Dear fellow shareholder,

**How to Panic Well**

Before this crisis began my younger daughter asked why all news is bad. I told her that not all news is bad but all news on "The News" is bad. Bad things happen suddenly, good things slowly. That is difficult to believe right now, since the news is rightly telling us about daily deaths, silent streets and business failure. Now is the time not to underestimate what has happened and what may yet happen. In this letter I shall only deal with the economic implications but none of us are unaware of the human cost. The good news will take some time to arrive.

Investing wise, there is a lot of undeserved optimism about. This decline is quite unlike the Lehman crisis. That was a liquidity shock, with the consequences centred on financial institutions and those sectors, especially property, dependent on them. This time we are seeing an unprecedented, simultaneous collapse in supply and demand across vast areas of the economy. Many businesses have closed by government order or through lack of revenue; some will never reopen. And a second or third wave of pandemic awaits. A certain amount of panic is in order. I find many investors too sanguine, focussed only on imminent lockdown relaxation and not on the long haul that is ahead of us. A permanent return to normality waits on a vaccine or other treatment, which may take a year or more to arrive. In the meantime, there is bound to be a depression in demand, even as supply re-emerges, with unknown knock on effects on spending, unemployment, the savings rate, and so on. Moreover, the essential intermediaries of capital – government, banks, pension funds and landlords – are likely to be weakened by tax shortfalls, deficit spending, rent and debt holidays and the continuing low interest rate environment. I don't include the oil price collapse in this list, as this benefits more people than it harms. All in all, equities as a class are worth less now than they were at the beginning of the year.

This is the long term which we must contemplate as investors. I thought it would be useful to go through the investment lenses we have been employing as this panic develops, to demonstrate how to predict and benefit from long term outcomes and how to avoid loss in the meantime. Some of this will be obvious to you now but of course our own thinking developed dramatically, in real time, over the past quarter.

**What we stopped doing and avoided doing**

1. Avoiding permanent capital loss

   When you see a bulldozer coming towards you it is not mandatory to lie down in its path. Coming into 2020 we held a number of investments which were vulnerable to the havoc Coronavirus was starting to wreak. Most obvious were the airlines, Wizz Air, Ryanair and Dart Group. Electra's largest investment is TGI Fridays, a restaurant chain. These positions we reduced. Our criterion was: can this business survive the crisis *without material dilution?* The italics emphasize that all these companies will likely continue to exist but may have to borrow or seek equity capital which would diminish their intrinsic value.

2. Trimming the fat

As we have said before, valuations for the average company have been high in recent years, probably because of the historically low interest rates. We took the opportunity early in this crisis to trim holdings of excellent companies which were trading at high valuations and whose trading was likely to be affected by the crisis. For example, we reduced our positions in The Property Franchise Group and Impax.

3. The short-term winners

Many funds have been beguiled by the prospect of making money from the crisis. One can sort these ideas into two types. Funeral directors, ventilator manufacturers and derivatives brokers are seeing demand surge. But this will only last for as long as the pandemic does. As a friend sardonically remarked, “They'll bury more this year, but the same amount in the long term.”

The second kind of idea is to invest businesses that are growing rapidly because of the crisis and will likely keep on growing as behaviour shifts in the direction of their model. Amazon, Ocado, Zoom Video, online gaming, Microsoft, restaurant delivery, and so on. This is a perfectly coherent way of making money, with the problem that all these businesses were already highly valued three months ago and are even more expensive now. Zoom Video is an excellent business which had operating profits of $38m last quarter and you can pay $42 billion for that right now.

Over the last ten years or so we have invested in a number of businesses, such as Flutter, Rightmove, Ryanair and Gruppo MutuiOnline that have taken advantage of new technology to grow market share dramatically. But we have never paid the extremely high prices demanded today for Zoom and the others.

4. Long-term winners

The classic playbook for modern value investors is to buy excellent, long-term businesses at bargain prices. Unfortunately, the best businesses, including those I have just mentioned, were those whose share prices declined least, or appreciated, in this quarter. Impax is at around 35 times earnings and Hermes at over 40 times.

5. Daejan

It would be remiss to finish this section without mentioning our decision to sell what had been our largest UK holding, in the property company Daejan. I received more correspondence about this share than any other over the years. It was an easy value situation to understand, I presented on it many times, and Derby Street had become somewhat identified with it.

When my mother invited me to address her savings club in around 1999, I decided to read through the annual reports of all UK listed property companies, as I thought this an easy way to illustrate value, “buying £1 for 50 pence”. Daejan was the stand out company, as it had a rock solid balance sheet and was trading at a large discount to its net assets. It was the rare property company that survived the Lehman crisis without shareholder dilution. It must be one of the best long-term value creators in the property sector.

Certainly, it has added significant value to our managed accounts over the past thirteen years and, in the seven years' life of our fund, it has returned a compounded 16% p.a. The controlling shareholder bid for the whole company and we, reluctantly, sold.

It has been a pleasant association with the Freshwater family, excellent managers and generous charitable donors to the community.

**What we bought**

6. Crisis neutral businesses

   Although it is possible to find reasons to avoid 99% of all businesses right now (after all it is difficult to service a customer if you cannot go to work, ship in supplies or show products), we did manage to find some companies that appear to have no locus on the shutdowns.

   We have been following a company called Record plc for some years, always concluded it was too dear but were able to make an investment on advantageous terms in March. Record provides currency management services to companies. It is not a principal (it doesn't have currency exposure itself and does not clear trades), it merely charges an annual fee for its services. We have no reason to think that the current situation will either expand or diminish its market. It has been a rather cash profitable business and it currently has 11p per share in cash at bank. Its business, which is pretty stable in most years, makes about 2.5p per share in taxed profits. We paid 30p on average per share. Excluding the cash we therefore paid around seven and a half times earnings. While we don't pay much attention to dividends, the yield is 7.7% and the company has indicated it will also pay special dividends.

   Similarly, we bought a SIPP administrator called Curtis Banks which makes most of its revenue from fixed fees, and which has a good track record of organic and acquired growth, for about eight times earnings adjusted for surplus cash.

7. Manifestly cheap investments

   While it was good to find crisis neutral businesses, as we don't know how long the current situation will persist, it was even better to find exceptionally cheap investments as these will likely have the highest returns, albeit the timing will depend on how the crisis plays out.

   The new, largest position in the UK fund is Premier Miton Group plc. Older shareholders will recall that we first bought this when it was called plain Miton. This was during the last all-out panic, in the week of the Brexit referendum. We made further purchases at other opportune moments and received shares and a special dividend when it merged with a fellow asset manager last year. Turning to our recent purchases, at this point we estimated cash on balance sheet of 21p per share and run-rate profits of 17p, after post-merger synergies. To be clear this 17p is what they would have earned in a clean year without the crisis. Assets under management are down about 20% right now. We paid an average 73p. Net of cash, this is 52p enterprise value per share, or three times earnings if there is a recovery in AUM. Even if assets stay down, we estimate we have not paid more than about five- or six-times earnings.

We made two new purchases in the European fund. You may recall that we had a stake in GAM Holding, the Swiss wealth manager, which we sold for a swift profit last year. We have now bought this back but at a price 70% lower than our sale price. Moreover, we paid less than the company's net cash. Similarly, we have invested in CIR (Compagnie Industriali Riunite) for less than its liquid investments; it has many other assets.

8. Probably cheap investments, with high upside

   We bought British Land, at a significant discount to its last stated net asset value, in the full knowledge that that number will fall (at least in the short term) and that a significant minority of its properties are in the retail sector. Mitigating this is that the net debt of British Land is pretty low, the quality of the portfolio and tenants is high, and there is significant contractual rent spread over many years which should ultimately protect the underyling value.

   We have also initiated a position in On The Beach, an online travel company, with little chance of bankruptcy and good prospects in normal times. Unlike many travel companies, it does not operate aircraft or hotels and, uniquely among UK listed travel companies, it operates a ringfenced customer cash account, and therefore does not rely on advance cash receipts to trade. It will take some years for these ideas to work out.

9. Idiosyncratic investments

   At times of market panic we like to look at the bond market, which we last did in a serious way in 2008. Buying reasonable credits at very high yields to maturity is an excellent alternative to equity investing at such times. One can achieve equity returns (which we think of as 15% per annum plus), with less risk, with an in-built "catalyst" (if the bond pays off at maturity) and with returns that are lowly correlated to the wider world. There has only been a brief window for this so far, in the third week of March, in which we bought two different bonds issued by Burford Capital. This is a litigation finance provider whose equity shares have been targeted by short sellers (we also bought the equity in the wake of the short selling panic). From a creditor perspective, they have a substantial balance sheet, including plentiful cash and a number of non-cash liquid assets. We bought at yields to maturity averaging around 15% per annum. If the prices recover towards par, the actual IRR could be far higher.

The investments we made in the quarter have something in common. With the exception of British Land, they are in "low touch" businesses. These are able to operate without a physical locus to customers or suppliers. They also have high operating margins and largely discretionary costs (mainly labour), which means they ought to be able to survive periods of low or volatile demand. And, as mentioned, some are insulated or non-correlated to the wider market.

Nassim Taleb wrote a celebrated book called “The Black Swan”, about unusual, long-tail events. I do want to emphasise that we are not black swan investors. Derby Street does not hedge the market or short securities, so we would expect to lose money in sustained periods of market decline. We are white swan investors, happy to buy when prices are irrational and ready to profit as the world recovers. To borrow another Taleb-ism, we believe that good companies are antifragile – they will get stronger through the crisis. That is also true of family and society, and both will be strengthened by these terrible times.

Thank you for supporting Derby Street. We look forward to speaking to you all soon.

Keep well,

Richard Simmons
Derby Street Managers Limited
Investment Adviser to the Fund

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