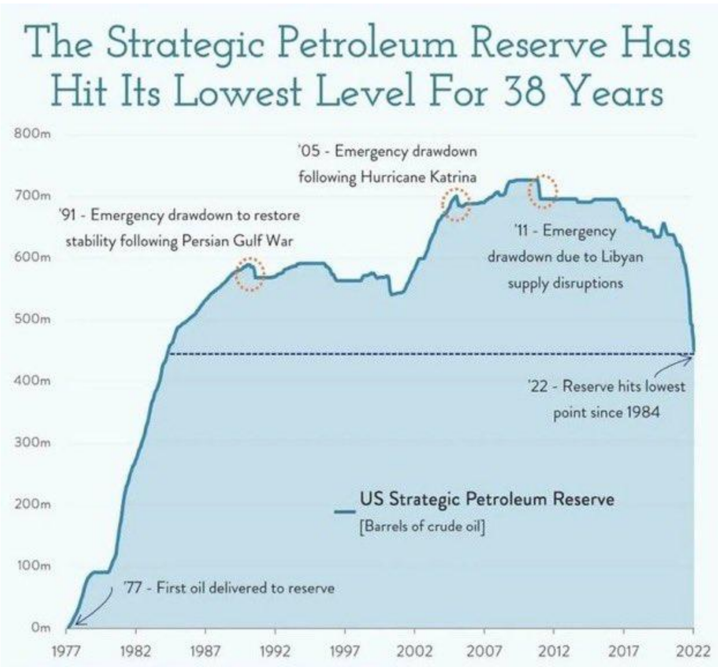
Quarterly report Q3 2022

The third quarter’s sting was in its tail. Having noted new all-time highs earlier in September, our portfolio was unable to escape the price tumult entirely and we closed the quarter down. Nevertheless, after three quarters we can say that portfolio is holding up well in an exceptionally turbulent market. While most indices are now showing substantial losses and have dropped by 20 to 30%, our portfolio is only down very slightly. Although there are significant differences in performance within the portfolio, the applied diversification is doing its job and there are both pluses and minuses. One important reason for the price pressure in our portfolio over the past few weeks has been the weak oil price. Yet the question is how long the oil price can remain depressed. The market continues to be extremely tight and the slightest disruption could send oil prices soaring again. There’s also uncertainty surrounding Russian oil production. So far, Russia has managed to find buyers for its oil but we’re seeing production gradually being reduced. This isn’t really a surprise. It's getting harder for oil companies in Russia to find enough components, materials and sales channels and a growing number of countries are joining the boycotts. OPEC also recently announced its target oil price of about USD100, meaning that cuts to production cannot be ruled out. The market has now priced in a severe recession, which is likely to occur, but the fundamental picture for oil remains exceedingly strong in our view as production can only keep up with demand with difficulty. Supplies have been artificially increased over the past few months because the US has dipped into its strategic oil reserve meant for use in emergencies. It cannot deploy this instrument indefinitely, however. Strategic reserves are now at their lowest levels since the 1980s and the US will have to stop doing this at some point.

Our interests in the oil sector are a major reason for the relatively sound performance this year. Almost overnight the sector has come to be viewed differently, as people suddenly realise that we’re dependent on these companies whether we like it or not. We see the current weakness in the oil price as an excellent reason for investors to increase their exposure to this sector. Investors are scared demand will drop in the event of a severe recession, forgetting that in that case OPEC can simply produce less oil to neutralise this effect. That makes an oil price of USD100 a pretty good target in our opinion and is what makes this sector so promising



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Another major reason for the outperformance versus the market is the enormous amount of income currently flowing into the portfolio. Received dividends have never been so high and this establishes a solid foundation under the portfolio. The investors being hit hardest this year are those who lack this crucial aspect of the investment game. When you invest in cryptocurrencies or growth companies, the return needs to derive from the next investor wanting to take over your investment at an ever higher price. When that stalls, you've suddenly got little tangible to hold onto and the value of your investment can plummet. Exactly a year ago we wrote about an investor who was at that time still highly regarded, Cathie Wood. She was the uncrowned queen of growth investment and saw unlimited upward potential in all kinds of companies. In particular those companies with the capacity to be 'disruptive' couldn't be expensive enough in her view, after all the world was going through a unique phase in which everything had to be – and was – different. A year later and the harsh reality has hit home. Her fund, Ark Invest, has dropped by 66% since we last wrote about it and we still can't say the companies in her fund are undervalued. Nearly all of them are loss-making companies that are only still in business thanks to continuous funding from the market. Now that borrowing money again costs money, and rightly so, the future of these cash-guzzling former market darlings suddenly looks a lot less rosy.

It's great to see bubbles bursting all around us and the extreme conditions on the interest rate market simply normalising. While it may not be that great for the economy in the short term – a recession is inevitable – it's certainly no bad thing for the markets. Those sectors that had become far too expensive are now hurting and investors being taught a valuable lesson: companies are only worth what the sum of their cashflows warrants. No more and no less. In our case this is good news, as the sum of the cashflows of our investments are a multiple of their present market values. For investors in all kinds of growth companies that have no positive cashflows at all, the outcome of this sum is perhaps less satisfying.

This makes it the ideal time to believe in Value. Buying undervalued companies that pay out a substantial portion of their profits to shareholders has always been a good idea but now it's one of the few ways of avoiding the effects of inflation. In contrast to savings accounts or bonds, sound companies can raise their prices and, over time, revenues and earnings will grow in line with the general price levels. This is a unique distinguishing factor that is one of the main reasons why you should always have confidence in a portfolio constructed on this premise. Even if there are wars, crises or recessions, ultimately it pays to invest money in this type of investment and then sit back and enjoy the dividends flow in each year. History tells us that holding large amounts of cash at such times can be exceedingly risky as purchasing power deteriorates quickly. Owning 'real assets' is the only way to escape these forces. After all the crises we've been through over the past few years (and there have been quite a few of them: the credit crisis, the euro crisis, the Coronavirus crisis, the energy crisis, the inflation crisis...) we can only conclude that the market is the gift that keeps on giving: the opportunities that keep landing in the laps of investors that do their sums are more a cause for celebration than panic. Just as in all the preceding crises, we're poised to take advantage of new opportunities and have a portfolio that generates so much cash that we'll have more than enough small change to enable us to strike when the time is right.

Energy and inflation: 1973 vs. 2022

Back in 1973, the political solution to the previous energy crisis was clear: the introduction of a car-free Sunday. The 2022 solution is quite different: the government must provide support!

It neatly summarises how society has changed in the last fifty years and provides a handy guide for how we'll come out of the inflation crisis. The Northern European economies have long been aware, especially in the wake of the Weimar Republic's hyperinflation of the 1920s, of the need to keep a close eye on government debt and inflation. It's essential to step hard on the brake every now and then, to cut back and accept a recession in order to curb excessive debt levels and price increases. Southern European countries have generally opted for a compromise strategy involving the accrual of high levels of debt and inflation getting out of hand, ultimately necessitating debt restructuring and a devaluation of the currency to keep afloat. A policy that feels good in the short term but in the long term has resulted in Northern Europe developing a prosperity gap versus Southern Europe, by always being considered a reliable trading partner that would tighten its belt when required. Yet society has changed, including in Northern Europe, and the abovementioned energy support measures are a sign of the political direction that has been taken. In recent years, economic pain has resulted in governments adopting a strategy of safety nets, support, stimulation and reimbursement. This backstop is of course wonderful for those involved but does come at a price. On top of this, politicians are still very occupied with solving yesterday's problems. Where we spent years thinking we were debating the stretched housing market, the shortage of residential properties, the health of pension funds and tightness on the job market, we were in fact only talking about one thing: interest rates. As interest rates were so completely removed from what's normal, things were taken out of context.

House prices climb when you can borrow money for almost nothing. This process is then reversed when interest rates start to rise again. The good news is that normal ratios are being restored, as a result of which pension funds are looking healthier again, house prices are falling (and as a result – surprise, surprise – there will soon be no shortage of properties) and the recession will probably also make it easier to find people happy to wait at tables and check in suitcases. There's a risk of this normalisation coinciding with planned government measures, in response to criticism from society of the excesses of Disneyesque monetary policies, to solve problems that will already have dissipated by the time the measures have been implemented. These include taxing price gains that are no longer occurring, taxing profits on homes while house prices are in fact falling or building homes that no-one can afford because of the higher interest rates. Yet there is also good news. The Netherlands enjoys a relatively low level of government debt and can withstand a knock. Soaring inflation is also leading to government debt declining as a percentage of our GDP as we've been able to borrow money almost for free for so many years while our economy is growing in line with inflation in nominal terms. Even in the case of government deficits this ensures that our level of debt remains within limits. The Netherlands is therefore still in good shape but needs to be wary of shutting the stable door after the horse has bolted and to recognise that major monetary policy errors have been committed for which we now need to pay a fair price. The party has to end at some point, and sometimes the economy needs to mark time or even take a step back. There's nothing wrong with that and it's much better than denying that these are forces of nature we just have to live with.

Special Bond Fund

Be careful what you wish for: a rare year of losses for the SBF.

It's a cynical situation. Having spent years warning against the perilous cocktail of monetary easing that we believed would ultimately lead to inflation and in turn higher interest rates, 2022 has turned out to be the year in which this actually happened. Several years ago we structured our bond portfolio in such a way that it contains almost no duration risk. What does that mean? A bond is a contract between two parties. On one side you usually have a company or government. On the other you have the buyer, and that might be a private individual, a pension fund or an asset manager. One party lends the other party money and promises to repay the amount after a set time. The terms and conditions that apply in the interim vary greatly, however. There are bonds with short durations, bonds with long durations, fixed yields, variable rates of interest, bonds that will be redeemed in their entirety as of a specific date, bonds that will be redeemed in instalments, bonds that will never be redeemed… the list goes on. In short, one bond can be very different from another. When, like us, you're worried that interest rates will rise, it's extremely imprudent to buy long-term bonds with fixed yields. After all, this fixed yield will become less attractive as interest rates rise in the interim. The bond will consequently fall in value. One way to mitigate this risk is to buy bonds with a variable yield. As the yield on these bonds moves in line with interest rates, what happens to interest rates suddenly no longer matters so much. In asset management, we call the extent to which bond prices move in line with interest rates 'duration'.

A long-term bond has a high duration, except when a variable coupon is attached to it. In this respect we're exceedingly well protected against the current upturn in interest rates. Yet our portfolio is also noting substantial losses. How is this possible? There's something else going on in parallel to the higher interest rates: credit spreads are widening. These spreads are the premiums companies have to pay versus government bonds. And these have shot up. All of a sudden, fears of a deep recession have prompted investors who invest in bonds outside the investment grade segment to want several percent more interest compensation than they did until recently. This is on top of general interest rates already having risen by several percent. The upshot is that bonds in this segment are currently paying yields of 10% or even 15%. That's great for future returns but is of course at the expense of current returns as prices have dropped sharply. The portfolio is also being adversely affected by the highly exceptional shape of the yield curve. A portion of the portfolio is invested in what are known as steepeners. These are bonds for which the coupon payment depends on the difference between long and short-term yields. We own a whole series of this type of bond, all issued by US merchant banks (JP Morgan, Morgan Stanley, Goldman Sachs etc.) in USD. The credit quality of these bonds is extremely high as they're all senior bonds from highly creditworthy banks. The problem lies in the current shape of the yield curve. As a result of the US central bank quickly raising short-term interest rates, we've ended up in the topsy-turvy situation in which short-term interest rates are higher than long-term interest rates. From a historical perspective this inverse yield curve is almost unprecedented, as long-term yields are normally higher than their short-term counterparts. This structure has led to yields on these bonds falling. Although they can never become negative (the floor is 0%), yields on these bonds are extremely low at present and a reason for investors to sell them. We believe this is the wrong thing to do. In the long term we expect the yield curve to normalise, causing either long-term yields to rise higher or short-term yields to decline slightly. The yield curve reverting to its usual shape would lead to these bonds again suddenly paying coupons of 8% to 10%, which would easily push prices back up to par or even higher. At the moment, however, these bonds are trading at about 50%, which explains some of this year's loss.

Nevertheless, we continue to be enthusiastic about this building block of the fund, which combines security on the credit side with generous upside on both coupons and prices. Moreover, the interest compensation on some of the other bonds (e.g. our investments in Kurdistan bonds such as Shamaran, HKN and Genel) has climbed sharply, while the default risk is practically zero thanks to these companies' extremely large cash positions. Buyers of these bonds can easily earn returns of 12% or even 15% at the moment and these will be redeemed within a couple of years. It's only a question of time before investors realise this is an exceedingly attractive proposition. Even if they fail to do so, it doesn't matter as we'll just wait for the bonds to be redeemed and collect the coupons ourselves.

International Personal Finance PLC London (IPF LN) 9.75% Nov-2025 bond

Another good example of the effect of the current market sentiment on bonds can be seen from the IPF bond we hold in the OVMK Special Bond Fund. This bond, which we bought when it started to trade below par, has fallen further and can now be bought at prices of about 75%. A yield to maturity (annualised return per year) of in excess of 20% would normally be a cause for alarm. What is it that makes investors doubt this bond's sustainability?

IPF is a company that lends consumers money for e.g. school fees, medical expenses, micro businesses and insurance. Many people don't even have a bank account for transferring school fees, for example. IPF provides services to people who may otherwise be excluded from the financial system. Obviously, it gets something in return. It has to be remembered that we're not talking about the most creditworthy part of the consumer loan sector. Consumers pay high rates of interest and impairments (money that will probably never be repaid) have stood at 10.2% over the past six months. That percentage was even higher prior to the Covid-19 pandemic; between 20 and 25% of the loans were written off back then. Write-downs are expected to normalise to their former level. Even then that doesn't mean that IPF will get into difficulties. Its current performance and outlook are both still positive. So positive in fact that IPF raised the dividend paid to shareholders because of improved capital ratios, higher revenue and higher earnings.

IPF has three business units: European Home Credit, Home Credit Mexico and IPF Digital. These loans don't work via 'buy now, pay later' schemes but are a kind of wallet containing credit, arranged online or via local intermediaries. The company has outstanding loans of about GBP700 million in Mexico, Eastern Europe and Australia. A total of 1.7 million customers have borrowed an average amount of GBP500-800 for a term of slightly over one year. The huge advantage of this enormous number of customers is that their payment behaviour can be predicted fairly accurately by models. The losses on this book can therefore be estimated reasonably easily in a range of scenarios, against which balance sheet ratios can be adjusted.

Laws and regulations in the countries in which IPF operates always pose a risk for the company. If, for instance, a cap is set on the maximum amount a consumer loan may cost, this could mean that certain markets cease to be of interest. The company has exited a number of markets for this reason and now focuses on those markets in which it occupies a strong position. Mexico is a particular growth market in this respect.

IPF itself has issued two bonds on the market. The abovementioned bond is the largest of the two. In November 2025, investors will collect about GBP300 million in redemptions and the bond is currently trading at GBP720 versus the redemption price of GBP1,000 per bond. Why is this bond so far under water?

We and other analysts have struggled to pinpoint a valid reason. IPF's balance sheet is sound and the outlook (even with some headwind) is good. The prevailing macro-economic conditions are of course playing a part here. Inflation is naturally affecting consumer purchasing power and then the question is whether consumers will be able to repay their loans. IPF itself says that so far there's no sign of this happening. These loans involve relatively small sums of money for what are essential expenses. Yet a deep recession could squeeze the company's results. Then again there's the ever-present risk from laws and regulations on local markets. In addition, IPF faces fluctuations in exchange rates that it's not always possible to hedge perfectly. Prices are yo-yoing on the currency markets as well at the moment. So there are a number of risk factors that play a role in how the price evolves. IPF's equities are also down by nearly 40% this year.

The bond price is weak too. You've no doubt read that this applies to the entire bond market. Here there's the remarkable cocktail of an inverse yield curve, soaring inflation and central banks that are again being forced to intervene.

Nevertheless, we intend to keep a firm hold on the IPF bond and even bought some more IPF bonds in the last quarter in order to profit from the low prices.

Although IPF's business model undoubtedly involves risk – let's not forget that without risk there's no return – we believe that the market is being far too pessimistic here. We deliberately don't hold any IPF equities in the portfolio though. The bonds offer greater security and for us are preferable to a potentially sizeable dividend from the group. If things do go wrong for IPF (in other words, if the company requires additional funds to improve its balance sheet), then its shareholders will be the first to be affected by this.

The fact that investors demanded an annual return of 9.75% in November 2020 (when the bond was issued) tells us something about the risk profile. Market interest rates were low at that time and of course now they've risen sharply, which means that holders of fixed yield bonds (even at 9.75%) will see the prices of their bonds being squeezed. The higher market interest rates are clearly leaving their mark on both the bond and equity markets. Once the markets normalise, we'll also see ratios return here and investors will push up the price of this bond again as well. If IPF continues to perform well even when conditions are tough, there's little chance of investors in this IPF bond not receiving their money in three years' time. The return is certainly there. Three more coupon payments of 9.75% plus GBP1,000 per bond; a yield of over 20% for patient investors who dare to look beyond the prevailing market sentiment.

RAK Petroleum

A splendid outcome for an exotic investment. We first became interested in Kurdistan oil in 2016. It was the year of Islamic State, declining oil prices and a whole raft of bad news for the (mainly British and Scandinavian) oil companies on the ground in Kurdistan. We stumbled across this niche theme almost by accident at a conference in Oslo and subsequently began to acquire positions in the bonds, which at the time could be bought for half their par value despite being hedged fully by cash.

From this starting position, we began to accrue what would become a substantial range of equities and bonds issued by several Kurdistan oil players. One of these is RAK Petroleum. Even within the obscure and overlooked playing field that is this niche, RAK is in a class of its own. Its stocks stayed completely below the radar for many years and this is largely down to the company's structure. RAK Petroleum is the company that once sold its Kurdistan oil fields to Norway's DNO and received a large number of DNO stocks in exchange. The company continued to be listed on the stock exchange but sank into obscurity. The lack of interest from investors caused its equities to trade at a substantial discount versus the countervalue in DNO stocks, a sum that was easy to arrive at as apart from the DNO stocks Rak Petroleum held few assets (other than a small investment in an oil field in Africa). That made it simple to calculate that the stocks were undervalued. For a long time, investors were therefore able to buy DNO stocks at a discount of as much as 50% via a roundabout route. It was precisely this discount that we were after, also because we considered DNO stocks themselves to be good value. And then the waiting game began. Although we knew this structure would eventually come to an end, we didn't know precisely when this would happen. Until 22 August of this year. That morning, Rak Petroleum announced plans to sell its participation in Africa (an interest in Foxtrot International) to DNO as well. In exchange, the company will receive another basket of DNO stocks, meaning that Rak Petroleum will then consist entirely of DNO shares.

These shares will in turn be paid out in full to RAK shareholders, after which RAK Petroleum will cease to exist. And this is of course excellent news. This announcement brought an abrupt end to the discount, which as of that date stood at about 45%, and suddenly the equities were worth 75% more. The exchange will take place on 12 October and then we'll be direct owners of DNO stocks. At today's prices, this is a cheap enough investment to hold onto for the time being but this transaction gives us some useful small change that will come in handy in a market that's overflowing with bargains. We're not at all bothered at losing yet another model name this year. At the right price, all our investments are for sale on any day of the week!