ALPHYN CAPITAL
MANAGEMENT

Alphyn Capital Management, LLC
100 Duffy Avenue, Suite 510
Hicksville, NY 11801
samer@alphyncap.com
www.alphyncap.com

Letter to investors, Q2 2020

Performance

The Master Account, in which I am personally invested alongside SMA clients, returned 14.4% net in Q2 2020, as reported by our fund administrator. As of June 30th, 2020, the top ten positions comprised approximately 69% of the portfolio, and the portfolio held approximately 20% in cash.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020 YTD	-10.4%	-3.1%

In this letter I discuss why many of the companies we own are positioned to do well over the long term due to their advantaged business models. I believe it is important to maintain this perspective in markets that are news-driven and, perhaps, influenced by the Fed.[1]

Synthetic Leverage and discounts to holdings

Some companies with advantaged business models can safely leverage alternative third-party sources of capital or operations to generate significant incremental income. I broadly refer to this as "synthetic leverage." Probably the best-known example is Warren Buffett financing his investments at Berkshire Hathaway with insurance float. While it is standard practice for insurance companies to invest their float in relatively safe fixed income, Buffett excelled at using float to invest in equities and buy whole companies.

Over 70% of our portfolio is invested in companies that have "synthetic leverage." Leverage is of course the use of borrowed capital to amplify investment returns. Investors can borrow against the value of the assets they are buying, for example with real estate, or use margin loans in the case of public securities. Companies can fund their operations through debt, with the goal of enhancing return on capital while avoiding dilution associated with equity raises. The major drawbacks are the costs to service loans, and the often severe consequences of failing to do so (having debts called, the risk of bankruptcy), as well as the threat of margin calls on public security investors when the value of their investments deteriorates, forcing liquidations often at precisely the wrong time. In contrast, synthetic leverage has fewer of these downsides.

In a 2018 paper[2] researchers from AQR Capital Management analyzed Berkshire Hathaway's record from 1976 to 2017 in search of factors that contributed to Warrant Buffett's remarkable investment performance. They note that while Berkshire was still subject to "significant risk and periods of losses and significant drawdowns," Buffett's outperformance was largely due to his use of leverage of about 1.7-to-1, combined with his fortitude to stick with "a good strategy for a very long time period, surviving rough periods where others might have been forced into a fire sale or a career shift." The "good strategy" refers to buying high quality companies cheaply, and the authors caution that making mediocre investments with leverage mostly serves to amplify both risk and volatility.

A significant proportion of Berkshire's financing, in addition to standard equity and debt, was in the form of insurance float. Insurance businesses collect premiums upfront and later pay a diversified set of claims extended over the lifetime of the policies written. Float is the money they get to hold between the time customers pay premiums and the time they make claims on their policies. This money is similar to taking a loan, but notably, these

[1] https://www.bloomberg.com/opinion/articles/2020-06-22/fed-s-balance-sheet-heads-to-10-trillion-to-support-u-s-economy
[2] "Buffet's Alpha" by Andrea Frazzini, David Kabiller, Lasse H. Pedersen, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3197185

"loans" are not subject to margin calls and are cheap; Berkshire's average annual cost of float was 1.72% or 3 percentage points below the average T-bill rate over the 41-year period analyzed in the paper. Berkshire has made occasional use of other more esoteric sources of low risk leverage, such as collecting premiums from selling index put options and credit default contracts that *contained no collateral posting requirements*. Regular investors do not have the luxury of selling put options without posting collateral. As the AQR paper states, Berkshire's derivative contracts served as sources of both revenue and safe financing.

Inspired by this story, I have intentionally looked to invest in companies that have access to "synthetic leverage" and will highlight a few types of synthetic leverage used by companies we own in the portfolio.

Insurance Float

Exor owns PartnerRe, a reinsurance business, which makes up approximately one-third of Exor's gross asset value. In March 2020, Exor received an unsolicited offer from Covéa to acquire PartnerRe for $9bn, and both companies signed a Memorandum of Understanding. However, in May Covéa reneged on the deal, sighting "significant uncertainties" following Covid-19. My interpretation is that Covéa tried to negotiate the price down, while Exor, to its credit, refused to do so. The silver lining is that Exor can now continue to benefit from PartnerRe's float. PartnerRe started 2019 with shareholder's equity of $5.8bn. However, its investment portfolio was much larger at $16.3bn. In 2019 it earned a net investment return of $1.35bn. Subtracting operating costs, interest, and taxes, the business generated net income of $890m for the year. ParterRe's Return on Equity was therefore "levered up" to 14.4% ($890m divided by $6.2bn). These are attractive returns considering the majority of the portfolio is invested in fixed income securities, with only 6% in equities.

Fairfax Financial's 2019 annual report unambiguously states, "We expect to compound our mark-to-market book value per share over the long term by 15% annually." Fairfax's strategy is to run profitable insurance operations and use float to invest in a wide range of public and private businesses and fixed income. In 2019 Fairfax generated $395m of underwriting profits from its insurance operations and a further $2.8bn of investment returns on a total investment portfolio of approximately $39bn (a 7% return). Subtracting out operating costs, interest, and taxes, Fairfax earned approx. $2bn of net income. Return on Equity was therefore "levered up" to 14.8% on shareholder's equity of approx. $12bn. As a further point, Fairfax had $22bn of float. If one considers this to be a form of synthetic "loan," then the $395m underwriting profit can be thought of as a *negative 1.8% interest rate* on the float (vs +2.5% for Canadian government bonds). In effect, Fairfax was *paid* interest for taking out float loans.

Management and performance fees on external AUM

Alternative asset managers are masters at earning management and performance fees on client assets under management. Performance fees provide asymmetrical returns as managers participate in the upside but are not economically on the hook for losses. This stands in contrast to float leverage, where the insurance companies are levered equally to wins and losses. Moreover, the alts often structure multi-year lockups on capital that limit redemptions during periods of potential under-performance.

Brookfield Asset Management is an alternative asset manager investing in real estate, infrastructure, renewable power, private equity, and credit. Pension funds and endowments in particular are under pressure to generate returns to meet obligations and are increasing their allocations to alternatives. With its scale, operating expertise, and global reach, Brookfield has built an impressive fee harvesting platform to attract capital from institutions and sovereign wealth funds. Brookfield invests its own balance sheet and that of its listed subsidiaries, currently totaling $43bn, on which it generates an annual return of $1.7bn. Brookfield also invests "fee bearing assets under management" of $264bn, from which it generates a further $1bn in fee related earnings. Fee related earnings have compounded at 17% over the last 4 years and could continue growing at a similar rate as fee bearing assets under management grow to over $400bn in the next 5 years. Brookfield is well on its way to achieving this, having already raised $56bn in the first half of 2020, despite Covid. As its investments and funds mature, Brookfield will harvest increased carried interest income (performance fees). All this should drive strong cash flow growth over the next 5 years, from $2.5bn to $6bn, a 19% compound annual growth rate.[3]

[3] Figures taken from various Brookfield presentations, including 2019 investor day, Q1 2020 interim, and June 2020 AGM

KKR invests its $16bn balance sheet, on which it expects to generate mid-teens returns going forward. It further manages $160bn of fee paying AUM, from which it generates $1bn of fee related earnings. AUM and fees have compounded at 12% and 15% respectively since 2007. KKR has branched out from its traditional private equity operations and now over 60% of AUM is in credit, real asset, hedge fund, and other private market verticals. Funds typically make investments over a 5-7 year period following which they harvest returns and performance fees. Many of KKR's newer funds are entering a stage where they can accelerate payment of carried interest in addition to regular management fees. For example, "carry eligible AUM" increased 60% to $93bn over the last 2 years. As KKR continues to grow both its total and carry eligible AUM, after-tax distributable earnings per share should compound from $1.67 to $10 over the next decade.[4]

Burford Capital provides litigation finance. This is a less correlated asset class that does not follow regular equity and fixed income market cycles as litigation cases, and therefore Burford's returns, move at the speed of the courts. As a result, returns can be irregular, but they can also be highly asymmetric as wins can be many multiples of the capital deployed to bring cases to trial. In 2017 Burford invested $17m to finance a set of claims brought by investors against Argentina's renationalization of YPF, the Argentine energy company, claiming the government expropriated shares without making the investors whole. While the cases are still outstanding, positive developments have allowed Buford to recognize over $1bn of value on their balance sheet and monetize $236m in cash by selling a portion of the claims to institutional investors. Burford has exploited this major win both to size up and to accelerate its move to a fee paying AUM business, which it entered in 2016. While Burford had a $551m portfolio in 2015, mostly raised from selling equity, it now manages $4.2bn, of which $2.9bn is external AUM raised across 8 funds. Burford's management fees were only $26m in 2019, but its earnings power should accelerate as the funds mature and performance fees are paid; most of Burford's funds employ a "European" structure where the manager is not paid any performance fees until fund investors have had their entire investment repaid.

Ancillary Finance Income

CarMax is the largest used car retailer in the US, with approximately 3% of the market. CarMax earns a profit on used car sales and earns significant incremental income from the provision of auto finance through its Carmax Auto Finance (CAF) unit. CarMax has a strategic advantage at the point of sale, as it offers CAF financing to customers with better credit profiles and hands off those with lower credit to third-party lenders. CarMax pays those lenders a modest fee in order to make a car sale while managing credit risk. CAF sells the loans it makes to bankruptcy-remote special purpose entities that further package and sell them into the debt securitization markets, earning a spread on the difference between its financing costs and interest it charges customers. In 2019 CarMax generated pre-tax profits of $705m from retail operations and an incremental $456m through CAF.

Ceridian is a Human Capital Management software company, providing payroll, benefits and workforce management functionality to mid-to-large businesses. Its core revenues come from renting its software on a per month per seat basis. Ceridian also earns "float revenue," interest on the $4bn of employer funds it holds in trust before paying employees and tax authorities. This amounted to $20m in Q1 2020, a significant portion of its $24m in operating profits. The company is now leveraging its technology to enter the electronic payments space and in April launched the Dayforce Wallet, an electronic Mastercard, with over a dozen enterprise customers signed up. Many employees live paycheck to paycheck and bridge the gap between receiving their salary and their cost of living with expensive credit cards or payday loans.[5] Using its unique "continuous calculation engine," Ceridian knows exactly how much is owed to a person, net of all taxes and deductions, at the end of every shift of every day. Employees can request to have the pay they have earned added to their wallet instead of waiting to be paid in arrears at the end of a 1-2 week pay period. Ceridian earns a spread between its cost to borrow funds and the interchange fees it earns when employees spend money, which nets to approximately 80 basis points. This could significantly boost the company's future earnings power as it rolls the product out to a $40bn global market.

[4] Figures taken from various KKR presentations, including 2018 investor day, November 2019 "teach in," 2019 full year, and Q1 2020

[5] https://investors.ceridian.com/news-and-events/press-releases/press-release-details/2020/Ceridian-Report-Half-of-Working-Americans-Struggled-to-Cover-Expenses-Between-Pay-Periods-Over-Past-Six-Months/default.aspx

Royalty Revenues

WANdisco, a data replication company that lets enterprises move massive amounts of their data to the cloud, is a small company with limited resources to market its product directly to enterprise customers. Its solution is fully integrated into Microsoft's Azure cloud platform, and it earns recurring revenues through a royalty model at 95%+ gross margins. Microsoft has incentivized approximately 2,000 members of its own sales force to sell WANdisco's product (selling WANdisco solutions will be applicable to their quotas, and the increased Azure consumption that WANdisco enables will also help their commissions). This compares to WANdisco's own salesforce of only 10 people. The benefit of leveraging a large partner's sales force is apparent when one considers that many high growth SAAS companies spend 30-50% of their revenues on sales and marketing, costs that WANdisco can largely avoid, which should translate to rapid earnings growth as sales ramp up.

Discounts to Economic Interests

GCI Liberty offers us economic access at a discount to Charter Communications, a high-quality compounder, and a way to benefit from John Malone's superior capital allocation skills and exemplary track record of finding ways to eliminate discounts and create shareholder value. GCI Liberty primarily consists of GCI Communications, Alaska's largest communications provider, a 24% stake in Liberty Broadband, a 2% stake in Charter Communications, and a 27% stake in LendingTree. Liberty Broadband is a tracking stock[6] that also owns shares in Charter and trades at a discount to Charter. GCI Liberty therefore trades at a 15% double-discount to the value of its holdings (less debt), though that discount had been greater than 20% in the past. On June 30th, the group announced the intention for Liberty Broadband to acquire shares in GCI Liberty (where each share in GCI will receive 0.58 shares in Liberty Broadband), which will eliminate one layer of discounts. We may benefit from more discount eliminations if Malone and team to find a way to merge Broadband and Charter at some point in the future.

In past letters I have written about both Exor's and Naspers' discounts to the sum of their holdings and their managements' actions to close those discounts.

Discussion on a selection of portfolio positions with an average weight over 1%:

Positions with an average weight over 1% of the portfolio throughout the quarter were: Alphabet Inc., Amazon Inc., Brookfield Asset Management Inc., Burford Capital Ltd, CarMax Inc., Ceridian HCM Holding Inc. (via options), Colfax Corp, Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., GCI Liberty Inc., KKR & Co Inc., Naspers Ltd., Prosus NV, Tencent Holding Ltd., and Wandisco Plc.[7]

Updates to Current holdings and New Positions:

We added modestly to existing positions in Burford and Fairfax and bought a small amount of SPX hedges that are now far out the money given the index's strong rally in the quarter.

Closing thoughts

The stock market rewards companies with strong earnings growth. Moreover, companies that can sustain earnings growth over long periods of time have the potential to compound significantly. This is easier said than done. When possible, I like to find companies run by accomplished operators and capital allocators who can use synthetic leverage to grow future earnings. Investing in these companies when their earning power might be under-appreciated by the market (evidenced by low valuations), presents opportunities for significant capital gains.

Samer Hakoura
Alphyn Capital Management, LLC
July 2020

[6] Tracking stock definition https://www.sec.gov/fast-answers/answerstrackhtm.html

[7] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.

Disclaimer

The description herein of the approach of Alphyn Capital Management, LLC and the targeted characteristics of its strategies and investments is based on current expectations and should not be considered definitive or a guarantee that the approaches, strategies, and investment portfolio will, in fact, possess these characteristics.

Reference or comparison to an index does not imply that the portfolio will be constructed in the same way as the index or achieve returns, volatility, or other results similar to the index. Unlike indices, the model portfolio will be actively managed and may include substantially fewer and different securities than those comprising each index. Results for the model portfolio as compared to the performance of the Standard & Poor's 500 Index (the "S&P 500") for informational purposes only. The S&P 500 is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. The investment program does not mirror this index and the volatility may be materially different than the volatility of the S&P 500.

Performance results of the master portfolio are presented for information purposes only and reflect the impact that material economic and market factors had on the manager's decision-making process. No representation is being made that any investor or portfolio will or is likely to achieve profits or losses similar to those shown.

Results are net of all standard fees calculated at the highest rate charged, expenses and estimated incentive allocation. Model portfolio returns are inclusive of the reinvestment of dividends and other earnings, including income from new issues. The return is based on annual returns since inception and does not give effect to high water marks, if any. Returns may vary for investors who are restricted from participating in new issues.

Hypothetical performance results are unaudited and do not reflect actual results of any accounts managed by Alphyn Capital Management, LLC. Hypothetical performance results are for illustrative purposes only and are not necessarily indicative of performance that would have been actually achieved if an investment utilized the strategy during the relevant periods, nor are these simulations necessarily indicative of future performance of the strategy. Inherent limitations of hypothetical performance may include: 1) hypothetical results are generally prepared with the benefit of hindsight; 2) hypothetical results do not represent the impact that material economic and market factors might have on an investment adviser's decision-making process if the adviser were actually managing client money; 3) there are numerous factors related to the markets in general, many of which cannot be fully accounted for in the preparation of hypothetical performance results and all of which may adversely affect actual investment results.

There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent an account's entire portfolio and, in the aggregate, may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

The graphs, charts and other visual aids are provided for informational purposes only. None of these graphs, charts or visual aids can and of themselves be used to make investment decisions. No representation is made that these will assist any person in making investment decisions and no graph, chart or other visual aid can capture all factors and variables required in making such decisions.

This report is for informational purposes only and should not be construed as investment advice. It is not a recommendation of, or an offer to sell or solicitation of an offer to buy, any particular security, strategy or investment product. Our research for this report is based on current public information that we consider reliable, but we do not represent that the research or the report is accurate or complete, and it should not be relied on as such. Our views and opinions expressed in this report are current as of the date of this report and are subject to change. Any reproduction or other distribution of this material in whole or in part without the prior written consent of Alphyn Capital Management, LLC is prohibited.