

June 2021
Fountainhead Partnerships Fund (FHPF)
Quarterly letter

“Holding cash is uncomfortable, but not as uncomfortable as doing something stupid.” Warren Buffett

“It takes character to sit there with all that cash and do nothing. There are worse situations than drowning in cash and sitting, sitting, sitting. I remember when I wasn’t awash in cash – and I don’t want to go back.” Charlie Munger

Portfolio performance and commentary: FHPF was up 9.7% in 2Q21 whereas S&P 500 was up 8.5%. Year to date, FHPF is up 13.5% (net of fees) vs S&P 500 return of 15.2%. The Fund has captured 90% of S&P 500 YTD return despite being only 77% invested. And if we include our hedging position, FHPF has achieved 110% of the market’s return despite significantly hedged to the downside. We consider it as a satisfactory situation.

In this quarterly letter we will talk about:

- Why FHPF is holding such a high cash position?
- We share our learnings from US Intelligence forecasting tournaments. The approach of *Super-forecasters* and how we use it in making investment decisions.
- Inflation and Growth: Are we experiencing a Prepaid recovery? Where we are vis a vis both. We provide the historical perspective in the debate of transitory inflation and growth drivers.
- Lastly, our new portfolio position that we believe we will hold for a long time. i.e. minimum of 5 years.

Holding large Cash positions:

This is the most repeatedly asked question we received from our investors in the last few months; why are we holding such a large amount of cash despite corporate earnings estimates being revised up and stock prices surging. Our defence typically starts with explaining the three main premises of our investing approach: *i) Allocate capital aggressively only when stocks are undervalued, ii) Preserve capital when valuations are high iii) Avoid errors forced by the rising market.* In the current market conditions, where equity valuations are at all-time highs, often we find this defence successful.

Nevertheless, our investors should find it comforting that we have managed to not miss out on any significant gains despite being significantly hedge to the market downside in 2021 so far. Going from a depression-like collapse to a war-time boom in a single year has been more than almost anyone can keep up with. This is especially true when it comes to corporate earnings. A year ago, companies cut operations far more than in a normal recession. The global economy suffered record declines in real GDP, jobs losses, and inventory liquidations. Businesses did not simply prepare for a pending recession; instead, they acted to survive a pandemic! Cutting operations to the bone and then immediately enjoying a war-time economic boom became a recipe for spectacular profits for them. This unprecedented, near-death to nirvana experience in corporate profits has created a huge gap on trailing and seemingly ever rising forward earnings.

Jan-Jun 2021	FHPF	S&P 500 return	FHPF return	If 100% invested with no hedges	Actual Fund return as % of S&P return	Fund return as % of S&P return if 100% invested
FHPF Average Invested	77%	15.2%	13.5%	17.5%	90%	115%
Jan	66%	-1.1%	-0.5%	-0.8%	45%	67%
Feb	77%	2.6%	1.9%	2.4%	71%	93%
Mar	76%	4.3%	2.2%	2.9%	51%	67%
Apr	82%	5.2%	4.8%	5.8%	92%	111%
May	81%	0.3%	2.1%	2.5%	624%	771%
June	82%	2.2%	2.1%	2.6%	96%	118%
Volatility		8.25%	5.82%	7.23%		

Instead of *forecasting* where the earnings will be post-pandemic and where they will be able to sustain themselves, we used options to capture the upside risks to the portfolio. **Two examples** may highlight how we have been navigating the uncertain profits trajectory at the stock level and still capturing (most of) the market returns. **i)** We bought S&P 500 (SPY) Dec-31-2021 options with strike of 4000 in July last year at \$4/contract when the S&P 500 was at 2600. We recently unwound those options at \$42/contract. **ii)** We bought NASDAQ (QQQ)

options in March this year after a sudden rise in interest rates spooked investors and created an opportunity in high growth mega tech stocks that were down about 10-20% from their highs. We still carry those options with significant gains.

The Super-forecasters:

In 2011, IARPA – a research body under the US National intelligence directorate – launched a massive competition to identify cutting-edge methods to forecast geopolitical events. Hundreds of forecasting questions were asked, thousands of forecasters were involved and over a million forecasts were made. Four years, 500 questions, and over a million forecasts later, the Good Judgment Project (GJP) – led by Philip Tetlock and Barbara Mellers at the University of Pennsylvania – emerged as the undisputed victor in the tournament. GJP's forecasts were so accurate that their top 2% forecasters performed about 30percent better than the average for intelligence community analysts who had access to classified intercepts and other secret data. These top forecasters are now renowned globally as *Super forecasters*. GJP research found compelling evidence that these Super forecasters are exceptionally skilled at assigning realistic probabilities to possible outcomes – even on topics outside their primary subject-matter training. Over the four years of the IARPA forecasting tournaments and across hundreds of questions, they demonstrated a ratio of skill vs. luck that rivals professional athletes. Since the conclusion of government research in 2015, Good Judgment's professional Super forecasters have beaten every challenger they've faced in forecasting real world outcomes from geo politics to the field of economics.

Why Super forecaster do better:

Super forecasters estimate a probability of an occurrence, and review the estimate when circumstances contributing to the estimate change. This is based on both personal impressions, public data, and incorporating input from other super forecasters. Understanding and minimising noise in the information is found to be the most unique skill in Super forecasters. Unlike most other forecasters they are rational consumers of the information as they put more emphasis on systematically reducing noise from their forecast by simplifying a complex problem into an easily understood statement.

Super forecasters are also not chickens. They back their prediction strongly but never feel ashamed of changing course even during the forecast period. One of *Tetlock's* findings from the Good Judgment Project was that cognitive and personality traits were more important common attributes than specialised knowledge when it came to predicting the outcome of various world events typically more accurately than intelligence agencies.

The Super forecasters know what they know—and what they don't know. They know how to think through alternative scenarios and how to “disagree without being disagreeable.” They also know the importance of keeping score. When it comes to calculating the odds for even highly polarized topics, their process shows how best practices deliver the best accuracy.

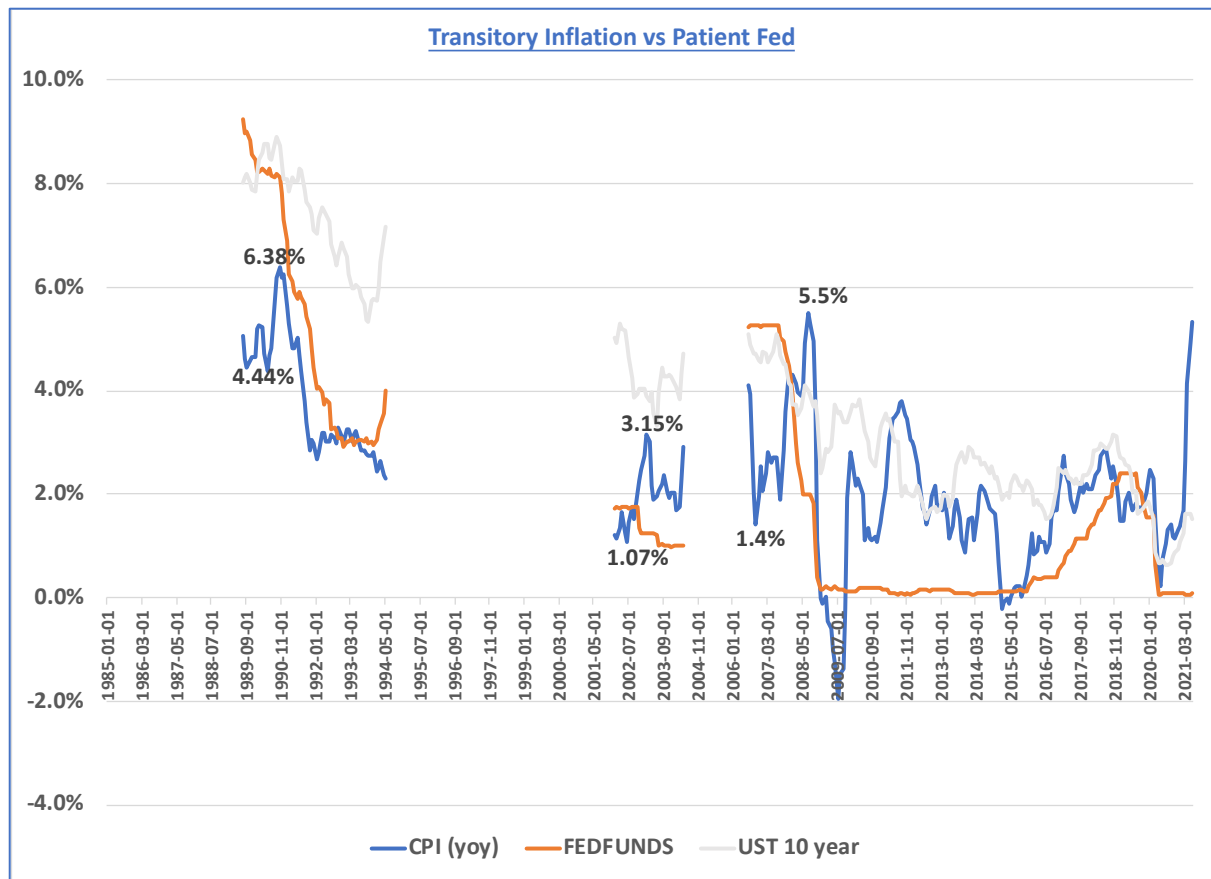
They look at their forecasts with fresh eyes from time to time. Play the devil's advocate and challenge the assumptions that underpin their high-confidence forecast. This exercise helps them to weigh more objectively those annoying little facts that call their forecast into question. Super forecasters forecast not just the geo political events but they also estimate the emerging trends in electric car sales, hydrogen-fuelled vehicles, the growth of Starlink services, and social media regulation, among others. They even have proven themselves very accurate in forecasting near term interest rates!

Lessons for investing from Super forecasters approach:

We find many important lessons from the Super forecasters relevant to our investment approach. To name a few – a multidisciplinary approach to forecasting; understanding and assigning accurate probabilities to events; understanding the individual importance of components in the outcome of forecasts and their interdependence; using facts to reduce bias, rational simplification of the complex problem to minimize noise; and course correction when needed with an open mind.

The forecasting challenge of our time - Is inflation transitory:

One of the most far reaching questions on every investor's mind is, is inflation transitory? But do many investors have the right approximation of what Transitory means: 3 – 6 months, or two years? In our opinion Transitory means coming out of a recession, how long historically a bout of inflation persists and how long US Federal reserve has stayed put before raising interest rates.



How Fed has historically looked at what is transitory?

Let's look at the evidence of transitory from prior inflation hiccups. From September 1989 to November 1990, the inflation rate spiked from 4.3% to 6.3%. The Fed didn't budge. January 2002 to March 2003, the inflation rate went from 1.1% to 3.0%. The Fed was cutting rates! October 2006 to July 2008, the inflation rate soared from 1.3% to 5.6%. The Fed didn't tighten. During the early-recovery and commodity run-up phase from June 2010 to September 2011, the inflation rate went up from 1.1% to 3.9%. It took the Fed four years to move off the sidelines.

So "transitory" in Fed speak could be as short as 14 months and as long as 22 months. **So the operative word is...patience.** And each time the policy hawks and the inflation-phobes come out of the woodwork, they are slayed by bond markets. But "transitory" is definitely not 4, 5, or 6 months. Maybe Larry Summers is right that we close the year at 5% but what if in a year it's back to zero? This is exactly what happened the last time we gripped a 5-handle on the inflation rate in the summer of 2008, as markets believed the Fed was behind the curve with oil soaring above \$100 per barrel and was on its way to over \$140 per barrel (in fact, the YoY trend in the CPI went negative the very next year, to the astonishment of virtually everyone)...imagine if then Fed chair Bernanke had tightened? And, in actuality,

he did switch to a de facto tightening bias and Mr. Trichet over at the ECB actually raised rates in one of the biggest policy blunders in modern history! Oops!!

A Prepaid Recovery - Have we pulled forward future growth?

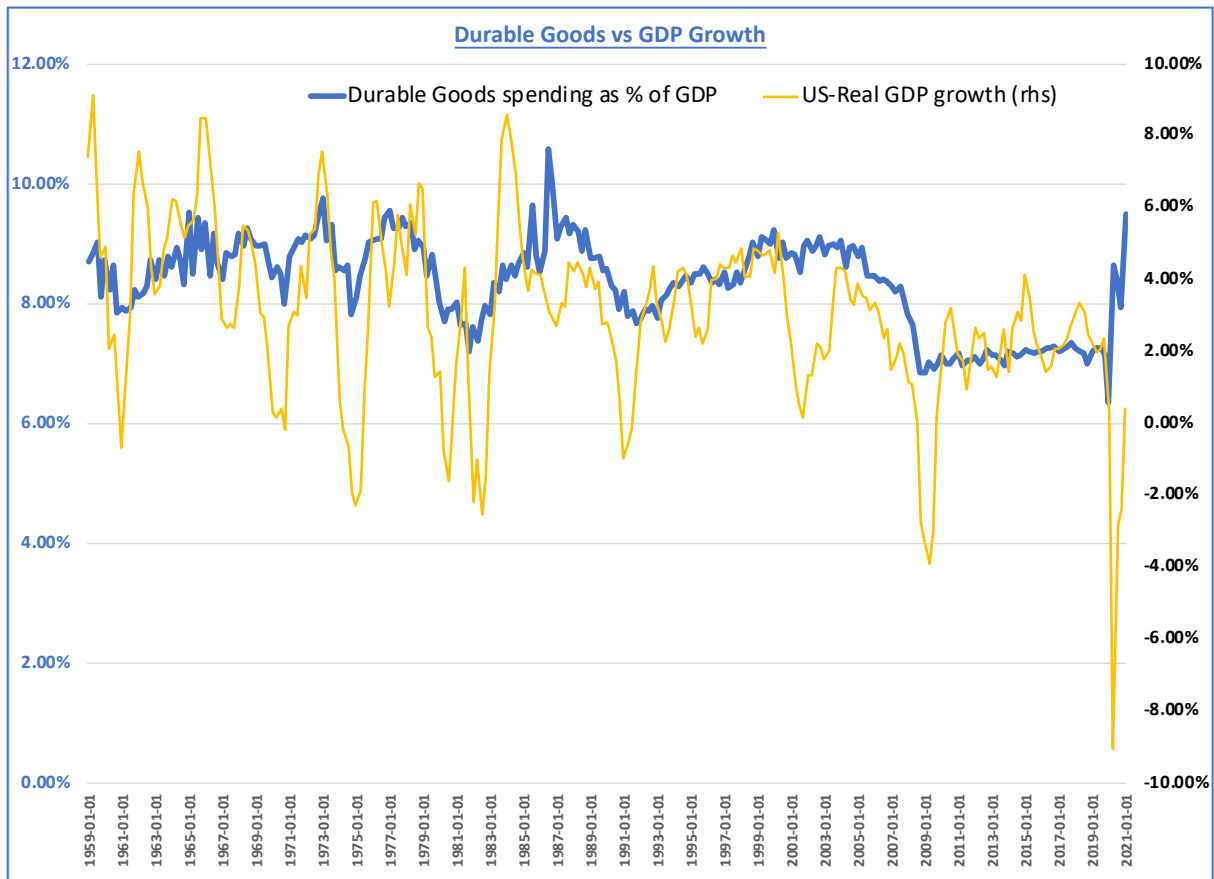
Although inflation may not be the most significant threat to economic recovery, an air-pocket in demand and its spill over impact through falling incomes can create a real wobble in the economy.

US consumers in the last 12 months have increased their annual spent by USD-592bn on durable goods like cars and furniture which is about 150% more than the annual increase on spending they did in the prior 10 years since 2011 !!

USD-bn	Durable Goods	Motor vehicles and parts	Furnishing durable HH equipment	Recreational goods and vehicles	Other durable goods	Non durable goods
annual increase in spending From 2011-Jan 2020	409	117	115	138	38	675
Spending increase since March 2020	592	225	126	131	111	515
Spending increase in last 12 months vs spending increase in 10 years prior	145%	193%	109%	94%	292%	76%

Source: <https://fred.stlouisfed.org/series/PCEDG#>

Durable goods are infrequent purchases by consumers. It is unreasonable to believe that consumers will be able to keep up, let alone increase, their buying of refrigerators and furniture in the coming months. A look at the historical pattern suggests that US consumers spent the highest amount on durable goods as percentage of GDP since forever except 1985! And every time in the past sixty years this kind of splash in spending has been followed by more muted consumer demand of durable goods that slowed down the GDP growth quite sharply.



Source: <https://fred.stlouisfed.org/series/PCEDG#>

Our New Portfolio Position:

In the last quarter we built two new equity positions in two very different but extremely strong businesses. We believe both these companies have a very long growth runway and we will keep them in portfolio for a very long time.

PTC (PTC)- A little known High Quality Industrial Automation business

PTC offers software solutions covering the industrial/manufacturing process from product design, through facilities management, automation, monitoring, training, and maintenance.

PTC's platforms include computer aided drawing (CAD) for industrial design, product lifecycle management, Internet of Things (IoT) integration and Augmented Reality (AR) in the industrial setting.

The CAD offering is focussed on the high-end user and the company has an array of tier one customers across its other product suites. We expect these customers to be sticky over time

as implementation of these systems within their businesses is costly in funds and resources. The data rich nature of the offerings within the industrial setting provides insight into ongoing benefits and the value of maintaining the subscriptions. This is important for managing churn and pricing.

We have been following CAD companies for a very long time because of their sticky products. Last year we built a significant stake in Autodesk (ADSK) who is the leader in CAD offerings. The trigger that we believe that has transformed the PTC business model and revenue generating structure is CAD's platform transformation towards the SaaS (Software as a service) model. Previously PTC like other CAD providers used to sell the product once and then earn only the maintenance revenue afterwards. In a SaaS model the company earns a recurring revenue of the product and can enhance it with upgrades as per specific client needs. PTC has executed the move to a SaaS model in the last 18 months, investing both internally and via acquisitions, particularly for their cloud platform development. We believe they are now moving past the point of inflection where operating leverage begins to ramp as revenues move higher on a relatively fixed cost base. Our other CAD business holding, Autodesk (ADSK), has shown us the power of this inflection at work.

PTC revenue growth in the March quarter was almost 30% YOY. Management are targeting similar numbers going forward. We expect improved free cash flow conversion to eventuate over time and lead to share buybacks.

We think PTC offer fantastic long term return opportunities of double digit stock returns but have been overlooked by the market because of the somewhat opaque nature of the financials/deal metrics. We believe it may take some time, probably about the next one to two years before the value of the businesses will be clear to the market. We generally adhere to the principle that simple is best, but in the current market environment, where valuations are at a premium, it requires digging a little deeper into the weeds to find the long term value opportunities.

Thank You.