Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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NET ASSESMENT

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*E*very investor has their unique style and beliefs that underpin their investment philosophy and processes. My personal bias, assuming an investor has a reasonably long-time horizon and the appropriate psychological composition, is that the most successful investments (at the lowest risk) are most likely to be in quality equities that have high returns on invested capital, decent prospective growth prospects and sustainable competitive advantages. As a secondary consideration, such equities bought at a fair price further reduce risk. My bias for such investments is underpinned by the following rationale:

1. Good quality businesses, by definition, have good margins, are cash generative, earn decent returns on invested capital, and have favourable economics and consumer place of mind that make them sustainable and understandable thereby compounding cash flows over time and by extension reducing risk.
2. Good quality businesses bought at fair prices further reduce risk because they eliminate the need to make numerous successive 'good' investment decisions over an investment time horizon, which statistically results in lower odds of success. Such businesses can be held for a long duration.
3. Following on from the previous point, holding such businesses over a long duration allows them to compound their retained earnings thereby increasing intrinsic value over time as the effects of compound interest materialize.

*A*n inherent vulnerability of such an investment philosophy is that the economic characteristics of such quality businesses turn out to be illusionary. Further compounding the issue would be that such businesses usually trade at higher multiples than substandard businesses. A value trap is defined as: "a stock or other investment that appears attractively priced because it has been trading at low valuation metrics, such as price to earnings (P/E), price to cash flow (P/CF), or price to book value (P/B) for an extended period."

I believe that in such a case a case study would be informative. A stock, in my investable universe i.e. meeting the definition of a quality stock, is currently trading at an 80% discount to its peak price in July of 2021 primarily because of investors' concerns regarding its future growth prospects. At each stage of its downward trajectory, I have been debating its inclusion in my portfolio. However, once a new low price point is reached, it seems to fall further. A look at the stock's fundamentals indicates that margins, free cash flow and returns on invested capital have all remained largely static. It seems that investors have punished the stock because its growth rate of revenue has slowed down significantly to single-digit growth. At its current price, and assuming a low growth rate in free cash flow over time and no benefit to future reinvestment, the stock seems fairly priced (i.e. to return approximately 10% per annum over time). Such a scenario would make a compelling case to buy the stock at its current price. However, the issue is that it is not clear at all where the company's source of growth is going to come from and further, it occupies a place in consumers' minds and behaviours that would give a competitive advantage in a market that is expected to grow over time. In such a scenario, this stock no longer meets the 'quality' definition where valuation is a secondary factor since the inherent compounding at high levels of Return on Invested Capital which, usually results in such stocks being mispriced, and instead is classified as a 'value' stock per the industry's interpretation. In this instance,

an investment in such a stock would only be viable if there was a significant discount to intrinsic value.

To quote Warren Buffett:

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price".

*A*t its current price and given that this business has no obvious source of growth there is not much margin of safety in such an investment.

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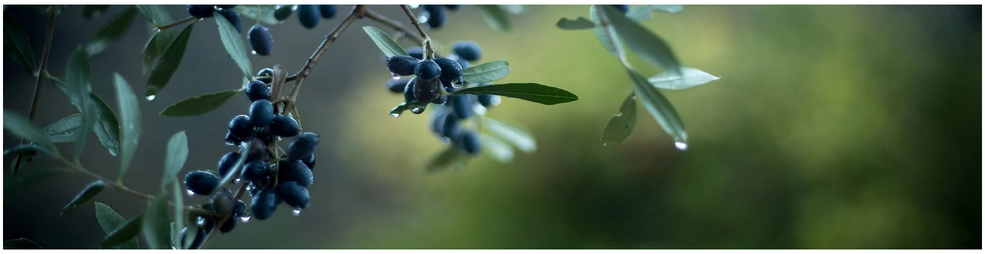

Strong Roots, Sustainable Growth

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