CIO Commentary
December 2nd 2020

As we approach the end of 2020 and recap the turbulent ride we have all been on over the last 9 months, I can say that in my 33 years of professionally investing in the capital markets, I have never faced a set of issues as complex as those we have witnessed of late. We have encountered numerous “black swan”-styled events and even though most of the major equity markets are pushing through to new highs having fully recovered from their March lows, the economic damage of the Covid-19/lockdowns, the transformative impact that it has accelerated and the resultant policy responses will continue to be felt for an extended period of time. These conditions have stirred heated emotions around the world and national leaders are facing continued challenges of social disparity to extreme degrees. Of course, if one studies history there are plenty of distant historic examples (wars and social revolutions) where our predecessors must have also faced quite challenging circumstances, but it does not make today’s navigation any easier. The degrees of disparity between the digital elite are so wide that this will contribute to pressure on political leadership for many years to come.

All of these macroeconomic conditions have reinforced our asset allocation or style emphasis going forward. For readers that have followed our investment strategy, you will recall that we materially pivoted towards growth-oriented approaches three years ago. This was premised on our belief that technology and its deepening application in a variety of industries was driving continuing significant fundamental changes across a wide range of industries and that these were likely to take place over longer periods of time. We consciously did not want to be on the wrong side of the digital divide. The issue is that this transformation process is augmenting the disparity of wealth between the haves and the have nots and governments are beginning to run out of additional capacity to cover these disparities. The digital divide augmenting the divergence of economic power is the reason why we believe that embracing these digital solutions in all ways is imperative for capital preservation and capital growth.

The intense competition and lots of dry powder at the high-end of the market resulted in return compression of classic large-cap buyouts, in turn leading us to pivot the portfolios. Of course, there still remains attractive returns in buyouts, but out of all the funds and transactions that we consider at ALP, we found the ones that had plausible potential to deliver 2 times net MOIC were ones that had a transformative-growth strategy as part of their thesis (whether it is roll-ups, merger-related synergies or through the implementation of a digital strategy).

The beauty of knowledge-rich companies (high intellectual property (IP), quotient and high innovation potential) is that this approach/investment strategy allows one to be very diversified across a wide range of industries and stages. One can invest into “IP-rich” strategies for consumer goods companies that use big data to make smarter decisions on how to reach target customers and promote products. The diffusion of social media and its ubiquity and access to all, has meant that the old oligopoly on consumer product distribution through the large consumer branded companies with large advertising budgets is losing its power. Smaller insurgent brands of products can now reach and target their customers in ways that was not possible 5-10 years ago, which is why in the consumer goods areas you can see smaller branded goods or services go viral into significant size like rarely before. Or in the areas of healthcare services, companies that use software and mobile apps to make the healthcare delivery method more efficient (through appointment bookings and remote diagnosis or through sharing medical records) are gaining significant momentum.

Further, in the areas of drug discovery, AI or computational drug discovery/development is leading to the acceleration of knowledge on how drugs can be designed to be more effective in addressing a wide variety of diseases. In the area of financial services, AI and software are improving the efficiency of originating mortgages, underwriting insurance and streamlining banking and payment processes.

Virtually all industries are being transformed by some form of software, which means that one can construct portfolios that have broad diversification across a wide range of underlying industries.

We have also approached portfolio construction in the knowledge-rich thesis by seeking to diversify by stage of investment. We recognized that seed stage investing, which is often very seductive because of the ground floor entry appeal, is often coincidental with higher mortality rates that are inherent in very early stage investing. As a result, we have emphasized investing into companies and managers (GPs) that mitigate this company mortality risk by investing at points where material revenue has been proven and with meaningful customers already on board. We refer to these companies as inflection-growth investments where the trigger for the need to take on new investors is driven by the idea that the company needs professional help and capital to expand a model that is proving to already work on some level. It can mean capital used to expand the sales and marketing force into new geographies and/or channels or it can mean capital used to further strengthen the product suite sold into an existing customer base.

Capital markets are now starting to anticipate a more robust economic recovery facilitated by the reports of an imminent vaccine for Covid-19. Furthermore, now that the US has elected Joe Biden, the markets are focused on the likelihood of the new US presidential administration's efforts to subdue voter angst, approve yet another stimulus package and install a presidential cabinet that will support the hopeful return of some essence of economic normalcy. All of this optimism is offset by: (i) continued elevation of Covid-19 cases and fatalities around the world; (ii) a return to more stringent social distancing and restrictions on travel freedoms; and (iii) longer-term concerns that all of the costs of the Covid-19 stimulus will eventually have to be paid for by increased taxes at many levels of society.

What this means is that depending on the mood of the day, the markets either reprice small-cap value stocks and credit exposure of the economically sensitive sectors ("risk-on" economic recovery trades) or they revert back to "hiding" in the perceived safety of large capitalized tech companies that have shown enormous lock-down resiliency.

After November's election, it was a remarkably positive month for risk-on economic recovery trades and small-cap/value-styled investments had a significant snap back after a long stretch of relative underperformance. Now with economic recovery more widely anticipated, treasury yields rose at the long end anticipating some minor increases in rates and the US dollar weakened against many other global currencies as investors lightened their priority and emphasis on safe-haven features that the US dollar has historically held. A weaker dollar (relatively speaking) lifted gold in USD terms, value stocks, Bitcoin, and emerging market equities and the shares of companies with weaker balance sheets.

Coincidental with this (momentary?) tidal movement back into value stocks, the queue of companies ready to launch and go public is robust. Many notable "unicorns" are lined up for record level IPO's in 2021 and iconic venture capital firms such as Sequoia Capital are describing 10x MOICs for their venture capital funds. Whether this ascendance of value in the month of November is temporary or marking a sustainable resurgence of value relative to growth styles is an important question likely debated by investment committees around the world. What we can say is that irrespective of the relative value between the two paradigms of investing, the amount of liquidity in the markets is enormous; some estimate it to be in the trillions of dollars, because of prior government stimulus packages and Fed balance sheet expansion. This liquidity is desperately seeking a home that offers returns greater than the near 0% returns offered by cash, and we think that this will drive risk asset performance for the near term.

The irony that will lead to continued political tension is that the lockdown effects and the monetary response seems to have widened the disparity of wealth between those that have capital in the markets and those that are still suffering because of continued weak job conditions and depleted home balance sheets.
We are cognizant of these social tensions and note that they have not been alleviated by a mere change in political leadership in the USA as an example and are certainly keeping a focus on policy changes that will affect investment strategy.

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