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asset management

Gleneagle Asset Management Limited
Gleneagle Investment Trust (Equity Fund)

June 2022 Review

A brutal 6 months has seen the worst start to the year since 1970. The Nasdaq lost 30%; the S&P 500 shed 21%; and the Dow Jones only gave back 15%. There have been few safe havens, bonds have been hit hard, gold hasn't been a good inflation hedge, gold stocks have been hit harder, and bitcoin has been savaged down around 75% from its highs last year.

The Gleneagle GT Momentum Fund was officially handed over to Tim Muirhead on 1 July. As the new portfolio manager of the Fund, I'll briefly discuss the market outlook, the positions the fund has inherited, and my trading strategy. I understand that the fund performed poorly in the 2022 financial year, so our aim is to turn things around.

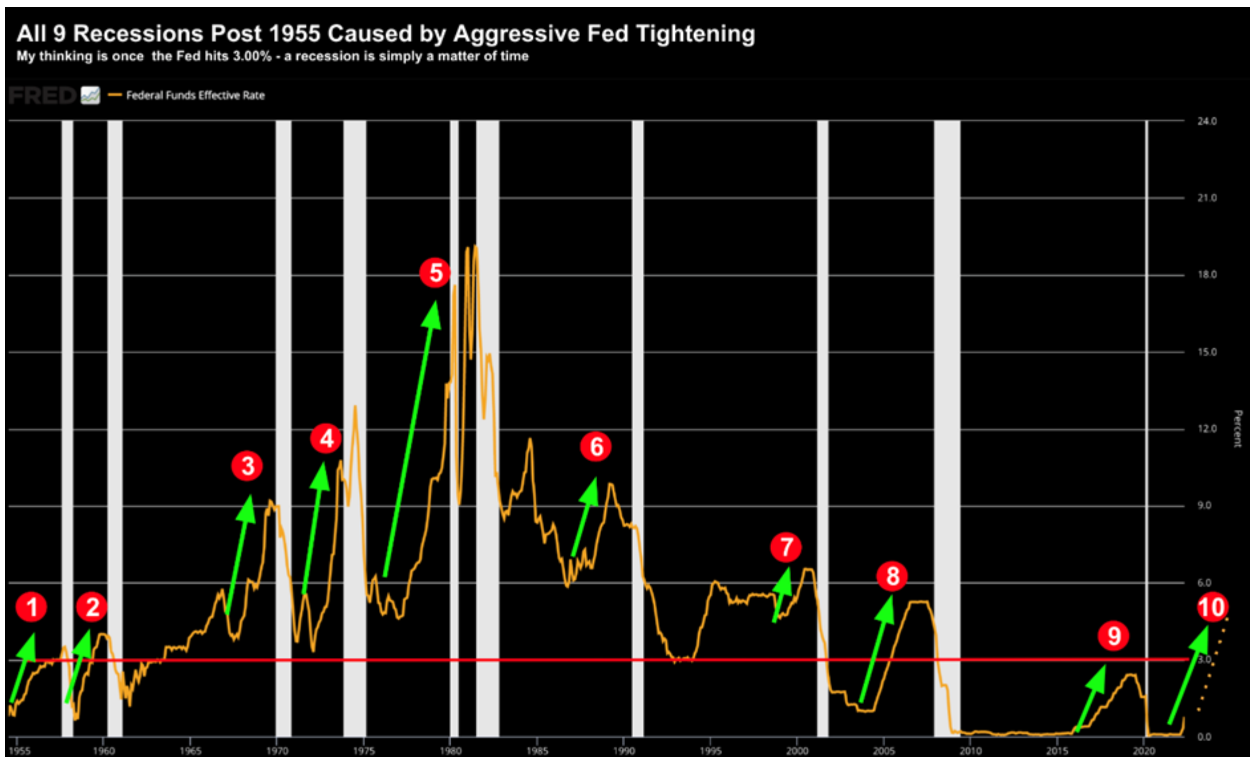
Market Summary

A quick summary of markets now, US yields have started to recede from the highs as the market is starting to worry about the risk of the US going into a recession. Europe is almost certainly in a recession as we speak with the war in Ukraine still raging, putting Germany into its first trade deficit since 1991, and unsurprisingly pushing the EUR to new lows. The US Fed is currently focused on fighting inflation, and is in the process of raising the Fed Funds rate and reducing their balance sheet, which have been negatively impacting markets. Being late to the game increases the probability that the Fed overreacts, because it didn't act soon enough as inflation started to break higher. This increases uncertainty and elevates the probability of a hard landing, which is what everybody wants to avoid. Hard landing means we go into a serious recession, like the one associated with the global financial crisis.

"*I think we now understand better how little we understand about inflation.*" - Jerome Powell

What does recession mean:

- Unemployment rate rises
- Consumers spend less
- Companies make less
- GDP falls (and 70% of US GDP tied to consumer spend)



Every recession after 1955 (9 in total) was caused by aggressive Fed tightening.

We are now approaching the US earnings season, and it is likely we'll be seeing the earnings side of companies being hit. The question as traders is what type of recession will this be:

- A Recession where inflation is not fully brought to heel and thus rates remain higher for longer and inflation comes back after recession. This is what happened during the 1970's
- A Recession which lowers demand and price rises fall back to the 2% range. The recovery when it comes does see commodity prices firm but the percent increases aren't enough to drive inflation (like 2003 to 2008). i.e. a short sharp recession.
- A Recession which leads to negative inflation prints in 12 to 18 months. This is a repeat of the late 1940's, and would likely see the Fed step back into support markets aggressively.

The investing landscape is changing quickly and we are thus likely to continue to see continued market volatility. While we are seeing some green shoots in oversold US tech, significant downside risks still remain. The key number to keep an eye on will be US CPI. If the 8% handle CPI hangs around for several more months, the Fed has no choice but to stay very aggressive. Powell has been very clear that unless things get really ugly, he is hiking and will continue to hike until inflation breaks. We have thus been increasing our cash positions and reducing our exposure, to take advantage of opportunities when they present themselves.

Portfolio Holdings:

I don't normally like to talk about individual positions, but feel it's important to outline some of the current core holdings that the portfolio manager has inherited, as they have been caught up in low liquidity and tax loss selling and are trading well below what 'fair' value might be. Most of these are illiquid and cutting these positions in this environment would be difficult at this time without further depressing the prices and locking in severe losses.

When the fundamentals for the company are solid, I believe we should see them rebound strongly, so I shall give you an overview of each and why we have decided to ride them out for now.

One of the best performing sectors this year is energy, with West Texas crude starting the year at around $76/barrel, and currently trading around $100. One company that we have been following very closely since 2017 is Helios Energy, an oil and gas explorer with ~$30 million cash, no debt, with its main operations in Texas, USA. The management team are experienced in developing Texas oil assets, as they previously were involved in Aurora Oil and Gas which was sold for $2.6 billion in 2014.

Helios also is developing Helium assets in China which alone could support its current market capitalisation, but for now we shall focus solely on its Texas operations. They have been drilling their Presidio oil projects and recently completed drilling its 4th well, with strong oil and gas shows from 6000 to 8250 feet, which has also confirmed with oil saturated core samples. On the way down to the primary targets they discovered a new pay zone in the Boquillas which is highly naturally fractured and full of oil, and this could end up being a conventional oil play. From previous seismic they have done, they estimate at least 10,000 acres of similar zones in their area, and this might extend to ~20,000 acres.

So let's do some math. If they manage to be able to successfully extract oil from these wells using a vertical fracking method, Helios management believes they will cost around US$2-3 million to complete, take under a month to drill and they will get at least 200 barrels of oil per day from each well. They can put wells at 40 acre spacing, so in 10,000 acres, that's 250 wells. 250 wells at 200 barrels a day is 50K barrels of oil per day. If we assume a more conversative oil price of say US$80/barrel, with US$20 of costs, that is 50,000 x (80-20) = US$3 million per day, or over US$1.095 billion per year. And then if we look at the gas sales, gas prices have tripled in a year, although we won't know the extent of the gas until they start pumping the oil. The wells very quickly start paying for themselves so they won't need any further capital. The current market cap of Helios is around US$133 million, so we believe it is very cheap.

Helios has done an extremely poor job at conveying the information to the market, and with little information other than the falling price, exacerbated by tax loss selling, the market is currently assuming the worst. Selling creates fear which creates more selling. Management is now very aware of this issue, so we believe they will attempt to rectify the information flow over the coming weeks. We expect to see them announce well 3 on pump and this will give us a better idea of flow rates, plus the completion of a 35 mile road into their area which was one of the causes of the delay in drilling the 4th well, the location of the next well, and more updates on their Helium plans.

Our second core holding is in Elsight, developer of the Halo high security, high redundancy communication device being used widely in the Drone Delivery space. While drone delivery is still very young and emerging, we expect to see drone delivery continue to disrupt typical delivery methods due to its low cost, high speed and user convenience (being able to order and receive an item in under 15 minutes). Imagine ordering a meal online, delivered to your house for a dollar and delivered faster than any driver could - this is fast becoming reality. Walmart via Droneup started with 3 stores last year, which has grown to 33 stores, and will expand by another 80 stores in the coming months. They have ~4700 stores across the US, and given that nearly 90% of US citizens live within the drone delivery radius of Walmart, Walmart via drone delivery might even start disrupting the likes of Amazon which have fewer locations and thus don't have the same coverage. Elsight has just announced a partnership with Air Methods Corporation subsidiary, Sprite to expand into drone delivery in healthcare in the US, and as I write this ELS have been selected by Speedbird for drone parcel delivery in Brazil. Elsight's Halo is rapidly becoming the de facto standard for all drone communications, now with over 50 design wins with other drone companies, so we believe we shall see positive news and sales grow exponentially over the coming months and years.

Our final core holding, albeit in smaller size, is in the biotech space, with a company called Vectus Biosystems based out of Sydney. This is another company that we have followed closely since they listed on the ASX in 2016. They have a platform technology and have developed a library of over 200 small molecules with varying degrees of anti-hypertensive and/or anti-fibrotic properties. To quote from their website "Fibrosis, the formation of excess fibrous connective tissue in an organ, plays a role in more than 40% of deaths worldwide. This figure includes different diseases affecting the heart, lungs, kidneys and liver, among others. While current treatments only slow the progression of fibrosis, Vectus has demonstrated in animal models that its compounds can reverse the process, leading to the restoration of normal tissue architecture."

The company is currently in the late stages of their phase 1 trials for their lead compound VBS004, and is showing no signs of adverse safety. In their single ascending dose trials, even a high 300 milligram dose could be safely tolerated by humans with no adverse reactions. They are now mid-way through their multiple ascending dose trials. Passing the phase 1 trial would likely be "the largest and most important drug to come out of Australia", according to their chairman Mauri Stang, and we believe would see a massive re-rating of the stock price.

Trading Strategy

The Fund implements a long/short investment process which aims to produce consistently positive returns in multiple market cycles. Our primary focus is Australian and US equities, and complement this strategy with global index futures, currencies, commodity and government bonds when opportunities present. We use a global macro framework to identify changes in trends, and apply a fundamental and technical overlay. Our aim is to find the intersection between value and momentum, and grow your wealth while managing risk.

I should point out that Investing is a marathon, not a sprint and while there are times where the aim is to protect capital and just survive, new opportunities in the market are always presenting themselves. Our continued focus is to find trades where the upside outweighs the downside, and then diligently execute our trade plans; profitable trades then tend to be a byproduct of this process.

If you have any questions or comments, please drop us a line at info@arbidyne.com

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