

September 2021
Fountainhead Partnerships Fund (FHPF)
Quarterly letter

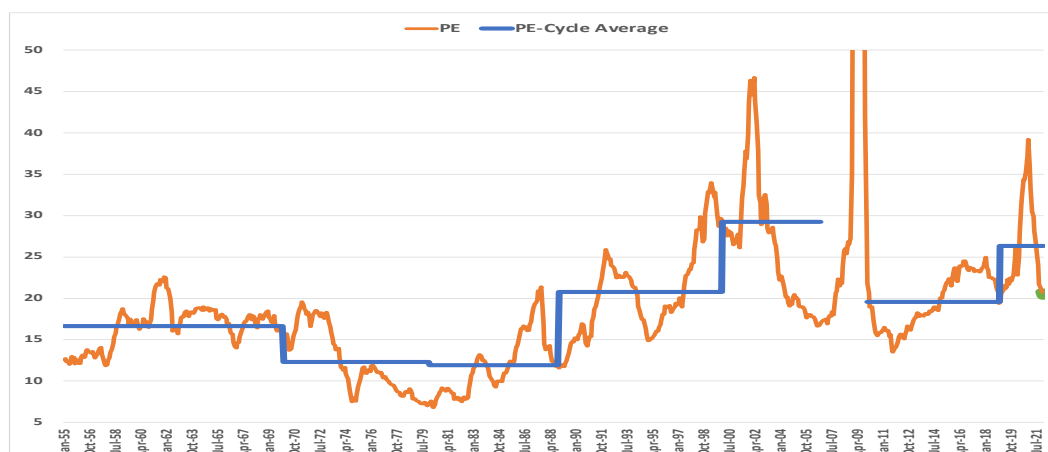
Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. Marcus Aurelius

Portfolio performance and commentary: FHPF was up 3.5% in 3Q21 whereas S&P 500 was up 0.5% and MSCI-world was down -1.3%. In September, after a seven-month positive return streak S&P 500 and MSCI-world were down 4.6% and 4.2% respectively, while FHPF outperformed with -3.6% return. Nevertheless, year to date, FHPF was up 17.5% (net of fees) vs S&P 500 return of 15.8% and MSCI-world return of 10.8%. As of October 15th the fund is ahead of where it was at on August 31st and has recouped all the losses of September while markets are still down 2% from their highs.

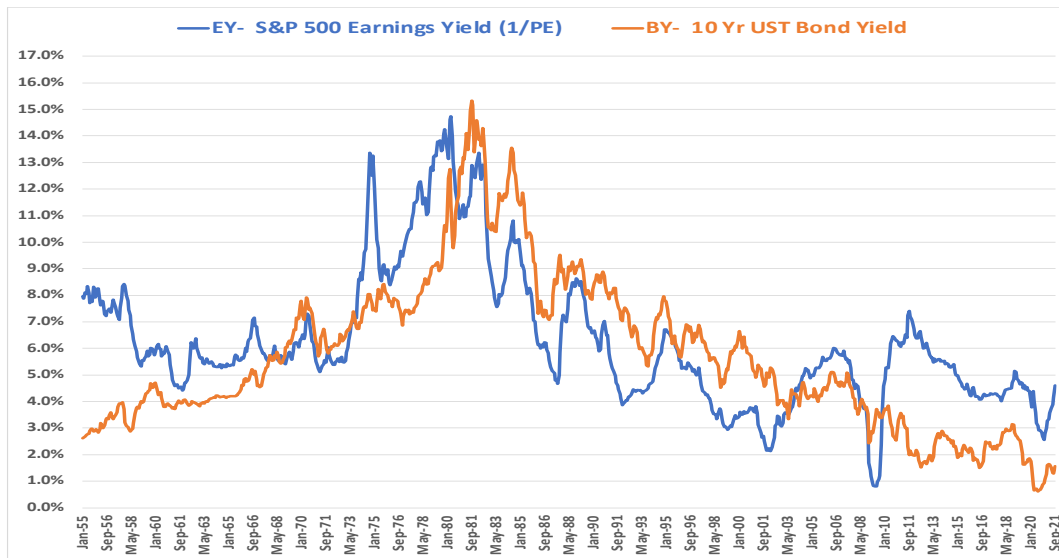
In this quarterly letter we will talk about:

- The valuations- how high (or low) are they?
- The Interest rates- how high can they rise without creating a recession?
- Our bullish bet on Carbon Credits.

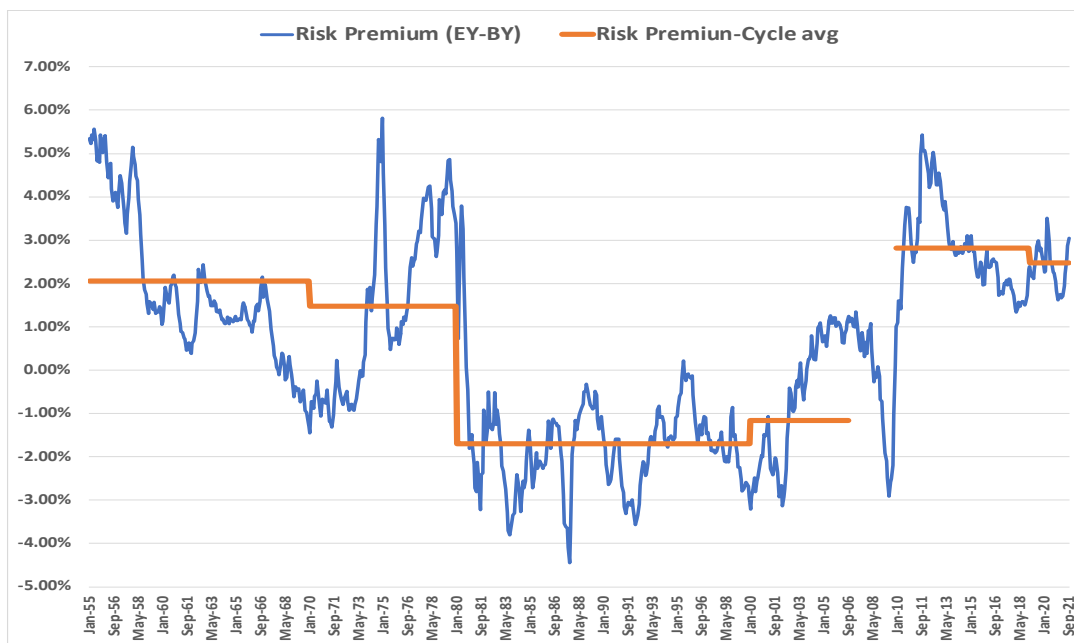
As central banks around the world start talking about taking away the punch bowl of liquidity, investors get concerned about valuations. Throughout this bull market, since March 2020, near record high valuations have been a huge concern for investors (including us). In the past, valuations were elevated at the start of every economic expansion and bull market of the last 70 years: because earnings were wiped out during the previous recession, stocks always appeared vastly overpriced. Nonetheless, in each prior instance, stock market valuations improved as the bull developed and earnings recovered. *(all charts in this document are sourced from, Bloomberg)*



A very famous investor¹ said, “Interest rates are to the value of assets what gravity is to matter”. The simple reason for high valuation is very low interest rates. And over the last many decades interest rate movements in either direction have pulled the equity valuations:



However, the most important thing to note about valuations is that with the decline in bond yields, Equity Risk Premium - the excess return demanded by equity investors over risk free bonds, has increased substantially as compared to previous economic cycles:

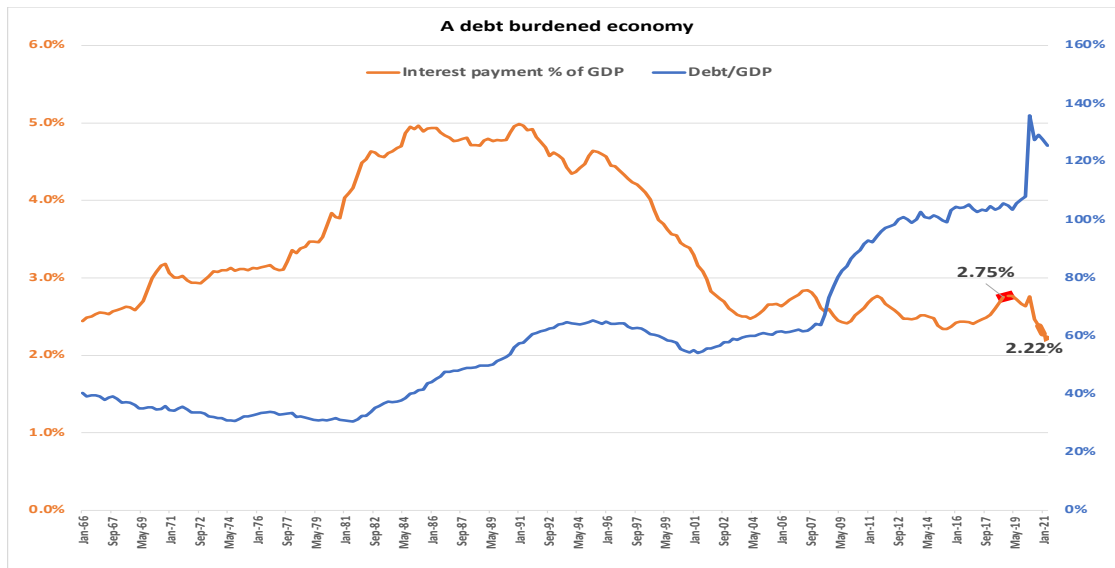


On PE basis the stock market is in the 78th percentile – meaning it has been cheaper during only 15 out of the last 66 years. However, relative to interest rates suggested by the risk premium stocks are as cheap as they have ever been in decades.

¹ Warren Buffet. (Paul has barred me from using Warren’s quote anymore this year at the top, so I squeezed one in here)

So, the call on stocks and valuations basically hinges on where will the interest rates go from here? And our call is they can't go much higher from here, at least on a sustainable basis! Here we show why.

US economy's debt to GDP has grown from 50% in year 2000 to 130% now. This economy is very unlikely to sustain the burden of high interest payments without going into a recession. The Fed discovered this the hard way in 2018 when it stubbornly raised the interest rates and pushed the economy to a near recession before pivoting back.

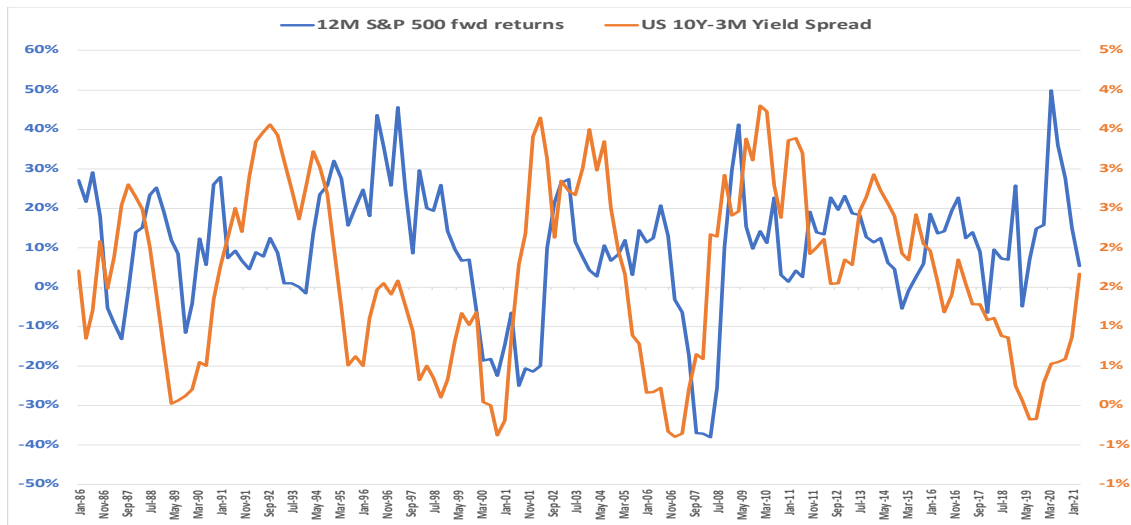


Yield Curve- best predictor of economic growth and stock returns

In our analysis, it is not the valuations but the yield curve that holds the strongest predictive power of the economic growth trajectory:

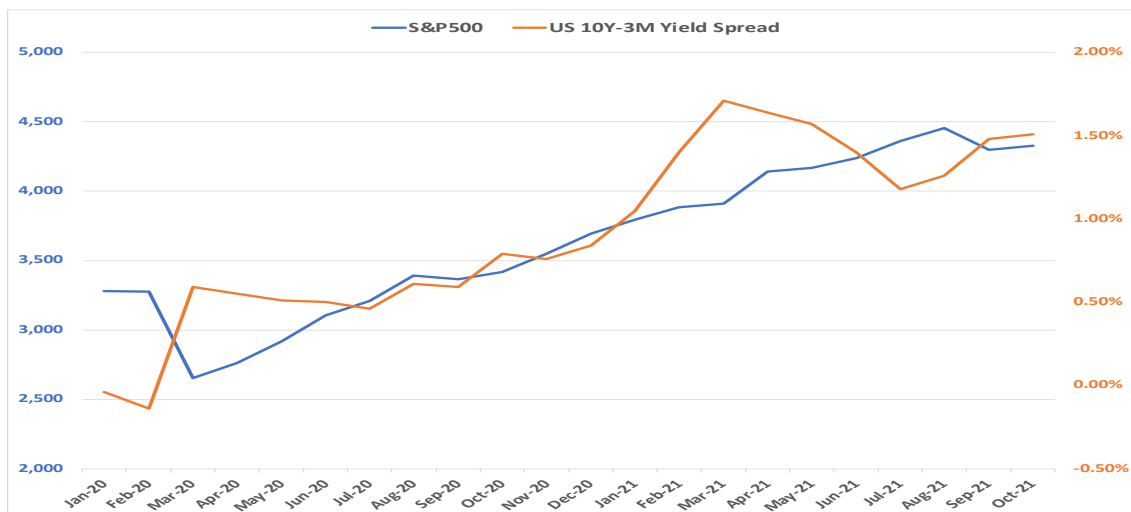


and the future equity returns:



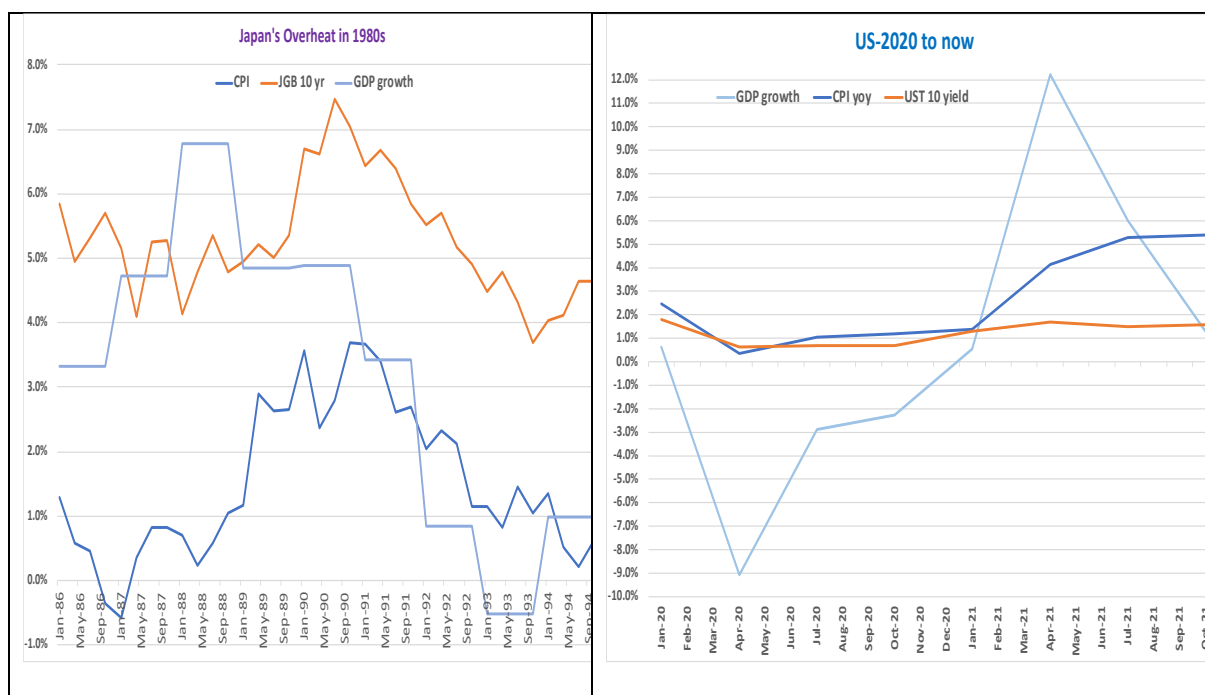
In Yield Curve they trust

Primarily the yield curve (YC) reflects two things: a) the direction of economic growth 6-12 months out, and b) monetary policy stance vis a vis the economic growth. 100% of the time, in the last 5 decades when the yield curve went negative the US economy had a recession and stocks posted negative returns in the next 12 months. Not only the level but also the direction of the yield curve is a good indicator of whether the economy is weakening or accelerating. E.g. earlier this year in March the yield curve started signalling a weaker economy ahead and that's exactly what we have got now – third quarter GDP forecast by Atlanta Fed has come down from 7% in March to 1.2%. YC also signalled after the June Fed meeting that the current economic growth trajectory does not warrant the monetary policy stance and forced the Fed to sound dovish. Also, since the yield curve started flattening the equity returns from the beginning of the second quarter have been quite muted. Now, the yield curve has started steepening again and suggesting better times ahead both for the economy and for the stocks.



Supply Side shortages >> Inflationary or will result in increased deflationary gap? (wonkish)

Economics 101 suggests that when demand is higher than supply - economies will face upward pricing pressures. Currently the global supply shortages are not the result of any permanent lack of production capacity but mostly due to the virtual collapse of all kinds of delivery channels from producers to consumers. This unprecedented situation has resulted in inflationary pressures caused initially by the fiscal stimulus induced excessive demand and then exacerbated by Covid control policies particularly in China & Asia. It is a conducive setup for a *supply side growth recession: A significant drop in economic growth caused by cost push factors and lack of supply. Since this situation cannot be resolved by monetary or fiscal policies, central banks have an impossible job on their hands.* They are staring at an economy which is fast losing momentum and they have to ensure at the same time that inflation does not get out of hand. If they use the tools they have got (raise interest rate or tighten financial conditions) to tackle the price pressures they will turn a growth recession into a full blown business cycle recession. And if they do raise interest rates in this environment it will expand the deflationary gap that has mired the US economy since the great financial crisis. In our March-21 letter we compared the situation in the US evolving very similarly to what happened in Japan in the late 80s. I am afraid we are just getting closer to Japan's path in US.



Carbon Credits

Climate change is the most important issue of our time. Government, corporates and public all have joined forces to reduce the carbon emissions from the environment. These efforts have

significant investment implications. Here we explain the carbon credit market and our bullish bet on the industry.

What are Carbon Credits: A Carbon Credit is an allowance for a company holding the credit to emit carbon emissions / greenhouse gases. A single credit equals one ton of carbon dioxide to be emitted or the mass equivalent to carbon dioxide for other gases. Companies hold many credits, as many as they wish to purchase to balance out their emissions. These carbon credits would come from four categories: avoided nature loss (including deforestation); nature-based sequestration, such as reforestation; avoidance or reduction of emissions such as methane from landfills; and technology-based removal of carbon dioxide from the atmosphere. Credits do however decay over time which means companies continually need to create new ideas to remove emissions.

Carbon markets:

There are two types of carbon markets:

- i. **Compliance Carbon markets:** Mandatory systems regulated by government organisations to cap emissions from specific industries which includes United Nations Clean Development Mechanism, the source of offsets for Kyoto Protocol Signatory Countries and buyers in the (the most important) European Union Emissions Trading Scheme. The size of compliance market is estimated at USD 260bn in 2020.
- ii. **Voluntary carbon market:** Where carbon credits can be purchased by those that voluntary want to offset their emissions. Voluntary carbon credits direct private financing to climate-action projects that would not otherwise get off the ground. The size of voluntary market is estimated around USD 500mn.

Carbon Pricing

Carbon pricing can take two basic forms (i) an emissions trading system (ETS or carbon market) or (ii) a carbon tax imposed by a government.

ETS is a system where emitters can trade emission units to meet their emission targets. To comply with their emission targets at least cost, regulated entities can either implement internal abatement measures or acquire emission units in the carbon market. By creating supply and demand for emissions units, an ETS establishes a market price for GHG emissions. The two main types of ETSs are cap-and-trade and baseline-and-credit.

How we are invested: KRBN- Global Carbon Index

IHS Markit, one of the leading global index providers, together with Climate Finance Partners (CLIFI), have developed the Global Carbon Index, a first-of-its-kind index that tracks the underlying assets of the most liquid carbon markets – the European Union Emissions Trading System (EU ETS), the California Cap-and-Trade (CA C&T) system, and the Regional Greenhouse Gas Initiative (RGGI) representing ten states in the north-eastern United States.

Composition of the Global Carbon Index

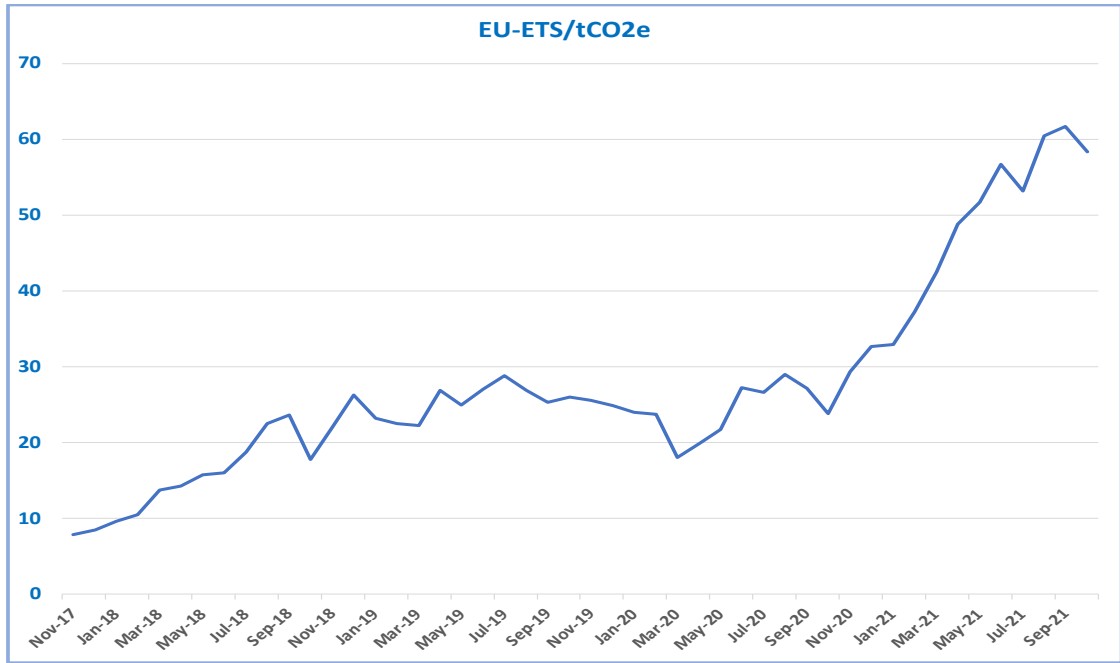
The IHS Markit Global Carbon Index is designed to track the liquid, investable segments of the global carbon allowance market using relevant futures contracts. The index contains three constituents.

- European Union ETS (EU ETS) 95%
- California Carbon Allowance (CCA) 4%
- Regional Greenhouse Gas Initiative (RGGI) 1%

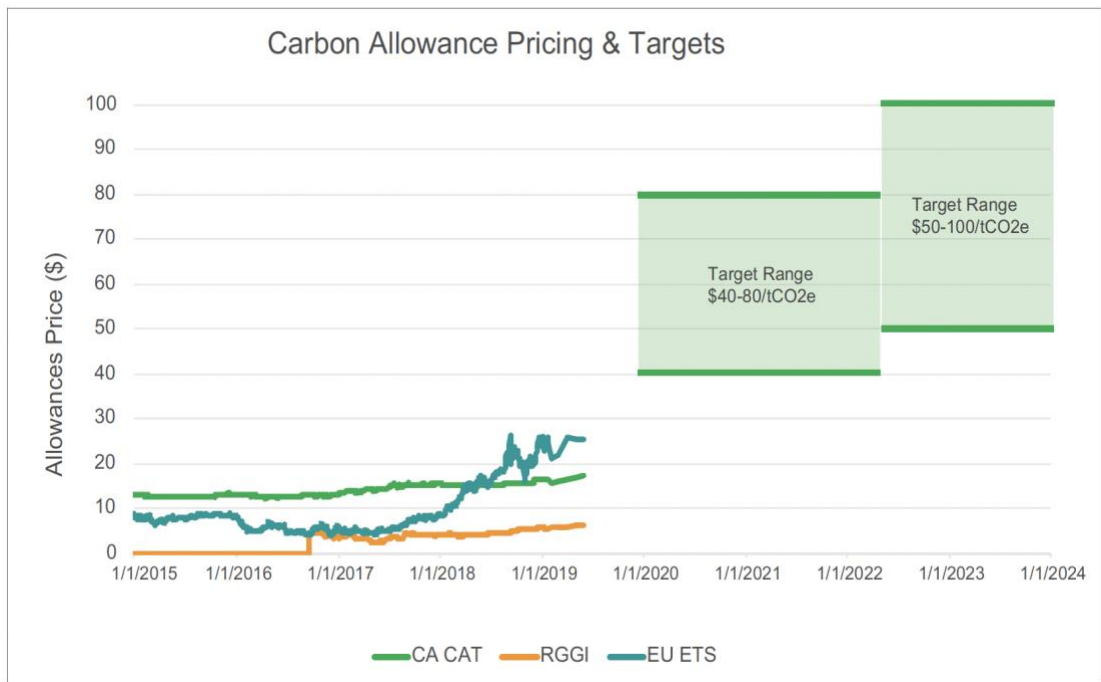
These constituents feature significant liquidity, and furthermore, are available to a broad investor base through their respective futures contracts. We started investing in the index when its size was only USD50 mn. It has now crossed USD988mn. EU-ETS market has experienced total notional trading volumes of over \$400billion from end of 2018 to end of 2020 and has grown exponentially in recent years.

The KRBN is constructed in such a manner that new carbon allowance futures are quickly added to the composition as carbon trading systems evolve and become globally accessible to investors. Furthermore, any carbon allowance programs with over 20% weight in the underlying index will feature 5% of their weight at rebalancing in next-year vintage futures contracts.

We like KRBN because it offers a pure play to invest in the carbon credit markets. We believe that carbon prices are extremely undervalued right now and the amount of investment that is required to achieve the desired temperature standards under the Paris Agreement and other environmental standards will increase significantly in the next few years. As per a recent United Nations study, Carbon prices would need to at least double to come in anyway close to the desired environmental standards by 2024.



Historical prices are right on track to achieve the price target



Source: United Nations.

Thank You.