September 2020
Fountainhead Partnerships Fund (FHPF)
Quarterly letter

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so – Mark Twain

Portfolio performance and commentary: FHPF was up 2% in the month of September, 4.3% for the quarter, and in every month of the quarter with a much smoother ride than global equity markets. YTD Jan-Sept 2020, FHPF was up 17.8% whereas S&P 500 was up 4.1%. It was quite a quarter in which S&P 500 first exploded 12% higher in July and August, then gave back almost all of these gains by mid-September, and then recovered to settle 8% higher for the quarter. Still, September was the first down month (-4%) for S&P 500 since March and a tell-tale sign of what to expect from other asset classes when the equity markets go down. The most interesting reading of September was that all the traditional hedges stopped working when S&P 500 went down 10% and NASDAQ 15%; govt bonds, gold, commodities and safe-haven currencies all declined and failed to protect equity market exposures during this down move in September.

In terms of market behavior, we have observed a significant change in the nature of up and down moves in the last two years. Historically, stock prices tend to go down much faster than they go up but the velocity at which market goes up and down 5% or more has increased significantly. We just want to clarify here that velocity is not synonymous to volatility. A high velocity move could precede or follow a very low volatile market environment. Algorithmic trading, passive investing and hyper option trading could be the key reasons for these rapid market moves but for us they are almost meaningless with regards to what is driving them. What is important for us is to ascertain how these moves are impacting investors' behavior, including our own and how we respond to them. If the movement of stock prices is stretched over a longer period of time it allows investors to think and rationalize their response. However, these faster moves now tend to freeze investors thinking and catch off-guard the unprepared.

Our investors and readers of this letter would know the two components of our portfolio management: a) Our long-term thematic equity portfolio and b) Our hedging of market risk. Investment decisions in equity portfolio are based on our assessment of businesses and their valuation and those decisions are almost completely irrelevant to the market levels. Any high velocity moves up or down is a test of our agility, conviction and temperament to make investment decisions. In the last three months since we have realized this market behavior, we are looking out for the opportunities thrown at us by the high velocity moves in prices. And we got some in this quarter. In July/August, we reduced our allocation by 9% when market went up 12% and some of our stocks were up 20% or more. And when market dropped over 10% in September, we deployed capital and increased our equity allocation by 6%. We have also improved the efficiency of our hedging program in response to the heightened market velocity. We will share more details about it in our next quarterly letter.

During September we found the opportunity to allocate capital to two new companies in the portfolio: i) ICON Plc and ii) Autodesk. Both are fantastic businesses and belong to industries that have very long growth runways, generate very high returns, produce a lot of free cash flows and need very little capital to grow. You may read our investment reasoning on page 2 and 3 of this letter.

Deficit Myth: The Mark Twain quote at the start of this letter is from Stephanie Kelton's best selling book "Deficit Myth" on Modern Monetary Theory (MMT). The book is a best seller this year and we would highly encourage everyone to read it. We read and discussed this book recently amongst ourselves and with many peers. The book stresses on a fiscal solution of increasing government deficit (by printing money) to address societal issues like inequality, environment, health care, low wages and student debt. Kelton suggests, for a developed market government and Central Bank (CB) who can create/print their own currency, revenue is not a constraint for spending in the absence of an inflation threat. The author argues, citing the Mark Twain quote, to think about debt differently from the conventional thinking; it suggests bonds are not the required instruments for issuing govt debt, interest rates are not a market price but a govt/CB option and for an independent or a reserve currency, devaluation is not a serious threat. Given the deflationary/populist world we live in today, there is no doubt governments and CBs will pounce to test the total efficacy of this theory. We believe our job is not to make a judgement about the correctness of MMT, but our observation is that most policy makers and central bankers have already put the MMT into practice and are feeling encouraged to find that it is having a similar effect on the global economy recovering from the current Covid crisis which Keynesian economics had on ending the great depression of the 1930s and the decades afterwards.

Two new portfolio positions:

ICON PLC ($ICLR)

ICON plc is one of the largest Clinical Research Organisations (CRO) globally. CROs industry provides independent product development solutions and services for the pharmaceutical, biotechnology and medical device industries. Companies in these industries outsource services to CROs in order to manage the drug and device development process more efficiently and to bring their products to market faster to enhance patient well-being and maximize their return on investment.

The CRO industry has evolved since the 1970s from a small number of companies that provided limited clinical development services to a larger number of CROs. They offer a range of services that encompass the entire research and development process, including pre-clinical development, clinical trials and data management, study design, biostatistical analyses, post market surveillance, regulatory affairs, central laboratory and market access services.

ISR estimated in its “2019 CRO Market Size Projections, the size of the worldwide CRO market was approximately $39 billion in 2018 and will grow at a 7.5% annually to $56 billion in 2023. This growth will be driven by an increase in the amount of R&D expenditure and levels of clinical development outsourcing by biopharmaceutical companies. ISR further estimated that approximately 42% of Phase I through IV clinical development spend is outsourced to CROs in 2018, and the levels of penetration are expected to increase to approximately 49% by 2023.

The CRO industry is highly fragmented, consisting of several hundred small, limited-service providers, medium sized CROs and a small number of large CROs with global operations. Although there are few barriers to entry for small specialist service providers, there are significant barriers to becoming a CRO with global capabilities and expertise. These barriers include the infrastructure and experience necessary to serve the global demands of clients (sponsors), the ability to recruit sites and patients globally, the simultaneous management of complex clinical trials, the ability to offer customers a variety of delivery models, broad therapeutic expertise and the development and maintenance of the complex information technology systems required to integrate these capabilities.

There are 5 big CROs which capture ~50% of the total CRO industry revenue, namely IQVIA, ICON Plc, PAREXEL, LabCorp, PRA Health Sciences and Syneos Health.

ICON is one of a select group of CROs with the expertise and capability to conduct clinical trials in most major therapeutic areas on a global basis and have the operational flexibility to provide development services on a stand-alone basis or as part of an integrated "full service" solution. ICON has been recognized as one of the world's leading CRO through a number of high-profile industry awards. ICON is a major partner and client of our other large portfolio holdings. ICON is the kind of company that we like. It belongs to an industry that has very long growth runway, generate very high returns, produces a lot of free cash flows and need very little capital to grow. ICON is the only pure play CRO vs its competitors, best margins in the industry, net cash balance sheet and trading at good valuations after the recent decline when we build our position.

Autodesk ($ADSK)

ADSK makes AutoCAD- the dominant software package used in the architecture engineering, and construction industries. The company first went public in 1985 with AutoCAD now having been the industry standard for decades. The product is often first introduced during education with free packages bringing eventual paying customers into the funnel early before their careers even start. As technology has improved, the software offers 3D modelling/renders and new products focus on industrial design/manufacturing and media/entertainment.

The company converted its business to a Software as a Service model in 2016 – moving away from perpetual licenses to subscriptions ranging from monthly to three-yearly. The business is now 90% subscription revenue with gross margins over 90% and growing well over 20% per annum.

A majority of sales are still through re-seller channels. This is a legacy across the industry but over time ADSK is converting more sales directly online. We consider this as the key reason for investing in ADSK. This will improve margins, with marketing and sales currently making up half of operating expenses. Different contractors need to use software that ‘talks’ to each other as they work on sections of the same project making it very hard for a competitor to emerge –pricing power is strong. The increased level of collaboration undertaken between users will also lead to less piracy over time. Converting 1 million of the existing pirated base is literally a billion dollar per annum opportunity.

Unlike other current popular SaaS names, ADSK has proven they are able to drive revenue growth while managing expenses and have now hit an inflection point with significant operating leverage generating strong cashflow. They will likely also be able to use the significant profitability from AutoCAD leadership to drive market penetration in their other offerings, where they are not the dominant player - more R&D, aggressive pricing etc.

Another significant growth opportunity is the very large number of users (6 million+) who use pirated copies of their software. ADSK approaches this sensibly under the premise they are more likely to convert the pirate user to a customer than if they nuke them and they move to a competitor. Pirated copies of the software likely led to the dominant market share they have achieved over the decades. SaaS model encourages less pirating than the lifetime license model.