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**1st December 2021**

# November Investor Letter

## OVERVIEW

We estimate the Geometrica Fund closed down -4.6%[1] in the month of November.

There are three messages we would like to convey in this letter:

1. What happened.
2. What we did.
3. Why we believe this presents opportunity.

| Top 5 stocks (alphabetically) |
|---|
| ASICS |
| Autodesk |
| Daiichi Sankyo |
| HelloFresh |
| IDP Education |

The negative contributors were concentrated in a few stocks, including AutoDesk, Opendoor Technologies and Entain Plc.

The price declines in these stocks preceded the news of the Omicron mutation of Covid-19. Omicron had less impact on the portfolio. Below, we explain what happened and what actions we've taken.

Positive contributors during the month included HelloFresh, Advanced Micro Devices, Shake Shack and a series of shorts.

## PORTFOLIO

A quick look at the back page of this newsletter (which lists our monthly return history) will show November 2021 as an outlier.

This outlier was caused by a number of negative catalysts occurring around the same time in some of our top holdings.

We have spent a significant amount of time digging into these events to understand whether or not they constitute a thesis break and we do not believe this to be the case.

As stock pickers we are most interested in our entry and exit price.

Inevitably between those two points there will be a price pattern of volatility a stock will traverse in its journey of price discovery.

Our approach is not to just blithely accept negative aspects of that price action.

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[1] *These figures are estimates, calculated by the investment manager and may be subject to error. Final performance figures calculated by the Fund's external administrator will be reflected in the Fund's monthly newsletter and unitholder's monthly NAV statements, dispatched to all unitholders directly by the Fund's external administrator. These figures refer to the Founders Class units – Lead Series*

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Rather, we run a portfolio of stocks which are deliberately diversified across sector, geography, type of investment and even stage of thesis. All this to dampen volatility at an aggregate portfolio level.

We then go a step further by varying the sizing of our stock positions through time according to how they score on expected return, asymmetry, and our ability to access relevant alternative data, noting the questions of asymmetry and alternative data can be related (it works a whole lot better when that's the case).

Generally, this approach works to dampen volatility from month to month across the portfolio whilst allowing the stocks to shine as they undergo price discovery.

This is crudely analogous to throwing 2 dice rather than a single dice. For a single dice, the chance of throwing the lowest score of 1 is 1/6 = 16.7%. With 2 dice thrown the chance of throwing the lowest score of 2 (i.e. 1+1) is 1/36 = 3%. There are clear benefits to diversification, but they diminish as your number of stocks increases. And no amount of diversification can stop you occasionally throwing snake eyes.

**Entain Plc** (ENT.LN, mkt cap £9.8bn) was a detractor during the month, falling from £20.48 on 29 October 2021 to £16.69 on 30 November 2021, a decline of -18.5%.

We bought Entain back in 2020 because we could see in two data sources that Entain's BetMGM was taking market share from Flutter and Draftkings.

The consensus view at the time was Flutter and Draftkings would dominate. Our perspective was decidedly non-consensus.

Buying into situations offering significant change, where market participants will be forced to change their views, can deliver large returns.

Being dogmatic in a view can of course deliver the exact opposite. Which is why we always go back to evidence and data and why we will happily change our view on a dime when the underlying evidence changes.

**US online sports gaming stocks**

| Name | Ticker | Market cap. (US$m) | 30-Nov-20 | 30-Nov-21 | 1 year return | Month of November 2021 |
|---|---|---|---|---|---|---|
| Flutter | FLTR LN | 23,775 | £137.05 | £101.90 | **(25.6)%** | (26.1)% |
| DraftKings | DKNG US | 14,043 | $52.36 | $34.55 | **(34.0)%** | (25.8)% |
| Entain | ENT LN | 13,015 | £10.36 | £16.69 | **61.2 %** | (18.5)% |

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This month, the sector sold off on fears that competitive intensity would reduce long run profitability for all players. UK gaming reforms were also a factor for Flutter and Entain.

In the near term the competition fears are credible. Any sector experiencing a sudden rapid influx of capacity tends to experience pricing pressure.

A plethora of the smaller companies in this sector are unprofitable, lack cashflow and are reliant for their ongoing funding upon the continued credulity of capital markets which appears to be waning fast.

These smaller players are probably either going to go bust or consolidate. As this happens, and capacity is removed, pricing pressures will abate.

Because capacity in the industry is digital, not bricks and mortar, the competitive structure of the market can change fairly quickly.

After the negative wave of competition and UK gaming reform is priced in and we have an inkling of structural improvement, a few of these stocks will be very attractive. These are the ones that are taking market share by means other than spraying cash at the problem.

Longer term, the industry has a cost curve, meaning at a certain price some will be able to make money, and some will not. We own in modest size now two players with distinct structural advantages. We believe both will more than double in value, probably across the next two years.

We just have to keep monitoring the evidence and avoid dogma. Excessive confidence in a predicted outcome that flies in the face of evidence is a sure-fire way to turn a good investment into a bad one.

**Opendoor Technologies** (OPEN.US, mkt cap US$9.7bn) was another detractor during the month. We've spent a lot of time developing a means to track unit and state level profitability in this business.

Opendoor are an "iBuyer" meaning they use a model to buy houses, offering a typical potential customer a hard cash offer for their existing home that they can use in bidding for a new home, typically as part of an upgrading transaction.

Opendoor typically charge a vendor 5% and don't seek to make much on the price spread between buy and sell price. The unit cost for the vendor makes sense, largely due to the US having a prevailing real estate brokerage rate of ~6%, which they avoid paying by selling to Opendoor. In the very long run this may end up being a problem for Zillow's core business, but we're nowhere near that point yet.

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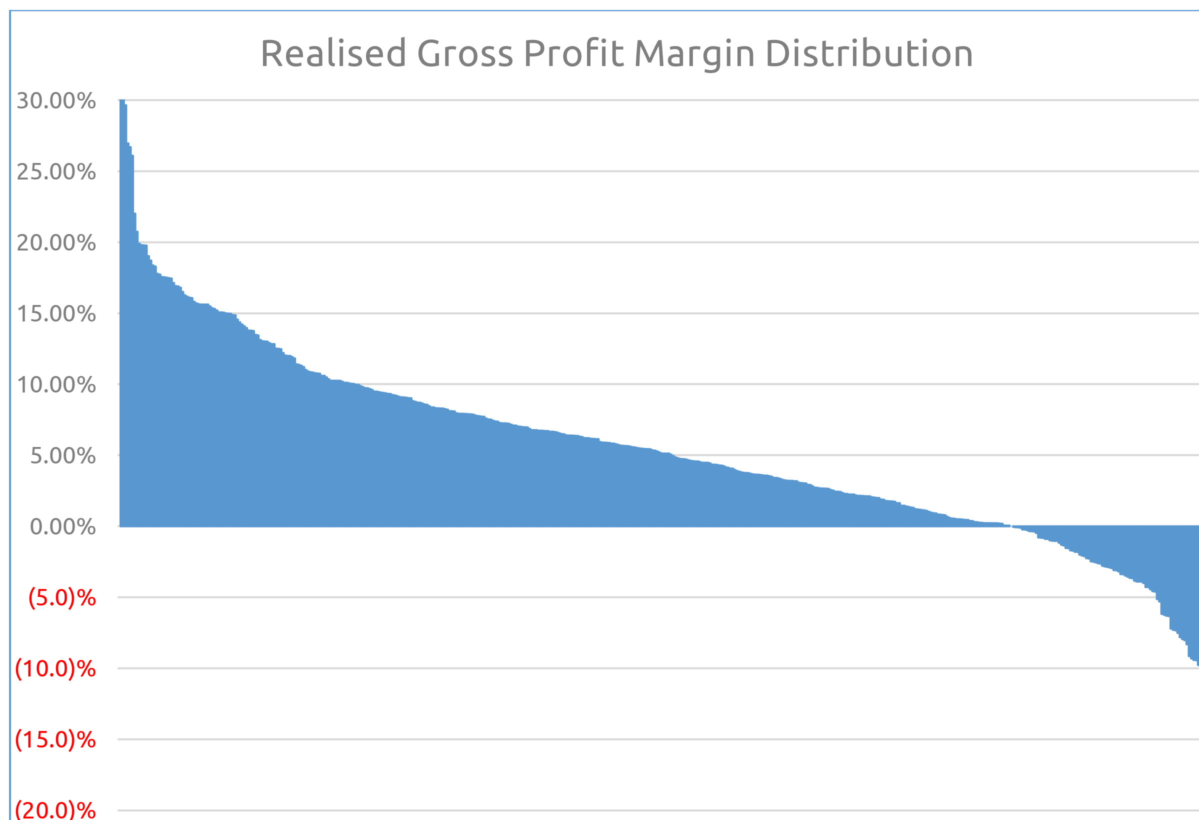
We probably got a little over-confident in this stock because we think we can understand with some granularity what kind of profits they're earning through time.

The other insight our work appears to yield is that the company may not be as reliant upon algorithmic buying as some think. It looks like there is some human intervention.

A typical pricing model with predictive power should display some homogeneity of variance between buy and initial offer price – we should be observing a highly homoscedastic variance between these two sets of numbers, yet we are not.




Source: Geometrica

This isn't fatal; it may be that the pricing algorithm used in the business is a work in progress given the significant complexity in pricing a highly heterogenous asset.

But what really screwed things up in November for Opendoor was Zillow shocking the market by announcing it was exiting the iBuying sector after racking up big losses.

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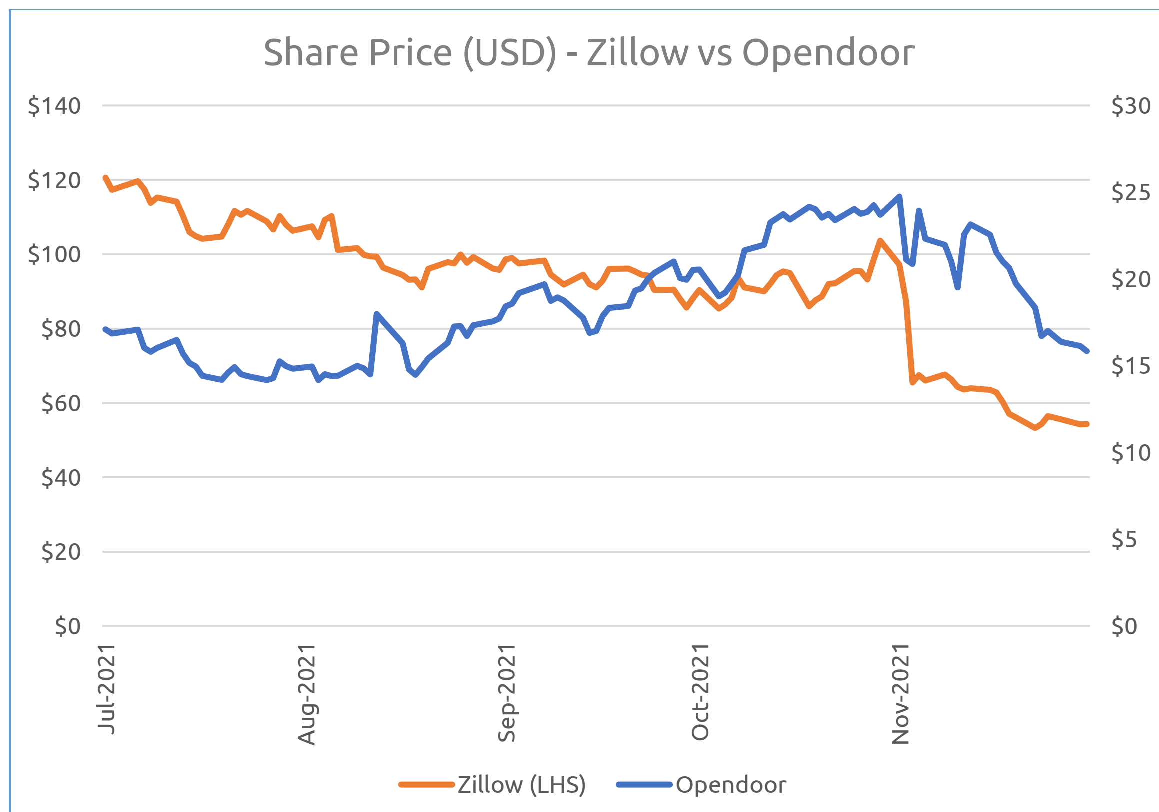
Reading between the lines, Zillow appears to have been rushing to buy market share by offering extremely aggressive prices for houses resulting in losses upon sale.

We think with very good reason that Opendoor continues to have a positive contribution margin after direct and variable costs.




For now we've reduced our sizing. But we're watching the space closely for an improvement in Opendoor's margin profile which might yet force the market to reassess the stock after it was tarred with the same brush as Zillow.

And remember: the biggest competitor has just exited the sector. Usually, a decrease in competition means more profit for the remaining industry participants. OpenDoor is of course the largest of these.

Having the answer in terms of potentially knowing revenue and gross profit before a company announces them to the market doesn't help you when something from left field hits. But if this stock does ultimately track earnings, then we should be well positioned to make money out of it.

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**Autodesk** (ADSK.US, mkt cap US$55.9bn) also cost us during the month. Thankfully, we had sold out the stock we'd bought on the last share price dip. We've added incrementally to the position very recently.

The stock sold off after guidance undershot expectations, largely around new customer additions. Autodesk's end markets are construction, architecture and manufacturing. In some of these markets, customers have excellent order backlog but are struggling to turn that into revenue due to shortages of labour and goods. This in turn is impeding Autodesk's capacity to grow new customers (i.e. software "seats").

The back book of business is very strong as net revenue retention is high at close to 110%. Put another way, revenue from Autodesk's 2020 customers is now 10% higher in 2021 – implying a mix of low customer churn, price increases and product up selling.

We can also see growth in recurring revenue is holding up. We can see Autodesk is outgrowing its competitors. We have done channel checks around competition; this is a factor in China where local companies are strongly encouraged to use local software providers, but Autodesk's China business is very small.

Because the stock is cheap relative to comps yet growing twice as fast, we think only delivery of growth will see it exit its current funk. We've added incrementally to the position.

It may be a bold statement, but Autodesk exhibits many similarities to Adobe before that stock really took off. Into the later stages of its conversion from perpetual licence sales to a full SaaS and cloud-based offering there remains considerable scepticism around operating margin targets. Time should be the salve here.

The positive contributors during the month were **HelloFresh** (HFG.GY, mkt cap €15.5bn), **Advanced Micro Devices** (AMD.US, mkt cap US$191.2bn) and **Shake Shack** (SHAK.US, mkt cap US$3.1bn).

The issue with these stocks was sizing.

HelloFresh we owned at the start of November but in small size as we'd expected margins would not bottom until the next quarter at which point we planned to increase our position.

**HelloFresh** we think will experience ongoing margin growth from here as fulfilment costs are fractionalised and return to levels more akin to before Covid-19.

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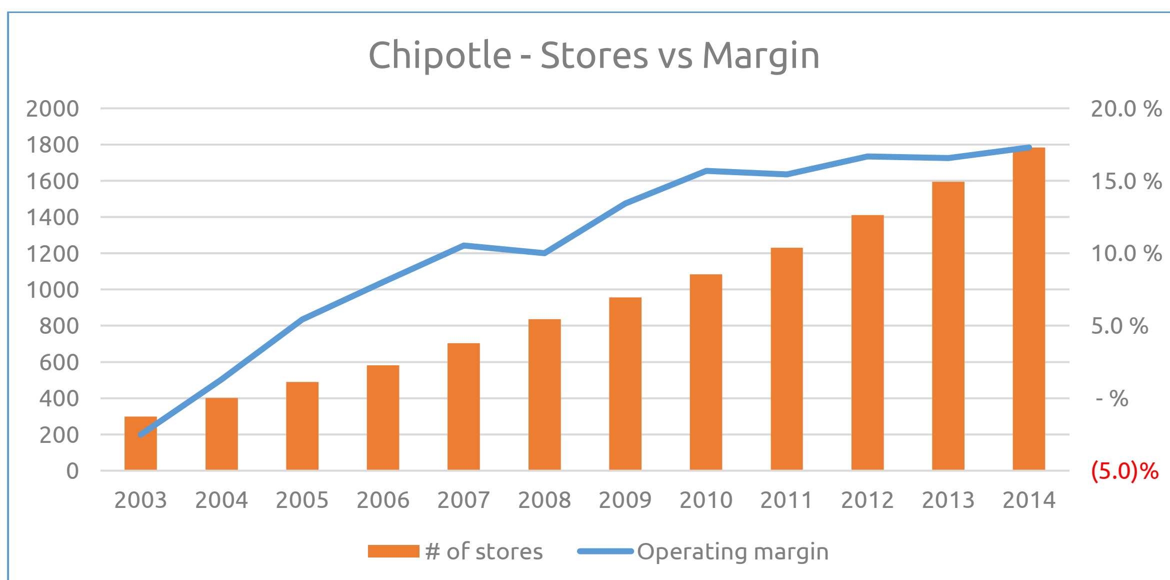
**AMD** similarly we had reduced in size. A presentation by AMD's CEO during the month provided further evidence that AMD was eating Intel's market share in the server market. The stock ran up 31% during the month.

**Shake Shack** is a small position we added to very recently. We have invested in this and other stocks in the QSR industry on both the long and short side successfully previously.

Shake Shack's average store sales are very high and the concept is unusual in that it's been proven to work across multiple global markets.

Because there are less than 210 company stores in the US, versus over 2,500 for, say, Chipotle, Shake Shack's margins are immature. But we think this will change as the business rolls out new stores, which it is doing at pace.

By looking at analogues and undertaking benchmarking, we see large margin upside for Shake Shack as fixed costs are fractionalised over an ever-expanding sales base and company level margins converge close to store level margins. For example, the history of Chipotle's margin development as it grew stores is shown below. This bodes well for Shake Shack.




Source: Company announcements

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## CONCLUSION

In closing, we never want to deliver outlier results but they will occur from time to time. When that happens we will communicate with you in a forthright manner. For now, we are working once again to find highly idiosyncratic stocks that can buck the macro and perform and where our evidence and data based investment process can confer an edge.

As ever, thank you for your trust.

Team

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## INVESTMENT PERFORMANCE (NET)[2]

| | 2019 | 2020 | 2021 |
|---|---|---|---|
| Jan | - | -1.3% | 4.5% |
| Feb | - | -0.3% | 6.9% |
| Mar | - | -5.2% | 1.2% |
| Apr | - | 2.4% | 3.0% |
| May | - | 7.9% | -1.5% |
| Jun | - | 3.0% | -0.7% |
| Jul | - | 9.5% | -1.4% |
| Aug | - | 3.5% | 2.6% |
| Sep | 1.1% | -1.4% | 3.1% |
| Oct | 0.8% | -1.4% | -0.6% |
| Nov | 0.1% | 4.8% | -4.6% |
| Dec | -1.6% | 2.0% | - |
| **Total** | **0.5%** | **25.2%** | **12.8%** |

[2] *Founder Class units – Lead Series*