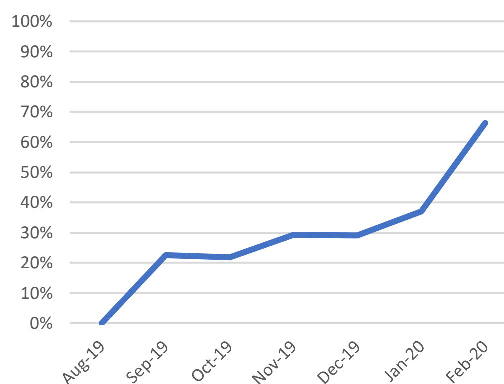
Asset allocation

Country	Long	Short	Gross	Net
Australia	16.5%	(1.9)%	18.4%	14.6%
United States	26.2%	(16.8)%	43.0%	9.4%
Asia	2.8%	(2.1)%	4.9%	0.7%
Total	45.5%	(20.8)%	66.3%	24.7%

Investment performance (net)

	Founder Lead Series - 2019	Founder Lead Series - 2020
Jan	-	-1.3%
Feb	-	-0.3%
Mar	-	
Apr	-	
May	-	
Jun	-	
Jul	-	
Aug	-	
Sep	1.1%	
Oct	0.8%	
Nov	0.1%	
Dec	-1.6%	
Total	0.9%	

Gross exposure



DISCLAIMER

This document has been prepared as general information only for wholesale investors in the Geometrica Fund and should not be distributed in any form to any retail or other investor that is not a wholesale investor as defined by the Corporations Act 2001.

*Geometrica Management Pty Ltd (the **Manager**) (ABN 25 633 189 929) has prepared this document and is a Corporate Authorised Representative (CAR No. 001275640) of Lanterne Fund Services Pty Ltd (**Lanterne**) (ACN 098 472 587, AFSL No. 238198) and is authorised to provide advisory, dealing and incidental custody services in connection with the Fund to wholesale clients only.*

The nature of investment necessarily involves the risk of loss. The Manager is of the view that the information provided herein is accurate and complete, however, no warranty of accuracy, completeness or reliability is given, and no responsibility for loss or damage whatsoever or howsoever arising as a result of any representation, act or omission whether express or implied, is accepted by the Manager, its directors, employees or related bodies corporate. The Manager does not provide accountancy or tax advice and you should seek independent advice on these matters. Any advice is general advice only and does not take into account your personal financial position, needs or objectives.

This document does not constitute an offer. Any offer of units in the Geometrica Fund can only be made pursuant to an Information Memorandum which details the relevant risks related to investing in the Fund and other important information you must read and acknowledge prior to making any investment in the Fund.

The Fund is not suitable for all investors. Investing in any security or fund involves significant risk. The price of any security or fund may decline as well as rise.

Past performance is not predictive of future performance and no guarantee or representation as to expected future returns is or can be made.