Geometrica Fund

Investor Newsletter – April 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

Net of costs, the Geometrica Fund closed the month of April up +2.4%.

Viewed through the lens of cumulative returns the Fund has significantly outperformed many major indices on a calendar year to date basis.

We are laser focused on converting that relative outperformance into absolute performance. At the time of writing May is shaping up for another strong performance.

Perspective

March's lesson was do not ignore the regulators. Debt and equity markets were beginning to discount a fully-fledged financial crisis before coordinated central bank and government activity disabused most of us of that notion in late March.

April's question was really "where to from here?". Because it's a complex question, there are no simple answers.

The US Federal Reserve has bought us time by building a liquidity bridge. For now, the Fed has greatly reduced the risk that liquidity risk might morph into solvency risk for many companies reliant upon ongoing access to capital markets. But the Fed's assurance that it will "do whatever it takes", including buying limitless Treasury and Agency mortgage backed securities (and even junk debt) is a stop gap reliant upon the willingness of financial market participants to believe; it is not a solution anyone should want to see tested.

The most severely Covid-19 affected companies have ongoing costs and little to no revenue. There is a time limit to their solvency. This makes the valuation question for these most affected of businesses increasingly difficult as time passes without a clearly articulated path back to normal levels of activity.

Our approach, as always, is to go deep and narrow on individual stocks, endeavouring to gain an informational and analytical advantage. We only invest when idiosyncratic factors indicate favourable upside risk.

Portfolio level concentrations – 3 exposure buckets

At a portfolio level, in order to control for risk concentrations linked to Covid-19, we classified our holdings in the context of Covid-19, into one of three buckets - "Immune", "Infected" or "At-risk".

If that liquidity bridge that the Fed has built for us starts to wobble, or our leaders reintroduce or elongate lock downs, we don't want to be overly exposed to stocks we would classify as "Infected".

To qualify as Immune, a holding had to either be a beneficiary of Covid-19, unaffected or capable of rapidly adjusting its business model to adapt to life with Covid-19 without impairment (see below for an example with our two largest contributors during April).

The Immune bucket is the largest of the three buckets in our long portfolio. It's also punching above its weighting in P&L contribution. The ongoing pricing bifurcation in credit markets speaks to the need to tilt portfolio concentration towards these Immune holdings for now and maybe well into the future.

The Infected are those stocks whose revenue has experienced a hard stop. No doubt there are many potential bargains out there fitting this description, but unless you can conclusively answer the liquidity and solvency questions for an elongated period of time, it's a dangerous bet. This is the smallest of our buckets. We are actively working on a few names and may come to own them, but in small size until we have real insight into their recovery trajectory, which is where our data work may yield some advantages. One of our holdings here has 18 months of liquidity and around 200% upside after full equity dilution and the capacity to compound thereafter. But it is too early to size it beyond a small position until we know they are on the recovery path. Until then, every day that passes sees a small reduction in both their liquidity position and equity value given the compounding nature of interest charged on their debt and unavoidable operating expenses that simply cannot be cut any further.

The At-risk bucket is really the in-between, both in sizing, and in risk and reward profile. These are businesses where there is no existential liquidity or solvency risk but an economic exposure that has seen material share price dislocation. Whilst they are economically sensitive, the ones we own have idiosyncratic traits that should skew the upside risk to our favour.

Follow the leader and follow the stimulus

China was first into the Covid-19 hole. It follows it should be first out, notwithstanding sporadic new virus outbreaks continuing. Absent a major mutation, subsequent waves should be smaller in terms of impact than the first, not least because we have a much better idea of what we are dealing with and the element of surprise is no longer present.

The recovery in Chinese activity was extremely patchy initially, with travel data showing a slow return to work from the emigrant provinces and a gradual increase in metro activity. But that is the general nature of any recovery. Recent industrial production data is emphatically positive.

Remembering the lesson of March, we are attuned to the activity of regulators and governments.

In China, a crucial part of the recovery trajectory appears to be a massive stimulus. China is not a conventional economy. Rather than an explicit and widely communicated fiscal stimulus, a large credit surge, akin to what occurred in 2009 and 2015, is clearly discernible. Like 2009 and 2015, this appears to be a quasi-fiscal credit pulse, with the channel of transmission to the broader economy being via fixed asset investment.

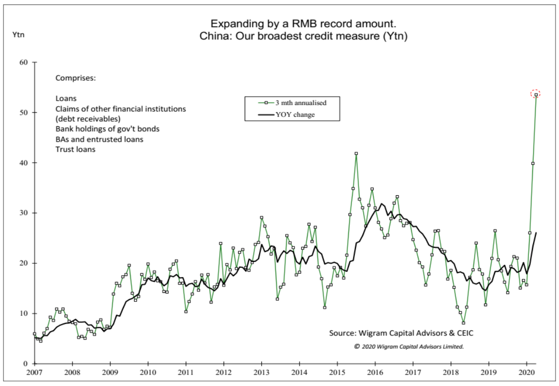
Iron ore

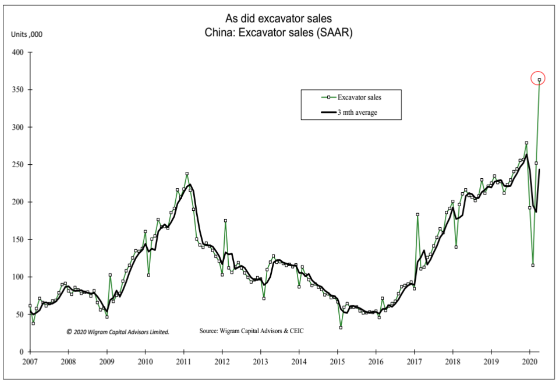
During the month we built a position in iron ore equities. What we see are analyst forecasts that we think are simply too bearish when it comes to iron ore.

Invariably these focus on the long term, with forecasts of a reduction in Chinese steel production and an oversupply of iron ore leading to a slow collapse in prices. In the long term this might be right, but in the long term as someone once quipped, we're all dead. For the next year or two, we smell opportunity.

Historically the errors in forecasting iron ore prices have been around both demand and supply. On the demand side due to possible underappreciation of the role of credit in Chinese investment stimulus and on the supply side where invariably it has proven harder to produce and ship iron ore than companies forecast. This time is no different.

China as an unconventional economy has unleashed a record credit surge. Data shows this going to corporates over households. Sales of excavators have boomed. Property prices are now stabilizing, and property transactional values have recovered to early 2019 levels. Housing starts are also clearly accelerating.





Source: Wigram Capital Advisors

Meanwhile supply is set to disappoint as Brazil deals with the onset of Covid-19. Vale has downgraded their production forecast for calendar 2020 but the data appears to suggest they'll need to do that again.

A market once projected to be in modest oversupply appears to be swinging to undersupply, even when generously allowing for reduced demand outside of China. Because China is ~3x the size of all other seaborne iron ore demand, in a period of rapid Chinese demand growth, weakness elsewhere becomes irrelevant.

Maybe China has gone back to its old ways of centrally planned and credit driven growth. Whether that's right or wrong is for now irrelevant, as long as we can make money out of it for our co-investors. And with an iron ore price that might just punch through $100/tonne, that seems firmly on the cards.

Australia is another opportunity set

Whilst the US is mired in a botched response, Australia and New Zealand have joined the ranks of the early responders. The curve has been crushed. When the outbreak started, we forecast that Australia would exhaust its intensive care unit capacity by early April. We were miles off, solely due to a smart and rapid response. Now, there is much more ICU capacity and a much deeper understanding of the virus.

When you line up the phasing of Australian fiscal stimulus, it is greater than estimates of wages lost due to Covid-19, it scales over time and it coincides with what should be the progression to increased economic activity over the coming months.

We are long one Australian domestic recovery story in size, in tandem with that company's management who opted to forego salary in return for stock. That business has also changed its revenue model and future margin profile. It is a veritable coiled spring, and when its underlying volumes stabilise and grow again, which leading indicators now portend, we believe the stock price can comfortably double and compound into the future.

Buy Now, Pay Later

The two largest positive contributors to the Fund's investment performance during April were Afterpay (APT.AU, mkt cap A$11.6bn) and Sezzle (SZL.AU, mkt cap A$425m). Both are Buy Now, Pay Later (BNPL) businesses.

We've owned Sezzle since September 2019 and have written about it before. Whilst Sezzle is a little on the small side in terms of market cap for us, we chose it over Afterpay at that time due to valuation; Sezzle traded at a significant discount to Afterpay but was growing faster off a much smaller base exclusively in the USA.

When we bought Sezzle, we forecast it would materially beat on consensus forecasts for revenues and margins. This all came about, but the stock price fell nonetheless, with Covid-19 not helping the cause.

Markets can be humbling. The crucial thing is to stick to a process that works. Provided a company's cash earnings grow over time, the stock price should follow assuming the starting valuation is reasonable.

The street has always been concerned that these BNPL companies might experience a rapid deterioration in credit quality in a sharp economic shock. A global lock down definitely qualifies as an economic shock…

We have long thought this concern over credit risk misplaced for three reasons.

First, the value of individual transactions is small, so the credit risk is really from a whole cohort or wave of customers deteriorating all at once.

Second, payment performance is as close to real time as it gets.

A typical, non-BNPL, consumer credit book with an average maturity horizon measured in years sees monthly payments coming in (or not coming in) all at the end of each month. So, you hold your breath each month until the scheduled direct debits happen or don't happen.

BNPLs are totally different. In the case of Afterpay's historical business model, a customer made 4 payments over 8 weeks, making a payment of 25% of the outstanding balance once each fortnight. The precise timing of payments being driven by the date of purchase, not the next month end, meant that Afterpay saw, on average, 10% of its customers making payments every single business day. All through that day. This is real time performance data.

Third, because Afterpay and Sezzle approve individual transactions, not just customers, they can adjust the approval rules based on real time payment performance data.

This is exactly what happened. In the case of Afterpay, we know they saw a slowing of performance and then they changed the model to require customers to make the first payment upfront. Meaning that the payment cycle was truncated from 8 weeks to 6 weeks.

Mathematically, Afterpay increased their return on assets and return on equity. They earn the same merchant commission over a 6 week rather than 8-week tenor. The business just got 25% more profitable over a constant capital base.

When we saw this business model adaption and saw that Sezzle was seeing no adverse credit experience at the same time, we bought Afterpay. We are enthused about the company's imminent entry into Canada and what should follow which is a logical expansion into Europe.

Open for subscriptions

The Geometrica Fund is now open for subscriptions. We cannot say with any surety whether market indices will be higher or lower a year from now.

What we can do is put our hands on our hearts and say – and show – opportunities. Dislocation always brings them. In this case given the magnitude of the dislocation they will persist for years.

The Geometrica Fund is hard capped. The business is owned by its staff, who are all investors in the Fund and unable to buy equities other than via their subscriptions to units in the Fund. We're on the same page as our co-investors on the question of alignment.

As ever, thank you for your trust. We will work towards rewarding it with investment performance in the years ahead.

Gary, James and Ben

18 May, 2020

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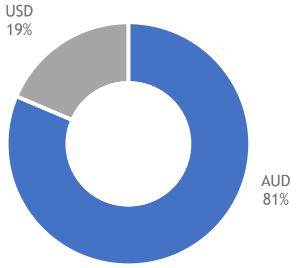
Fund overview (Alpha Units)

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	up to 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



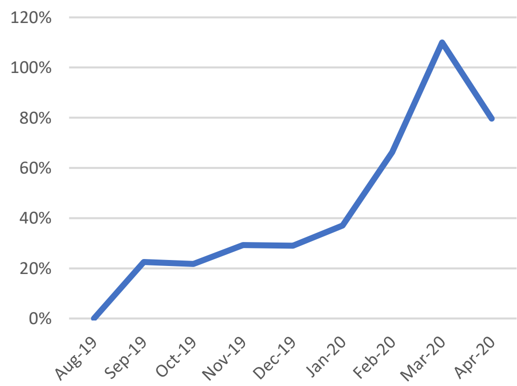
Asset allocation

Country	Long	Short	Gross	Net
Australia	37.4%	(2.4)%	39.9%	35.0%
United States	30.6%	(3.1)%	33.7%	27.4%
Asia	1.2%	0.0%	1.2%	1.3%
Europe	4.8%	0.0%	4.8%	4.8%

Investment performance (net)

	Founder Lead Series 2019	Founder Lead Series 2020
Jan	-	-1.3%
Feb	-	-0.3%
Mar	-	-5.2%
Apr	-	2.4%
May	-	
Jun	-	
Jul	-	
Aug	-	
Sep	1.1%	
Oct	0.8%	
Nov	0.1%	
Dec	-1.6%	
Total	0.5%	-4.5%

Gross exposure



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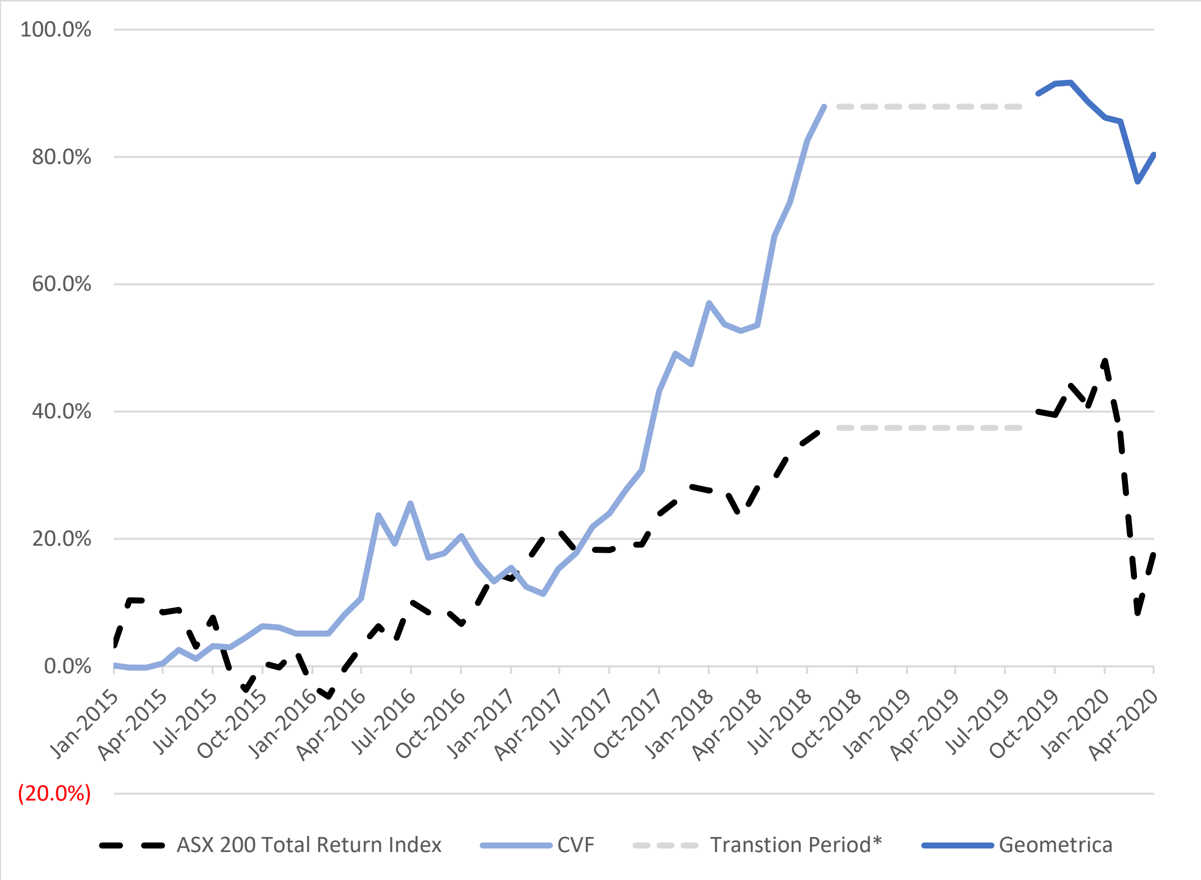
Manager performance history



*** Manager left CVF in Sept 2018 and began GFA in Sept 2019**

NB: Performance period is from 5 Jan 2015 – 30 April 2020. Performance is net of all fees

DISCLAIMER

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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.