Fountainhead Partnerships

Dec 2022
Fountainhead Partnerships Fund
Quarterly Letter

It is not the most intellectual of the species that survives; nor the strongest ones; but the species that survives is the one that is able best to adapt and adjust to the changing environment in which it finds itself. ***Charles Darwin***

Happy New year.

Fountainhead Partnerships Fund (FHPF) was down 14.6% (net of fees) in 2022 while S&P 500 and MSCI World were down 18%.

Portfolio Analysis:

Here is the Fund's comparative performance vs a few benchmarks:

	CY2022	2 years' return	3 years' return	5 years' return	Since inception (Jan-1 2015)	1H 2022	2H2022
Fountainhead Partnership Fund (FHPF)	**-14.6%**	**7.4%**	**39.8%**	**47.7%**	**18.7%**	**-23.3%**	**11.3%**
SP500	-18.1%	5.3%	24.7%	56.6%	10.1%	-20.0%	2.3%
MSCI World	-18.3%	-3.2%	12.6%	29.6%	6.9%	-19.9%	2.1%
MSCI Europe	-16.2%	-2.6%	3.7%	9.7%	4.0%	-21.3%	6.5%
MSCI Emerging Markets	-20.6%	-23.5%	-10.1%	-10.1%	1.7%	-17.4%	-3.8%
US 60/40 (Balance Portfolio)	-16.7%	-4.1%	11.2%	33.1%	6.5%	-16.2%	-0.5%
XLE	57.6%	130.8%	45.7%	24.7%	1.6%	28.8%	22.3%
Apple	-26.8%	-2.1%	77.0%	207.1%	21.4%	-23.0%	-5.0%
Microsoft	-28.7%	7.8%	52.1%	180.4%	22.8%	-23.6%	-6.6%
Amazon	-49.6%	-48.4%	-9.1%	43.7%	23.5%	-36.3%	-20.9%
Google	-38.7%	1.3%	32.7%	69.6%	16.4%	-24.4%	-18.9%

The Fund outperformed all relevant equity benchmarks in 2022 by ~4%. In our portfolio, about 20% of companies produced positive stocks returns in 2022, while we kept about 20% in cash throughout the year.

Is Cream rising to the Top now

After a deep and rapid correction in the first nine months markets now seem to be stabilizing. It is interesting to observe which sectors have been working better after the top to bottom drawdown of ~30% in the S&P500. The top 4 stocks are still close to their bottom, while oil stocks ($XLE), which performed tremendously well in the first half of the year, are also down 28% from their peak. However, the **Fountainhead Fund has risen 11.3% in the second half, beating the market by ~10%. More importantly, all of the stocks in the portfolio are up more than the market in 2H22.**

FHPF- Capture ratios	S&P 500	MSCI World
	2022	
Upside Capture ratio	98.4%	109.4%
Down side Capture ratio	90.8%	97.0%
FHPF- Total Capture ratio	108.3%	112.9%

We tried to capture less of the downside in the falling markets while outperforming in the rising months. Our performance on that metric was satisfactory

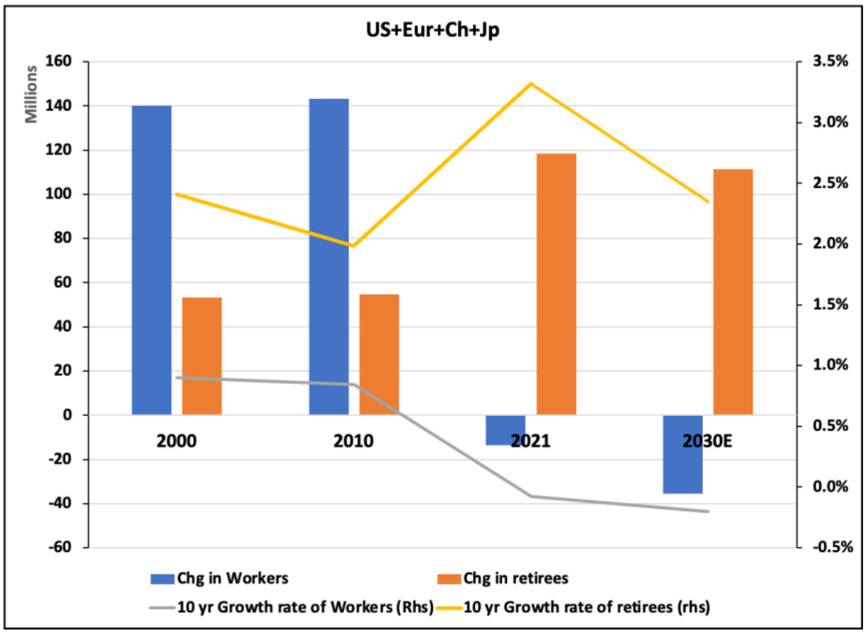
Losers and (a few) Winners

	Top 5 stocks	Absolute performance	Avg weight in Portfolio	EPS growth 2022	EPS growth 2023	P/E 2022	P/E 2023
1	Shell Plc	43.4%	3.2%	86.7%	-1.9%	3.04	4.45
2	Novo Nordisk A/S ADR	27.6%	7.6%	16.2%	24.9%	30.21	30.86
3	COMPAGNIE DE L'ODET SE	4.5%	1.2%	15.0%	9.6%	13.63	13.00
4	Berkshire Hathaway B	3.3%	4.7%	16.0%	10.0%	16.00	13.53
5	Ryan	2.9%	2.2%	167.1%	16.9%	35.36	31.11

	Worst 5 stocks	Absolute performance	Avg weight in Portfolio	EPS growth 2022	EPS growth 2023	P/E 2022	P/E 2023
1	Givaudan SA	-40.9%	1.4%	5.4%	11.7%	50.56	26.77
2	Alphabet Inc	-39.1%	6.8%	2.8%	13.0%	28.04	15.11
3	EUROFINS SCIENTIFIX SE SHS	-38.4%	1.4%	-9.7%	-1.8%	29.57	18.56
4	Icon Plc	-37.3%	3.7%	16.0%	6.1%	26.51	15.67
5	Carl Zeiss Meditec AG	-36.2%	2.1%	11.0%	-2.9%	55.02	36.14

We tried to analyse why certain stocks performed so well and others not so much in 2022. In our opinion, and strictly from our portfolio perspective, if a stock was either a pandemic beneficiary or perceived by investors as a cyclical growth company, it got absolutely hammered regardless of its track record or even valuation. However, what we are encouraged by in the second half in particular, is the return of discretion in the market, as companies that are proving the strength of their business models in terms of earnings' growth and margins' sustainability are now being rewarded by investors.

Ageing Demographics: A revisit of Our Core long term investment thesis

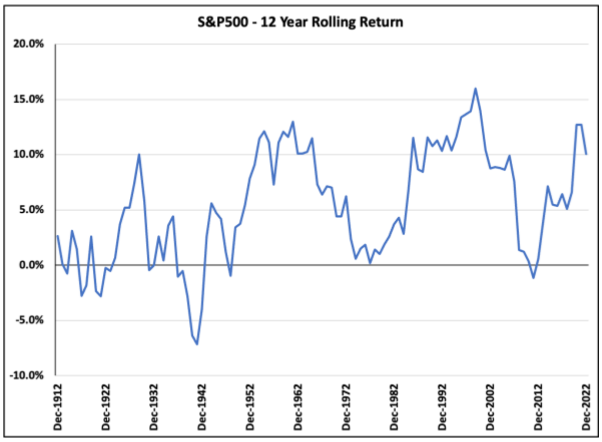


When we started this strategy, the core of our investment thesis was to build a portfolio of companies that are going to fulfil the needs of ageing populations. We believed, and still firmly do, that companies whose business models are geared towards elderly care needs are going to grow very substantially for a very long period of time. The core idea then was that the elderly populations (65+ age) will grow at 3% pa rate, 3x the rate of working age populations and that will result in rapidly rising dependency ratios in the developed world and in China. The thesis has turned out better than we expected and the 2020 global pandemic has only worsened the dependency ratios around the world. The companies have enjoyed much better growth rates than we expected and the stock prices have risen 3x more than the market on average.

So, what has changed (or, is changing?)

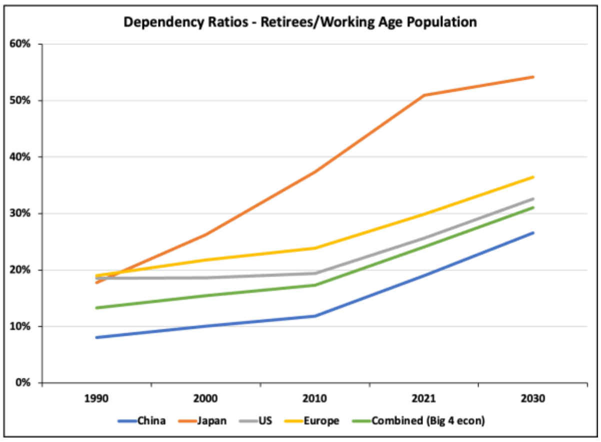
Between 2010 and 2021, US equities produced a 12.7% annualised return, which is the second highest return for any 12 year period in US history since 1901. Those returns were based on two major tailwinds: mobile-led rapid adoption of technology, and lower interest rates on the back of subdued inflation. The massive returns in technology businesses in the US attracted a lot of new businesses (wannabe FAANGs!), increased competition and now are probably going to go through the process of Schumpeterian Creative destruction. What also helped these businesses significantly was the very low interest rate environment. We think it is reasonable to believe that the low inflation of the last decade may not repeat in the next.

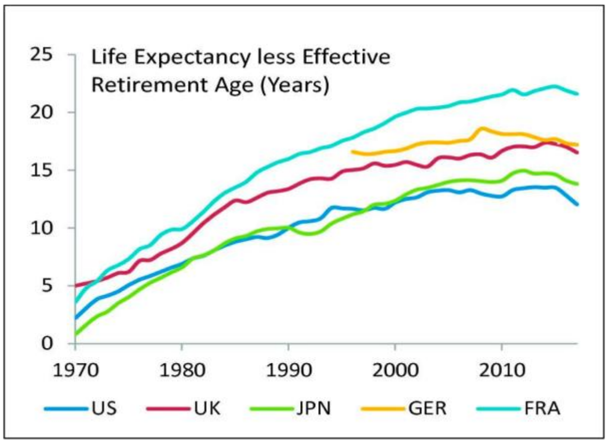
2010-2021	S&P 500
Annualised return	12.7%
AVG PE	19.32
EPS growth CAGR	12.0%
Operating Margin Increase (Absolute Change)	6.4%
AVG 10 year bond yield	2.2%
Avg US CPI inflation yoy	2.0%



The fundamental drivers of our core strategy are however, firmly in place. In fact, they have improved in the last two years. During the pandemic, governments around the world tried to protect the elderly (higher voting) populations by incentivizing them to stay at home. The Pandemic also provided an opportunity for people to better understand their health dynamics and spend more on healthcare than previously. Another lifestyle shift occurred in the work from home phenomenon. All these factors have accelerated our three key focussed themes: Aging demographics, Cloud computing and Insurance broking. However, the macro backdrop of equity investing seems to be on the cusp of a shift.

The Great Demographic Reversal:





We would like to share some excerpts from, and our thoughts on the book by Charles Goodhart and Manoj Pradhan (titled above), who very eloquently argue why the developed economies (and China) are going to experience higher and rising inflation in the coming years. We will later connect their argument with our investment strategy. **Their argument for higher inflation is primarily based on the rising dependency ratio: an accelerated rise in the number of retirees compared to the increase (or even decline) in the number of workers in the next 10 years and beyond**. That would also mean a significant increase in the pension users versus the pension contributors. We agree with this argument. Historically, the argument against higher inflation resulting from the rising dependency ratio was "because it didn't happen in Japan, it won't happen elsewhere in the developed economies". The writers very eloquently showed the factual reasoning that when the dependency ratio started rising in Japan, corporates in Japan expanded their manufacturing base in China and other parts of North Asia. Globally, the decline in the supply of labor in Japan was more than compensated by the cheap and abundant supply of labor from China and eastern Europe. Hence, the higher dependency ratio in Japan did not result in higher inflation in Japan. However, the supply of labor from China has stopped at a time when all the other developed economies are at an inflection point of aging, and are struggling with population growth and unpopular immigration and retirement policies. And all we know is that the Pandemic has front-loaded the retirements, worsening the dependency ratios much faster than projected prior to the pandemic.

Economic Cycle based on demography

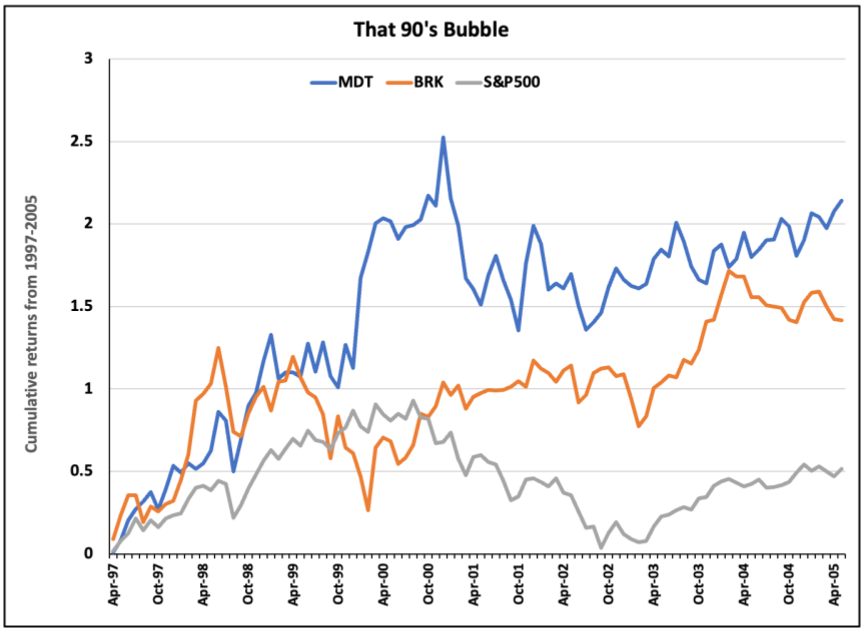
2012 - 2018 Period	GDP Growth	Contributions to Global GDP Growth
Early cycle economies	4.9	27
Mid-cycle economies	2.4	28
Late cycle economies	4.5	45

* table 3.3 from The Great Demographic Reversal

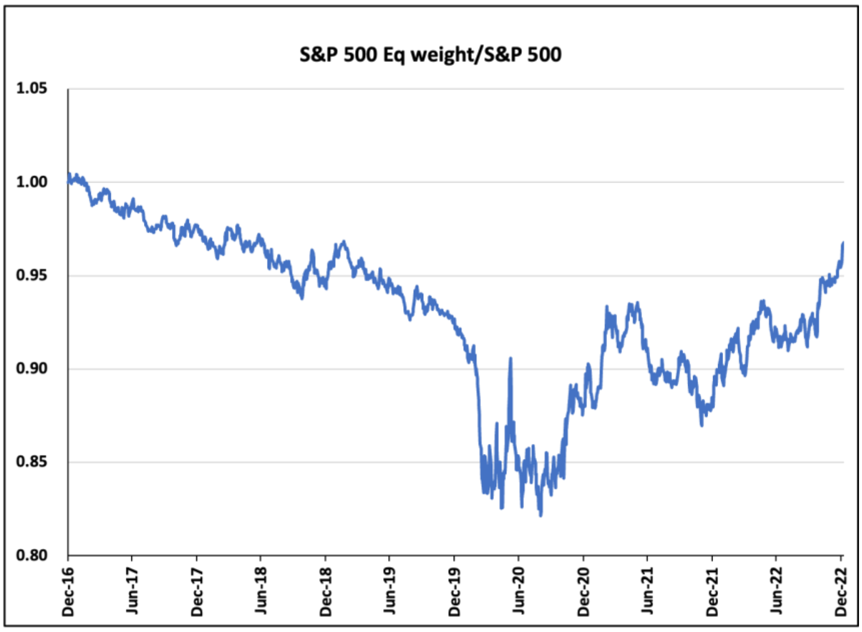
Another problem with global growth would be the very high debt ratios in the same developed economies that are at the inflection point of aging. And these are the very economies who have significantly contributed to the global growth in the last two decades. There is some hope that labor supply from India and Africa and automation, Robotics and AI are going to support the global dependency ratio but all these factors are at a very early stage of development to replace the vacuum created by high quality Chinese workers.

Portfolio Strategy in the times of higher inflation:

The economic consequence of the demographics transformation in the developed economies (plus China) will be shorter economic cycles, in our opinion. Worker shortages will continue to resurface inflation and force central banks to keep rates elevated. The last few years of low inflation and low interest rates have been extremely supportive of long duration-high growth stocks. A large part of our portfolio represents these features. Hence, although we believe that the fundamentals of our key themes – aging demographics, cloud computing and insurance broking have improved, valuations dynamics will be the key to making returns going forward.



The 2023 market set up however, resembles quite a bit the post 2001 bubble period. In late 2001, when the key equity indices were still being dragged down by melting tech shares, the "Old Economy" stocks like Berkshire Hathaway and profitable growth stocks like Medtronics started/continued to rally strongly in the background. At the time, this was referred to as the "stealth" bull market. Similarly, like the early 2000s when Fed rate hikes pricked the dotcom bubble, the meltdown in mega-cap growth stocks and other speculative assets was also triggered and aggravated by rising rates and fears of inflation.



From peak to trough in 2022, the market fell 27%, which is closer to an average 30% drop during a recession. Does it mean that, being an anticipatory mechanism, the market has already discounted a recession and now has already started favoring stocks that will benefit on the other side of a recession? This is the message at least that we read from the stock market. However, if the next stage of the bear market is indeed driven more by earnings downgrades than discount rate-led multiple compression, companies with better financial and earnings quality, more resilient business models and stronger balance sheets (less debt offers defence and optionality for capital deployment) should do well. We estimate ~80% of our portfolio fits this profile. For 2023, market is debating hard vs soft recession with minimal EPS revisions so far. For our portfolio, we are positioned for longer term growth while we remain agile to deliver short term outperformance. The key would be to be able to adapt to the changing environment and remain openminded with the portfolio construction.

Thank You.