April 28, 2023

COMMENT ON PERFORMANCE

The Fund's underlying holdings performed relatively in line with our expectations except for our long position in Colliers International Group (CIGI) and our short position in Tesla (TSLA). Colliers has been a modest contributor to our performance year-to-date while Tesla has been a modest detractor.

Colliers has outperformed the market this year despite the stock being down ~15% from its mid-February highs. The company reported better than expected results and issued better than feared guidance, and the stock was briefly rewarded, before giving it all back over the following month. Investors are clearly worried about anything commercial real estate related given the enormous stress in the regional banking sector and a wall of debt coming due in 2024 that will require refinancing. Our belief is this will only have a slightly negative impact on Colliers EPS.

We closed our long position in Activision Blizzard (ATVI) on the last trading day of the quarter. We initiated the position in November 2021 and, despite crystalizing a gain on the investment, we are admittedly a little frustrated with how this has played out. In January 2022, Microsoft (MSFT) agreed to acquire the company for $95/share, but regulators are determined to block the transaction, and appear increasingly activist, in our opinion.

MARKET COMMENTARY

In the first quarter, nihilistic behaviour accompanied widespread soft-landing hopes and the fear of missing out was pervasive. Investors were eagerly anticipating cooler inflation data and a subsequent pause in the Fed's rate hiking cycle. Then suddenly, in a matter of weeks, we experienced multiple regional bank failures, bailouts (that were considered "Not Bailouts" for political reasons), and the biggest three-day decline in 2-year U.S. Treasury yields since the stock market crash in 1987. Financial stability, rather than inflation, will likely drive policy decisions now.

Risk assets since the bank failures in mid-March have been buoyed mainly due to the following two factors. First, the expectation that policy makers have taken enough action to prevent further contagion in financial markets. The immediate fallout has effectively been contained and the worst-case scenario for what these failures could have been has been taken off the table. Second, the Fed's rate hiking cycle finally "broke" something in financial markets, suggesting further rate hikes, if any, will be minimal.

Equity performance during the first quarter experienced a distinct sector rotation towards higher beta sectors. Technology and consumer discretionary largely outperformed defensives such as healthcare and utilities. We continue to expect the market will remain somewhat directionless and choppy for the near future until the uncertain macroeconomic outlook becomes clearer.

MOVE FAST AND BREAK THINGS

Mark Zuckerberg originally coined the phrase "move fast and break things" which served as Facebook's company motto until 2014. In the early days, Mark Zuckerberg prioritized speed and believed moving quickly was so important that tolerating a few bugs was a small price to pay for increased expediency. Over time, however, going back and re-writing poor code became too costly and too time consuming that it actually slowed the company down.

Short term gain for long term pain inevitably becomes untenable and, thus, the motto was eventually changed to "move fast with stable infrastructure" as Facebook grew. While this shift in attitude was a subtle turning point in the company's maturation process, the phrase itself was fairly boring. We suspect fewer employees were inspired by such an innocuous statement compared to the trailblazing mission that preceded it.

Nonetheless, the 'move fast and break things' adage remained incredibly popular amongst startups and venture capital firms especially in the technology industry. Founders glorified thinking way outside the box to foster improved innovation, launching minimum viable products before potential competitors could get to market, playing it fast and loose with regulatory requirements, utilizing ultra-aggressive growth strategies, breaking the concept of positive unit economics, and re-defining metrics like Adjusted EBITDA, etc.

In our opinion, some of this attitude is required for creative destruction to thrive in a free market economy. On aggregate, the benefits will outweigh the costs when applied correctly under the right circumstances. But it is important to recognize one size does not fit all. While moving fast can be beneficial in certain sectors with a lot of innovation, such as technology, it can be equally bad for more static sectors that do not, such as finance and banking. For example, it is less applicable to central banks, where the fastest rate hiking cycle in history broke regional banks.

Gradually, Then Suddenly

"How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly."

Ernest Hemingway wrote The Sun Also Rises in 1926. While most people haven't read the novel, and some may not even be able to attribute its origins to Hemmingway, the concept of gradually and then suddenly permeates throughout society. Related concepts, among others, include Bak's Sandpile, which we have previously written about, and The Tipping Point, which went mainstream after Malcolm Gladwell published his best-selling book.

Small changes accumulate over time and then suddenly, in the blink of an eye, everything changes all at once. This phenomenon applies to technological innovation, geopolitical conflict, revolutions, crowd psychology, natural disasters, and of course, bankruptcies. Everything is seemingly fine until it isn't.

The bankruptcy of Silicon Valley Bank (SVB) was the epitome of gradually and then suddenly.

- **March 7, 2023:** Silicon Valley Bank presented at the Morgan Stanley TMT conference. SVB's balance sheet, held-to-maturity losses, insolvency, or anything even suggesting trouble was not mentioned even once.

- **March 9, 2023:** Silicon Valley Bank stock price fell 60%. VCs and startups began to pull money out of the bank totaling $42 billion in withdrawals, the largest bank run in history.

- **March 10, 2023:** U.S. banking regulators assumed control of Silicon Valley Bank before market open.

- **March 12, 2023:** The U.S. government announced it would backstop all deposits, including deposits above the $250,000 FDIC limit. Even still, the U.S. government remained unable to find an adequate buyer for SVB.

There has been no shortage of spilled ink with respect to analyzing how quickly this bankruptcy unfolded, debating who was ultimately at fault, and weighing the ethical considerations about how the bailout was structured. Our opinion is as follows: There is plenty of blame to go around. Silicon Valley Bank found itself at the centre of a perfect storm partly due to its own missteps and partly due to factors beyond its control.

Unlike other regional banks, Silicon Valley Bank had a niche depositor base that was unusually susceptible to tighter financial conditions. Rewinding back to 2020-2021, enormous fiscal spending and easy monetary policy disproportionately benefited their depositors and the bank found itself flooded with fresh new deposits. Those fresh new deposits had to find a home somewhere.

Perpetual ZIRP made it challenging for yield-starved banks to generate adequate NIMs. As a result, Silicon Valley Bank ended up piling a lot of those new deposits into longer-term Treasuries and mortgage bonds, exacerbating the duration mismatch between its assets and liabilities. While government guaranteed bonds have virtually no credit risk, the securities still carry significant interest rate risk. Generally, this isn't a problem if banks intend to hold the bonds to maturity but when customers want their deposits back, they don't have the option.

Fast forward to 2022 when the Fed starts raising interest rates and starts raising them quickly. As interest rates kept rising, the value of Silicon Valley Bank's long-term Treasuries and mortgage bonds eroded quickly. Accounting rules are different depending on how a bank categorizes its assets. Securities that are considered available for sale require mark-to-market accounting. Held-to-maturity securities do not. This means Silicon Valley Bank, despite having significant paper losses on its Treasuries portfolio, did not take an impairment charge and reported earnings obfuscated the carnage that was taking place on its balance sheet.

Risk management was horrendous at Silicon Valley Bank which, in our opinion, there is no excuse for. The management team simply dropped the ball. We understand that from a tax standpoint, banks are disincentivized to hedge interest rate risk on held-to-maturity securities (and these losses can obviously become very large) but this was particularly egregious, in our opinion. Worth noting, other banks failed too so it was not an isolated incident.

Depositors at Silicon Valley Bank, which were mainly corporations, are also partly responsible. Approximately 96% of the bank's deposits were in excess of the FDIC limit, and therefore uninsured, at the time the bank failed. If several sophisticated companies willingly chose to hold anywhere from $50 million - $487 million dollars in uninsured bank deposits, then perhaps those businesses should take a hair cut when said bank fails. Otherwise, making them whole disincentives other businesses to prudently manage their cash going forward.

FINANCIAL STABILITY VS. DUAL MANDATE

Opinions vary widely but the ultimate scope and severity of the regional banking crisis remains to be seen. Silicon Valley Bank was badly mismanaged but there were also extraneous factors that negatively impacted even the most prudently run banks. The flood of new deposits from 2020-2021 are being unwound at the same time bond portfolios are experiencing significant losses across the board. We expect customers to continue moving their bank deposits into higher yielding instruments like money market funds which carry higher returns with less risk.

Even if the worst is behind us, we believe credit conditions will tighten rapidly from here. Banks "create money" via lending and if there is widespread general risk aversion to underwriting new loans, the obvious result is less lending. Less lending means banks will conduct the quantitative tightening that central bankers rarely have the stomach for. Worsening credit conditions increase the likelihood of a recession and are disinflationary by nature.

The Federal Reserve can really only fulfill its dual mandate as long as financial stability is not threatened. When forced to choose between two, the Fed will choose financial stability every time. The market believes the next rate increase will be the last one in this hiking cycle, not because inflation is totally under control, but because instability risk is rising. Any pause thereafter will probably be delivered with an abundance of cautionary language.

We believed, like many other market participants, that the Fed would continue hiking interest rates until something broke, and something eventually did. As discussed in our annual letter, the timing of when the pause begins is less important than the duration of the pause once it finally arrives. We wonder how long the Fed can maintain its higher for longer stance given recent stress in the banking sector. Underlying economic weakness on top of that will make it even more challenging. Any whiff of further financial instability and they likely pivot quickly.

REPAIRING MALINVESTMENT

The ZIRP era lengthened cash-burning runways for early stage disruptive companies with uneconomical business models and, after more than a decade of ultra-low rates, the accumulated malinvestment has been significant. Unwinding that misallocation of capital will be a similarly lengthy process and we are beginning to see evidence this painful process may already be underway.

The post-GFC paradigm of 'high revenue growth combined with perpetually negative earnings' only works until there is a meaningful cost of capital. In our opinion, this prior investment paradigm cannot possibly co-exist with the Fed's higher for longer policy stance which suggests we may be on the cusp of a paradigm shift. Real interest rates will have to drift back into ZIRP (or NIRP) territory to justify a continuation of the last paradigm.

We have written about how profitless companies have responded to an increased cost of capital by starting with low-hanging fruit. Raising prices and cutting costs is the first step towards cash-flow breakeven. We have already seen growth rates crater since revenues were heavily dependent on their products remaining structurally underpriced in the first place. Simultaneously pulling back on advertising spend was a double whammy. Stock prices for many of these companies have bounced year-to-date but remain decimated from all-time highs and rightfully so.

What is relatively new, however, is that we are beginning to see substantial write-downs and impairment charges. For instance, Lululemon (LULU) is already exploring a sale of Mirror, the struggling fitness technology company it bought less than three years ago for half a billion dollars. Lululemon executives recently announced a $433 million impairment charge on the business (-89%). That is not an insignificant amount of money.

Just Eat Takeaway (AMS:TKWY) is another shining example of pandemic-era misallocation of capital. The cash-incinerating online food delivery company recently reported nearly €5 billion in write-downs associated with mergers and acquisitions that were announced after the pandemic had already started. The company is exploring a sale of GrubHub, which was acquired for $7.3 billion worth of stock in June 2020, but is struggling to find a buyer. For those wondering, Just Eat Takeaway currently has a market capitalization of €3.5 billion, by the way.

These specific examples are not isolated events either. And while they are both egregious post-pandemic transactions, make no mistake, malinvestment has occurred over the past decade of artificially low interest rates and excess liquidity. Acquisitions over the past few years have been historical outliers from a valuation standpoint. Of course, it's only appropriate write-downs begin with that vintage. But if interest rates remain higher for longer, and we are on the cusp of a paradigm shift, continued impairment charges may be a warning sign.

LOOKING AHEAD

In our opinion, the risk of recession continues to rise. Recent banking stress will almost certainly lead to a credit crunch, although the severity of that crunch cannot yet be known. Further interest rate hikes will increase the likelihood of a more severe credit crunch with more unpredictable ramifications. We maintain that manipulating interest rates and credit supply is an indirect and blunt object to achieve the Fed's mandates. The unintended consequences of such policy decisions will only surface after a long lag.

We continue to expect elevated stock market volatility going forward. We also expect higher volatility in traditionally lower volatility asset classes. We are hopeful that, if such a scenario unfolds, investors with long-term time horizons will be presented with attractive opportunities to purchase select securities at significant discounts to intrinsic value. We entered the year expecting to trade more and, although that has not happened yet, we continue to wait patiently for deeper bargains.

Sincerely,

A. Agostino

Alexander Agostino

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