

## Letter to investors, Q4 2020

### Performance

The Master Account, in which I am personally invested alongside SMA clients, returned 17.2% net in Q4 2020, as reported by our fund administrator. As of December 31st, 2020, the top ten positions comprised approximately 80% of the portfolio, and the portfolio held approximately 11% in cash.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020 YTD	4.6%	18.4%

### Regret Minimization

In a year in which the world has experienced a pandemic, substantial loss of life, existential threats to jobs and small businesses, social unrest, and major disruptions to our normal way of life I consider myself fortunate to emerge with my loved ones' health intact and to have preserved capital in the portfolio. I am also pleased with the overall quality of companies we own.

In reviewing our performance for the year, I am aware that 2020 was unusual and drawing too firm an interpretation of events opens up the risk of “resulting,”<sup>1</sup> the tendency to equate the quality of a decision with the quality of its outcome, which is a risky and incorrect thing to do with any decision that has a probabilistic outcome (as is the case with investing).

With that in mind, there were several things we did right. First, we held on to high quality companies through turbulence. This helped us participate in some of the April recovery and contributed meaningfully to our Q4 returns as the share prices of some of our larger positions began to move in the last couple of months of the year. While it is difficult to know when the market will recognize the merits of any particular company we own, it is important not to get shaken out of good holdings during periods of volatility.

Second, we took advantage of volatility to upgrade the quality of our portfolio over the course of the year, shedding those companies that have weaker managements and less certain growth prospects, and replacing them with what I believe are high quality businesses that should perform well over long periods of time. For longer term investors such as ourselves, “upgrading the quality of the portfolio” is an important concept and a continual process (albeit slow moving as we are not looking to churn the portfolio and thereby engage in shorter term trading).

In defining a high quality business, I'll refer to Charlie Munger who said “The difference between a good business and a bad business is that good businesses throw up one easy decision after another. The bad businesses throw up painful decisions time after time.”<sup>2</sup> I think this is a wonderful description of the type of company to own over a longer time period, in addition concepts such as economic moats and high returns on capital, which are largely well understood by investors today, and of “synthetic leverage” which remains a core part of our strategy as discussed in the Q2 & Q3 letters. This idea resonates with my personal experiences working with my family's real estate and business investments. Our “good” properties or businesses seemed much easier to run. For example, with our best building we consistently experienced easier and more successful rent negotiations, had fewer problems with maintenance, and had virtually no issues with zoning/legal/planning. In contrast, heroic efforts produced only marginal improvements in the “bad” buildings. Similarly, running our best business, while still hard work, seemed

<sup>1</sup> A term popularized by professional poker player and author Annie Duke in her book “Thinking in Bets”

<sup>2</sup> “Damn Right: Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger” By Janet Lowe

easier – new growth initiatives were successful, expansion plans produced high returns on time and investment. Whereas with “bad” businesses we struggled with difficult tradeoffs between investing in the business and preserving cashflows or increasing prices to improve margins and losing customers.

Similarly, good portfolio companies operate from a position of strength which allows them both to pursue high value opportunities and to adapt to changing market conditions or tackle problems effectively. On balance, they announce more good news than bad, and this makes the decision to hold these companies much easier. For example, Carmax adapted to the internet with a strong omnichannel offering and continues to post the highest returns on investment in its industry. KKR not only raised \$4bn in capital during April and May, demonstrating the power of its platform, but then announced the acquisition of Global Atlantic which would add \$70bn to its AUM and increase its opportunity set for generating returns and fees. Exor, which has faced numerous challenges in 2020 (such as the change of CEOs at both CNH and Ferrari, and the cancelled deal to sell PartnerRe), made substantive progress towards completing the Fiat-Peugeot merger, and announced exciting new investments, including €80 million in Shang Xia (one of the first Chinese luxury brands) in partnership with Hermès, and \$200m for 9% of transport software business Via.

Third, we gained exposure to fast growing tech companies under cover of holding company discounts. This allowed us to participate in some of the upside that tech companies have enjoyed this year, but from a more defensive position with respect to valuation and margin of safety. Examples include GCI Liberty/Liberty Broadband (play on Charter, which is benefitting from internet growth), Naspers/Prosus (play on Tencent and a portfolio of international tech subsidiaries), and IAC (play on Vimeo which will be spun out). These are all holding companies trading at discounts to their high quality components. Our new position initiated this quarter, Oaktree Acquisition Corp, is a SPAC that will purchase a fast growing telehealth company. We invested at a minimal premium to the cash-secured net asset value (described in more detail below).

Nevertheless, with the benefit of hindsight and in the spirit of continual learning, I could have done a better job with overall portfolio management. First, we purchased 6 new companies in March and a further 2 companies in the third and fourth quarters, respectively. The March companies had all been on my watchlist, for which I had been waiting patiently for good entry points. Given the uncertainties at the time I purchased relatively small “starter positions” but failed to increase to full allocations when it became clear that they were going to weather the pandemic intact. We might have posted better numbers had I not anchored to the lower initial prices, instead of running the portfolio with large cash balances following a big market correction.

Second, three of our largest holdings stagnated or declined during the year. It is difficult to draw too many conclusions from this over a relatively shorter time period of one year. I continue to believe the risk reward is favorable on these names and taking a single point-in-time assessment of their share prices ignores their potential. Nevertheless, I will look to better manage position sizing going forward.

Third, my investment in Alliance Data Systems was a mistake, as mentioned in my Q1 letter. I allowed myself to be drawn to management’s narrative and was not critical enough of their excuses for poor performance. I was also heavily influenced by the notion that the valuation appeared cheap on a price-to-free cash flow basis. As I should have better remembered from my investment banking days in the early 2000’s when I was involved with IPOs, the stock market seeks growth and does not attribute high terminal value to stagnating companies, especially when management teams have lost the market’s confidence. While this seems obvious in hindsight, the lesson is to act more decisively in cutting a “bad” position in the future.

There is an old video of Jeff Bezos where he describes using a “regret minimization” framework to make the tough decision to leave a secure and high paying job at D.E Shaw to start Amazon.<sup>3</sup> According to the interview “I knew that when I was 80, I was not going to regret having tried this. I was not going to regret trying to participate in this thing called the internet that I thought was going to be a really big deal. I knew that if I failed, I wouldn’t regret that, but I knew the one thing I might regret is not ever having tried. I knew that that would haunt me every day, and so, when I thought about it that way it was an incredibly easy decision.” I think that investing is a game of

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<sup>3</sup> [https://www.youtube.com/watch?v=jwG\\_qR6XmDQ](https://www.youtube.com/watch?v=jwG_qR6XmDQ)

regret minimization, of balancing difficult decisions between taking risk and seeking reward. On the one hand, especially during times of extreme turbulence, it is important to seek to preserve capital. Investing in high quality companies, having some cash on hand or even initiating hedges are important and reasonable actions. On the other hand, once a promising investment has been found, it is equally important to invest with appropriate size and not pass up opportunities due to fear, inertia, or anchoring to a lower price.

#### **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., Colfax Corp., Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., IAC/Interactivecorp, KKR & Co Inc., Liberty Broadband, Naspers Ltd., Oaktree Acquisition Corp., Prosus NV, Tencent Holding Ltd., and Wandisco Plc.<sup>4</sup>

#### **GCI Liberty, Liberty Broadband – Update**

On November 17<sup>th</sup>, GCI Liberty sold its stake in Lending Tree for \$1bn, a 6x return on its initial investment of \$141m and used tax offsets at GCI to net \$900m in after-tax proceeds (in a testament to John Malone’s tax management skills). It will use proceeds for debt reduction and share buybacks. On December 18<sup>th</sup>, GCI Liberty and Liberty Broadband announced the closing of their previously announced combination, tax efficiently eliminating one layer of the “double discount” to Charter Communications. Charter has continued to perform admirably, adding 2.3 million internet customers over the last 12 months (to Q3 2020) and increasing free cash flow by 65% to \$5bn. We continue to ride the Liberty folks’ coat tails as they continue to demonstrate their superior capital allocation skills, for example initiating buybacks at a Charter “look through” price of \$485 vs Charter’s price of \$644 per share.

#### **Burford Capital – Update**

Burford, a litigation company, was subjected to a short attack in August 2019, which alleged the company fudges its accounting by dishonestly inflating the fair value of cases it has financed on its balance sheet. In response, Burford management released a large amount of additional financial information to give investors much more visibility into its accounting. Then on October 19<sup>th</sup> of this year, Burford listed and began trading on the NYSE. This is significant because governance standards are higher on the NYSE than on London’s AIM. Moreover, the management team is now exposed to potential criminal liability should there be any accounting fraud, to which they were previously not exposed. While NYSE listing alone is not a guarantee (as Enron and other case studies show), management’s willingness to list on the NYSE while under intense investor scrutiny signals probity to the market.

#### **IAC/Interactive – Update**

On November 22<sup>nd</sup>, IAC announced it would look into spinning out Vimeo, its Software-As-A-Service video creation company, on the back of strong revenue growth and robust investor interest. To quote from the IAC shareholder letter “We just tested Vimeo’s ability to access capital with a small private fundraise to bolster Vimeo’s balance sheet and to repay capital to IAC. We entered into agreements today to raise \$150 million of equity capital at Vimeo from outside investors at an implied enterprise value of \$2.75 billion, a large multiple of current revenue. We don’t normally think in terms of revenue multiples, but we found real appetite among investors who do – we had more interest in Vimeo than the number of shares we were willing to let Vimeo sell.” In other words, IAC will exploit current valuations while the market is willing to pay for it. This has so far been a good example of our defensive approach towards investing software companies from the cover of an undervalued holding company run by intelligent capital allocators.

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<sup>4</sup> 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.

## **Oaktree Acquisition Corp – New Position**

Our new position is in Oaktree Acquisition Corp, a Special Purpose Acquisition Company (SPAC). We invested in OAC after it announced its intention to purchase Hims and Hers Ltd. a fast growing telehealth company. SPACs raise money from investors, following which they have a set window (typically 2 years) within which they must complete an acquisition of a private company or dissolve and return funds to investors. Investors' funds are held in trust earning interest. When the SPAC announces it has found a target, investors are given the option to redeem their shares for the trust value of their initial investment, plus accumulated interest. I chose to invest in OAC given the quality of Oaktree as a sponsor with high integrity and significant resources to execute the deal, my perception of the quality of the target, and our entry price of approximately \$10.35/share, which is a fraction above the cash secured trust price of \$10/share. This was a lower risk opportunity with the potential for significant returns.

Oaktree have elegantly summarized the investment merits: “Our thesis is underpinned by three key points. Number one - Hims and Hers has a unique, hard to replicate, and highly-scalable platform with a massive opportunity set in front of it. Number two - we have achieved an attractive transaction structure with an exceptional management team and leading institutional shareholders who are rolling virtually all of their stock, forging strong alignment for future value creation. Number three - we think it's a compelling entry point at more than a 50% discount to its closest public peers despite boasting similar or better growth profile and margin structure than those peers.”

Hims lets patients set up virtual appointments with licensed doctors for conditions such as hair loss (a \$3bn market), erectile dysfunction (a \$4bn market), anxiety & depression (a \$14bn market), and dermatology (a \$44bn market). These conditions are often stigmatized, and frequently treated with repeat ongoing prescriptions, such as Viagra or a generic equivalent. They are therefore attractive markets for Hims as patients prefer the relative anonymity of remote consultations, and prescriptions generate recurring high margin revenue. Furthermore, the markets are large, providing Hims very long runways for growth. The company states that as the patient base grows and gets older, there is scope to grow into adjacent markets such as primary care, sleep, fertility, diabetes, and cholesterol.

Hims targets the millennial age group with high quality branding and marketing. This has encouraged word-of-mouth referrals, resulting in an attractive 3x 3-year LTV-to-CAC return ratio.<sup>5</sup> The company has achieved strong “product-market fit,” with a high NPS<sup>6</sup> score of 65, and rapid revenue growth. Founded in 2017, Hims generated \$1m in sales in its first week of operation<sup>7</sup> and has grown annual revenue from \$27m in 2018, to \$83m in 2019, with run-rate revenue of over \$160m for 2020 (based on Q3 annualized numbers). This is a compound annual growth rate of over 140%. Revenues grew 91% in Q3 2020 with attractive gross margins of 76% (selling generic prescription medications is a good business). The company is forecasting EBITDA break even by 2022, assuming 30% per year revenue growth (a big haircut to their historic growth),

Hims has built a robust platform to support this future growth and to provide a high standard of care to patients, using algorithms and processes to verify patient information, link patients with credentialed doctors, and provide continuity of care with personalized follow-ups. To counter the risk of abuse of the system and what some might call “restaurant-menu medicine,”<sup>8</sup> the company has built processes into the system to ensure doctors comply with evidence-based clinical guidelines.

Finally, Hims has a high quality team. For example, Andrew Dudam, founder and CEO, is a serial entrepreneur and early stage investor who previously co-founded Atomic, a \$600m VC fund with backing from Peter Thiel. Dr Pat Carroll, Chief Medical Officer, was former Group Vice President/Chief Medical Officer at Walgreens where he oversaw the retail clinic business unit as well as clinical programs and health system alliance.<sup>9</sup> Lynne Chou O’Keefe, new board member, is an experienced life sciences VC (founder of Define Ventures, former partner in the

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<sup>5</sup> Customer-Lifetime-Value to Customer-Acquisition-Cost ratio measures the relationship between the lifetime value of a customer, and the cost of acquiring that customer. A signal of customer profitability, and of sales and marketing efficiency

<sup>6</sup> Net Promoter Score, which measures the loyalty of customers to a company. Range of -100 to +100, NPS > 0 is considered “good,” >50 is considered “excellent,” and >70 is considered “world-class.”

<sup>7</sup> <https://www.forbes.com/sites/alexandrocmades/2019/06/23/he-did-1-million-in-sales-in-the-first-week-of-business-and-his-startup-is-now-worth-1-billion/?sh=229658d65c3e>

<sup>8</sup> <https://www.nytimes.com/2019/04/02/technology/for-him-for-hers-get-roman.html>

<sup>9</sup> <https://medium.com/hims-hers/welcome-pat-carroll-hims-hers-new-chief-medical-officer-3105de68bbe2>

life sciences group at Kleiner Perkins, former telehealth company Livongo board member), and David Wells, also a new board member, was former CFO at Netflix and provides strong consumer internet experience.<sup>10</sup>

While I recognize the potential for the company (it is clear from hearing him speak that founder and CEO Andrew Dudam believes there is scope to grow a \$20bn brand similar to public competitor Teladoc), Hims is obviously an earlier stage company valued at a relatively high multiple of sales. Moreover, the telehealth space is still emerging, with the likes of Amazon showing keen interest,<sup>11</sup> which presents some risk.

Furthermore, general SPAC dynamics could impact the value of our shares (through no fault of Oaktree or Hims). SPACs raised \$83bn in gross proceeds from 248 IPOs,<sup>12</sup> and there is undoubtedly some frothiness in this part of the market. Many SPACs, often backed by high profile “celebrity” investors and sports personalities, have had their share prices run up ahead of any deal announcement. Some have purchased target companies at aggressive valuations. Lastly, SPACs in aggregate have had a poor post-merger share price performance record.<sup>13</sup> The reasons for this are numerous. For example, SPACs’ limited window within which to close a deal can set up poor incentives to rush to buy a sub-optimal company. Sponsors typically receive a 20% promote and warrants which dilute public shareholders. Several hedge funds have adopted a practice of redeeming shares to generate low risk returns on cash, while keeping warrants as a “free option” should the post-acquisition entity perform well in the stock market, which can result in the need to raise additional capital to complete the deal, diluting remaining shareholders.

Given the above, I feel it important to take a defensive approach to the investment. Having secured an attractive entry point, I will be ready to stop out aggressively to preserve capital and/or profits.

### **Closing thoughts**

A final encouraging thought is that the market can throw up potential investment opportunities whether in the midst of great fear as in March, or more exuberance as in the fourth quarter. The key is to stick to a disciplined process and keep on looking. I am grateful for the opportunity to grow your capital alongside my own.

Alphyn Capital Management is open to new investors. If you know someone with whom our investment approach would resonate, I would be grateful for an introduction. Please feel free to forward the attached 2-page tear sheet.

Samer Hakoura  
Alphyn Capital Management, LLC  
January 2021

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<sup>10</sup> <https://medium.com/hims-hers/hims-hers-appoints-two-new-board-members-beb4a8f22bf5>

<sup>11</sup> <https://mhealthintelligence.com/news/amazon-makes-its-move-dtc-telehealth-service-opens-for-employees>

<sup>12</sup> [www.spacinsider.com/stats](http://www.spacinsider.com/stats)

<sup>13</sup> “A Sober Look at SPACS” [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3720919](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919)

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