Farrer Wealth Managed Solution Quarterly Update

Q4 FY2022 Returns Summary

(Quarter ending June 2022)

All values in SGD terms unless otherwise stated, data is as of most recent quarter end

					Year-to-Date Returns		
Model Portfolio Returns*	**Q1**	**Q2**	**Q3**	**Q4**	**Portfolio**	**Benchmark SGD****	**Benchmark USD**
FY 2022	-0.20%	-7.40%	-20.47%	-21.96%	-42.64%	-12.39%	-15.15%

	Cumulative	Annualized
Model Portfolio Return Since Inception***:	-42.64%	-42.64%
Benchmark (SGD) Return Since Inception:	-12.39%	-12.39%

Top 5 Holdings (Alphabetical Order)	**Key Terms:**	
eDreams Odigeo	Management Fees:	1% p.a, monthly
Evolution	Performance Fees:	15% p.a/bmark
HDFC Bank (ADR)	Minimum Size:	S$250,000
IAC	High water mark:	Yes
Sendas Distribuidora	Liquidity:	30 days notice
Total Weighting of Top 5: 54.10%	Structure:	SMA

* In order to display the most accurate representation of the returns, we use a model portfolio which has been subject to full fees since the inception of the Managed Solution. While this model account is a real client account, clients should check their own statements via their Interactive Brokers accounts to ascertain their returns as fluctuations between accounts are to be expected. Model Portfolio returns are in SGD.
** We use the iShares MSCI ACWI ETF as our Benchmark. Since this Benchmark is in USD, we convert to SGD based at the prevailing FX rates for an easier comparison. All return figures are indicative only, clients should check their own statements via their Interactive Brokers accounts for accurate figures.
*** Inception was 1st July 2021; The Managed Solutions financial year goes from July-June

Background

We launched the Farrer Wealth Managed Solution ("Managed Solution") on 1st July 2021. Through the solution we aim to provide our clients with positive returns over the long-term using bottom-up research and asset selection. While the mandate of the Managed Solution is broad, we tend to stick to equities as it's the asset class we know best. Typically, the Managed Solution will have between 12-20 positions in assets that we believe will outperform the relevant benchmark over time. Our investment decisions are based on deep fundamental research, much of which we publish on our website. Investments are sector- and geography- agnostic, and instead focus on businesses that are growing market share in markets that are growing. The solution does not short nor use leverage but may buy options from time to time to hedge or express a particular view.

A year completed; several lessons learned…

This quarter the Managed Solution returned -21.98% versus the benchmark's returns of -12.61%. For the 2022 calendar year so far, the Managed Solution returned -37.93% versus the benchmark's returns of -17.55%. Since inception (exactly 1 year to 30th June 2022) the Managed Solution has returned -42.64% versus -12.39% for the benchmark (all figures are in SGD terms).

This first half of 2022 marked the worst initial six months for the S&P 500 in about 50 years. The market was ripe with bearish news including the highest inflation we've seen in decades, the war in Europe,

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a threat of a recession, and a fear of poor corporate earnings as the year progresses. Given our portfolio concentration we will typically underperform in bad markets but should make it back (and more) in up-trending markets. That said, the quantum of underperformance so far is frustrating. While I always imagined we would be down 30-40% sometime during the Managed Solution, I did not expect it to happen in our very first year and nor did I expect to happen when the benchmarks were showing so much relative strength. While that benchmark strength really did break down this past quarter, benchmark gains in Q42021 and a significant underperformance of the Managed Solution in Q12022 has created a gap in performance.

I believe that this gross underperformance is driven by three process errors I made, which I discuss below. I highlight them not necessarily to go through a public self-flagellation, but rather to illustrate how we evaluate our portfolio decisions using data and adjust when things aren't going to plan.

1) Scaling too quickly into positions: When we started the Managed Solution, our top 5 positions made up ~45%+ of the portfolio on day one. Now granted, the Managed Solution evolved out of our advisory business, so many of those positions weren't "new" per se, as they were transferred into client accounts from their other brokerage accounts. However, the launch of the Managed Solution could have been treated as an opportunity to "reset" those positions. The problem with having several 10% positions going into a bear market is that the negative impact on these positions is large and their size does not allow us to significantly add to them. We've learned this lesson and have been scaling into new positions slowly. For example, last quarter we entered a position in Atento which during this quarter (due to poor short-term earnings and a lack of liquidity) fell ~60%. But given the position size the fall had a minimal impact on our portfolio, and we have plenty of room to add more as the company gets back on track. I will caveat this point by stating that position size must also be weighed against valuation. In hindsight our position in Sea Limited was a mistake given it was trading at a lofty valuation without the cash-flows to back it up. Our position in Evolution while backed by an incredible business model and high free-cash flows was probably on the more expensive side for a rising rate environment (despite stellar earnings results). However, valuations in IAC, Sendas Distribuidora, and Meta were reasonable (although Meta had other problems). That said, given the state of current markets we will scale into positions more carefully.

2) Selling too slowly: While we were typically good at not overpaying for assets (for example despite Sea Limited falling 80% from its peak it's still above where we recommended clients purchase it in 2019/2020), I was not good at selling our positions when they overshot their fair value. I was of the belief that despite lofty valuations, I shouldn't sell quality businesses. However, these last nine months have shown that "quality" will not save you when markets turn, and just as fast as those stocks rose, they fell at an even faster pace. Multiple compression has occurred swifter than I imagined, and that caught us off guard. Going forward, while we certainly won't sell our positions at the sign of any profit, we will look to trim positions as they start to reach what we think is fair value. If our positions overshoot significantly, we will likely sell them and look for new opportunities.

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3) Tech heavy portfolio: While not a mistake per se, our portfolio did have a heavy tech bias going into this year (47% of the portfolio including IAC – which has several businesses). Since inception our tech positions have accounted for nearly 75% or our losses. Given the run tech has had over the 2011-2020 decade it was probably prudent (in hindsight) to have lowered our tech exposure going into this year. Certainly, the tech sector has been hit amongst the hardest this year with the Nasdaq down ~30% YTD. While it does seem like most of these positions have bottomed out, the ride down was painful to say the least. Going forward, while we will not shun tech (not by a long shot) nor will we invest in things we don't understand such as pharma/biotech/Oil & Gas (except for hedge), we will bear in mind the importance of having a healthy balance of uncorrelated industries such as consumer non-discretionary (Sendas Distribuidora), financials (HDFC Bank), and consumer discretionary (eDreams, Basic Fit).

We want to be careful here and we don't want clients to misconstrue the above as 'laws' for the portfolio rather than the 'guidelines' they are meant to be. Different market conditions require different strategies, so we won't be dogmatic about any one. To put this in perspective, had markets continued their upward trajectory all three of the 'mistakes' above would have been boons to our portfolio. Further, I don't think if you were invested even a little bit this year that you could have avoided losses in this market unless you were net short (we don't short). I reflect here instead to see how I could have limited those losses. Thus, the point of going through the above is to convey that we will be more balanced in our approach moving forward and so allowing the portfolio to better weather the storms it will face in the future.

Portfolio Changes…

There we minimal changes to our portfolio this quarter, and while we trimmed some positions and added to others, the portfolio roughly stayed the same. We do have two toe-hold positions in the portfolio which we may discuss in due time if we build the positions bigger. We did make one switch however and that was to sell Disney and add a 'tactical' position in 1stDibs.

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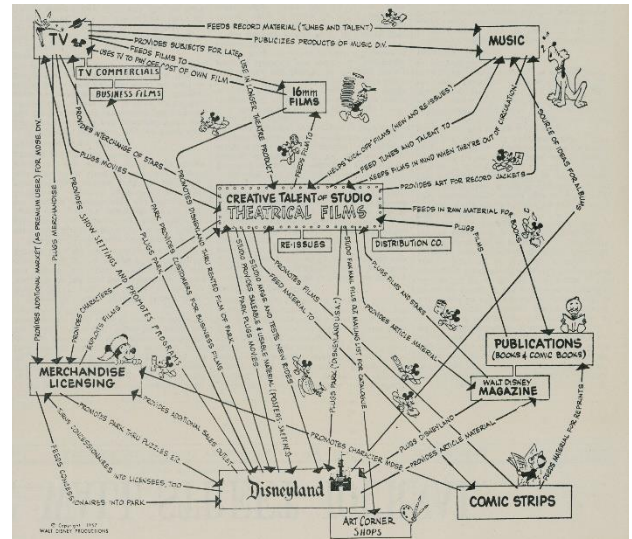
Farrer Wealth Advisors

Selling Disney

Our clients have owned a medium-sized position in Disney since the depths of the pandemic when the stock price slipped below $90. We have deeply admired the business model of the company which has largely gone unchanged for most of its nearly 100-year history (see image to the right that highlights Disney's strategy in 1957, source). Despite the focus on streaming and movies, our attraction the company have always been its park business. With 12 sprawling parks across the globe that immerse visitors in the worlds of Disney, Pixar, Marvel, Lucas Films, and other beloved franchises, we are yet to see a better mechanism for separating consumers from their money. The capital and time spent creating these parks makes it extremely difficult to replicate, and despite the company raising park prices each year, attendance continues to increase (pre-covid). Knowing the strength of this business, we felt that when the pandemic receded, visitors would rush back to the parks. In the meantime, the pandemic gave a boost to the Disney+ expansion, aiding the service in gaining nearly 100MM subscribers by the end of 2020 (just a little over a year after launch). We believed that while this was a good buoy for the business/stock, that the market would return to focusing on the business as a whole once thew world returned to normal. However, as we got over the pandemic and Parks and Experiences revenue recovered to pre-pandemic levels, the stock continued to struggle. This it seemed to us, was because the market was entirely focused on Disney+ numbers and the stock lived/died by the most recent quarterly adds. Thus, the reasons for us holding the stock and the reasons that were driving the stock were divergent. This year has shown us the video streaming business is far more difficult than the market believed and if this is the majority of what the market cares about with regards to Disney it is better to focus our energy elsewhere. Essentially, we didn't really know what we were holding anymore, and it was clear the story had changed. Further, given the weakness in streaming adds that we've seen in Netflix, and the lofty goals Disney has for itself for subscriber numbers, we decided to exit the position this last quarter. This was done in the $134 range (on average) resulting in minimal losses to the portfolio (although overall since initial purchase clients would have done decently in the stock). I have however, retained my Disney+ subscription.



A Tactical Add

Clients might notice a small position the portfolio called 1stDibs. 1stDibs is *the* marketplace for high-end goods (predominantly furniture, décor, art, and jewellery). The average value of anything sold on the site is upwards of US$3,000 and buyers range from individuals to interior decorators. Sellers, typically dealers, are vetted, and typically use 1stDibs as their go-to site for selling anything online. 1stDibs takes a 23% cut for their services of brokering roughly $450MM in GMV a year. The company is lead by David Rosenblatt who was the CEO of DoubleClick when it was acquired by Google in 2008

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really paving the way for Google's Ad Manager business. Rosenblatt also sits on the boards of IAC and Twitter.

We started our research on 1stDibs on Q4 last year and spent a fair bit of time speaking to the company, to sellers, and modelling out the business. However, in the end we passed, believing growth was reliant on international markets for which the company was just laying the foundation for. We thought tough covid comparisons would make Q1/Q2 numbers look ugly and that could damage the stock. We were proven right, and the stock fell 60%+ from the time we passed on the opportunity. However, this drawdown bought valuations to what we thought was a ridiculous level. When the stock bottomed it was trading at $30MM Enterprise value and a market cap of ~$190MM. This valued the company at essentially at 0.42x gross margins for a business that is expected to grow 15% a year on average for the next several years, has no debt, and is essentially cashflow break even. This gives significant option value to the stock to outperform especially with a seasoned entrepreneur leading the company. Based on this quick analysis we decided to take a tactical position the company. We call it tactical as we think the market is giving us a dirt-cheap price for a so-so business. The downside is limited but the upside could easily be 3-4x. Essentially, we're taking a call more on the valuation than on the business. The position size is small (we sold the last tranche of our Disney position and bought this) as normally will be for positions that we don't plan to hold too long. Bear markets provide several of these tactical opportunities, that when within our wheelhouse we will take advantage off. That said, clients need not worry that we are changing strategies, we won't do very much of this, but when the market throws you an opportunity like this, we will take a bite.

Company Updates…

There wasn't a whole lot of news on our portfolio companies this quarter with the macro overshadowing the micro. The big exceptions were HDFC Bank's merger and Spotify's investor day.

HDFC Bank Limited

Some might have noticed that HDFC Bank in our top 5 holdings. The funny thing here is HDFC Bank has always been a mid-sized position, however given it relative performance this year, it has creeped into our top 5. Somewhat like Disney, we recommended clients purchase HDFC Bank during the height of the pandemic when the price fell to ~Rs. 850 (ADR price ~$35). Our thesis was simple, HDFC Bank has grown its loan book by 22% annualized over the last decade, it would continue to grow at ~15% (slight premium to India's LT GDP Growth + Inflation), a cheap cost of capital through high CASA ratios, incredibly low long-term Gross NPL and Net NPLs (1.17% and 0.32% as of the last quarter) and the stock was trading at valuations not seen since the GFC. Certainly, covid was a risk but the bank managed its loan book well with NPLs rising only slightly. The investment worked out well for us with HDFC Bank trading 40-50% higher than its covid-lows.

The quality of the company and the relative strength of the Indian market has helped keep the stock

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afloat with HDFC Bank only down 11.3%/15.5% (in INR/USD terms) YTD 30th June. A big announcement was made in early April this year stating that HDFC Bank would merge with its parent HDFC Limited. In this case the child would essentially be buying the parent to create a financial behemoth with assets worth INR 31 trillion (US$ 386bn). The benefit to HDFC Bank is that the merger gives it access to the largest housing loan book in the country and direct links to HDFC's 48MM customer base, 70% of whom do not bank with HDFC Bank. The benefit to HDFC is a lower cost of capital and access to HDFC Bank's branch footprint.

The merger itself has some hurdles to clear but has been ok'd by the Reserve Bank of India and the relevant exchanges. The one risk is that given HDFC's higher cost of capital the entity at the whole will see an increase in interest expense. Overall, though, we view the merger as a positive. Also, HDFC Bank is aggressively going after low costing capital by ramping up its branch expansion. The CEO has stated that HDFC Bank will double its branches (already over 6,000) over the next 3-5 years. Given this, we believe HDFC Bank will continue to be a solid investment in the portfolio with a mid-teens return profile.

Spotify

Spotify held an investor day in June which really set up the next decade for the leader in music streaming. There was an abundance of information thrown at investors during the event and the most pertinent of it was follows:

- Monthly subscriber churn is down 30% over the last four years, and the current churn rate (3.9%) is significantly lower than all other major competitors.
- Music Gross Margin is 28.3%, generally higher than what the market expected and has been rising since 2017 (disproving the theory that labels have too much leverage on Spotify).
- The company expects music margins and podcasting margins to hit 30% and 32.5% (midpoint) respectively over the next 3-5 years.
- Spotify announced several new verticals including audiobooks (announced) and education/news (hinted at)
- Over the next decade Spotify expects to make $100bn in revenue (~$10bn currently), achieve 40% gross margins, and 20% operating margins. To hit this, they expect that by 2030 podcasting will be a $20bn industry, music will be $80bn, and live music will be $40bn.

We'll get to the last point (for which we have a healthy dose of scepticism), but before that, let's look at the positives. The margins, churn numbers, and strength in podcasting that Spotify presented was far higher than we expected. The company continues to separate itself from the audio streaming pack, and despite several controversies, seems to be moving from strength to strength. Looking back from the time we have invested in mid-2020, Spotify has seen its MAUs increase 47%, premium users up 40%, and ad-supported revenue increase 91%. Thus, the question arises as to why the stock has fallen around 50%+ since then. The only conclusion that I can reach, which is the obvious one, is that when business fundaments are stellar but the stock falls, I paid too much. While overall we've been decent about not doing this, it will happen from time to time (or at least appear so in the short run).

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Now – given that we made a pricing mistake during the initial purchase, the question becomes what do we do now? This is where we loop back to Spotify's target of $100bn in revenue and 20% operating margins over the next decade. The problem with this target is that we think for it to work the market for music and podcasts would have to grow about 18% and 40% annually over the next decade. Independent reports put the music industry growth closer to around 13-14% and the podcast industry around 31%. Thus, using independent numbers, our assumptions are that Spotify will reach half of their $100bn target with just music and podcasts. Further based on some more guidance we think operating margins will be at 11% (again roughly half of what management says). That said this still implies around a $50MM in revenue, $5.25MM in operating income and with a 15x exit multiple, a valuation of ~$80MM. Given the current EV of the company is around $18MM this is more than a 4x upside. It is also worth noting that our assumptions do not assume any gains in audio booking, education, or news (or any other verticals for that matter). It also assumes no further buybacks.

Now despite us having far more conservative numbers than the company, the upside of the stock looks attractive. So, while we may have paid too much to begin with, I do believe we would compound that mistake by selling for too little. That said a lot can happen in a decade, and thus we have been trimming the position a bit to allocate more to nearer term opportunities, but are still holders of Spotify for the long-run.

Moving Forward…

I will be the first to admit that the significant underperformance of the portfolio has been frustrating and disappointing. I was especially disappointed over the last few weeks of the quarter where our positions that had done relatively well over the year (eDreams, Assai, Evolution) started to crack as this drawdown comes for all assets. Before this, our returns for the quarter were quite in line with the benchmark. Further, the weakness of the EUR and SEK versus the USD/SGD have not helped returns. However, we are just one year into a multi-year journey, and I remain excited and optimistic for the future of the portfolio. I suspect it won't take a lot to make back these losses once the market turns as I strongly believe several of our positions are trading at ~30-50% of what they should be worth. Timing is the unknown. The macroeconomic scenario remains dark, but we do invest with the intention of holding several years. So, should you have a long-term view, we should do just fine (if not better than fine) over time.

One must also keep in mind that the market tends to bottom before the economy does. So, while inflation runs high, and a recession is likely (or perhaps self-fulfilling) waiting for clear skies is typically a bad strategy. We have started to see signs of the environment improving with commodity prices rolling off, inventory gluts, and China reopening. But just in case things get worse in the short run we do have active hedges on the portfolio and will keep them on (in one form or the other) for the foreseeable future. While we wait for markets to recover, we will be doing what we've always done and that is to 1) constantly revaluate our current holdings 2) look for bargains in the market on great

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businesses and adding them to the portfolio. Despite the doom and gloom we still come to work everyday eager to find new opportunities and immensely thankful we get to invest for a living.

We've said this before, and will repeat it often, but it is an immense privilege to manage our client's hard-earned money. It is a privilege we do not take lightly and work daily at earning and keeping our client's trust. If you are a current client and ever have any questions or just want to chat, please do not hesitate to reach out.

Lastly, for non-clients reading this letter, if you are interested in learning more about Farrer Wealth, please reach out at pratyush@farrerwealth.com. All interested parties must be based in Singapore and must be Accredited Investors (as per MAS's definition).

Pratyush Rastogi
CEO – Farrer Wealth Advisors

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