March 2024
Fountainhead Partnerships Fund
Quarterly Letter

In a bull market, time horizons grow longer and longer, in a bear market they become shorter and shorter!

The Fountainhead Partnerships Fund (FHPF) gained 8% in Q1 2024. This aligns with broader market increases in the MSCI World (+8%) and S&P 500 (+10%), indicating optimism surrounding a potential disinflationary boom in the global economy.

Table 1: Performance

	1Q2024	Last 12 months	Last 24 months
Fountainhead Partnerships Fund	**8%**	**22%**	**24%**
MSCI World	8%	23%	14%
S&P 500 (IVV)	10%	27%	15%
S&P 500 Equal Weight Index	7%	17%	7%
Small Cap Russell 2000	5%	18%	2%
MSCI Japan	11%	22%	15%
MSCI Europe	5%	10%	7%
MSCI Emerging Markets	2%	4%	-11%
US Dollar Index	3%	3%	2%
US Aggregate Bond Index	-1%	-2%	-8%

Source: Bloomberg

Portfolio Performance Analysis and Market Commentary:

Three out of the five best performers in the portfolio were from the insurance sector in the first quarter of 2024. The Fund has about 17% exposure to insurance and insurance brokers (considering Berkshire Hathaway as primarily an insurance-based operation). Our investment allocation in the top 5 performers of the portfolio was 20% in 1Q24 against 8% in the bottom five performers.

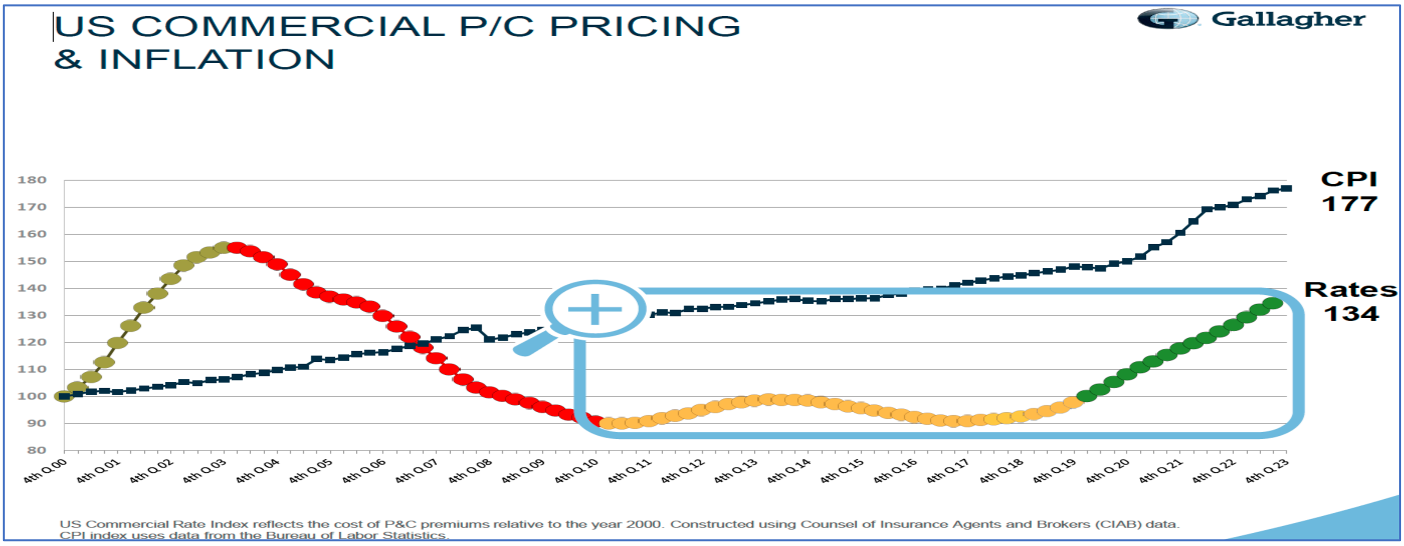
We exited one long-term holding – Microsoft – this quarter, as we considered it over valued, and initiated a significant position in a very exciting payment company. We will share the details of that company in our next quarterly letter.

Table 2: Top and bottom performers

Top 5 Performers	1Q2024 return	Bottom Performers	1Q2024 return
Fairfax Financial	58%	GMO Payment Gateway	0%
Ryan Specialty Group	29%	Accenture PLC	-1%
Novo Nordisk	26%	Warner Music Group	-6%
Hikari Tsushin	21%	Kering SA	-8%
Stryker Corp	19%	SMS Co Ltd	-10%

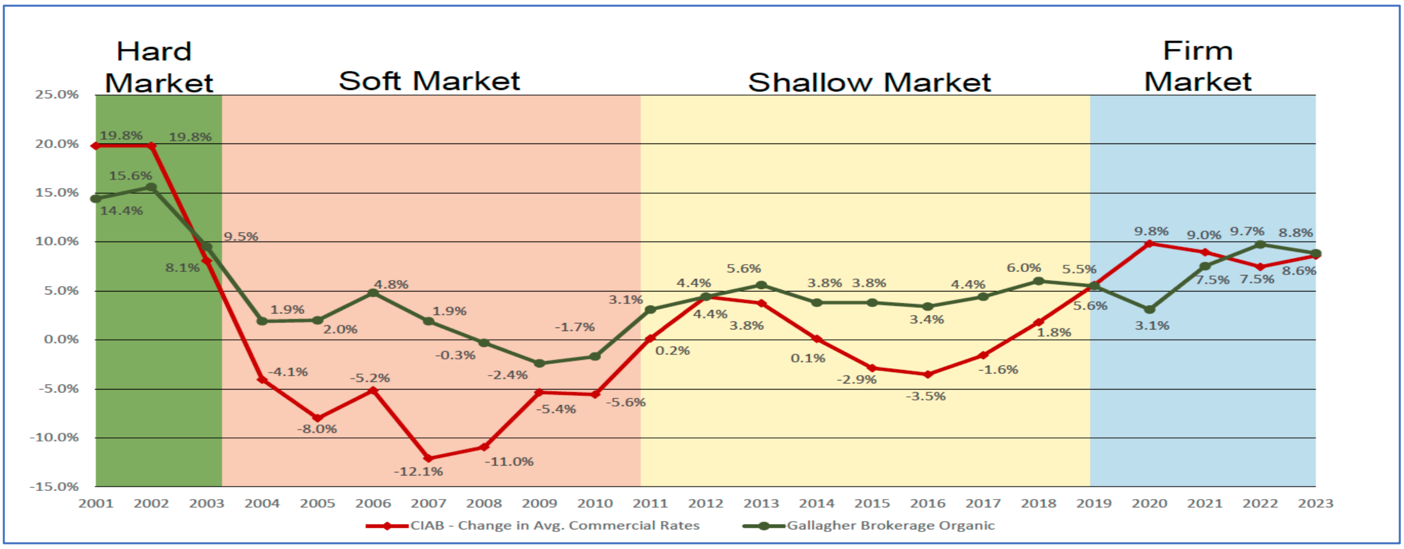
Insurance Sector Dynamics:

The insurance sector cycle is going through a favorable period of high growth and profitability. Sector dynamics changed significantly in the post covid economy, where first insurance companies had virtually no claims as people were locked down in their homes and insurance companies returned some part of the premiums to their customers. However, thereafter, a significant rise in inflation and supply disruptions caused an unprecedented increase in cost of repairs and replacement, pushing insurance companies to raise their premiums.



Source: Arthur J. Gallagher & Co.

While insurance companies have increased premiums to cover for potential higher claim expenses in the future, the claims are lagging premiums growth for most of the companies we monitor, boosting their underwriting profits. The higher underwriting profit is getting a further boost from high returns on investment portfolios due to higher interest rates.



Source: Arthur J. Gallagher & Co.

Although the cycle is strong, there are as many losers in the insurance industry as winners, even in an upcycle. We have been very selective in deciding which companies to invest in. Insurance brokers have been our preferred area in this space since they have been key beneficiaries of the rising tide. We also own one insurance company each in the US, Canada and Japan. Insurance companies with larger exposure to Property and Autos are delivering high premium growth (low to high teens). Meanwhile, those with broader exposure, including Insurance Brokers, are delivering relatively modest high single digit/low double-digit growth.

While we are bullish about the insurance sector's dynamics, particularly in the current higher interest rate environment, we are closely monitoring this cycle, especially the trends in claim expenses. Fairfax Financial (FFH) is one of our holdings and they reported deceleration in premiums growth in their 4Q 2023. It was a deliberate management decision due to the rising risks. FFH remains our key Insurance exposure with all three of its growth engines delivering strong performance, underwriting profits, interest and dividend income and contribution from Joint Ventures and Associates (not consolidated). Insurance Brokers provide us with more steady, less volatile returns over the full insurance cycle.

Why is the stock market strong? It is earnings, or more appropriately, earnings expectations.

Amongst the drivers of stock prices such as multiples, interest rates and inflation, earnings are perhaps the most fundamental and sustainable. Stocks tend to do well in a rising earnings scenario particularly when earnings are expected to rise more than 10% in a calendar year.

Market reaction in the current result season indicates a clear shift from earnings beat/miss to earning guidance. Companies that are becoming more conservative in their 2024 guidance are seeing adverse share price reaction even in the cases where they matched/beat consensus earnings forecast for the given quarter.

Table 3: Earnings drive returns

S&P 500	Operating-EPS	Earnings Growth	S&P 500 Return	PE Multiple
2008	50			17.7
2009	57	15%	27%	19.5
2010	84	47%	12%	14.8
2011	96	15%	0%	12.9
2012	97	0%	14%	14.7
2013	107	11%	27%	16.8
2014	113	5%	14%	18.2
2015	100	-11%	0%	20.4
2016	106	6%	9%	21.1
2017	125	17%	19%	21.4
2018	152	22%	-4%	16.9
2019	157	4%	24%	20.2
2020	122	-22%	16%	30.2
2021	208	70%	27%	22.5
2022	197	-5%	-16%	19.9
2023	214	8%	20%	21.9
YTD 2024E	240	13%	10%	21.2

Source: S&P Global

Bottom-up consensus earnings expectations for 2024 is still around 13%, which, if it comes out true, bodes well for stock prices. Investors are generally expecting a disinflationary boom – a period of declining inflation and interest rates with a strong economy – that can expand the PE multiples of stocks and add to the returns. Central banks globally, apart from Japan, are looking (perhaps too keenly) to start a rate cutting cycle. That is also embedded in the current strength of the stock market.

What are the risks:

At the moment, based on data not on views, it seems the risks for the stock market are more from higher and sticky inflation, leading to higher interest rates and lower earnings and multiples than from a much-awaited recession. Can the global economy turn upside down from relatively good economic growth (outside of China) to a very weak one within next few quarters? It is possible but remains a low probability.

One area that may be a fork in the road for stocks this year is the resurgence of inflation. Until recently, due to the significant fiscal thrust provided to the economy, the fear and probability of inflation rising again was higher in US than in other parts of the world. However, with the rise in the geo-political temperature of the Middle East pushing oil and commodity prices higher, that fear of inflation resurgence impacting global growth has increased.

Since October 2023 stock market has risen 25% and cost have hedging has declined significantly. We have employed a substantial size hedging position on our portfolio at a very low cost.

Duopoly Dominance:

The term "Duopoly" is used in business for an industry where two companies have a very large share of the total industry revenues and profits.

The history of the most profitable and sticky product industry of Cola drinks producers – Coke and Pepsi, tells investors that if an industry emerges into a duopoly it can sustain very strong economic returns for the businesses. Often high returns attract competition that takes away the profit margins of the incumbent either through cheaper pricing or better product. It is very rare that companies find a product that is either inimitable in terms of taste, benefits or value in a high return industry.

In our investment journey we have observed and invested in some great businesses whose industries have transformed into duopolies. These businesses have built their competitive moats based on technology (Google), consumer taste (Universal Music), an unmatchable product (Novo/Lindt), too big to displace (Visa), or captive ecosystem (Apple). While most of the duopolies are usually successful, the airline industry is a glaring exception.

Table 4: The Dominant Duopolies

	Industry	Top 2 % revenue	Duopoly	Net Income Margins	ROE / ROCE	Industry Margin	Industry ROE/ROCE
1	**Diabetes GLP-1**	93%	**Novo Nordisk, Eli Lily**	28%	77%	17%	15%
2	**Premium Chocolate**	52%	**Lindt, Hershey**	15%	33%	8%	13%
3	**Medical devices / Orthopaedic care**	57%	**Stryker, Zimmer Biomet**	21%	16%	15%	16%
4	**Clinical Research Org**	58%	**Icon Plc, IQV**	16%	21%	13%	14%
5	**Med Devices/Hearing implants**	95%	**Cochlear, Sonova**	21%	33%	20%	30%
6	**Online Advertising**	62%	**Google, Meta**	28%	30%	10%	10%
7	**Insurance Broking**	22%	**Aon, MMC**	20%	15%	15%	12%
8	**Music catalogues**	73%	**Universal Music, Sony**	13%	31%	10%	14%
9	**Smart Phones**	53%	**Apple, Samsung**	23%	83%	10%	12%
10	**Colas**	100%	**Pepsi, Coke**	20%	45%	20%	45%
11	**Payment processors**	100%	**Visa, Mastercard**	48%	112%	48%	112%

Source: Fountainhead research

Once an industry transforms into a duopolistic structure it often requires very little capital to grow at higher than the nominal economic growth rate. It secures pricing power with little competition and generates a large pool of excess capital to return to the shareholders.

Fountainhead's portfolio is invested in eleven of those companies equalling 40% of allocation that operate as part of a duopoly. The margins and return on capital in these businesses are much higher not only from their respective industries but from the other businesses in our portfolio.

Thank You.

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