Sept 2022
Fountainhead Partnerships Fund
Quarterly Letter

"If you can keep your head when all about you are losing theirs ... yours is the Earth and everything that's in it." Rudyard Kipling- (1865-1936) English writer and poet

Fountainhead Partnerships Fund (FHPF) was down 4.0% in Sept, with the S&P 500 down 9.6% and MSCI World down 9.3%. In the first nine months of 2022, FHPF is down 22% vs the S&P 500 and MSCI World down 25%. MSCI Emerging markets are down -30% while Europe is down more than 40% in 2022. So, nowhere to hide for the investors this year.

However, we will show in this letter that we might have reached to a point where there is a greater then 95% probability of positive return in the next 12, 24 and 36 months.

But first a view on the most important thing: The earnings. While the markets are hostage to the top-down macro movements of interest rates and inflation, we would like to share a bottom-up perspective from an earnings and fundamentals standpoint. We also share views on our portfolio hedging and how we are looking (*salivating..*) at the valuations and looking forward to deploying the HUGE pile of cash and liquidity we have accumulated this year.

Portfolio Earnings: There has been a lot of talk about the earnings trajectory. Will they be higher in 2023 (current consensus S&P 2022 EPS est: $240/sh, 2023 est $250/sh) or will they be downgraded?

Although the earnings estimates have not come down <u>YET</u> - have the stocks (down 25% YTD) already discounted the decline in profits?

We believe earnings are going to be the ultimate arbiter of stock prices. Earnings of our portfolio of 30 companies were 16.5% higher in 2Q22, which is 5x the EPS growth of S&P 500 during the same period. The robustness of our portfolio companies' earnings is a reflection of the secular growth nature of our strategy.

We would like to highlight 3 examples of very different sized companies from the portfolio:

Accenture (Mcap: USD 160bn) : Accenture reported their results on 22nd Sept and were the latest to report in the portfolio. The company reported 20% and 16% revenue and EPS growth respectively. Accenture produces its earnings from the most globally diversified operations you can imagine. These superlative results were achieved despite the USD appreciation taking 6% from organic revenue growth of 26% in the quarter. Accenture <u>raised</u> its FY23 earnings growth guidance to 10%. The primary drivers of Accenture's growth are its **cloud consulting** and product suites businesses that grew close to 30% organically.

ACN stock traded at $420 in Dec-21 at 40x PE and 3% FCF yield. Now the stock is trading at $250, at 21x PE and 5.4% FCF yield. Cheap!

Lindt (Mcap: USD 23bn): Lindt is not just an iconic chocolate brand (and delicious of course) - they are probably one of the very few businesses in the world that can confidently boast to increase their operating margins by 20-40bps for the next 10 years.

Lindt reported **40%** growth in earnings with 12% revenue growth 1H22. The reason we wanted to mention Lindt here is that there are businesses we own in the portfolio who are increasing their profit margins even in such a high inflation environment.

Lindt is the market leader in the premium chocolate segment which represents about 15% of the overall chocolate industry and is growing at twice the rate of industry growth.

SMS Corp (Mcap: USD 1.8bn): SMS is a core holding of the portfolio from the very first day of the fund.

Based in Minato-ku Tokyo, the company has businesses in the elderly care space:

a) it provides health care workers into Japan

b) a software solution (extremely profitable)

c) a rapidly growing medical information solution business

Unlike many SaaS businesses, SMS is a very profitable operation in which the founder Mr. Muroto still owns 19% of the company.

The company has grown its profit at a 30% annual growth rate since its inception in 2003. In the last 3,5 and 10 years it has grown its profit at >15% annually.

The 2Q22 was no different when SMS grew its profit by 21% from last year.

Portfolio Hedging: It has been a difficult year for us to hedge given how strong the the portfolio earnings have been so far. Hedging this year required a strong view on macro and we never thought that we have any edge in forecasting the interest rates or inflation.

However, we were able to add about 10% return from our hedging activity to our YTD performance. Mostly in September where major equity indices were down >9% our portfolio was down 4%.

We primarily use S&P 500 put spread to hedge the portfolio which are cost efficient and provide the closest cover to the decline in the stock prices of our portfolio companies. Our view now is we are in the last phase of this downdraft and going forward most of the value addition to the performance will be driven by our stock selection.

Investors are depressed

We are avid readers of history, the stock market's in particular. Rarely have we seen the level of bearishness amongst investors comparable to what we are seeing today - particularly in the absence of a decline in earnings.

Gloomy Sentiment: Sentiment measures have seldom been lower, ever.

The AAII (Institutional Investors) Bulls Less Bears indicator has been below -20 much of the year and is now at -31—lower than 98% of the time since its 1987 inception. The CNN Fear and Greed Index is at 19—categorized as "extreme fear."

The Investors Intelligence Bull/Bear Ratio, which tracks the market sentiment of financial advisors, is currently less than 1.0, illustrating panic!

The 10-day moving average of the CBOE Equity Put/Call Ratio is higher than at any time since the March 2020 pandemic collapse. And, finally, the stock market's "fear gauge"—the CBOE VIX Volatility Index—has frequently been above 30 this year (as it is now).

Low CEO and Consumer Confidence: The dark mood isn't just on Wall Street. Consumer confidence recently dropped to an 80 year record low, and both small-business sentiment and CEO confidence are off substantially. Indeed, we don't remember any other time when so many CEOs warned of an imminent recession before actually being in one. Media stories help feed this fear frenzy. It's not their fault; there is just so much 'good' material.

And who can blame them, after all, inflation is near a 40-year high, pump prices are painful, bond yields are surging, the mortgage rate is now above 7% in US, and the Federal Reserve is re-enacting the "Volcker Moment." The Ukraine war rages on with no end in sight, and in between hawkish speeches by the Fed Cabal, Putin warns he may use nuclear weapons. And, oh yes, in November — leadership in the world's most powerful country may change within a period of just a few days.

So, does this pessimistic backdrop lead the global economy into a (deep!) recession?

In our opinion it is not just the fundamentals that tip economies into a recession but morale and sentiment that perpetuate them. And right now we have plenty of BAD material to have a deep recession.

However, the most important thing for our investors is to remember is that the stock market is a "discounting" mechanism.

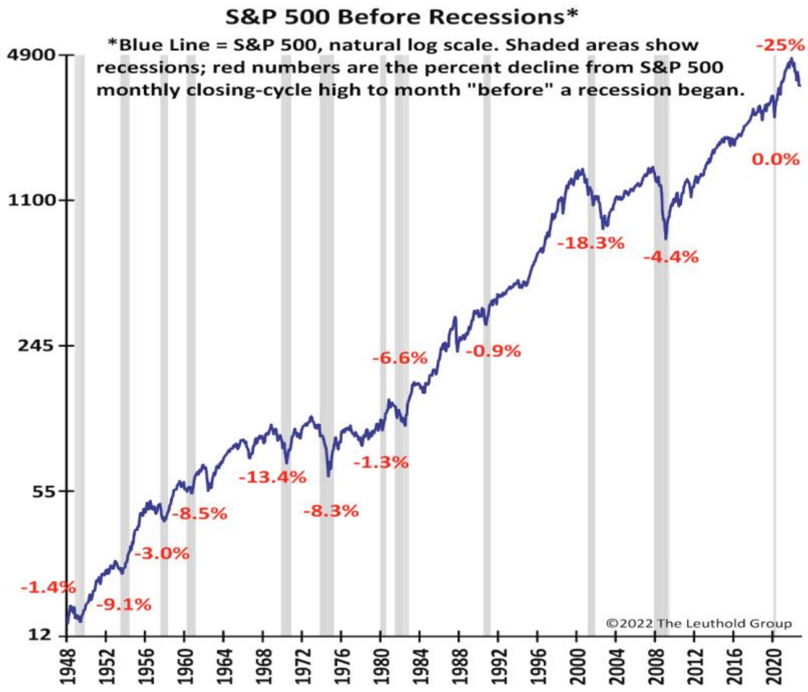
The market is not pricing where we are "at the moment"; it prices what it "expects" (dreads?) is coming.

Perhaps it is obvious, but given the contemporary world of worry, it seems a good bet that the stock market is probably "discounting" plenty of BAD?

And we will show here that the odds are very high that S&P 500 will be ~10% higher in the next 12 months.

But first the Perspective on the FEARS of Recession and The Death of Earnings

Because the US Federal Reserve is convinced it must keep raising interest rates to win the inflation war, the likelihood of a recession is growing. In a recession, won't the stock market fall a lot further? **Not necessarily.**



Since 1948, the USA has experienced twelve recessions. The red numbers on the chart (from Leuthold group) illustrate how much the stock market "discounted" each recession. Specifically, the numbers show the percent decline from the S&P 500's monthly closing-cycle high to the month "before" the beginning of each recession.

The S&P 500 "discounted" recessions by -6.3% on average—or a median decline of only 5.5%.

Recessions often extend stock market losses because a downturn is not usually expected. In the contemporary market cycle, the S&P 500 is already off by 25% **"before" a recession has begun** (if one does occur soon). That is, the "discount" for any pending slowdown has been much more significant today than that preceding any other post-war recession. Indeed, at -25%, the S&P 500 loss is 4.5 times worse than the median return leading up to the last twelve recessions.

Could the stock market still move lower if a recession unfolds? Sure. Is it apt to be drastically lower? Probably not, because "fear" has already caused investors to price in plenty of BAD.

Outlook in the Historical Perspective –

We dived into the stocks and bond markets history of the last 52 years (from 1970) and looked for similar conditions to the ones that prevail today.

We used the Fed model of Equity Risk Premium, which indicates the misprices of bond and equities and accounts for the bond yields and its impact on stock prices, instead of using a simple PE.

We also used the worst case 2023 earnings by discounting the current earnings of $240 by 17%. We used only those periods of history where the UST 10 year was 3% or higher. And lastly we filtered those periods where the markets were already very bearish and down 20% in the previous 12 months.

In other words, we used the most bearish forecasts and conditions and looked for what happened in the following 12, 24 and 36 months to stock returns.

What we found out is that out of 634 months since 1970, there were only 19 months (or 3% of the time) when we had these extreme bearish conditions in the financial markets. And every single time the stock market was higher - with an average return of 25% and a range of minimum 7% to 41% in the next 12 months. Forward 24 months returns were even more impressive.

Here is a table of all previous periods where these conditions prevailed:

Date	S&P 500	UST 10Yr	Forward ERP	Last 12m return	Forward PE
Jul-1974	79.31	7.81%	6.82%	-25.04%	6.84
Aug-1974	76.03	8.04%	7.13%	-26.75%	6.59
Sep-1974	68.12	8.04%	8.80%	-35.49%	5.94
Oct-1974	69.44	7.90%	8.70%	-36.76%	6.02
Nov-1974	71.74	7.68%	8.47%	-29.67%	6.19
Dec-1974	67.07	7.43%	9.93%	-29.24%	5.76
Jan-1975	72.56	7.50%	8.87%	-24.50%	6.11
Aug-2002	912.55	4.13%	1.75%	-22.57%	17.00
Oct-2002	854.63	3.90%	2.99%	-20.62%	14.53
Dec-2002	899.18	3.82%	3.54%	-21.46%	13.60
Jan-2003	895.84	3.97%	3.56%	-21.43%	13.29
Feb-2003	837.03	3.69%	4.52%	-23.95%	12.18
Mar-2003	846.63	3.80%	4.47%	-26.62%	12.09
Feb-2009	805.23	3.02%	6.87%	-40.57%	10.11
Apr-2009	848.15	3.12%	6.89%	-38.11%	9.99
May-2009	902.41	3.46%	6.18%	-35.69%	10.37
Jun-2009	926.12	3.54%	6.09%	-30.95%	10.39
Jul-2009	935.82	3.48%	6.22%	-25.57%	10.30
Aug-2009	1009.73	3.40%	5.76%	-21.21%	10.91
Sep-2022	**3593.00**	**4%**	**2.26%**	**-25.20%**	**15.97**

Bottom line:

Given current conditions in financial markets, we believe we are very close to a point where we would be close to 100% invested

We don't think that we or anyone else has the foresight to find the exact bottom in the stock market.

The earnings power of our portfolio companies remains very strong and the valuations are very attractive.

As the autumn begins in the northern hemisphere and the trees put on the most breath-taking display of the colours of nature, we end our letter with a shortened version of this beautiful poem by Rudyard Kipling (recommended by Warren Buffett in Berkshire Hathaway 2017 annual letter to all investors when major stock market declines occur)

If you can keep your head when all about you

Are losing theirs and blaming it on you,

If you can trust yourself when all men doubt you,

But make allowance for their doubting too;

And yet don't look too good, nor talk too wise:

If you can dream—and not make dreams your master;

If you can think—and not make thoughts your aim;

If you can meet with Triumph and Disaster

And treat those two impostors just the same;

If you can bear to hear the truth you've spoken

Twisted by knaves to make a trap for fools,

If you can force your heart and nerve and sinew

Except the Will which says to them: 'Hold on!'

If you can talk with crowds and keep your virtue,

Or walk with Kings—nor lose the common touch,

If you can fill the unforgiving minute

With sixty seconds' worth of distance run,

Yours is the Earth and everything that's in it.

Rudyard Kipling- (1865-1936) English writer and poet

Thank You.