Geometrica Fund

Investor Newsletter – June 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 June up +2.98%*.

Key positive contributors in June were long positions in Sezzle, Norwegian Cruise Lines, Domain and Autodesk.

The largest single performance detractor was our underlying exposure to various foreign currencies, of which USD was the largest by virtue of our holdings in US dollar denominated equities. Underlying unhedged FX exposure ran at around 30% during the month. We were in a sense leaning against the wind, in part as a hedge against any sudden deterioration in markets. With the USA sleepwalking into an epic experiment in Coronavirus herd immunity, the future cost of that position is probably more than we want to bear. Our current portfolio is entirely hedged back into AUD.

At a stock level, positions in IDP Education and Oil Search were detractors.

Net exposure closed the month at 82% but net of gold and associated stocks sat at 73%. As we write, net exposure sits at 68% with the number net of gold at 59%, with this reduction in exposure driven largely by profit taking in a few positions that played out (positively) a little faster than we had anticipated.

Short positioning is still very low. This is a function of the potential rewards on the long side continuing to be, in our estimation, much greater and a conscious desire to invest at a stock level solely based on idiosyncratic drivers. We don't want to short stocks simply because they're exposed to prolonged Covid-19 closures for example.

Conditions remain fluid. It is always this way, but Covid-19 seems to be operating to compress time and accentuate volatility.

Portfolio comments

It has been abundantly clear for a few months now that Covid-19 has driven a bifurcation in equity market performance between the beneficiaries (example: the software sector) and the victims (example: the travel sector).

The greatest uncertainty regarding Covid-19 is probably its duration.

Without a vaccine our best analogue is the Spanish Flu which raged from February 1918 to April 1920. On that timescale we are about one quarter of the way into it. On that timescale you'd have to question the US Federal Reserve's capacity to bridge solvency risk for the most impacted corporates and consider the potential corollary impacts to affected lenders and the broader financial system.

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* *Founders Class units – Lead Series. Small variations will occur between unit classes and series based on differences in timing and terms. Source: Mainstream Fund Services, the Fund's external administrator and calculation agent.*

Humans appear to have habitually underestimated the duration of crises historically and there are a veritable plethora of anecdotes we could cite in support of this contention.

As counter to that, we have the vaccine race. There are around 200 different candidates with approximately 10% of that number now in human based trials.

If you assume a successful vaccine outcome, the time to "normal" should improve. More importantly, because equity markets are discounting machines a positive vaccine outcome will almost certainly cause the most deeply affected stocks to rally very hard. You can see the potential for such an equity market rally every time very early stage (and inconclusive) positive vaccine trial data are released and travel sector names as an example leap higher.

The vaccine outcome is unknowable. We have no edge on whether there will be a successful vaccine and so across the portfolio we are not betting either way. We are simply maintaining tight rein on what we choose to own and remain laser focused on picking stocks that have predominantly idiosyncratic drivers.

China exposures

China was first into the Covid-19 crisis. Rule by absolute authority permitted an unremittingly harsh but extremely effective lock down in late January 2020. Now, as the US has fumbled its response, China has first mover advantage in economic emergence from Covid-19.

There is ample evidence of Chinese policy shifting to capitalise on this position of relative strength; economically and geopolitically.

As one veteran commentator has recently observed, it is "Fortress China". With rigid exchange controls that all but preclude capital outflows and a rapidly growing trade surplus, China is strongly positioned for a liquidity and credit driven domestic recovery.

We noted back in our April letter a great credit pump-priming of the Chinese economy. The benefit of a centrally planned economy where the government controls the major banks is that credit growth can occur via diktat. Credit provision becomes an extension of government policy.

Now, home prices, land prices and transaction volumes are rising. Economic activity is clearly rebounding.

The market this week fretted over a slower than expected recovery in Chinese consumption, which is in part counterpoint to rapid investment / supply led growth and in part probably a premature concern. All recoveries are uneven in the early phases. We think it is more profitable to focus on the likely end point rather than imperfections in the trajectory.

We have a bit over 15% of capital exposed to China. We would include Australian listed iron ore stocks in this. Bottom up research work drives the stock selection but the overlay of a highly supportive liquidity environment in a market that has the as yet unheralded capacity to decouple should be additive to returns.

We have maintained our exposure to several iron ore producers, as disclosed back in April, despite consensus sell side forecasts of rising Brazilian iron ore shipments. We did this based on analysis surrounding likely iron ore demand, noting that construction in China accounts for probably over 60% of Chinese steel demand and the sell side analysts tend to be more focused on the supply side.

Similarly, we have a position in a Chinese consumption stock that is part way through a multi-year turn around. This is a self-help story. They are the leader in their vertical. A recent management decision to reinvest near term excess returns in order to build a more entrenched and dominant position with customers is effectively expanding the company's addressable market. We see ongoing margin, earnings, and valuation upside from here.

Buy Now, Pay Later

Our June performance benefited from our exposure to this sector.

We wrote almost ad nauseum about Sezzle last year, explaining its business model and why it might prove to have strong asymmetric upside given its organic growth and margin profile and (relatively) depressed valuation.

During June that started to play out and we added to the position when we saw data that materially exceeded our expectations.

Autodesk Inc. (ticker: ADSK.US, US$51bn mkt cap)

Autodesk was another significant contributor to performance during the month.

The company undertook an Investor Day that had been delayed from earlier in the year due to Covid-19 and articulated in unambiguous terms the scale of the revenue opportunity ahead of them from conversion of non-paying users.

A simple slide on that day showed *15 million* users of the product that are non-compliant and currently pay nothing, versus a paying user base of 5 million users. 2 million of the 15 million non-compliant users reside within the current customer base and are using a recent version, the point being that these users have often unwittingly purchased pirated software and are thus easily identified for cooperation in moving towards legally compliant usage. This is another benefit of a true cloud-based product.

Autodesk's approach to conversion has benefitted from prior analogues that assisted us to forecast the size of the potential upside from non-compliant user conversion. The street is led by medium term guidance on conversion provided by management which we thought was very conservative. This was illustrated when management maintained guidance in the latest quarter even after the pandemic has ravaged the global economy. Beyond conversions, Autodesk are in the throes of moving to a dominant position in one adjacency and have that potential in another by virtue of the structural change occurring at the intersection of bespoke design and manufacture. If there was ever a stock the market could fall in love with this is it. Whilst we cannot know the timescale over which the market will reward the coming earnings upside, we're quite confident it is there.

Norwegian Cruise Line Holdings (ticker: NCLH.US, US$4bn mkt cap)

We mention this stock because it was a (positive) contributor, but also because it has relevance to investment process and single stock risk management.

We invested in May after studying the industry. Someone recently asked why we were attracted to it, to which we quipped we were personally repulsed rather than attracted. The point being that the investment process is designed to plough through and hopefully correct for personal bias, given its reliance on numbers, data and our aspiration of ruthless logic.

We modelled several companies in the sector in April and concluded that they all potentially had more than 100% upside yet would likely all be insolvent before being able to capitalise on an eventual earnings recovery. Meaning these companies needed to raise a lot of liquidity as fast as possible.

We were surprised by the data we discovered in our research. We could see, systematically, that existing customers appeared to be applying their forced cancellation booking credit to future bookings and that on future sailings, the better class cabins were in some cases booking out fully. There was also clear evidence of new bookings.

The crux issue driving solvency risk was quite surprisingly supply not demand driven.

People wanted to sail. The relevant question was would they be allowed to.

We chose Norwegian as our horse because after they raised capital, they had the best liquidity profile in the sector and the smallest fleet and so were most likely to recover first.

And crucially, at the time of our investment, the US was clearly on a positive trajectory in terms of Covid-19 replication rates. Norwegian had commendably also embraced a need to proactively reconfigure their business to put health concerns first.

It seemed highly plausible, even logical at that juncture that the US would be able to move to a benign outcome and subject to sensible precautions and protocol, a future date of sailing resumption would be possible.

We were acutely aware that within the national case numbers there were regional trends. By example, New York was improving while other parts of the country were more ambiguous in their replication development trends.

Within a short time of our investment we saw that US southern state replication rates were not only not abating in the manner expected, they were deteriorating. The models should show over-forecasting errors if social distancing is proving effective, but in several of the southern US states it was the exact opposite. These states are particularly important because the single largest destination for the industry is the Caribbean and the logical embarkation points are in states such as Texas and Florida given US cabotage rules.

Whilst we had a price target implying well over 100% upside, that was only logically valid if the enabling conditions held true.

The single most lethal risk in our business is what we call thesis drift.

Succinctly: “if the reason you invested changes get the hell out and move on”.

When we saw unmistakable evidence of the US covid-19 replication rates rapidly deteriorating in Florida, Texas, Alabama and elsewhere we closed the position out. A crucial precondition to a successful long investment had been crushed by the data in a matter of weeks.

At the time we invested US daily case volume was less than half its current rate.

We now see US case rates that are currently 60-70,000 per day breaching 120,000 per day in the weeks ahead with daily deaths moving up to 4-5,000 per day.

Gary, James & Ben.

20th July 2020.

Geometrica Fund

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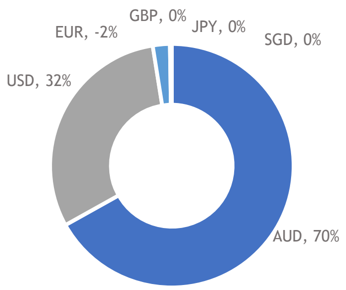
Fund overview (Alpha Units)

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



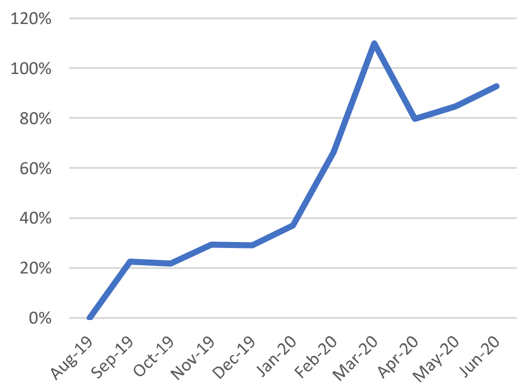
Investment performance (net)

	Founder Lead Series 2019	Founder Lead Series 2020
Jan	-	-1.3%
Feb	-	-0.3%
Mar	-	-5.2%
Apr	-	2.4%
May	-	7.9%
Jun	-	3.0%
Jul	-	
Aug	-	
Sep	1.1%	
Oct	0.8%	
Nov	0.1%	
Dec	-1.6%	
Total	0.5%	6.2%

Asset allocation

Country	Long	Short	Gross	Net
Australia	29.6%	(3.9)%	33.5%	25.7%
North America	38.7%	(1.5)%	40.2%	37.1%
Asia	9.4%	0.0%	9.4%	9.4%
Europe	9.6%	0.0%	9.6%	9.6%
Total	87.2%	(5.5)%	92.7%	81.7%

Gross exposure



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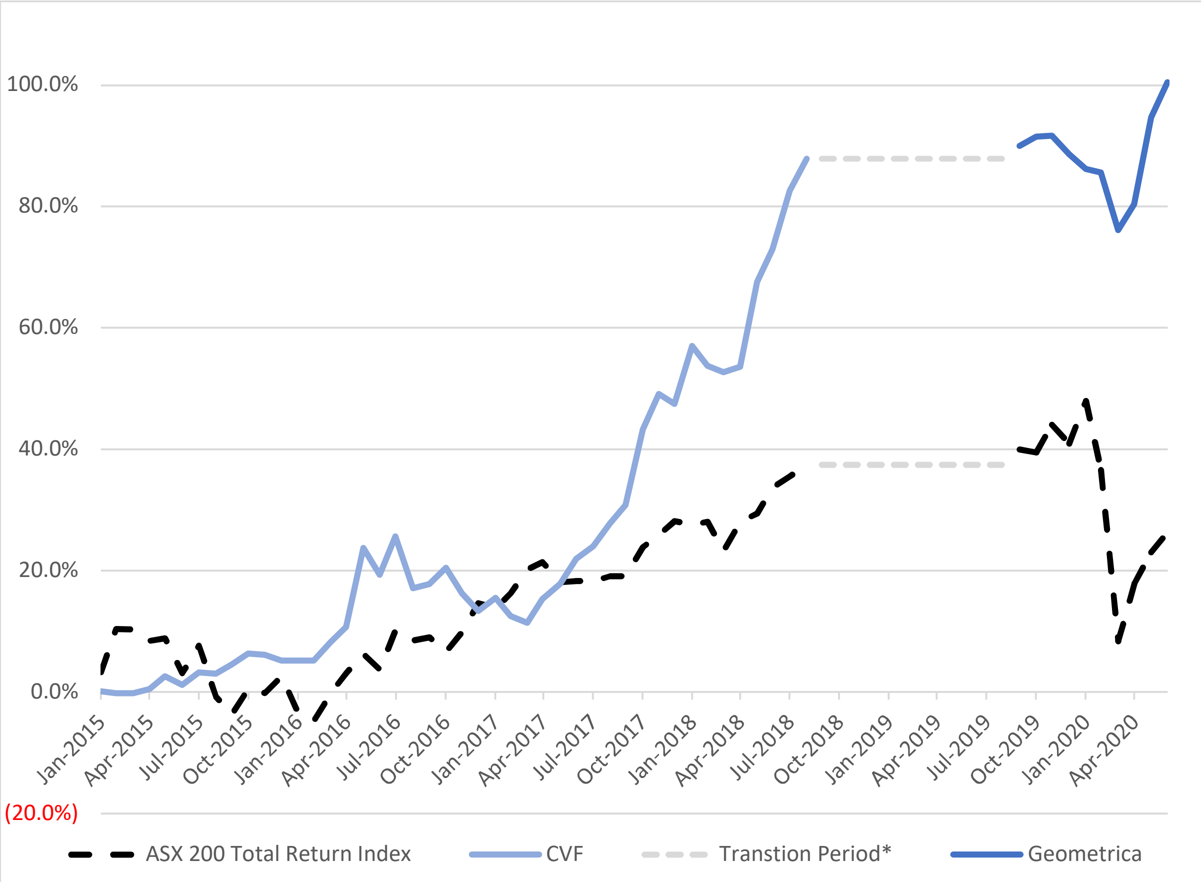
Manager performance history



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

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