

March 2021  
Fountainhead Partnerships Fund (FHPF)  
Quarterly letter

*"A good decision is based on knowledge not on numbers." Plato*

*"When it's obvious what to do...it's not." Anonymous*

**Portfolio performance and commentary:** FHPF was up 3.42% in 1Q21 whereas S&P 500 was up 6.1%. Year to date, FHPF has had net long allocation of 68% and delivered 60% of S&P 500 return.

In the last 12 months or so, developments in the economy and movements in the markets have been frantic. After declining 30% in March-20 from its all-time high levels, S&P 500 has risen 74% and is now at a new all-time high level and peak valuations. VIX Index (the fear gauge of the market) has also made its round trip from an all-time high level in March-20 to the very low level where it was last year before the pandemic.



Source, <http://www.econ.yale.edu/~shiller/data.htm>

During this quarter we initiated three new positions in the portfolio:

1. Allocated 6% capital to a basket of Value stocks.
2. A hedging program using options.
3. A bull-spread on Nasdaq.

As the market becomes overvalued, we believe the most attractive value trade is hedging. And interestingly, if the market continues to go up, hedging will become more and more attractive as the cost of hedging may continue to decline. We made all of these portfolio moves by reducing our cash position by 6% and without changing anything in our core portfolio. We will

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elaborate all our trades including hedging later in this marathon letter but first we want to explain our thinking and context behind our portfolio positioning. So please bear with us.

### **First a strategy recap**

We are primarily a growth investor. Since 2015, our growth strategy has produced 23.8% p.a. return vs S&P 500 and MSCI World return of 12.7% and 10% p.a. respectively, while Global and US GDP growth have averaged 1.3% and 1.6% pa respectively from 2015-20. From a top down perspective, our strategy was premised on three key macro pillars: aging demographics, persistent debt-deflation, and low real and nominal interest rates (leading to misallocation of resources). When these macro dynamics hold, most asset prices tend to rise and multiples in equity markets stay elevated, which generally benefits high income households. We constructed a portfolio that was overwhelmingly synchronised to that macro environment and we have been steadfast in holding 75% of the companies for over six years with minimal adjustments.

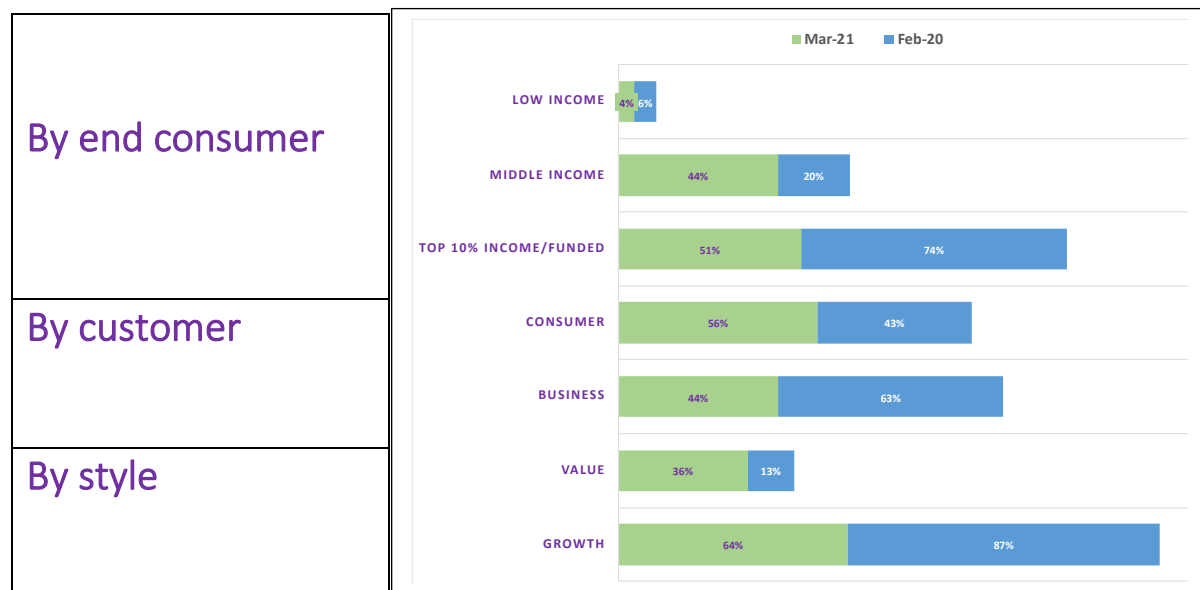
### **Portfolio positioning- Feb 2020 vs March 2021**

Our portfolio positioning is often a reflection of where our thoughts are about the economic trajectory. We typically divide our portfolio into three broad categories:

1. **Value vs Growth.**
2. **Product sale – Business to Business vs Business to consumer.**
3. **The end consumer – Top 10% or govt funded, middle income or low income.**

Twelve months ago we believed that we were closer to the end of economic cycle and interest rates could only go down. Hence, we maxed out our secular growth (long duration) portfolio, geared towards the high income consumers and hedged the recession risk with our options' strategy.

## Our Portfolio positioning:



Fast-forward 12 months and a lot has changed. The economy is recovering faster than ever coming out of a recession and the trajectory and direction of interest rates have never been more uncertain. And this is what our equity portfolio is reflecting with a 60-40 growth to value exposure.

### Is anything changing?

Rarely did we find ourselves at a point in the last six years where we felt the long-term trajectory of our investing style required a major review. And we still believe that we are not there yet. However, every big crisis in history has changed the discourse around the economy and societal dynamics that determine the trajectory of asset prices. Certainly a once-in-a-hundred-years crisis will still unfold more surprises.

Going into the Covid recession, the backdrop of 12 years of economic and fiscal policies was the tremendous increase in public and private *debt* that did not lead to higher inflation or interest rates. The lack of negative consequences bolstered the mindset of the fiscal and monetary authorities to go as big as they wanted to support the economies without fearing inflation. This response helped to contain the covid crisis and even further emboldened the authorities to go for more debt-financed economic stimulus to accelerate the recovery. This no-holds-barred attitude of governments particularly in United States has started to make financial markets a little *nervous* about the outlook of the economy, inflation and interest rates.

*Question on everybody's mind now is: will the moribund horse of inflation come back to life with continuous hammering of ever thicker and longer leashes of debt?*

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History suggests not so soon.. the fundamental composition of deflationary forces in the society that has shaped the economic trajectory of the last 12 years has not changed, and arguably has become more intense. So, how can the economy respond to those hefty fiscal measures post-pandemic? And will the behaviour of the economy and the response of asset prices be different?

There are three possibilities going forward in our analysis:

1. **Sizzle and Fizzle:** after a splash of growth in 2021, the economy goes back to either another recession or falls back to the slower growth trajectory of 2008-20 which leads to lower interest rates and perhaps a correction in asset prices followed by continuation of elevated asset price multiples.
2. **A Melt Up:** too much stimulus *scorches* the economy that leads to a melt up in asset prices but this situation is short circuited by a sudden spike in interest rates and a subsequent collapse in asset prices.
3. **The New Dawn:** we somehow see the *rhymes* of the golden era of 1950-65 where GDP growth accelerated, inflation and interest remained subdued and asset prices continued to rise at a measured pace.

We will share our thoughts on the probability of each outcome and how we have positioned our portfolio to navigate each possible outcome. The evolving shape of these outcomes has become more complicated due to the fact it is a post-pandemic recovery.

## **1. A SIZZLE AND FIZZLE**

Because of extraordinarily accommodative monetary and fiscal policies, a somewhat synchronized global-economic expansion, unprecedented savings pools, substantial pent-up demand, a post-pandemic reopening, and a record-low inventory/GDP ratio, the U.S. and global economy are poised to run HOT! ***But for how long? Historically, recession is an event and the recovery is a process.*** While the recovery, due to its lightning pace, might have the feel of an event this time, it may take years for the economy to go back to full employment where the inflationary pressures take hold. We have seen no evidence in the data of the last twelve months that suggests incomes or demand of consumers and businesses will be and grow significantly higher than what they were pre-pandemic, once the fiscal policies' stimuli start to relapse. We find ourselves in a transitory inflation camp where the slower GDP growth may come back as the more protracted deflationary economic forces take hold and set the growth trajectory. We prepared a checklist to analyse **the transitory and permanent features** of inflation and deflation.

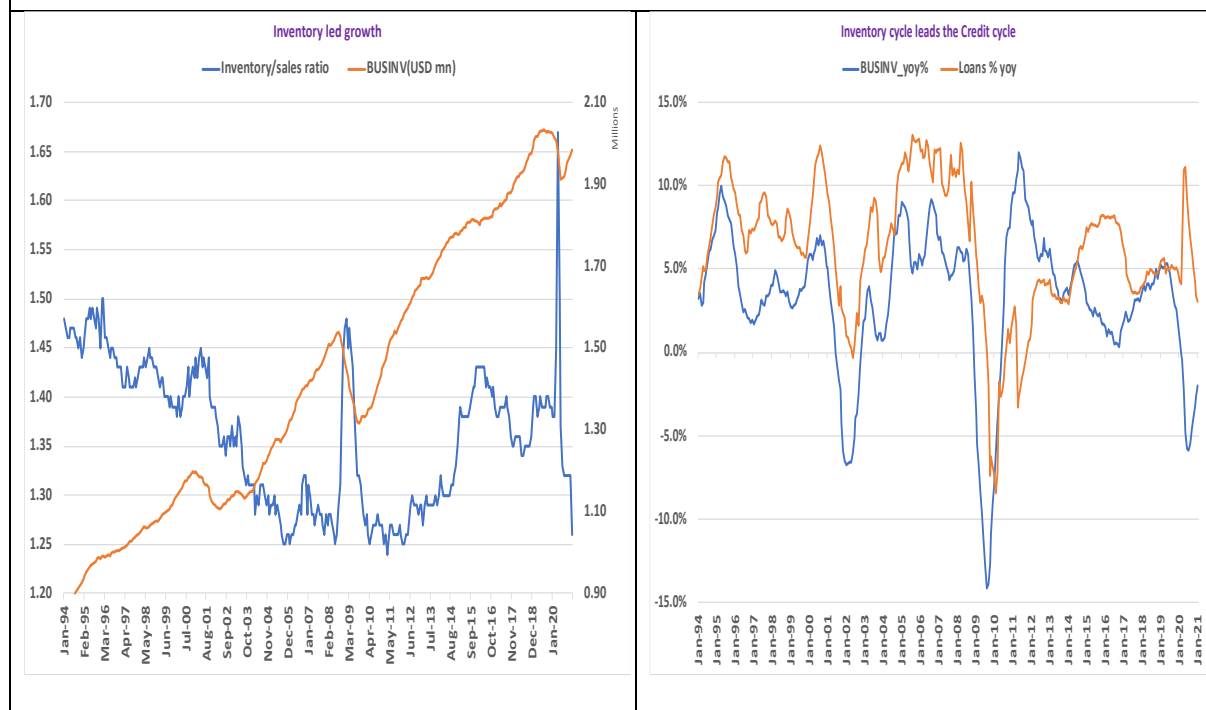
We believe that a transitory inflation and structural deflation checklist still wins

Inflationary Structural	The winner checklist		Deflationary Transitory
	Inflationary Transitory	Deflationary Structural	
rising food and metal prices?	Supply shortages	Aging demographics in west and China	Mkt share war bw domestic and export players
rising wages?	rising input costs	falling birth rates	Productivity dividends
Supply move from Asia to West	Fiscal impulse	Excess savings	Higher corporate/ consumption taxes
Millennials spending- Housing	Pent up demand	Technology	
Govt's redistribution policies	Inventory build up	Work from home	
	synchronised global growth	Collapsing money velocity	
	Money supply growth	High debt burden	

Therefore, our broader portfolio strategy remains aligned with a sizzle and a fizzle economic scenario where the US long term interest rates will remain below 3% and S&P 500 PE multiple will remain elevated at around 20x.

### Transitory Inflation

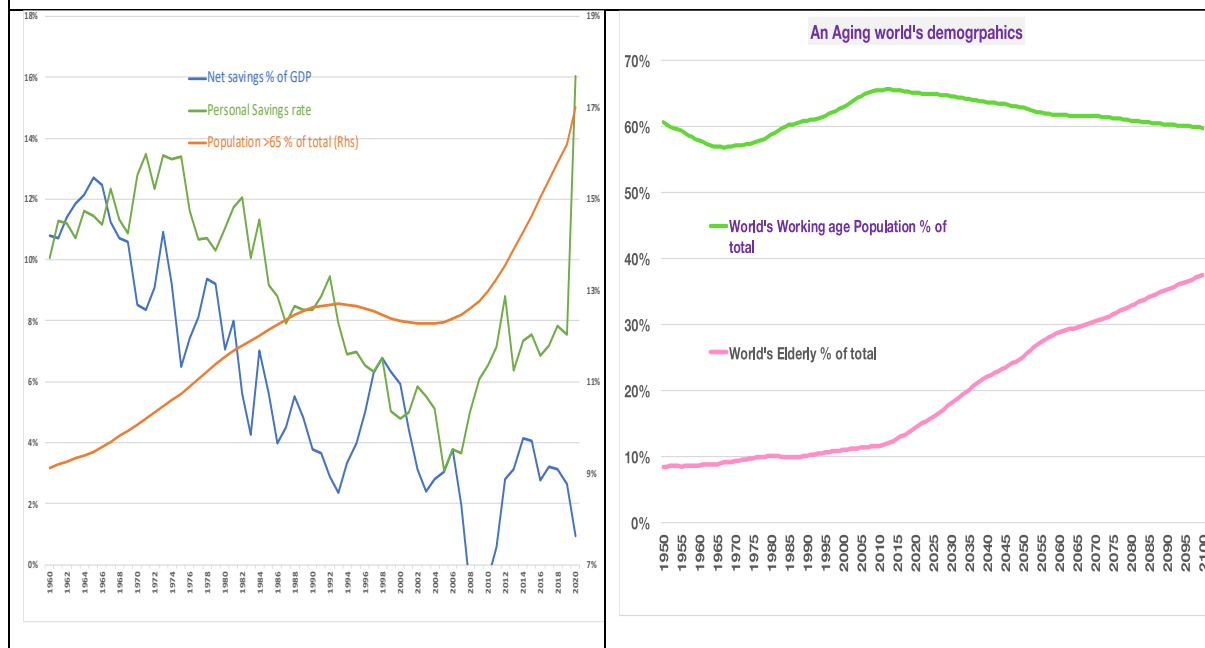
*Inventories lead the business cycle and if credit follows so does the inflation... for sometime*



Source: <https://fred.stlouisfed.org/>

## Structural Deflation

*Demographics are the strongest driver of savings. US and global economies may continue to increase the level of savings every decade as population gets older*



Source: <https://fred.stlouisfed.org/>

Source: <https://ourworldindata.org/>

*Elderly population is expected to grow 7-10x faster than the working age population in all major economies in the world. This analysis feeds into our broader long term thematic of debt deflation and demographics.*

Population Annual growth rates	China			US			Europe			Japan			World		
	Population	Working age (15-64)	Elderly >65	Population	Working age (15-64)	Elderly >65	Population	Working age (15-64)	Elderly >65	Population	Working age (15-64)	Elderly >65	Population	Working age (15-64)	Elderly >65
2000-2020	0.004%	0.66%	3.42%	0.619%	0.72%	2.33%	-0.09%	-0.11%	1.46%	-0.45%	-0.76%	2.53%	1.20%	1.36%	2.76%
2021-2040-Forecast	0.51%	-0.64%	3.39%	0.80%	0.28%	1.94%	0.11%	-0.51%	1.39%	-0.06%	-0.96%	0.50%	0.84%	0.73%	2.91%

Source: <https://ourworldindata.org/>

## 2. MAMU (Mother of All Melt Ups) coming

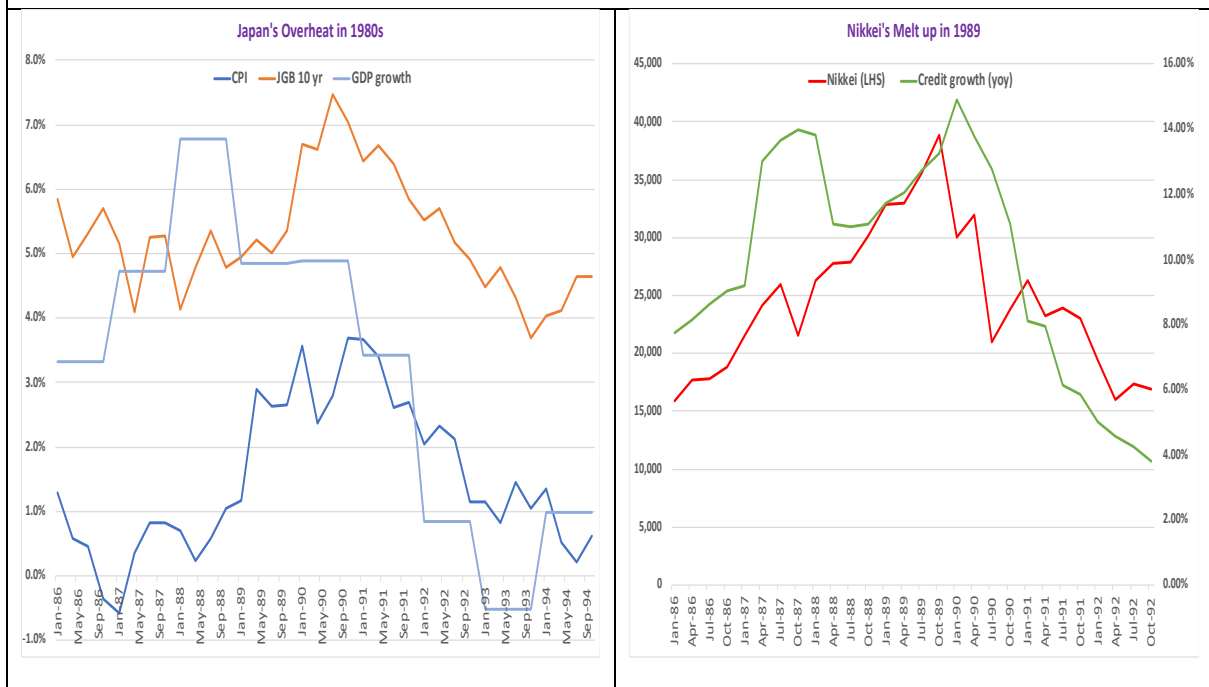
The second possible outcome could be an economic situation where the combination of an accelerated business cycle, a significant surge of pent-up consumer demand (or at least the perception of it) and a very optimistic investor sentiment can lead to a **Melt up** in equity markets. We are experiencing an economic event, particularly in the US, where in a supply constrained economy, short term demand pressures both from consumers and businesses can lead to significant inflationary pressure. From the businesses side those pressures could come from rebuilding of inventory and over-ordering of available inputs. In the transition back to a normal economy, consumers' spending will be the most interesting economic feature to watch: will they continue to spend on goods while they restart spending on services? Or will the services spending cannibalise the spending on goods? The answer is unclear at the

moment, but *if consumers and businesses both put the demand into top gear there are serious risks of overheating the US economy and a historic Melt Up in equity prices.*

Melt ups often occur when a stutter in a fully employed economy leads to a significant liquidity injection in the system. Before the melt up, equity prices experience a sharp pull back, sensing the stutter in the economy. But they not just make a swift recovery with the GDP growth but tend to Melt up much higher because of excessive liquidity. There have been past instances when this kind of economic overheat has pushed a buoyant equity market into a melt up phase followed by a melt-down.

**Japan melt-up in the late 80s**

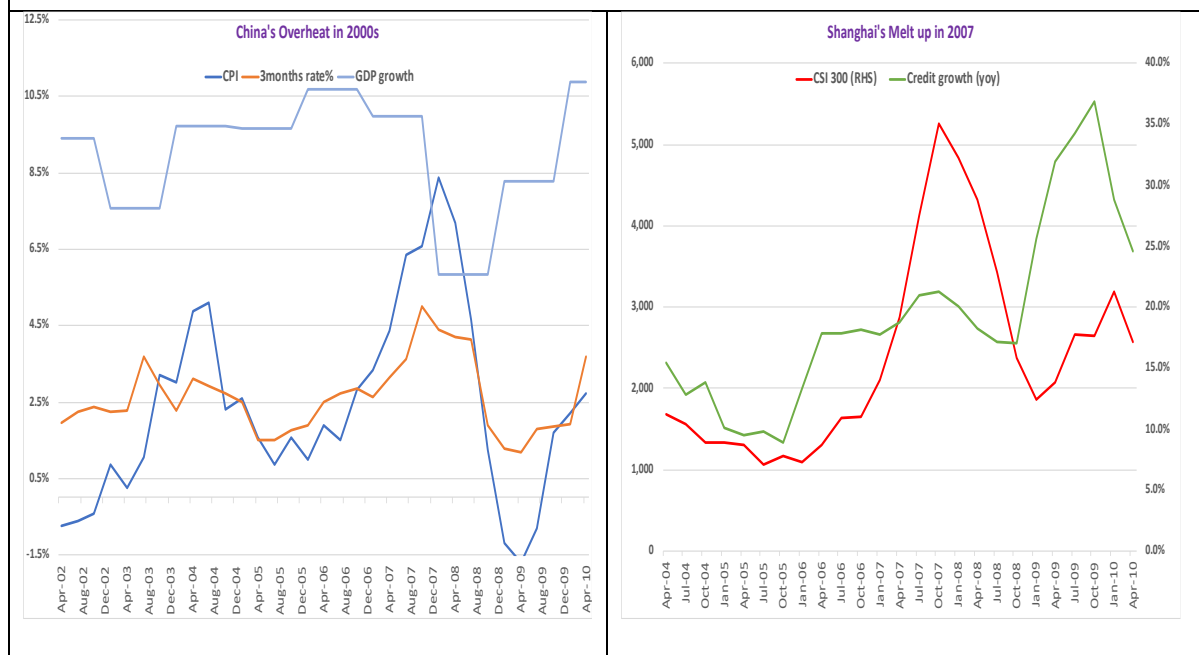
*In the mid 80s, following Plaza accord Japan had a blip in growth, where it fell from 5% to 3% in 1986, and CPI went negative. Japanese authorities pushed massive liquidity in the system to support growth. Nikkei had a 20% correction in the famous '87 global stock market crash, that prompted Japanese authorities to continue with massive policy accommodation despite an overheated economy. Within eight quarters GDP and credit growth doubled, pushed CPI from -1% to +4%. That excessive liquidity resulted in a classic Melt up where Nikkei rose 80% in the following eight quarters from its low, 50% higher than the pre-crash highs.*



Source: Japan ministry of finance

## China melt-up in the mid 00s

In the mid 2000s China's inflation came down to zero from 5% and credit growth from 22 to 8%. Although "miraculously" GDP growth didn't show any weakness, the equity market in four quarters plunged 34%. Within the next ten quarters credit growth tripled, GDP growth leaped up to 11% and CPI surged to 8%. Shanghai composite **Melted up 400%** from its low and 200% from its pre-crash high, before the inevitable meltdown



Source: <https://fred.stlouisfed.org/>

Source: <https://fred.stlouisfed.org/>

We are not trying to forecast any specific index level here and we don't think we are good at it anyway. We are trying to analyse an economic scenario that has a reasonable probability of happening and its impact on our portfolio.

### 3.THE NEW DAWN – Old Normal

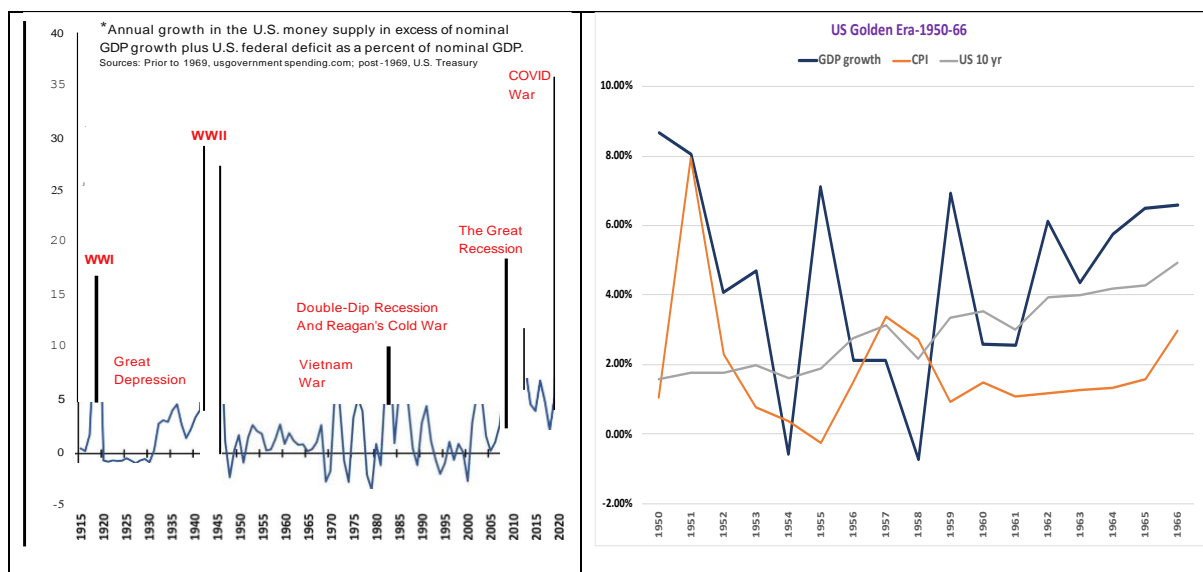
And there is the hope of the old normal. Can global economy go back to a 4-5% growth and US to elusive 3% ?

Although the chances are slim, there is a prospect of a different economic outcome, something that we have not seen in the last two decades. Too many are focused only on overheat risk; not enough attention is given to the prospect of a much rosier outcome. So what could be the drivers of that rosier outcome? We believe there could be two: tremendous amount of liquidity in the system and a pent up housing demand in the US. Both drivers have potential to create a not-so-hot and not-so-cold economy.



## That 40s Stimulus

The size of the policy accommodation during 2020 is only paralleled by that implemented during WWII. The policy accommodation that peaked in 1945 played a crucial role in boosting real growth during the Golden Era of the 1950s due to its size and long-standing effect. The 50s like today were preceded by a prolonged period of disappointing economic growth. The overwhelming policy response during WWII is widely considered to have finally ended the Great Depression. In a similar fashion, having sluggish growth since the Great Recession of 2008-09, will today's massive economic policies eventually be credited with ending the weakest phase of U.S. economic growth since WWII?



Source: Leuthold research

Source: <https://fred.stlouisfed.org/>

Just to put things in perspective, during the 1950-1966 Golden Era of US history, GDP growth averaged 4.5% annually with two mild recessions in 1954 and 1958. Even if the New Dawn occurs, US GDP growth would still be significantly lower. At this point, investors should keep an open mind about where we go from here.

*We will end our chart feast with one of the main drivers of inflation and growth: Housing, which – if it gets traction, will take the US growth to the old normal:*

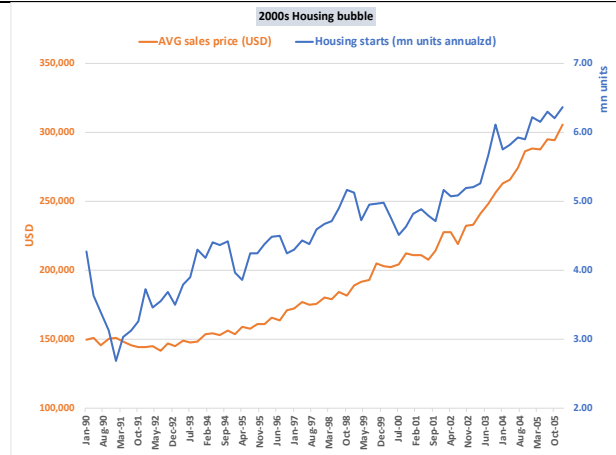
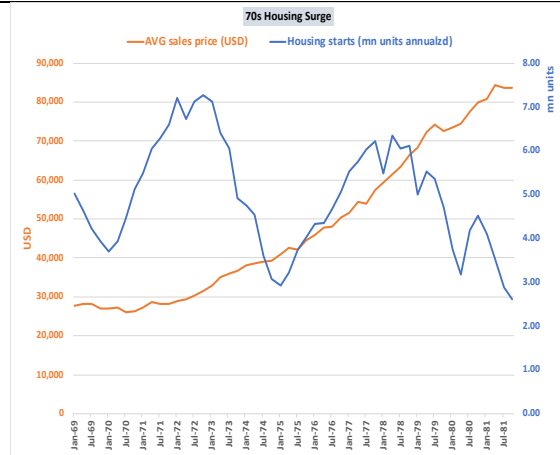
## Pent-up Housing Demand

*A pent-up housing demand could be the biggest driver of growth in the next decade*

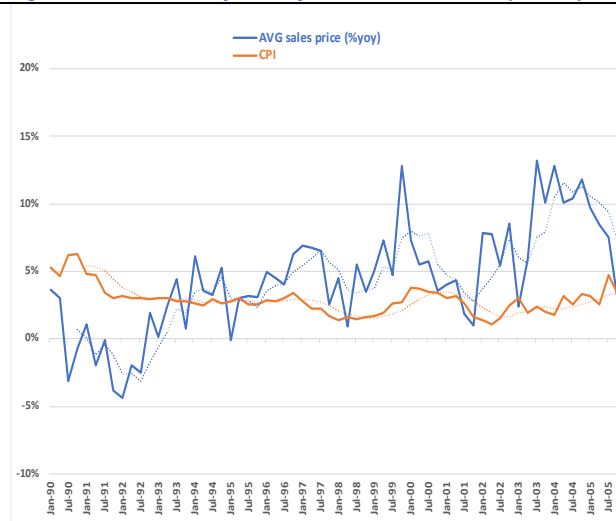
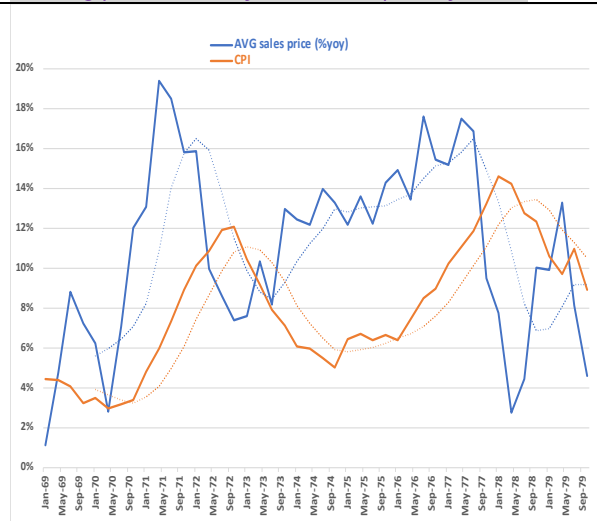
	1970-1980	1981-1990	1991-2000	2001-2010	2011-2020	2021-2030	2007-2020
<b>New units completed (mn)</b>	18.55	14.70	13.57	14.72	9.79		12.36
<b>House price Increase per year</b>	11.4%	7.5%	3.6%	3.1%	3.7%		2.0%
<b>Avg house price USD</b>	27000-73600	151,100	202,900	275,300	393,300		
<b>Inc in Work force (15-65) (mn)</b>	21.50	14.82	21.43	20.29	8.30	3.17	13.94
<b>Inc in total population (mn)</b>	20.17	22.77	29.88	26.66	22.79	23.28	30.84
<b>Increase in Elderlies</b>	5.44	5.32	2.74	5.30	15.04	17.16	17.60
<b>ratio of inc in work force/ elderlies</b>	3.95	2.79	7.83	3.83	0.55	0.18	0.79
<b>New houses/Potential buyers ratio (ratio of less then 1 means less houses built then ppl entred in work force)</b>	0.86	0.99	0.63	0.73	1.18		0.89
<b>Last 30 years' potential pent up house' demand (mn units)</b>						11.9	

<https://www.census.gov/topics/housing/data/datasets.html>

*House prices tripled in US during 70s, while during more famous housing boom of 2000s it doubled in 20 years.*



*Housing prices have a feedback loop to inflation: both during 70s and 2000s inflation followed the house prices path*



Source: <https://fred.stlouisfed.org/>

And finally, we conclude our Marathon letter with details of our portfolio positioning.

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## Portfolio Positioning

**10% FCF value basket:** In the last quarter, we started a position in six new companies in the US that we believe are going to benefit significantly from a rapid economic recovery or any overheat situation. These are cyclical value plays run by competent management and are guiding multi-fold earnings growth. We had calls with the managements of these companies to understand their outlook and their confidence in their earnings and free cash flow guidance. Our take away was that all of these companies are poised to significantly beat their guidance. The strong operating conditions for these names could really become appreciated in H2. We have taken a foothold in these names but may add further post Q1 reporting season. These stocks are still cheap relative to not only the index but also their own historical peaks.

### Valuation table of value stocks.

					2021					
	Company	Ticker	Mcap (USDmn)	Sector	Rev Growth	Earnings Grth	PE	FCF yld	Price \$	ATH-Price
1	Trinseo	TSE	2,455	Materials	15%	2501%	12.22	9.4%	63.6	82
2	Chemours	CC	4,500	Materials	11%	136%	9.22	7.8%	28.78	56
3	Domtar	UFS	2130	Materials	10%	300%	12.16	14.1%	36.48	52
4	XPO	XPO	11,860	Industrail	8%	191%	22.97	5.9%	134.37	122
5	Triton	TRTN	3,980	Industrail	11%	63%	8.17	12.6%	55.56	61
6	GraffTech Int	EAF	3,430	Industrail	31%	42%	5.04	17.5%	11.59	21
7	Vontier	VNT	5,240	Industrail		-1%	12.78	12.4%	31.3	36
8	Fiserv	FISV	82,000	Financials	10%	24%	22.64	5.3%	124.51	124
		<b>Average</b>			<b>14%</b>	<b>407%</b>	<b>13.15</b>	<b>11%</b>		

### Nasdaq bull-spread:

We initiated an upside option strategy on the Nasdaq. The strategy is based on convex returns if we see a Melt up phase in the market. We bought 10% out-of-the money call options and funded them with 22% out-of-the money puts and 25% out-of-the money calls. This was a cost-free trade where we are the buyer of Nasdaq if the index goes down to 10,000 from 14,000 currently. We believe the risk-reward of this trade is quite compelling. All the options are December 31, 2021 strike.

### Downside protection:

We started an index hedging program in the first quarter. As the market becomes overvalued in our view, we believe the most attractive value trade is hedging. And interestingly if market continues to go up, hedging will become more and more attractive as the cost of hedging may continue to decline. So far, we are only hedging for a 15% correction in the markets, not for any significant bear market or meltdown. However, we expect our hedging activity to be more dynamic going forward.

We are delighted that you make it to the end. Thank You.