Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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*I*nvesting is largely a probabilistic exercise. Simplistically, it involves valuing an asset (i.e., determining the excepted value of the asset – outcomes weighted by probabilities) and comparing it to its price. In Michael Mauboussin's latest insight (Confidence), he distinguished between probability and confidence. In essence, he noted that: "… the price of two investment opportunities may present the same discount to the expected value, but confidence in the probabilities for one may exceed those of the other. That nuance may be relevant for determining the appropriate weighting of securities within a portfolio or evaluating diversification."

*T*his distinction between probabilities and confidence, in the context of decision making, can best be understood through the intricacies of the St Petersburg Paradox - a game of chance in which a fair coin is tossed at each stage. The initial stake begins at $2 and is doubled every time a head appears. The first-time tails appear, the game ends and the player wins whatever is the current stake. The expected value of this game is infinity, yet empirically, most participants in the game would not be prepared to pay anything near this figure. Daniel Bernoulli introduced the concept of Utility to explain the paradox – "he conjectured that people will neglect unlikely events." In terms of probability and confidence, people have no confidence that the higher 'prizes' are simply attainable.

*I*t would be informative to extend this thought process to two specific stock examples:

'*A*mazon' was listed in 1997. By the mid-2000s, Amazon was on its way to becoming the dominant online retailer in the US and certain other developed markets. However, it only had one primary stream of revenue, it was investing heavily and undercutting its competitors to capture market share. The net result was that the firm's operating and free cash flow was negative. It was only much later, as it captured more and more of the market (both internally and through third party participants on its platform) as well with Amazon Web Services and its advertising platform (amongst others), that Amazon's economic prospects looked far more favourable, stable, and predictable. At the time, not only would an investor have had to predict that trajectory of online retail (which was relatively obvious), but more importantly, one would have had to predict the shear brilliance of Jeff Bezos (not so obvious at the time) in steering Amazon to the success that it is today.

*S*imply put, the confidence an investor would have made in the expected valuation of Amazon in the early stages has been low.

Thus, while the price-to-value relation in retrospect was favourable at the time, it was not obvious then. In this instance (and in the absence of some wonderful insight on both the industry and stock-specific characteristics), it would be advisable that such an investment be a small proportion of the overall portfolio and diversified across many similar investments.

*T*he second stock is 'Meta', previously referred to as 'Facebook'. 'Meta', and 'Alphabet' were the two dominant online advertising platforms capturing more than half of the online dollars spent on advertising in a high -growth market. 'Meta' had a high free cash flow and high return on invested capital. By 2021 'Meta' was facing several headwinds, specifically: investors were worrying about the dominance of 'Meta' as other online platforms, such as 'Tik Tok' was capturing market share; Apple's decision to allow consumers more control of their privacy settings which directly impacted Meta's tracking abilities, and Meta's decision to invest heavily in the Metaverse – something very few people really understand. The result was that while Meta's core business remained highly profitable, albeit slowing, it was burning through significant cash flow on the Metaverse investments. The share price went from a high of 383 in Sept '21 to a low of 90 in Nov '22, losing about 75% of its market value. In this instance and at that share price, 'Meta's' return to risk profile improved significantly. The fact that at present, 'Meta' has approximately 3.4 billion active users and from an operational perspective, maintains a positive cash flow and high return on operating assets increases the confidence of the excepted value projections for 'Meta', especially for investors with long time horizons. In addition, there is the possibility of even more upside as the Metaverse evolves and the opportunities to profit from it materialize and become clearer at virtually no cost to the investor. In this instance, a more concentrated less, diversified allocation would be more prudent even if macro and firm/industry specific factors affect the short-term earnings of 'Meta'.

*I*t is crucial to differentiate between probability and confidence in investment decisions, as demonstrated by the St. Petersburg Paradox. This paradox highlights how individuals tend to overlook improbable events, even if they have significant expected values. As a result, investors must factor in not only the anticipated value of an asset but also their confidence in the likelihood of various outcomes. By doing so, they can make well-informed and logical choices that align with their risk preferences and utility functions.

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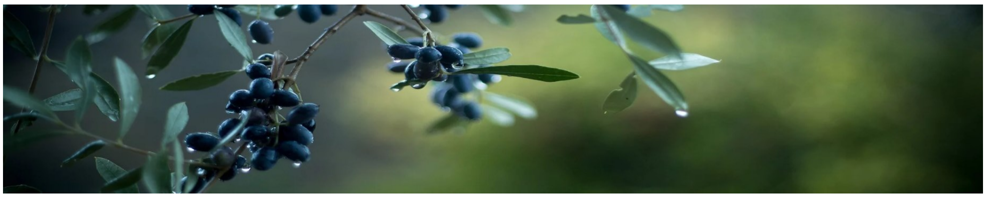

Strong Roots, Sustainable Growth

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