Altana Investment Thoughts by Lee Robinson

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Introduction

As many of you know, Altana co-invests our own money both directly into third party entities and also by incubating fund managers when we have high conviction in the information advantages they seek to exploit. Our investments range from VC to Growth Capital to asset-backed and also include listed opportunities. I am fortunate to be constantly meeting highly talented investors, ranging from self-made entrepreneurs, billionaires and family office decision-makers. I chair my own deal club of 18 entrepreneurial investors in Monaco, each of whom has their own networks, thus multiplying the opportunity sets. This group has grown and we now exchange investment ideas with over 140 individuals and groups globally. I also sit on the committee for the financial services network of the Young Presidents Organisation, which gives me a privileged insight into the future of this industry. Most investors that I meet first and foremost have a common desire to co-invest and, thus align their interests. They also either do not trust or think little of the financial industry in general, both from a value point of view (fees) and/or service (lack of quality ideas).

I have been asked to collate an overview of some of my investment theses and ideas from the last few months. Please feel free to share these with other sophisticated investors and contribute your own comments and ideas via email.

It is my long-term intention to cultivate a virtuous network of investors, investment ideas, and resources: one that is free from the usual conflicts of interest.

Altana: Growth Continues

There are really only two business models: high volume with low margin or high margin with low volume: “commodities" or “luxuries”. These are known as "Beta" and “Alpha" products in the investment world. Altana is an Alpha-hunter (for those of you unaware…).

Since our last letter in September, a great deal has happened. Over the last 18 months, Altana has made immense progress. Most notably, our Bitcoin and crypto investments have hit the headlines. Our Digital Currency Fund (ADCF Cayman/Lux Feeder) has won awards including Hedgeweek’s “Niche Hedge Fund of 2017” for its 1500% return and superior outperformance over a passive Bitcoin investment. Congratulations to Alistair Milne for his incredible work ethic and performance. There are plenty of articles in the press from the likes of Bloomberg, Reuters, FT and WSJ. Links are on our website. Again, thanks to Robin Eggar for improving Altana’s public profile.

We have found that potential investors are stunned that not only do we always participate meaningfully in all our trade ideas, but we also invite investors to sell alongside ourselves. Investors are perhaps too used to their counterparts front-running them or purely asset-gathering yet never asking them to redeem from a successful fund. True alignment of Interest is how Altana builds trust and foments long term relationships.

Additionally, our Cryptocurrency Trade Finance vehicle (ACTF, BVI) which lends US dollars to traders ended 2018 up over 32% (gross). The major risk with this strategy is that Bitcoin gaps down. Bitcoin is open 24 hours a day, 7 days a week, 365 days a year, so doesn’t have any open to close risk. In the recent move from $8,000 to $19,500, and back to $6,000 we suffered zero defaults. Admittedly (perhaps surprisingly, to some) the move was smooth and continuous.

Most non-crypto exchanges close at 4.30pm, allowing the trader to sleep knowing that no extra margin will be needed overnight, whereas on a 24 hour exchange margin might be called at any time. Whilst I cannot prove my theory, the fact that traders will (insofar as they are human) need to sleep means that crypto traders are posting larger margins to insure themselves against this risk, which in turn makes the opportunity more attractive.

We continue to believe that lending at 32% gross implies that 100% of loans would need to default, and that the gap be close to 40% (including the exchange limit buffers) in order to wipe out one year's profits. This is a very compelling Risk/Reward profile distinct from whether Bitcoin is a bubble or not.

When we started our electronic order book in 2016 as we estimated the market size of this intuitively capacity-constrained opportunity to be $30-50m we wanted our exposure to be capped at $5m. This is one reason why we are a market leader when we enter the market every 30 seconds, and why we are always getting filled, even if levels are above our targets. The market is too small for larger players. However, since we started, the market size has jumped to $500m+, so we have lifted the cap to $50m. We currently have $7m in our BVI vehicle, so have fresh capacity for co-investors, and welcome you to join us.

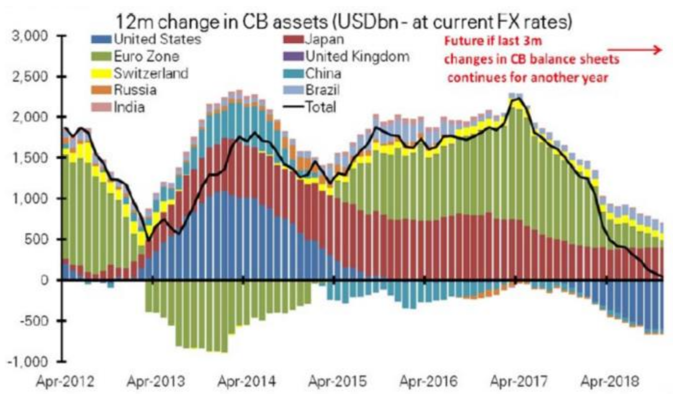
Our Volatility Overlay Fund conceived and implemented for another family office - was profitable in 2017, and only had marginal losses in Feb 2018. From personal experience, the February volatility spike was special. I believe this was the first time ever that rising volatility caused equity market weakness, rather than the other way round. We have shared a short summary piece with friends which is available here: **Volatility Flash**

Our Corporate Bond Fund added 5% net in 2017, following its 7% return of 2016. Once again, this was achieved with bonds averaging less than 1.8 years in duration, and with volatility always less than 2%. In the month of January 2018, when rates were rising, we were up 0.3% when most funds were flat or down.

Headcount at Altana continues to rise and we are now just shy of 30 people. Never short of entrepreneurial and pioneering spirit, we have just invested in new funds which include wine trading and special situations in oil and gas.

Quantitative Tightening

Without doubt, investors were given a 'free pass ' in 2017 with respect to almost every asset price, but with rising yields, and central bank tightening of rates as they reduce their balance sheets, combined with higher volatility, 2018 will be a much more difficult year to navigate. One of the most important charts to contemplate comes courtesy of Soc Gen.



Source: Société Générale

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The black line represents cumulative Central Bank buying of bonds. As you can see, we are heading into a selling period following a 10 year buying spree. For those of you that believe QE supported asset prices, what will the opposite do?

Inflation Scare

In our weekly risk meetings over the past three months we have been most concerned about an inflation scare. Whilst we continue to see enormous pressure from disintermediation and automation causing downward pressure on wages, we still felt the market was getting to a place where successive good news on the economy was bad news for markets, as bond yields would have to rise. Altana was built to generate real returns after inflation.

We send out a monthly inflation report so we are quick to notice any of the warning signs which included:

- a great year for synchronised global growth,
- rising bond yields [US 5-year bonds are up from 1.65% in Sep 17 to 2.65% in Feb 18],
- shipping rates are rising,
- industrial metals such as copper and iron are trading higher
- oil is at 3-year highs.

The market agrees with us that inflation is a real concern. Three US rate hikes are predicted for 2018, where four months ago there was barely one. European data implies at least one rate rise in 2018, where not long ago, it was predicting none until late 2019. Combine this with QE and the large amount of Treasuries that will be issued in the next 18 months, and bonds are a better short than long. For sure, 10-year bonds can go from 2.9% to 2.6% on the back of three to four months of bad news, but it can easily move to 3.5% on a continuation of good news.

What does this do to equity multiples? The sell side continues to say rising rates are not bad news if earnings are rising. Earnings are indeed rising and lower tax-rates help, but the argument that there is no alternative to equities has gone. Take strong, stable corporates such as Nestle and Unilever. Let's say they trade on free cash flow yields [FCF] 1% wider than corporate bond yields. Currently these are around 3.8%. Take the reciprocal and you get a PE of 1/0.038= 26. However if this moves to 4.8% due to higher corporate bond yields then the PE is now 1/0.048= 21. This means the stock needs to fall 21%. As I pointed out earlier yields have risen in the US by 50-100 bps across the curve since September implying the S&P should be lower by 10-20% … yet the market is up 10%. Yes, the tax effects help earnings grow by 5-10%, but something is not quite adding up, unless earnings are going to jump massively from here.

Our view is to switch from Long Only to Long Short, and so reduce gross leverage because volatility will be higher in a rising yield market. In Europe and Japan the moves are less drastic as Bunds, for example, have moved from 0 to 0.75% in the ten year maturity, meaning free cash flow yields on equities still look relatively attractive. However, I would caution that when US stocks fall rapidly Europe and emerging markets invariably trade lower.

Currency Outlook

As we regularly get asked our views, I thought I'd pen a few lines. First of all we are US dollar bullish. The market does not (yet) understand the consequences of the Republican Tax Bill. It will mean a repatriation of offshore dollars back to the US for a one-off tax hit. Everyone will tell you that these monies are already in US dollars. We can see that that must be true, otherwise companies with large cash piles like Cisco or Apple would have large quarterly swings in their reported US dollar profits. So what is the big deal? The subtle difference is that the money is moving to the US bank system onshore from offshore so those dollars will need to be replaced offshore. Now onshore banks have access to dollars all the time via the Federal Reserve, but the offshore banks will need to replace their access to US dollars. That will put pressure on currency swaps which have averaged 20 bps over the last five years. Ignoring the year-end spikes, the trend is clearly lower. When this occurs, it means that there is more demand for dollars, which will usually drive the currency higher. Never forget that this is capital in a levered system: Apple, Cisco, and others are beginning the move back this quarter. And never forget that Global Debt is now more than 200 trillion versus 150 trillion in 2008, and that a large portion of this interest bill is dollar-denominated/ linked...

Source: Bloomberg Finance L.P.

Add to this the immediate European situation. The result of Italian elections and the German Opposition's vote on whether to join the coalition will both to be known on 4 March. We could see some weakness ahead. You may recall that in last year's February ideas letter we were not overly concerned about the French or Dutch elections, but rather more the German, and then ultimately the Italian, elections. Germany has been without a government for nearly six months. Italy will almost certainly be run by a new coalition as Renzi's party is way behind in the polls. **{NOTE since the writing of this article the SPD has agreed to support Merkel and form a German government but the Italian voters have given 5 Star and the Northern League close to 50% of the votes with Renzi's party's support falling below 20% so we will have most likely a new untested government.}**

None of this of course helps the UK with Brexit. Without doubt this is the worst British cabinet in history. One that is utterly useless at negotiating, cannot even decide what they actually want nearly two years after calling for the referendum. Foreign direct investment is clearly on hold and important decisions about where to locate business in Europe are not being made - either into the UK or Europe - due to the uncertainty.

This is feeding into company results at the micro level. Large recruitment agencies such as Hays and Michael Page, for example, are showing strong growth in all regions except the UK. Construction and tool hire are the same. All of this implies Sterling weakness ahead, especially versus the Euro. However, Sterling weakness also drags down the Euro both from a real trade issue and relative attractiveness basis.

Another currency to watch is the Turkish Lira - a break above the $4 level combined with potential capital controls, would cause contagion in the whole emerging market space. With bond yields rising, I would be tactically reducing EM exposure in anticipation of adding at a better entry level. Longer term we are still bullish on many non-western markets, especially China.

Finally, with commodities trading well we plan to chase gold and then silver if they can break out of their long 5 year trading range. If gold breaks above the 2016 highs [~$1370] there could be a quick move to $1600 level. Both gold and miners are unloved with US investors booking outflows, but with China, Russia and now Germany coming in as larger buyers, this could change quickly given that supply levels have fallen.

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Diligence as a Service

We have enjoyed many interesting meetings, with several successful co-investment ideas arising from them, and have forged new relationships. We continue to progress towards better solutions with higher risk-adjusted returns for Altana and our colleagues. Everything we do is about co-investing. From these meetings we have discovered that we are not alone in facing issues of sourcing, filtering and striving to avoid the wrong people and investments. We believe and, again, are not alone – that the current platforms for ideas from banks and elsewhere are simply not good enough. They post average, overpriced and often downright desperate ideas from which (usually) they expect to earn a fee (which can create conflicts) and they have no skin in the game. Due diligence and selection is needed by **investors for investors** in order to short-list high quality ideas. We have identified that the blockage is at the filtering stage, and so are working with other groups to implement a filtering system, which gives graduated and differentiated levels of due diligence upon the concept, people and valuation under consideration.

Oleg Desh and I have set up Diligence as a Service to resolve that problem, and (we feel) out of necessity. See www.diligenceasaservice.com (DaaS).

Our proposal is that DaaS partners submit deals they are evaluating. A team of five+ professionals we will hire exclusively for this purpose will carry out the preliminary analysis and research to see if it is a viable investment, or, as in many cases, needs more information. Once past the initial stage, partners can share further information, or work on their own. There are no obligations to invest and no management fees, just an annual membership to cover the costs of the analysts. Essentially this is a time saving filter with the potential for huge economies of scale. However, as it grows it should evolve into an invaluable curated source of investor led deal flow coupled with a database of relevant searchable information on comparative deals, quality of people and competitive analysis. The filter thus becomes a valuable source of ideas in itself. We hope that the platform will over time become a leading marketplace for direct investments that will create a gravitational pool for entrepreneurs and investors alike.

We are inviting 10 groups to partner with us in this initial stage, and they will also benefit as founding shareholders. We have the first six partners already confirmed, so have now incorporated the company and intend to launch in April.

If you want further information please let us know.

Disintermediation & Technology

Whilst the inflation scare we discussed earlier continues to grow we still see enormous disruption in most industries. Machine learning and big data are cutting out whole groups of middlemen. Google and Facebook control nearly two thirds of advertising, removing the need for advertising agencies. In the US there are more Netflix subscription-paying customers than users with set-top boxes. This has driven Disney to buy Fox in order to try and regain control of distribution. An excellent free newsletter, written at a level above most of the research you will see from the sell-side, is published weekly with a few pages explaining simply with diagrams how the sector and strategic moves are developing. This is written by Ben Thompson at www.stratechery.com.

An area not recently discussed is the boom in home devices such as Alexa/Google Home that use voice-recognition to answer your questions. We stayed with relatives over Christmas who had bought one and saw how easy and frequently it was put to use, especially by the children. The manufacturers claim voice recognition is approaching a 95% success level. This has serious implications for the Western World. If you can recognise voice at 95% level in multiple languages, then you can translate at an 85-90% success rate. Imagine being able to directly call multiple companies for services or goods in emerging countries at materially lower costs to check documents, to do simple things like change brightness and colour on products and ultimately more complex tasks. This will destroy western semi-skilled and most skilled labour competitiveness. Disintermediation and technology are a disaster for future tax revenues and the increasing welfare needs of those left behind.

Corporations and especially governments have not put this high enough on their agenda.

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Blockchain & Private Ventures

2017 was a difficult year for finding new ventures. There were many overpriced deals, and fantasy valuations, often due to the insanity of the ICO market. Incumbent industries are also recognising that excess capital is allowing loss-making entities such as Uber and Tesla to raise enormous capital and waste it on ego-trip ventures. Vision Fund has raised $100 billion with leverage, and is spending money like a teenager in the film Brewster's Millions. This excess of capital will ultimately be negative for listed stocks as the capital allows these disruptors scale and scope that seriously threatens their core business. We have largely passed on most ideas but thankfully, with the recent fall in cryptocurrencies, some of the froth has come out of the market. We continue to believe in Blockchain related ventures and like in the Dotcom period believe we can find winners. As 2018 rolls into 2019 this will most likely be at lower valuations and requiring more proof of concept. Shortly we will be sharing some of those ideas with our 140 co-investment groups.

Conferences, Charity & Lonmin update

As a guest speaker I recommended Lonmin at the Ira Sohn Conference, which is a charity set up to help fund cancer research, specifically paediatric cancer. I believed Lonmin can go up 10-20 times. The video is around 10 minutes and can be seen on our website.

http://www.altanawealth.com/news/

The conference was a success and the charity raised over $100,000, hopefully more with additional donations if the trades are successful. Whilst Lonmin is up 25% since then this is due to a proposed takeover by Sibanye which lowers my upside target. Sibanye are buying a $5-10b asset for under $300m so I felt heavily let down by the management team. However, I plan to keep the Sibanye shares exchanged for my Lonmin ones, as this trophy asset will at least benefit their shareholders.

Talking about charities, many thanks to those of you that donated to the pregnancy and miscarriage charity – Tommy's. They carry out tremendous scientific research as well as supporting families in very emotionally traumatic periods. They asked me to pass on their thanks and that your kindness is appreciated. www.tommys.org

Wine Trading

We have been looking at wine trading for over three years as buying and selling wine on exchanges has facilitated the opportunity to compete in a previously closed industry. Wine is a great inflation hedge as many of its components - labour, land, fertiliser, transport - are positively correlated with inflation. Investors hold wine for that reason and, of course, to sell or drink it in 5-25 years. However many wine investors, like myself, are not wed to the actual wine that we hold. We are indifferent as to which Bordeaux wines we have in storage. If somebody could profitably buy and sell my portfolio two-three times a year but still give me comparable wines when I wanted to drink or sell them, then I would be delighted. Essentially I would be able to drink fine wine for free. Sounds like a dream come true!

We have paired up with Cru wine to do exactly that. Through them it is possible to roll in your current wine. Together we are launching a dedicated trading vehicle to generate higher yields from assets that many hold passively for the long term. Cru are young and hungry to succeed, taking risk without an initial salary. As always we are backing them with our own money.

Outlook

My currency views and fears over European elections, Brexit, and the new US tax law changes are outlined above. We continue to believe that we are late in the cycle in the global expansion. Clearly markets will be more volatile than last year, which was the lowest volatility year for the US stock market since 1928. We have already had the largest one-day percentage move in volatility ever recorded. Now is the time to switch to long-short managers rather than long only, to reduce duration on credit and especially cyclical industries. Long vs. short portfolios are more prudent than ever. If you have long only then some sort of protection is warranted. Rising bond yields means lower property prices and lower equity multiples. This is bad for levered portfolios. Risk parity and other levered bond plus equity portfolios should be avoided. Central bank largesse is coming to an end. Hopefully professional risk management will be back in favour. I would avoid long lock up private equity vehicles, many of which have moved from seven year (plus multi year extensions) to ten year lock ups. Given they do the hard work of investing in years one to three, why would you pay them egregious fees in years three onwards just to be monitoring companies? Hopefully private investments will rebase to more attractive levels this year as we continue our search for quality ventures.

Previous newsletters, videos and thematic pieces are on our website:

http://www.altanawealth.com/news/

and via Youtube:

https://www.youtube.com/channel/UCrjZ4lZ9okIQ0b0-c6wz3PQ

Yours sincerely,

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