QUARTERLY REPORT #11: PERIOD TO 31 MARCH 2019[1]

Performance and net asset value[2]

Quarterly portfolio return: 2.4%

"There's relative value in old fashioned value. What's holding it back? Time, patience and temperament". (Con Michalakis - on his observations from a recent US investment visit)[3]

Using someone else's tweet as your hook line to a quarterly report may seem unusual. However, these few words are especially pertinent when investment sentiment towards equities swung from dire to euphoric in less than three short months.

This quarterly is themed around looking out beyond the very short term to some of the obvious medium-longer term disparities which exist at present. We aim to show, in a practical fashion, why we have a more aggressive stance between long (203%) and short (156%) – which together aggregate to 359% of your capital – but that long **minus** short provides only an overall net exposure of 47%.

As a starting guide, we covered the last of our Apple short position on Xmas Eve at $149; the shares are now close to $190 **up** around 27%. In the meantime, earnings expectations have **fallen** around 10% for fiscal 2019. Hence, each dollar of expected Apple net income in the year to September 2019 now costs $16.60 rather than $13.10 three months ago, despite more competitive smart-phone markets and an apparent slowdown in global economic conditions. It's a similar situation for the US S&P500, where $1 of earnings in the year ahead was priced at ~$14.40 in late December and is now close to $17. Why?

Aside from the fact the $149 Apple price was anticipating an as then "unrevised" slowdown, the main factor behind this re-rating has been the decline in risk-free interest rates; the yield on a US Treasury 10-year bond has fallen from around 2.7% to 2.4% - some way below the 3.25% in October 2018 which caused the 7% fall (10.6% at worst) in S&P500 that month.

We are not surprised that bond yields have fallen sharply, since virtually every global economic statistic released of late has showed a distinct slowing of growth, despite very loose monetary (and fiscal) policy across Europe, Japan, China, Australia and now the US. With the economic cycle in the US long in the tooth, seeing bond rates so low is somewhat concerning. The paradox of equities pricing themselves higher into a clear slowing of earnings growth gives us greater anxiety.

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[1] East 72 Holdings Limited (**E72**) provides monthly **unaudited** updates on its company performance and exposure supplemented by a more substantial quarterly note. Readers are referred to footnotes 2 and 34-39 explaining the derivation of the numbers. All returns are pre-tax unless stated otherwise. At the current level of net assets, cost imposition is estimated at 0.45% per month over the course of a full year (excluding capital raising related expenses) and is fully accrued monthly according to the best estimates of management. Readers are explicitly referred to the disclaimer on page 15.

[2] Month by month tabulation of investment return and exposures is given on page 14, along with exposure metrics.

[3] 24 March 2019 tweet. Mr. Michalakis is the award winning Chief Investment Officer of Statewide Super, a not for profit Adelaide based super fund, with exceptional long-term performance.

A bounce from oversold and fairly valued US (and other global) equity markets in late December 2018 was expected. The sheer magnitude of gains from the December lows – S&P500 up 20.8% (13% in the quarter) and MSCI World Index +17.1% (12% in the quarter) - to current levels against a weaker backdrop was not. As a consequence, we have significantly reduced our long exposure to equities.

These rapid gains, and what we view as increasingly exorbitant valuations for growth companies – explored below – provides the basis for our "spread" between being long "value" and short "growth".

In the very short term, this has cost us some performance, especially in February and (late) March, as we will never catch the very top of these growth stock "surges". We examine how a number of US "growth" stocks are supported primarily by share based payments to retain their staff, which maintains their cash flow; an inability to issue such shares would virtually cripple their businesses. As a contrast, we also present over twenty "extreme value" stocks, virtually all trading at 20-50% below easily realisable short-term value, as well as two undervalued but long term thinking financial institutions.

Growth junkies and growth zombies

One of the greatest worries about the prevailing market environment is that amidst low bond yields and falling earnings expectations, investors have started to chase GAAP and YAAP: Growth At Any Price and Yield At Any Price. The former is reflected in astonishing quarterly gains for high (50-100x P/E) or no multiple stocks such as Afterpay (+69%), Wayfair (+65%), Shopify (+49%), Altium (+49%), Pro-Medicus (+36%), Wisetech (+37%) and Netflix (+33%). We now have small short positions in all of these names[4].

The magnificent chart[5] below partly shows the degree to which investors have become wedded to growth companies. This is obviously reflected in a high dispersion between relative valuations of "growth" and "value" stocks.

Chasing growth tends to happen in these slowing environments – and usually ends in tears. The current set-up has elements (I stress elements) of 1999 about it. Older readers may remember the year when the dot.com stocks trounced their traditional counterparts, prior to a seven-year period of aggressive reversal (purple loop on chart). Since the GFC, "growth" –largely the mega-cap technology stocks – has comprehensively trounced "value" (red loop), with the occasional blip – like 2016.

[4] Netflix, Shopify and Wayfair are US listed; the remaining securities are listed in Australia
[5] Source: Prof. Ken French, Tuck School of Business at Dartmouth (Wall St Journal 16 March 2019)

A "corporate zombie" is a company producing sufficient cash flow to pay interest on a high debt load, but incapable of repaying any meaningful part of the obligation.

A number of very highly priced technology companies might now be considered "growth zombie" companies: corporates with seemingly no visible ability to provide free cash flow to investors other than through the use of share based compensation payments to employees, and no great insight as to when this may change. However, they are unlikely to go out of business in the near-term due to past accumulated high cash piles from share issuance and customer cash paid up front.

Many of these companies are very highly valued enterprise software businesses. They all talk the same lingo - "transforming the way people use data to solve problems" and "opportunities for human advancement"[6] – so long as you are paid by them one might suggest.

These companies have particular attributes. Extra-ordinarily high gross margins (well over 80%), hefty R&D and almighty sales/marketing costs. Since they are subscription type models, they all generate significant quantum of deferred revenue[7], which in many cases accounts for a significant proportion of on balance sheet cash. Investors love subscription models with high margins and afford them extraordinary valuations – think the big-daddy of them all, Salesforce (CRM) with a market value of $123billion trading on 58x forward earnings. At least it makes a net profit after tax and doesn't have its operating cash flow more than 100% comprised of stock-based compensation and/or deferred revenue. Here's a selection of "new-age" listed enterprise software businesses:

ticker[8]	BOX	DATA	DBX	DOCU	WDAY	SPLK[9]	ZEN
Operating cash flow (A)	55	155	425	76	606	296	79
Share based pay (B)	119	239	650	411	652	442	119
Net deferred revenue impact (C)	26	56	66	39	344	153	43
Adjusted (A-B-C)	**(90)**	**(140)**	**(291)**	**(374)**	**(390)**	**(299)**	**(83)**
After tax profit	(135)	(77)	(485)	(426)	(418)	(276)	(131)
Cash & securities (D)	217	1,048	1,089	932	1,779	2,868	820
Debt – including converts (E)	140	-	245	463	1,204	1,635	458
Net carry value deferred revenue (F)	278	394	485	267	1,868	608	198
Adjusted cash (D-E-F)	**(201)**	**654**	**359**	**202**	**(1,293)**	**625**	**164**
Equity market value (G)	2,735	10,945	9,032	8,881	42,766	18,366	9,122
Share price Δ% 12months	-7%	+57%	-30%	+85%[10]	+52%	+26%	+76%
Sales (H)	608	1,155	1,392	701	2,822	1803	599
EMV/sales (G/H)	4.5x	9.5x	6.5x	12.7x	15.2x	10.2x	15.2x

[6] These feel good clichés come to you courtesy of Tableau Software (stock ticker: DATA)
[7] Revenue for a period paid up front, so cash is on balance sheet but significant liability for services yet to be provided
[8] All figures US$million for latest 12 months to December 2018/January 2019
[9] Splunk's marketing motto is "we take the sh out of IT" (but perhaps not their accounts….)
[10] versus IPO price April 2018

These “human advancement” companies are not as lucky as Salesforce in making a profit; or maybe they are, since investors, by and large, don’t worry about such minor details, focusing exclusively on the “business model”. God forbid some of these companies “spinning wheels” slow down, since the deferred revenue would slide, reducing available cash, and bringing on a situation not envisaged when equity values average out at over 10x trailing sales[11].

It will be most interesting to revisit these folks in a less buoyant environment – perhaps when the echo-chamber around them stops reverberating[12]....

Extreme Value: 26 examples from our portfolio

Here’s a contrast to companies where cash flow is reliant on their employees accepting payment in overpriced equity securities. What follows is a simple tabulation of our most extreme “discount to value” long holdings, the rationale and the potential catalysts for realisation might demonstrate how East 72 assesses such opportunities. We are cognisant that there will be the inevitable “value trap[13]” in this list, but attempt to isolate catalysts as to why a reduction in discount, if not complete realisation may be possible.

We obviously have numerous other holdings where we believe there is significant inherent value, but that such value accrues through the earnings base of the company over time (eg Virtu Financial; Blackstone; KKR, Alphabet). Some of the companies tabulated below have obvious longer-term income streams, but may also have short term catalysts which would significantly inflate the internal rate of return from ownership (eg EXOR).

In perusing the table, it might be instructive to know we hold a number of short sale positions in profitable and growing Australian companies which trade at P/E’s of 50-90x, together with a number of US based stocks which have no free cash flow outside of share based payments (including three of the “human advancement” companies in the table above) where any loss of confidence by creditors in their sustainability would result in rapid demise. Companies where in a slow growth world, GAAP[14] investors have, in our opinion, seemingly taken leave of their senses.

The list of companies is divided into four groupings; investment companies (4) and special situations (5) are most likely to see full realisations, family controlled entities (4) far less so, and operating companies (13) the most “risky” given their requirement to improve earnings, but potential for acquisition by others in some cases. We hold a number of other investment companies which trade at lesser discounts to net asset value (eg PM Capital Global Opportunities Fund, RENN Fund) owned for qualitative reasons.

[11] We fully acknowledge all these companies are rapidly growing sales and have given detailed guidance for FY 19. That’s not the point of the exercise.

[12] Only DATA (Seattle) is HQ’d outside San Francisco (albeit WDAY is in Pleasanton, CA)

[13] A value trap is generally where investors are able to calculate that the share price trades at a significant discount to realisable value but that realisation is elusive. This usually occurs because of a controlling shareholder with other motivations, an operating business which continues to decline in profitability due to management or industry factors or inept capital management by the directors. Value traps typically involve examples such as old-style retailers, media and food companies.

[14] Growth At Any Price

Company	Ticker	Asset/business	Rough valuation parameter	Realisation catalyst
Special Situations				
Brookfield DTLA prefs	DTLA.PR	Preferred shares in leveraged structure owning six office buildings + 1 centre in downtown LA	55% discount to par plus accrued dividends	Not guaranteed but Brookfield matching prefs suggest chance for realisation on sale of portfolio or legal structure
Rubicon Technologies	RBCN	Equity in company having sold most of operations, but owing strategically located property	15% discount to cash; 22% discount to cash & property; 37% to NTA excluding value for NOLs	Board started buying back shares and are searching for appropriate business transaction
Treasure ASA	TRE.OL	Equity in ungeared single purpose vehicle controlled by WWI.OL (below) owning 4.5million shares of Hyundai Glovis (086280.KS)	40% discount to NTA	Buybacks, change to Glovis structure (one attempt rejected by activists), sale
Vulcan International	VULC	Equity in ungeared manufacturing company with substantial investment portfolio dominated by USB and PNC	~25-30% discount to value of forest, property and ~$141m stock portfolio	Gettler family have announced "patient" liquidation process
PICO Holdings	PICO	Equity in ungeared holder of water rights and storage credits servicing growth markets in Nevada and Arizona	Estimated 40% discount to realisable value + significant tax losses	Restructured management with relevant expertise focused on sale and repatriation of assets
Investment Companies				
Third Point Overseas	TPOU.LN	Third Point managed hedge fund strategy	Approximate 22% discount to NTA	Ongoing strong performance and share buybacks
Adams Natural Resources Fund	PEO	Closed end fund with significant oil exposure	Approximate 17% discount to NTA	Gain in oil price
Monash Absolute	MA1.AX	Mid-cap Australian equity predominantly long portfolio	Approximate 21% discount to pre-tax NTA	Share buy backs and corporate actions
8IP Emerging Companies	8EC.AX	Small cap high beta equity growth portfolio	Approximate 20% discount to pre-tax NTA	Removal of corporate agitator/change of manager
Family Controlled Holding Companies				
EXOR SpA	EXO.MI	Agnelli family holding company – Partner Re; Fiat Chyrsler (29%); CNH Industrial (27%); Ferrari (23%) + other assets	Approximate 30% discount to NAV at market value (see Alleghany note cf Partner Re)	Distribution from Fiat on sale of parts business; potential sale /merger of Fiat
E-L Financial Corp	ELF.TO	Jackman family controlled Canadian investment and life insurance holding company (see Quarterly Report #8 June 2018)	Approximate 45% discount to NAV assuming Empire Life at market value	Sale of Empire Life (no share buybacks will be undertaken); growth in investments

Gowing Brothers Limited	GOW.AX	Gowing family holding company – mainly retail property assets in Northern NSW + private equity and strategic listed equity (see Quarterly Report #7 March 2018)	Approximate 40% discount to stated NAV including value of surf hardware business	Potential part realisation of one or more of NSW shopping centre assets on completion & share buy back
William Wilhelmsen Holding	WWI.OL	Holding company for stakes in Wallenius-Wilhelmsen (37%), Treasure (73% - above) and maritime & supply services businesses	~35% discount to value based on Treasure share price; 41%+ based on Treasure NTA	Realisation of Glovis stake/more consistent earnings/recovery in Wal-Wil value
Operating Companies				
Aercap Holdings	AER	Global leader in aircraft leasing	Approximate 30% discount to book value and P/E of 7.7x ex asset sales	Ongoing share repurchases/corporate potential
Bank of Georgia PLC	BGEO.L	Second largest bank in Georgia	Prospective PER <6x with ROE of >22%	Ongoing discovery of country (tourism) and growth in banking
Barclays PLC	BARCL.L	UK banking conglomerate	Prospective P/E ~7x and >40% discount to tangible book value	Reduction in remediation costs; improve investment banking profitability; Brexit fears subside
ING Groep	INGA.AS	Leading Dutch bank with significant challenger market assets (see prior section in this report)	>15% discount to tangible book, P/E <8x, yield >6.5%	Stopping tripping up and allow consistent growth from new markets to flow to bottom line
Janus Henderson	JHG.AX	Global funds manager with US$330billion fum	Prospective PER <10x	Management actions to tighten product focus; cost reductions; share buybacks
Joban Kaihatsu	1782.JP	Iwaki province based construction company	0.1x EV/EBITDA; no debt; EV is virtually all cash	Improved profitability and increased dividends.
MPC Containerships	MPCC.OL	Largest owner of feeder containerships	37% discount to NTA; 70% discount to new build parity	Sale of ships at above book value, share repurchases and global impact of environmental regulations IMO 2020
Namoi Cotton Limited	NAM.AX	Australia's largest cotton ginner	62% discount to NTA based on FY2019 guidance	Pro-active capital management by revamped board + breaking of current drought
Prime Media Group	PRT.AX	Australian regional TV (SWM affiliate)	EV/EBITDA multiple <3x	Centrepiece of corporate activity as either a buyer of regional media, being bought by another buyer or SWM.

Sberbank	SBER.IL	Russia's largest bank with significant 30-40% market shares across numerous categories & leading technology	Prospective PER ~ 5x	Clarity on Russia investment sanctions
Seaspan	SSW	World's largest container leasing company	Forward P/E <8x; 30% discount to NTA	Ongoing debt reduction and other capital management measures
Seven West Media	SWM.AX	Australian FTA media + printing	EV/EBITDA c5x; PER ~6x	Potential sale by controlling Stokes family as their emphasis changes to industrial services
Yellow Brick Road	YBR.AX	Australian mortgage broking based financial advisory group	Approximate 50% discount to NAV comprised of trail commission on mortgages	Move to warehouse facility structure; resolution of three-way 20% ownership between founder, NEC.AX and MVT.AX

ING Groep: Australian millennials versus money laundering

If you're an Australian millennial, chances are you have a little orange debit card – and told your baby boomer parents to get one.

The orange ING debit cards are issued by ING Groep (INGA.AS) - the largest bank in the Netherlands with a market capitalisation of ~€42billion. That's roughly twice its main listed competitor ABN Amro and holds a domestic asset base around one-third larger than the "co-op of co-ops", Rabobank. ING is also a prime example of where "sum of the parts" analysis of a financial institution should work to good effect; at present, that's not the case, and in our opinion, offers an ongoing opportunity. So long as it doesn't keep tripping itself up. Badly.

ING broadly operates a three-pronged strategy, armed with a highly futuristic and technologically driven culture- including significant venture investments in fintech platforms, through:

- Market leadership in the core, but slow growth markets of Netherlands, Belgium and Luxembourg;
- Challengers in markets such as Germany, Spain, Australia, Czech Republic, Austria, France and Italy, all of which (except Australia) will be placed on a single technology platform; and
- Other nascent growth markets such as Romania and Poland.

ING's profit growth from its core businesses is pretty slow, partly as a result of very low interest rates and modest loan growth; CY2018's pre-tax profit of €7.52billion (before abnormal items noted below) was about 4.5% ahead of 2017, mainly because of reduced losses in its corporate division, good growth in its main "challenger" market (Germany) and "other challenger markets". As a guide, challenger and growth markets now make up 25% of ING Groep's pre-tax profit, a proportion which will grow (Benelux retail is 39%; wholesale is ~37%).

The challenger strategy makes ING a virtually unique global bank. It has a proven ability to gain profitable market share in developed markets without a branch network. Germany is the jewel in the crown – a bank earning over 18% ROE, with €139billion of deposits, making it the third largest retail bank in Europe's largest economy.

So where does Australia fit into this picture?

Put bluntly, it is one of ING's most successful markets on the planet. This has been assisted by a core ING strategy: technology excellence and establishing a focus on attracting primary customers, which have trebled to 600,000 in three years[15]. In Australia, ING's last disclosed net promotor score[16] is a staggering 22points ahead of the second-best competitor[17] and ING is the highest ranked financial institution brand in Australia in respect of trust[18]. ING have had significant assistance from millennials seeking to adjust their financial futures through reading the best-selling book "The BareFoot Investor" by Scott Pape[19] and ING's promotion of its no fee on overseas ATM debit cards, hooked to a better than market paying savings account.

As a guide, the following table compares ING Bank (Australia) with the two larger regionally based listed competitors BOQ (market capitalisation: $3.65billion) and Bendigo Bank ($4.73billion):

A$million[20]	Bank of Queensland[21]	Bendigo & Adelaide	ING Bank (Australia)
Profit before tax and bad debts	$567	$676	$589
Pre-tax profit	$519	$626	$576
Tangible equity	$3,040	$3,907	$4,433
ROE (%)	~9.9%	7.4%	9.4%
Cost/income ratio (%)	47.5%	62.8%	40.0%
Retail deposits	28,900	52,200	33,800

Converted into euro, in pre-tax profit terms, Australia contributes just under 5% of ING Groep world wide, 19% of the total challenger banks and nearly 40% of the challenger banks outside Germany. In other words, it's important.

Australia's success is directly linked to this acquisition of a substantial retail customer base, which has seen pre-tax profit compound at 8.4%pa over the past ten years from $258million in 2008 to $576million in 2018. More notably, close to $11billion of debt issues in 2008 are now down to $3.6billion at end December 2018 as a clear result of attracting deposits.

[15] a guide to how ING penetrates new markets can be seen in two presentations from ING's Investor Day (25 March 2019) "How our customer focus drives shareholder value in retail" and "Growth and cross-border scalability: the value in Challengers and Growth Markets"
[16] net promotor score is a metric measuring the number of "promotors" (scored 9 – 10) in a customer survey less the number of "detractors" (scored 6 or less)
[17] ING Results Presentation Q1 2018
[18] Roy Morgan survey quoted in Australian Financial Review "What is the secret to ING's success?" 5 March 2019
[19] John Wiley & Sons December 2016 (over 1 million copies sold)
[20] as at 31 December 2018 or twelve months to 31 December 2018
[21] estimates for twelve months to 28 February 2019

Australia's four major banks are now hamstrung with badly battered reputations from the Hayne Royal commission. In turn this will lead to (vastly underestimated) remediation costs from poor lending practices and lousy financial advice, major management overhauls, strategic change and separation (at vast cost and disruption) and difficulty in refocusing on the core customer offering, despite the glossy ads and what they say[22]. The three challenger regionals are generally beset with low interest margins and modest profitability. In this environment, ING Bank (Australia) has a magnificent opportunity to multiply its Australian business.

So, why do ING (the parent) shares trade on prospective P/E ratio of ~7.4x, dividend yield of 6.7% and discount of over 15% to tangible book value of €12.62 - trash-heap ratings which frustrate investors and holders like ourselves?

We can identify three key reasons for this: slow domestic growth, low return other markets and (last but not least) money laundering.

Core growth in the Benelux retail and wholesale markets is pedestrian (it fell 3.1% in CY18) and not likely to speed up any time soon. The fact that Australia makes up 40% of non-German challenger market profits when most of the other banks are located in Europe shows how low return they are; Australia comprises 47% of mortgage loans for non-German challenger banks, but only 23% of deposits. ING needs to convert this deposit gathering into (prudent) lending and profitability. Additionally, one of its growth markets – Romania – has recently unilaterally imposed a bank tax - currently 0.3% of assets – quarterly!

However, ING's biggest bank-wide issue, in amazing contrast to its pristine reputation in Australia, is its actual and alleged participation in money laundering. If you are Uday Sareen, CEO of ING Bank (Australia), how do you feel to see your entire last two years pre-tax profits (+ another 10%) (€775million or €0.20/share) urinated away in a fine and illicit profit disgorgement to the Dutch Government, for six years of inadequate customer due diligence, which led to "financial crime"[23].

Now ING is being investigated in Italy where Bank of Italy identified compliance issues have forced ING to stop taking on new clients; further, ING Italy is being investigated for alleged money laundering of "scam" profits. That follows a recent acknowledgment that a Russian money laundering scheme used ING's Moscow office to pass through "dirty" Russian money[24].

Little wonder the first slide for the recent 25 March 2019 "Investor Day" was the CEO on KYC/AML[25]....

Our obvious hope is that these 'scandals' turn out to be less problematic than the lurid headlines suggest, at least from a financial perspective, and that a firm, if unspectacular "core" base, will allow the growth from newer challenger markets to shine through. ING has the unique strategy, technology and know-how few other banks possess to successfully infiltrate new markets without a high cost branch network. Its marketing and retail customer culture is strong and sets it apart from many others. If it can just stop servicing undesirable corporate customers......

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[22] The author who has accounts with the private banking arm of a Big Four bank received his first in-bound phone call from them in three years the other day..... true.
[23] The major case cited was the use of ING for bribes paid by Uzbek telecoms company VimpelCom (now VEON).
[24] "ING Money laundering woes worsen after Bank of Italy probe" Bloomberg (17 March 2019)
[25] Know your Client/Anti Money Laundering

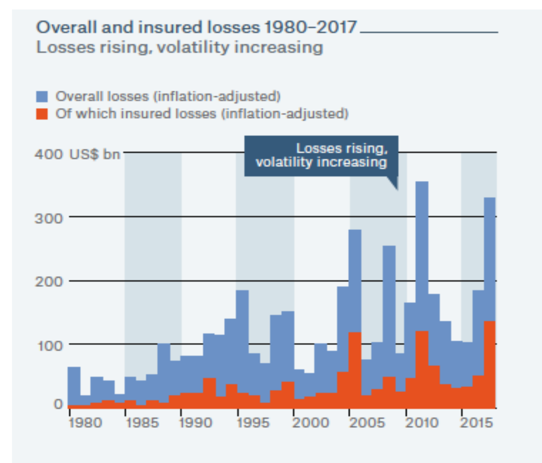
Better opportunities in the (cat) reinsurance market?

The past two calendar years have been notable for a hefty level of catastrophic insured losses, which have badly dented reinsurers profits and their equity market ratings. Four of the key US-listed insurer/reinsurers we follow have seen absorbed catastrophe losses (before reinstatement premiums) of $3.86billion and $3.09 billion in calendar 2017 and 2018 respectively[26].

Long term average events (inflation adjusted)

	Number of events	Overall losses (US$ bn)	Insured losses (US$ bn)
2018	850	160	80
2017	740	350	140
2008-17	630	190	61
1988-2017	500	140	41

Source: table and chart: Munich Re NatCat



Hardly surprising. The past two calendar years have had above average insured losses as the major catastrophes in each year have tended to occur in developed countries, thereby increasing the ratio of insured loss to overall loss. For example, the Camp Fire wildfire in California in November 2018 saw overall losses of a hefty $16.5billion, and insured losses of $12.5billion – 75% of the total. Contrast that with one of 2017's hefty losses: June/July floods and landslides in China cost $6billion in overall losses but only $250million in insured loss. The long term change in these figures reflects developments in countries - like Australia[27] - where an additional number of catastrophic events are now more fully insured.

The mainstream reinsurers have also been plagued – to an extent - by the development of the insurance loss securities (ILS) market, and specifically the growth in catastrophe bonds. Cat Bonds pay interest and an insurance premium to the investor, whose funds are placed into a special purpose vehicle. Cat bonds have evolved from their earliest versions which effectively provided retrocession[28] cover based on an index for a specific industry loss on a single event, to the vast majority providing "indemnity" to specific insurers or cedents, based on the underlying book of business subject to specific perils in the bond can be called upon (eg IAG's A$75million placement to Orchard ILS Pte Ltd in Singapore in February against ANZ cat risks.

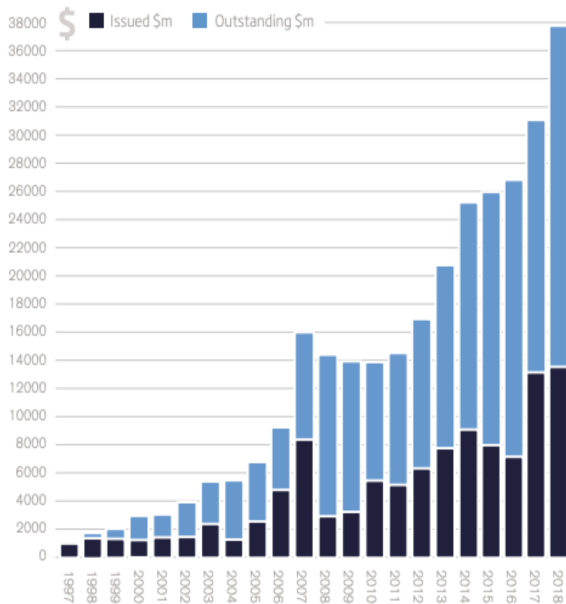
[26] All US$million figures before reinstatement premiums: Alleghany ($818 in 2017; 658 in 2018 respectively); Everest Re ($1472 and $1800); Markel ($585 and 293); Renaissance Re ($989 before subsequent writebacks and $340)

[27] Munich Re estimates Australia's insured losses in 2017 accounted for 57% of overall losses, the highest global figure, exceeding the 46% of North America/Caribbean.

[28] Reinsurance of reinsurance

Cat bonds enable reinsurance companies to source retrocession, potentially at cheaper rates to "yield" seeking investors. The yield seekers have the added "benefit" of holding a very non-correlating investment, given the added yield will be impacted by weather, rather than financial markets. The cat bond market has grown precipitously, and makes up around US$34billion of the $37bn or so of ILS at the end of 2018.

ILS issued and outstanding (US$million)[29]



Artemis' wonderful chart (left) shows how spectacularly investors piled into cat bonds (even allowing for ~ $4billion of mortgage based risks) in the 2017 and 2018 years – just ahead of two major loss years. Hence, the returns for these ILS have been very modest indeed.

Even more troublesome have been the equity-type ILS issued by companies such as CatCo (a subsidiary of Markel Corp) where the London quoted CatCo Reinsurance Opportunities Fund, which invests in a Markel run "masterfund" – itself plagued with adverse loss experiences from 2107 hurricanes, to the extent it expects to run-off the portfolio, subject to shareholder approval.

The quantum of losses suffered by catastrophe ILS retrocession providers is now starting to force up pricing in the area; in turn this means reinsurers have to decide whether to write as much risk (unlikely) or lower profitability (equally unlikely). Hence, reinsurance prices have shown a tendency to increase in the US (rather than Europe which has been less peril affected recently), where ILS capacity is under threat and the big event from 2018 (wildfire) has exposed a previously less recognised occurrence.

Markel's various issues saw the shares fall below the $1,000 mark in late December 2018 for the first time in eighteen months, and have seen increased questioning of the price premium made possible by its stellar track record: a compound annual growth rate in book value over thirty-two years years as a public company of 17.8%pa[30]. Likewise, Everest Re (RE) catastrophic experiences in 2017, repeated in 2018, have seen a reduction in its premium to book value; of the four covered (re) insurers, it provides most leverage to existing claims reserves - not necessarily a desirable trait at present.

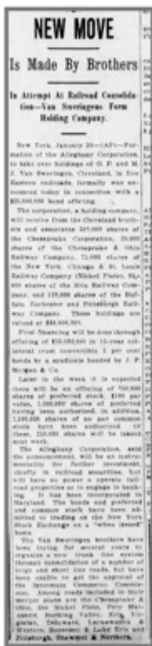
[29] source: Artemis (artemis.bm)

[30] Markel book value (including goodwill) at end 1986 was $3.42 and at end 2018 was $653.85

EAST 72

Markel (MKL) and Alleghany (Y) are more "Berkshire" type animals, with significant investments in operating businesses outside of insurance, as a form of genuine diversity. In that respect, after due recognition for the value of these businesses, we believe Alleghany offers a more interesting opportunity than the other three at present, and have acquired a new position.

Alleghany is one of the great storied American corporations, having publicly floated in February 1929 as a means to bringing together the major railroad holdings – 20% of the US track miles at the time - of the legendary van Sweringen brothers[31].


NEW MOVE

Is Made By Brothers

In Attempt At Railroad Consolidation—Van Sweringens Form Holding Company.

$35,000,000

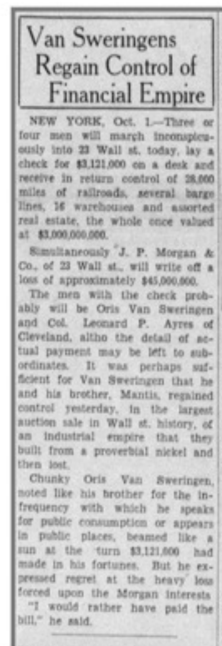
Alleghany Corporation

Van Sweringen Railroad Is Third Largest In The World

Cleveland Brothers Control 18,000-mile Network of Roads Valued at $2,000,000,000; Extends Over Large Section of U. S.

NEW YORK, March 26. (AP)—The New York Times said today that by recent deals O. P. and M. J. Van Sweringen of Cleveland have rounded out a railroad empire that is the largest privately owned one in the world.

Their $2,000,000,000 18,000-mile network is exceeded only in the western hemisphere by the 20,000 miles of the Canadian National railways and elsewhere only by the 30,000 miles of the German state railways. It eclipses those of such systems associated with the names of Gould, Vanderbilt, Hill and Harriman.


Van Sweringens Regain Control of Financial Empire

NEW YORK, Oct. 1—Three or four men will march inconspicuously into 23 Wall st. today, lay a check for $3,121,000 on a desk and receive in return control of 28,000 miles of railroads, several barge lines, 16 warehouses and assorted real estate, the whole once valued at $3,000,000,000.

Simultaneously J. P. Morgan & Co., of 23 Wall st., will write off a loss of approximately $45,000,000.

The men with the check probably will be Oris Van Sweringen and Col. Leonard P. Ayres of Cleveland, altho the detail of actual payment may be left to subordinates. It was perhaps sufficient for Van Sweringen that he and his brother, Mantis, regained control yesterday, in the largest auction sale in Wall st. history, of an industrial empire that they built from a proverbial nickel and then lost.

Chunky Oris Van Sweringen, noted like his brother for the infrequency with which he speaks for public consumption or appears in public places, beamed like a sun at the turn $3,121,000 had made in his fortunes. But he expressed regret at the heavy loss forced upon the Morgan interests.

"I would rather have paid the bill," he said.

Amidst allegations that monies from the public float had been used for stockmarket speculation, Alleghany's fortunes withered and in 1935, the van Swerigans bought "back" control of the railroads after a public auction of $48million of debt owned by J P Morgan & Co. In the period since Robert Young took over as President in 1936, the company has had a mere five other leaders, even through a significant 1960's proxy fight. Young effectively started the company's move towards financial services acquiring control of Investors Diversified Services in the 1950's – later sold to American Express in 1984.

The company's railroad interests were sold in the 1960s and a concerted plan to invest in insurance and related areas was pursued under the two presidents who ran the company for the next 37 years – F.M. Kirby and John Burns. The bulk of the current insurance and reinsurance businesses were acquired between 2003 and 2012; the current President, Weston Hicks has been in place since 2004.

This is a company imbued with long term thinking, conservative investment principles, and importantly, conservative insurance reserving principles. Alleghany has had consistent redundancy of prior years' claims reserves over the past six years, averaging ~US$270million per annum (equivalent to $18.62/share).

[31] News clippings c/- newspapers.com (L-R) Cincinnati Enquirer (31/1/1929); Philadelphia Inquirer (31/1/1929); Evening Independent (Ohio) (26/3/1930) and Ohio Tribune (1/10/1935)

Alleghany (Y) is compared to three other insurer/reinsurers as follows:

US$ million	RE	RNR[32]	Y	MKL
Issued shares	40.651	42.207	14.577	13.875
price	215.48	143.91	616	990.4
Equity market value)	8,759	6,074	8,979	13,742
tangible equity insurance	7,904	4,158	6,613	5,184
tangible equity other			72	(68)
Total tangible equity	7,904	4,158	6,684	5,116
Assessed equity value other businesses			517[33]	1206
Effective price insurance	8,759	6,074	8,462	12,536
P/BV insurance	1.11x	1.46x	1.28x	2.42x
Overall tangible book/share	$194.43	$98.51	$458.57	$368.76
P/TBV	1.11x	1.46x	1.34x	2.69x
insurance debt	638.6	991.1	884.6	2325.4
debt/tangible book	8.1%	23.8%	13.4%	44.9%
per $ of value				
NEP	$0.69	$0.33	$0.59	$0.34
claims (gross)	$1.50	$1.31	$1.45	$1.14
claims (net)	$1.29	$0.92	$1.22	$0.72

Alleghany has grown book value per share at a compound rate of 7.8% since 2000, with recent years hampered by the aforementioned catastrophe losses. When assessed against the cohort, it appears reasonably priced and gives us the desired exposure to premium (59c for every dollar of market value). Deducting an appropriate value for the non-insurance activities ascribes an estimated price of 1.28x tangible book value for the insurance business. This compares favourably to its peers, and in absolute terms for quality global insurance exposure. Note that EXOR carries its reinsurance business, Partner Re, at the same 1.28x tangible equity value in the deconsolidated accounts.

Conclusion

We view the March quarter as a "relief rally" where central bank liquidity has once again reduced equity volatility. In turn, this has encouraged more aggressive speculation and a re-rating of growth companies back to (and above) September 2018 levels. With S&P500 at ~17x forward earnings – which are now generally in a downward revision phase – and with very optimistic looking +11% estimates for FY 2020, we believe a real "divergence" opportunity between "value" and "speculative growth" exists, and are positioned accordingly.

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[32] excludes adjustments relating to acquisition of Tokio Millennium Re
[33] includes businesses in machine tools, trailer bodies, toys, funeral services, hospitality and steel fabrication. Excludes oil and property businesses

STATISTICAL APPENDIX: QUARTER & FYTD TO 31 MARCH 2019

1. Monthly performance, exposure and NAV

	Investment return[34]	Cost imposition[35]	Net Return[36]	R12 Return	NAV/share pre tax (c)	Gross Exposure[37]	Net Exposure[38]
30 Jun 17				46.6%	35.5	276%	-6%
30 Jun 18				-18.8%	29.0	278%	81%
				R12 return			
31 Jul 18	-3.8%	-0.3%	-4.1%	-22.5%	27.8	276%	63%
31 Aug 18	-6.4%	-0.4%	-6.8%	-23.7%	26.2	285%	48%
30 Sep 18	0.9%	-0.2%	0.7%	-25.0%	26.4	287%	42%
31 Oct 18	-0.8%	-0.2%	-1.0%	-19.8%	26.2	217%	145%
30 Nov 18	-0.2%	-0.2%	-0.4%	-12.1%	26.0	233%	152%
31 Dec 18	-10.3%	-0.2%	-10.4%	-14.5%	23.2	243%	185%
31 Jan 19	9.1%	-0.3%	8.8%	2.6%	25.2	256%	138%
28 Feb 19	-1.7%	-0.4%	-2.1%	-15.4%	24.7	313%	90%
31 Mar 19	-3.3%	-0.5%	-3.9%	-18.1%	23.7	359%	48%

2. Equity exposure as at 31 March 2019[39] (as % month end pre tax shareholders funds):

	AUSTRALIA		OVERSEAS		TOTAL	
	percent	exposures	percent	exposures	percent	exposures
LONG	84.9%	24	118.2%	45	203.1%	69
SHORT	(24.6%)	15	(28.9%)	13	(53.5%)	28
INDEX	(32.9%)	-	(69.2%)	-	(102.1%)	
TOTAL	27.5%	39	20.1%	58	47.6%	97

[34] Change in market value of all investments – cash and derivatives – after interest charges, dividends receivable, dividends and fees paid away divided by opening period net asset value and time weighted for equity raisings

[35] All accrued expenses for company administration (eg. listing fees, audit, registry) divided by opening period net asset value and time weighted for equity raisings

[36] Calculated as 2 (above) minus 3 (above)

[37] Calculated as total gross exposures being nominal exposure of all long and short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[38] Calculated as total net exposures being nominal exposure of all long minus short positions (cash and derivative) divided by end month pre tax net asset value – assumes index ∂ of 1

[39] Figures may not sum due to rounding

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