Geometrica Fund

Investor Newsletter – January 2021

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.

Investment performance (net)

31 Jan 2021	Inception pa	CYTD	FYTD	12 months	6 months	1 month
Founder*	+21.28%	+4.45%	+23.18%	+32.52%	+12.48%	+4.45%

Source: Mainstream, ASX Announcements, Geometrica and Bloomberg. Performance is after all fees, from Jan 2015 – Jan 2021 (excluding the period of Sep 2018 – Aug 2019; Manager left CVF in Aug 2018 and began Geometrica in Sept 2019). MSCI = MSCI ACWI (AUD).

Overview

Net of all costs and fees, the Geometrica Fund returned +4.45%* for the month of January 2021. This brings trailing 12 month returns to +32.52%*

The five largest contributors to positive performance during January were all stocks we discussed in prior newsletters.

The single largest negative contributor during January was AutoDesk, which declined 9% during the month, attributable it seems to a broker downgrade. We started buying it below $160/share on the view the market will pay $400/share for it in the not too-distant future, so there's still lots of upside from the current $275/share.

GameStop was a topical stock. We owned it but exited back in December, in accordance with our investment process.

* *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.*

Portfolio

Shake Shak Inc. (SHAK.US, mkt cap US$4.8bn) was a material performance contributor. We initially acquired the stock in late 2019 after soft sales guidance saw the stock price crater. Our work at that time showed that a change in SHAK's delivery business model was the main driver of the soft guidance and as that was almost certainly going to prove transitory in nature, it represented an opportunity.

But then in February 2020, part way through a validating recovery in SHAK's stock price, along came Covid-19.

Our response in early February 2020 to the epiphany that Covid-19 was rapidly going global was to short sell the shares of potential victims. Quick Service Restaurants with high operating lease leverage such as Darden, Chipotle and even SHAK, were squarely in that wheelhouse. In response we sold our entire holding of SHAK shares at that point, and then sold a few more for good measure. We try as a rule to avoid incremental thinking in the face of an abrupt change in underlying data, as it can prove expensive. SHAK shares fell heavily thereafter.

Fortunately, we bought back in. Not at the absolute bottom; not even close. The bad news is that we missed the absolute rock bottom of $32.51/share. We started buying, in very small volumes, below $40/share, but our average entry price was much higher in the $60s[†].

The good news is that the stock hit an all-time high of $125/share in late January.

We've now materially reduced the position size. The upside asymmetry on offer has reduced for now. And our ambitions for our investment returns drive us to look for new opportunities with more attractive prospective return asymmetry.

Entain Plc (ENT.LN, mkt cap £7.3bn), previously known as GVC, caught a takeover bid in the first few days of January. It was one of our 5 largest holdings. Happy days.

We'd taken a look at the whole sports gaming sector after some heady stock price action. Curious and yet deliberately dispassionate, we simply wanted to ascertain if there was an opportunity, on the long or short side of our investing ledger.

Entain (then GVC) proved particularly interesting. Entain's stock price had been poleaxed not just by Covid-19, but also an adverse regulatory event that had clearly scarred investor perceptions and resulted in persistently depressed valuation levels.

When one took a global view, the hottest part of the sector was anything with US online exposure, because this area was growing at warp speed and was forecast to continue growing, as regulatory change ushered in online gaming. To some extent however, a part

[†] *As the fund continues to receive net inflows from new and existing investors, we add to positions that continue to offer compelling upside asymmetry. This has the effect of raising our average entry prices on positions where stock prices are rising.*

of online growth was coming from the hollowing out of incumbent players reliant upon physical assets for customer acquisition and activity.

MGM Resorts International (MGM.US, mkt cap $14.6bn) was one such huckleberry. But one of MGM's growth antidotes to the structural stasis of most of its business was an online US gaming JV. This JV operated with MGM providing the customers and a seasoned online JV partner provided the technical systems.

MGM's US online JV partner was none other than Entain.

In that context, Entain's valuation was curious. If you simply ignored the US online JV, Entain traded cheap relative to its comps. Include the JV and it traded screamingly cheap.

What was happening was that Entain was being valued by the market on *earnings*, but new US online players were being valued on *sales*. Because Entain was investing furiously in its US online JV, this depressed earnings at an aggregate level. Break out the US online JV sales and earnings before costs associated with the US JV and value Entain as two businesses and you had a bargain, growing fast too.

Digging deeper still to understand customer acquisition costs for all players in the US online gaming space (a murky area driven by disparate disclosure standards possibly designed to obfuscate) we came to the conclusion that Entain was holding its own and then some.

So, we bought stock in Entain (then GVC) on the premise that its fastest growing and prospectively most valuable asset wasn't in the price and that might change in the not-too-distant future.

MGM it seems broadly concurred. They announced an intention to make a takeover bid in early January. Entain's board then rejected the bid when it came as materially undervalued.

We agreed with Entain's view but framed our choices from the perspective of least regret. The two errors we could prospectively commit were:

(1) Hold out, the deal falls apart and the stock tanks, or;

(2) Sell and you miss a bump in the takeover price.

In the near term the risk of (1) appeared to exceed the upside of (2). You can probability weight this stuff but in the final wash out the outcome is binary. A bird in the hand really is worth two in the bush. We sold the entire position shortly after the bid was announced.

Which proved fortunate because after Entain's rebuff, MGM pulled their takeover bid and Entain's stock price fell double digits on that day.

Sezzle Inc (SZL.AU, mkt cap A$1.6bn) was a material contributor to performance gaining 30% over the course of the month.

We've written a fair bit about Sezzle in prior letters; I imagine hearing groans of fatigue from potential readers when we write on it now.

You'd struggle to call Sezzle a consensus buy idea. Maybe they didn't do themselves any favours with the name. And the whole Buy Now Pay Later sector is very polarising.

New sectors tend to be controversial. Upset the apple cart of consensus and woe betide.

But this is where real opportunity typically resides. Consensus views driven by bias drive market prices in the near term, but they don't drive ultimate outcomes. In the words of Ben Graham: "*In the short run, the market is a voting machine but in the long run it is a weighing machine.*"

We remind ourselves that when we bought into 3.2 million shares of Afterpay (APT.AU, mkt cap A$38.6bn) at $2.84 a share in June 2017 representing 12% of fund assets (sadly, at a prior fund), it was a decidedly controversial stock.

Another large positive contributor during January was **Domain Holdings Limited** (DHG.AU, mkt cap A$2.9bn) which caught a broker upgrade or two.

The upgrades we're seeing now are milestones on a journey, not the end point. We continue to think DHG has a lot more margin upside than is generally appreciated. This is particularly the case when you compare DHG to the market leader REA Group (REA.AU, mkt cap A$19.1bn).

Both DHG and REA will benefit from a recovery in Australian listing volumes. But DHG will see much faster earnings growth as it is simply a less mature business. Which translates into DHG having much faster prospective earnings growth.

We sold our position in **GameStop Corp** (GME.US, mkt cap US$22.7bn) during December, unfortunately perhaps a month too early but in truth there's not a snowballs chance in hell we'd be holding it above $100/share or even $50/share.

GameStop has become rather topical of late. It is not often you see a stock go from $18.84/share to $325/share in a single month.

GameStop is a video and console game retailer. It probably has more stores than all of its competitors combined. And it is in structural decline, afflicted by persistently negative same store sales as the software industry migrates online and game developers seek a direct relationship with their customers, bypassing GameStop's stores in the process.

When we acquired our toehold of a position, valuation was undemanding, and we could see a new console cycle was likely to lift sales levels such that same store sales would jump to being firmly positive.

The fly in this ointment was that the profit margins accompanying the new console cycle were likely to be very low based on our examination of prior cycles.

GME was actively engaging in self-help as well, by closing loss making stores and cutting costs. But they'd been doing this for years. It was management incrementalism resulting in a slowing of the rate at which their business melted like an ice cube; it wasn't changing the ultimate fate of the ice cube becoming a puddle of water.

Perhaps this is what made the short sellers so certain of the outcome and profit opportunity. But as a wise former colleague often said when pitched an all too obvious structural short candidate: *"the two most dangerous words in the English language are 'structural short'."*

The really big prospective upside we saw wasn't more self-help; it was transformative business model change. There was the potential for another line in GME's P&L to become lucrative, enduring and fast growing. Which is why we set to work and bought a smidgen of the stock along the way. Early indications were encouraging.

However, when we sought to test our work with the company and its suppliers, we hit a brick wall. We persisted to no avail. And then, bereft of an ability to test our hypothesis, we sold the stock.

This was of course just before the Reddit r/WallStreetBets sub orchestrated what was akin to a drive by shooting of a select few hedge funds that had made stupendously large targets of themselves by running leveraged short positions in a stock whose short interest was over 100% of its float.

To get to a point of greater than 100% short interest isn't that easy, but its evidently possible.

A shareholder lends 1 share to a short seller who sells it to an investor who then lends out the same share to the next short seller. 1 share on issue at that point supports a short interest of 2 shares.

Short positions are inherently more volatile than longs - one reason why our mandate limit on shorts is 3x smaller than for longs.

Anyone shorting a stock with very high short interest needs their heads read, because all investors make mistakes, but when you make a really big mistake on a really large short position using leverage, you run the risk of blowing not only your own brains out but those of your investors as well.

GameStop's share price *will* crater from today's level of $325/share (at 29 Jan 2021). This outcome is a mathematical certainty. All pyramid schemes ultimately collapse.

But the temptation to bet on it is the financial equivalent of a suicidal thought.

Fundamentals are irrelevant. No one is buying GameStop at $325/share because they think earnings will beat.

This is a financial bare-knuckle fight. Melvin Capital, squarely in the ring, has reportedly lost US$4.5 billion or over 50% of its capital in January alone, largely attributable to its GameStop short position.

The buyers working to squeeze the short sellers know that as the price goes up, short sellers exposure rises and they're forced to cover their shorts, typically by mandate restrictions but ultimately by their prime brokers or fund liquidators. So, on the way up once you clear the gravity of fundamentals, you have two groups of buyers and no natural sellers.

But wait, it gets worse.

Look at it through the lens of Melvin. If you assume that 50% or $2.25bn of Melvin Capital's reported January loss of $4.5bn is attributable to GameStop, at today's share price it works to a 6.9m share short position.

Back on 31 July 2020 at $4.01/share those 6.9m shares were only worth $27.8m and it would have been 0.31% of capital.

Today though the 6.9m share short position is "worth" -$2.25 billion or -25% of their starting capital!

Now if you have a 6.9m share short position, equivalent to multiple days of turnover in a stock, its very hard to cover. Because once you start to cover, all the little funds who are short start front running you and buying to cover. It's like setting off a stadium stampede.

The reason the stock must crater is that the Reddit army piling into the stock above $100 a share are in a pyramid scheme. All pyramid schemes collapse with the variable being how many people get sucked into it, i.e. at what level does it peak.

Sooner or later participants want to take a profit. The more the stock price rises the greater that temptation. The temptation is greatest for the early participants.

When the incremental profit taker outweighs the buying from new recruits, the stock price must fall. At this juncture the pressure on short sellers to cover eases and a source of frenzied buying is removed. And the incentive to take profit for the Reddit army rises rapidly and a source of frenzied selling is introduced.

The bigger question is why GameStop hasn't issued a massive block of primary shares at a ludicrous price to allow the shorts to cover and build a cash pile to boot. Why look a gift horse in the mouth?

20m primary shares at $50/share would allow the 1/3rd of the shorts to cover at a massive discount, eradicate the company's debt and be wildly accretive to any remaining shareholders that aren't in the r/WallStreetBets retinue, because the stock isn't worth anything close to $50/share.

Founders Class units – Approaching Close

Founders Class units have lower fees than our standard Alpha Class units.

The Geometrica Information Memorandum stated that no more than 50 million Founders Class units would be on issue at any one point in time.

We have issued just under 30 million Founders Class units to date. Based on the pattern of recent investor inflows, we project that we will cease issuing Founders Class units at some point in the next five months.

Meaning if you want any, you should let us know.

The Geometrica Team

4 February 2021.

Geometrica Fund

Investor Newsletter – January 2021

Fund overview (Alpha Units)

Fund	Geometrica Fund	Investor Eligibility	Wholesale only
Structure	Wholesale unit trust	Platforms	Ausmaq, Hub24
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	Administration & custody	Mainstream Fund Services
Buy / Sell Spread	Nil / 0.25%		

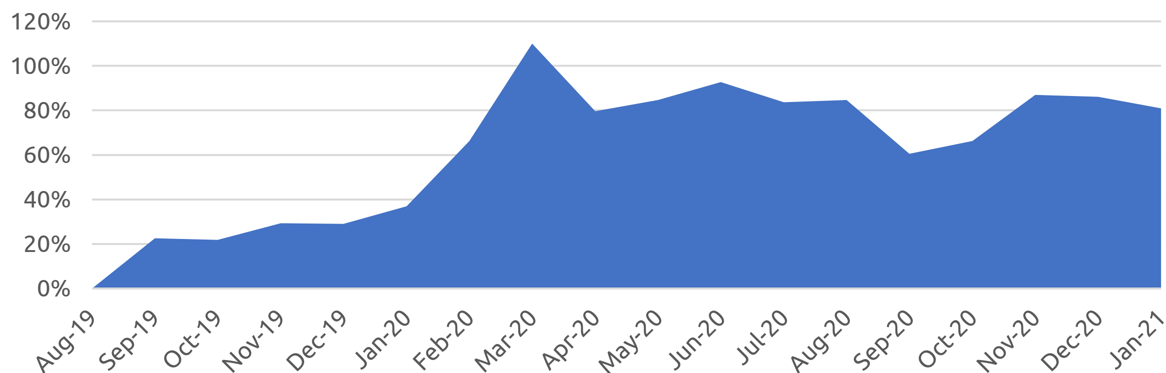
Investment performance (net)‡

	2019	2020	2021
Jan	-	-1.3%	4.5%
Feb	-	-0.3%	-
Mar	-	-5.2%	-
Apr	-	2.4%	-
May	-	7.9%	-
Jun	-	3.0%	-
Jul	-	9.5%	-
Aug	-	3.5%	-
Sep	1.1%	-1.4%	-
Oct	0.8%	-1.4%	-
Nov	0.1%	4.8%	-
Dec	-1.6%	2.0%	-
Total	0.5%	25.2%	4.5%

Asset allocation

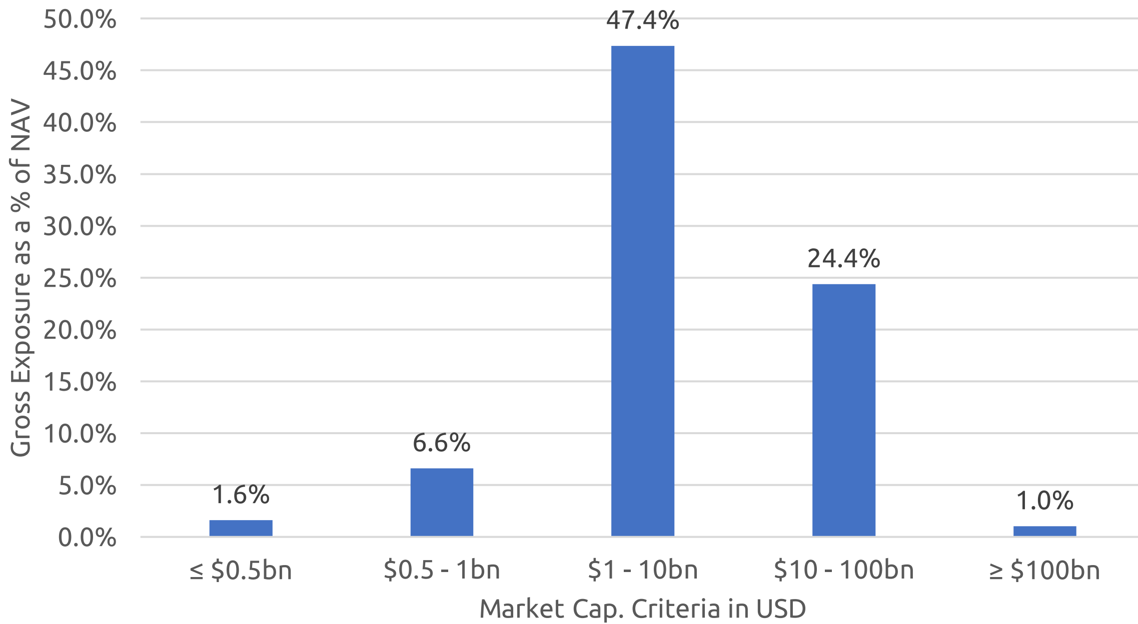
Country	Long	Short	Gross	Net
Australia	33.5%	(2.3)%	35.8%	31.2%
Americas	26.7%	(4.7)%	31.4%	22.0%
Asia	2.4%	0.0%	2.4%	2.4%
Europe	11.4%	0.0%	11.4%	11.4%
Total	74.0%	(7.0)%	81.0%	67.0%

Gross exposure

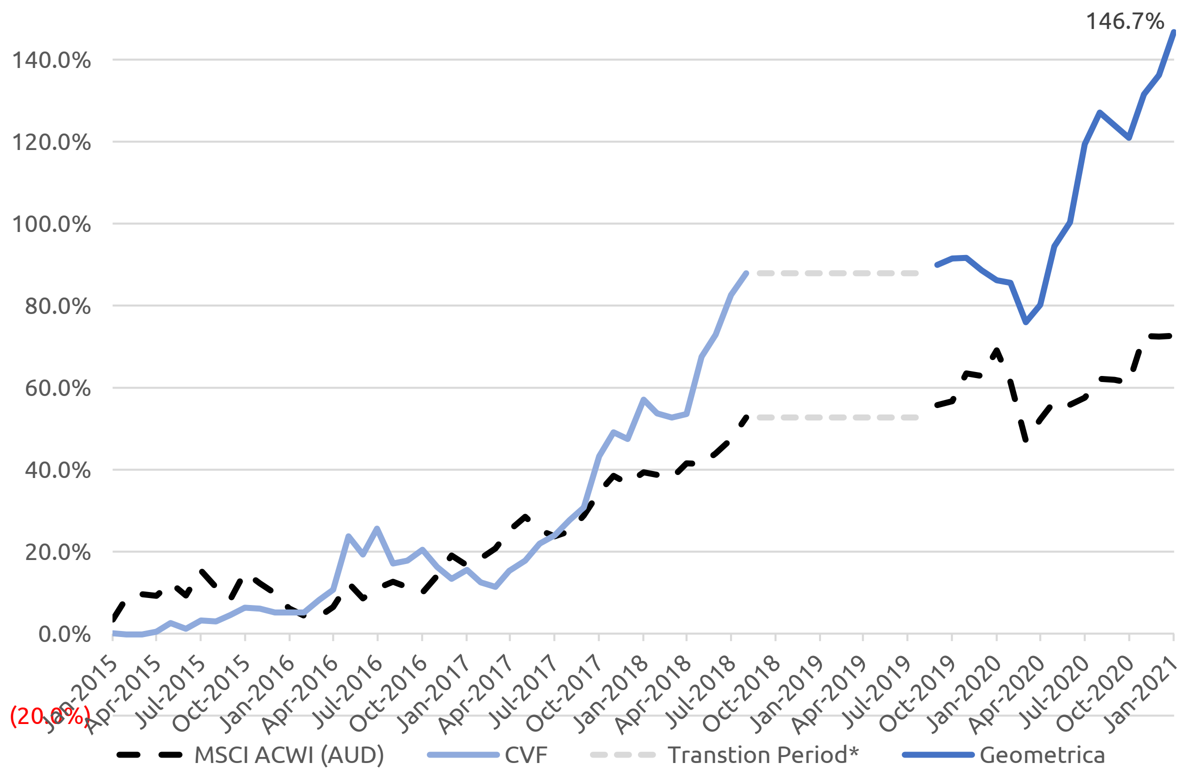


‡ *Founder Class units – Lead Series*

Gross exposure by market capitalisation



Manager performance history



*** Manager left CVF in Sept 2018 and began Geometrica in Sept 2019 NB: Performance period is from 5 Jan 2015 – 31 January 2021. Performance is net of all fees.**

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.