

MARKET UPDATE
APRIL 2019
COVID-19



KAIZEN GLOBAL
Investments

MARKET UPDATE APRIL 2020

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COVID-19: The pandemic many warned about now has a name

For many years there have been warnings that a serious pandemic was probable. SARS, MERS, Ebola etc all had the potential to become a global issue but were, fortunately, contained.

A highly interconnected world meant a disease, to which we had little immunity, could spread rapidly across borders. Covid-19 is the manifestation of the pandemic many had feared/predicted.



Plaza Mayor, Madrid
Source: AP

Adjusting to fast changing facts

We will focus on the facts as we currently* see them;

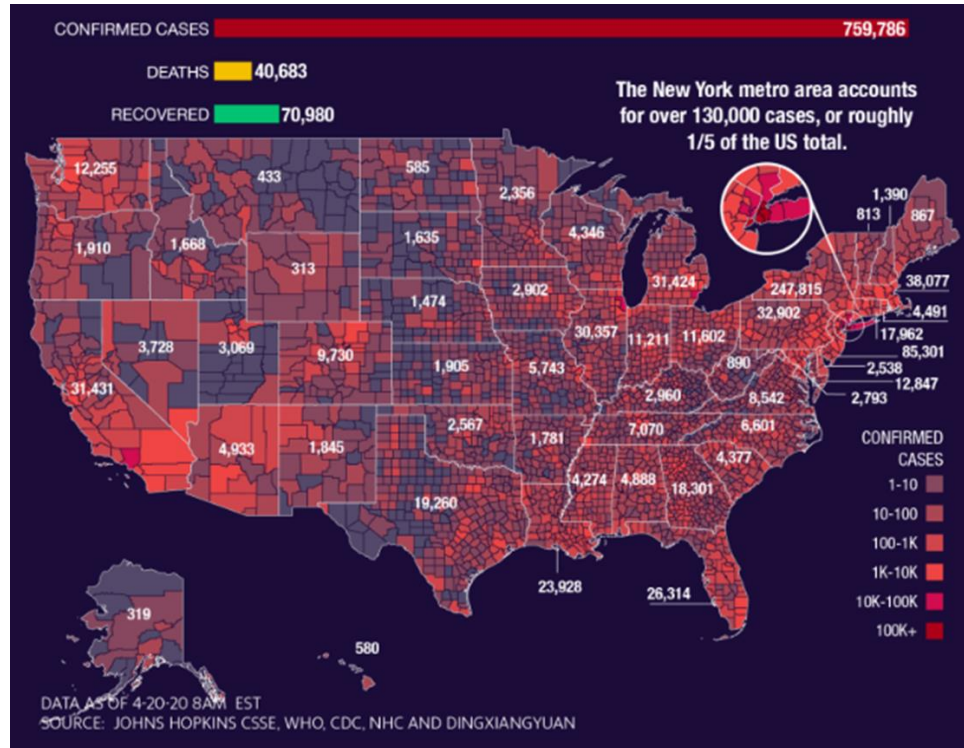
- 1) Lockdowns are largely working by slowing infection rates;
- 2) Inadequate testing means no-one knows the true infection rates;
- 3) Theoretically the virus can be eradicated in local areas if you pass through 3-4 week isolation cycle as it dies if not carried by an infected host, unlike a permanent virus like HIV;
- 4) Re-infection from other sources remains a continued threat:** note China's border control; and
- 5) Until we have a vaccine or herd immunity there will be continued outbreaks and these will need to be contained. It is uncertain that immunity is built even after recovering from infection.

*We will adjust thoughts/conclusions as new information presents itself.

It's everywhere

We found this map of the United States quite sobering

- 1) Covid-19 is extremely infectious;
- 2) Ground zero patient in Wuhan transferred globally;
- 3) Therefore, any single infection **can re-infect the entire world.**



Spanish Flu 1918: Pandemic

What 'could' be – lessons of history

Second winter was the worst for deaths.

40 million people died.

Second wave of mutated virus spread by wartime troop movements.



Impact on businesses and stock markets: Stage 1

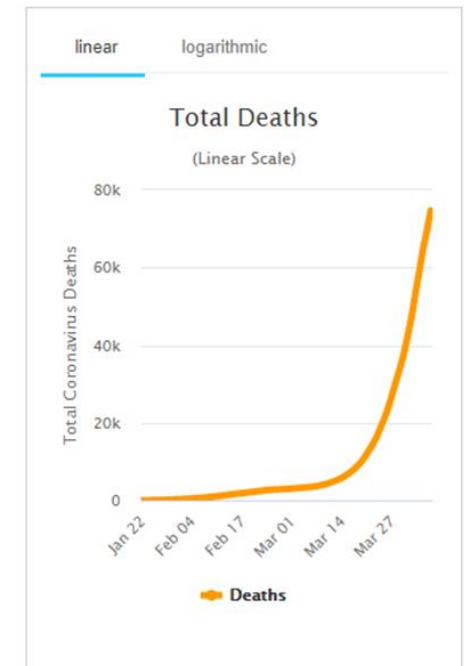
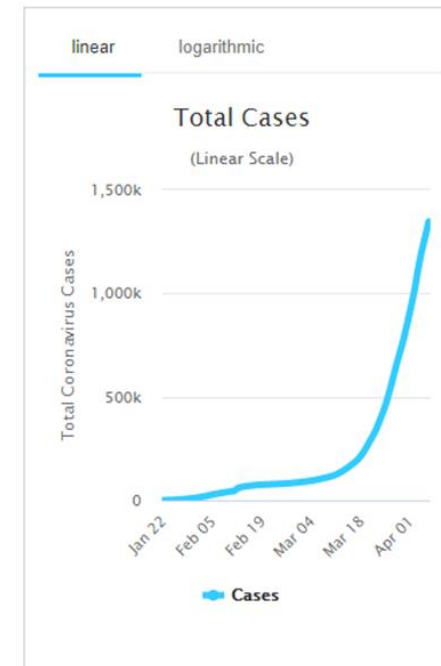
We see **two stages** for the economic impact of the virus

Stage 1: Frozen

Massive rise in global cases – growing exponentially;
Lock downs to ‘flatten’ that exponential growth curve;
Lock downs lead to demand destruction and unemployment;
Credit, across multiple industries, becomes very tight;
Massive government intervention, to provide liquidity.

Stock markets

In Stage 1, react negatively;
Highly volatile markets;
Credit crunch requires widespread equity issuance – happening now;
The shock of immediate economic impact leads to major sell-offs;
Governments and central banks step in (massively) to support; and
Markets stabilise and focus on a potential “V” shaped recovery and bounce back sharply.
Markets recover/rally as rate of increase in death rate slows.



Infections and deaths
Is data reliable?
Source :Worldometer

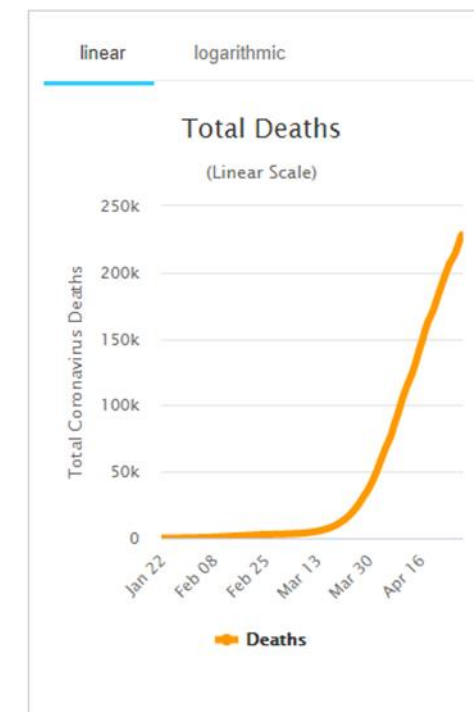
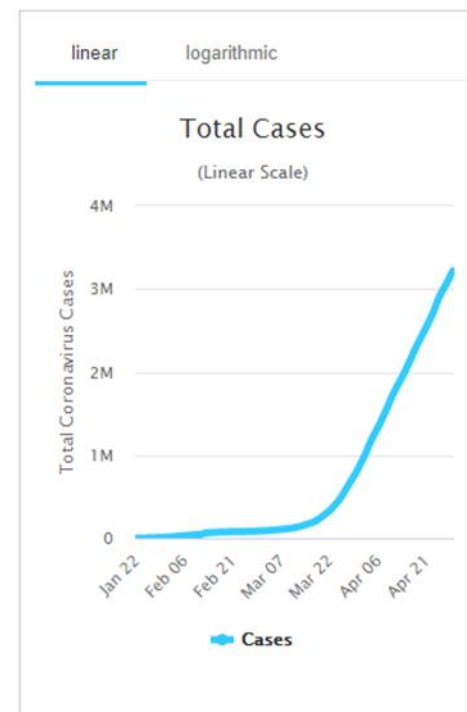
Impact on businesses and stock markets: Stage 2

Stage 2? Pause/Frozen state lifted

Infections/death rate slows/falls;
Restrictions lifted: Unknown if enough;
Recurring outbreaks = rapid reinstatement of restrictions?
Government intervention part II, III into certain sectors.
Interest free periods roll off.

Stock markets: Two paths

A) Restrictions enough – rebound justified.
B) Slow open/re-emergence of infections = new lock downs.
This scenario is not in market prices in our view = RISK.
Certain sectors remain under intense pressure (e.g. airlines); and
Inflation in 1-2 years a real possibility?



Infections and deaths - is data reliable?
Source: Worldometer

We are analysing the scenarios around a potential stage 2 and a deeper, flatter U-shaped recovery.

We see the market rebound as a sustainable outcome as a 50% probability. Markets have rallied as there seems to be progress in controlling the spread of the disease and expected sharp 'V' recovery.

However, **we see a 50% chance that disruption will continue and is not priced in.**

Background on markets pre outbreak – canvas important to understand

We have been cautious for some time – many years into the longest bull market in history

In our November AGM we reiterated our caution on markets.

We believed that there was widespread complacency esp. in U.S. market & technology stocks;

We were in the longest bull market in history; and

The probability of a set-back was rising with high valuations.



Average market price earnings ratio 1930-2020 is 17.2x P/E.

We have been above this level for some time, telling us markets are statistically expensive and therefore carry more risk.

High prices = more risk.

Low prices = margin of safety.

Weighing RISK vs REWARD – always changing

Investing when Reward outweighs Risk

Valuation ALWAYS matters – it's not enough to have a 'story' about a great company.

The price you pay for an investment is critical.

Retail investors tend to have no valuation compass, nor ETFs.

Yield hungry retirees etc buying stocks for dividend yields (higher than bank deposit rates).

Successful investing, in our view, requires;

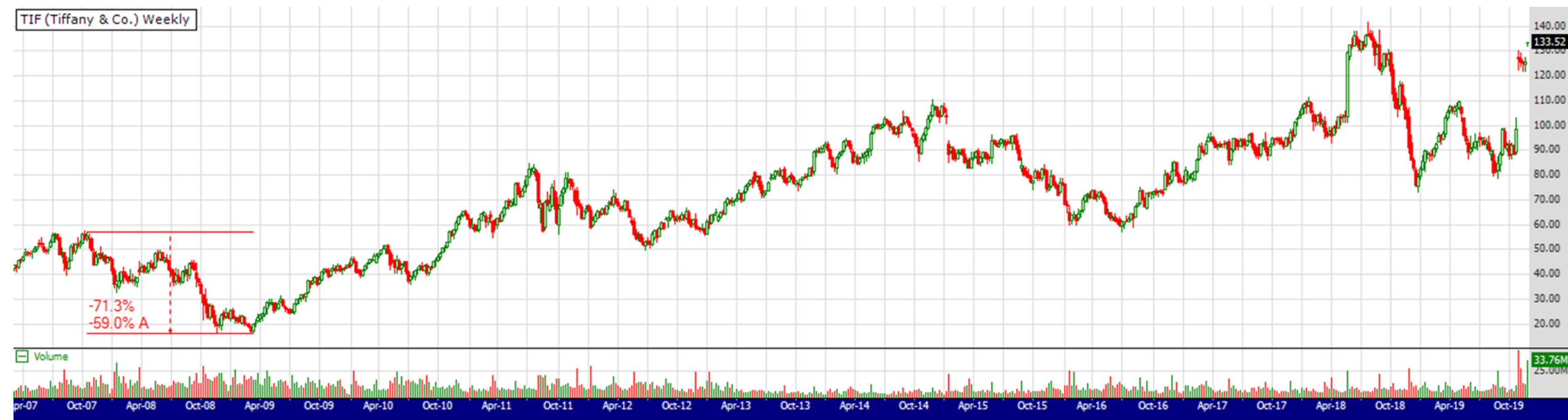
- 1) Fundamental analysis of companies and industries;
- 2) Detailed analysis of **valuation and risk**. What am I paying for reward vs risk?;
- 3) Where we are – roughly – in the bull/bear: risk on/risk off cycle;
- 4) Allocation of capital carefully/cautiously when everyone is bullish; and
- 5) To **allocate more aggressively when prices fall** – typically a bear market – when risk/reward is skewed to more than compensate for the risk.
- 6) Number 5 is a great opportunity because so many panic and sell at lows – a repeating pattern.
- 7) KGI is set up, in our opinion, to be able to allocate capital logically in panics.

ANNUAL GENERAL MEETING 2019 (historic slide we presented Nov 2019)

TIFFANY & Co.

2008 – No-one would finance. Buffett last resort.

2019: LVMH bid. A sign near a market top?



April 2020 commentary on the historic slide we presented

Our point at the AGM was that markets were pricing in a great deal of good news and the Tiffany & Co. bid by LVMH at almost 8X the price no-one would finance it in 2008 was an illustration of fear (2008) and greed? (2019).

Bear markets always happen and are GREAT opportunities to position for outsized returns

No-one can consistently call a **bear market**, know it's timing nor the depth of the correction;

But, bear markets are part of investing and **always occur**;

When stock markets trade on multiples above the average, for long periods, on a foundation of plentiful corporate debt-funded buy-backs, it is caution that is warranted;

“Caution” is the operative word

We are **not** market timers. But we are students of financial history and probabilities.

In engineering one designs for a probabilistic event: say, a 1:100 year wave etc

In **building portfolios we must consider the backdrop of market participants and probabilities.**

Excess caution by others = Cue for us to take more calculated risk.

No caution by others = move forward but carefully.

This is where we believe markets have been for a few years.

Bears triggered by the unforeseen

We did not know Covid-19 would occur: no-one did.

Bear markets are often triggered by something unforeseen – out of left field.

Is COVID-19 that trigger? No-one will know until after the event.

But the market was set up for no bad news and elevated valuations. It was complacent.

Bonds – Commodities – Stocks: What is going on?

We look at all asset classes for clues

Bond markets

Are being manipulated by central banks buying (to provide liquidity)
So they are an unreliable data point.

Commodity markets

Complex because;

- a) Some mines are shut due to Covid-19 – shrinking supply (which is good for prices); but
- b) some, like oil, are spelling out very weak end demand (storage is full).

Equity markets

Equity markets have rebounded but we wonder how much of this is due to massive Central bank intervention and low interest rates combined with an expected V-shape recovery vs fundamentals. We think that there is permanent job destruction, risk of Sovereign and company defaults in emerging markets and that these fundamentals need to be closely monitored.

PORTFOLIO positioning

Cautious but still long (i.e. hold shares in companies)

We have long investments that we like and have a medium to long term view;
We had increased our shorts/hedges to guard against set backs;
Stock prices are moving sharply and could throw up exceptional risk/reward opportunities;
Some sectors are already pricing in Armageddon, but may have further to fall.
We are ready to reallocate capital if prices move to make other investments more compelling.

A bear market will be an opportunity for KGI

Why?

We have a prepared mind and buy-list for a bear market (bears).
This isn't to say we think we are 100% in a bear nor that every stock on our list will become cheap enough.
Investing is about weighing probabilities and Buffett is a good example to watch.
He allocates aggressively in bears and builds dry powder over bull markets.
He shifts the probabilities in his favour.
He underperforms later stage bull markets – when prices are full and complacency is high.
By allocating capital in dislocations he supercharges his performance in the recovery phase.
It is noteworthy that Berkshire did nothing this sell-off despite holding record amounts of cash.

Historic slide we presented Nov 2019

WEAK MARKET OPPORTUNITIES COMING

Have an extensive shopping list
Understand WHAT can go down a lot
Understand WHY

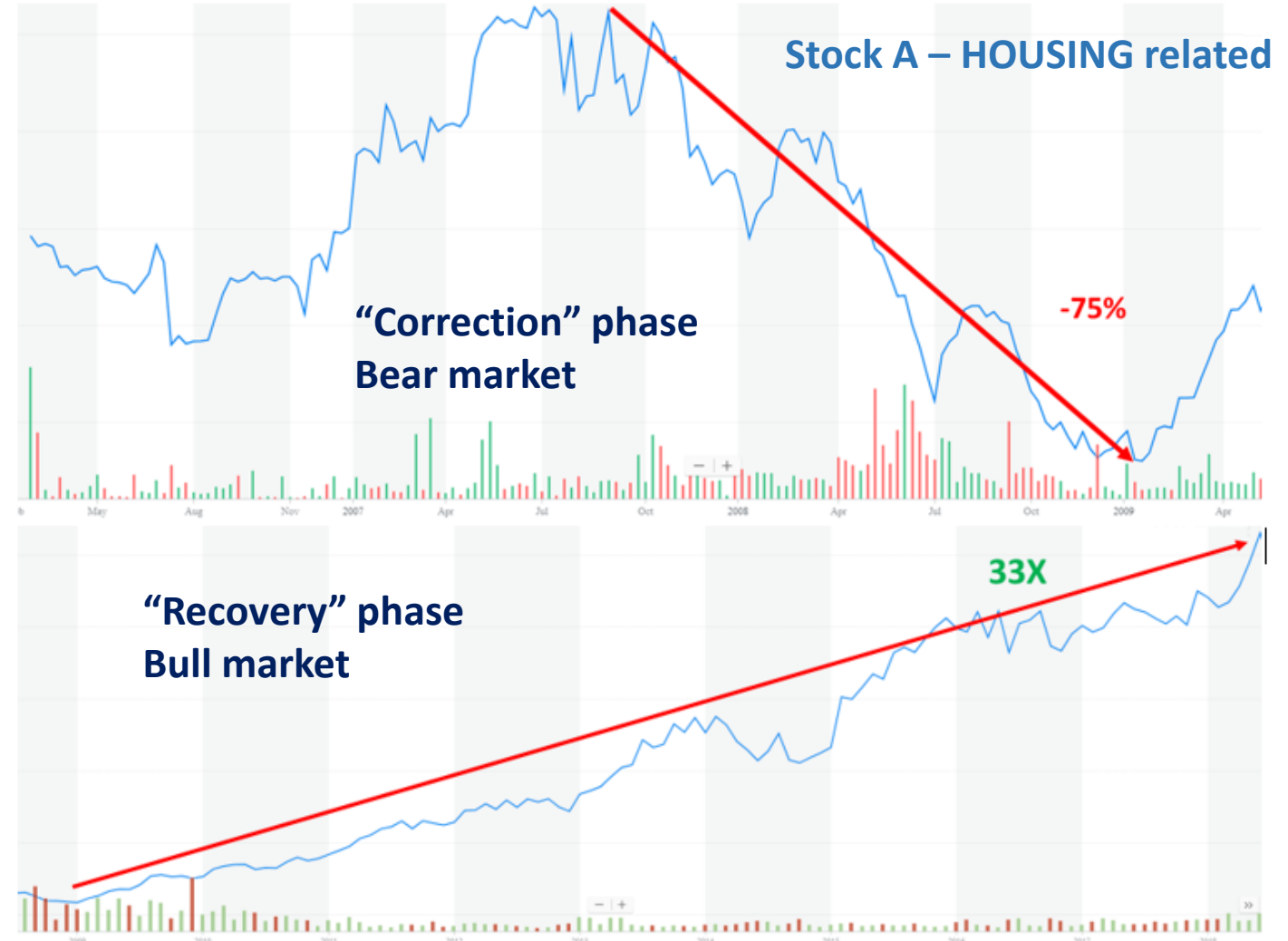
WHY would institutional investors sell in a panic?
WHY does this pattern rhyme/repeat?

Stock A – HOUSING related

We do not own it
It is a great company but....
Price reflects cheery outlook

In last storm

Smart investors were rewarded with 33X
No guarantee history will rhyme/repeat



*We must **BUY** when fundamentals are at their **trough** and emotions are **most negative***

Historic slide we presented Nov 2019

PREPARED MIND = OPPORTUNITY

Have an extensive shopping list
Understand WHAT can go down a lot
Understand WHY

WHY would institutional investors sell in a panic?
WHY does this pattern rhyme/repeat?

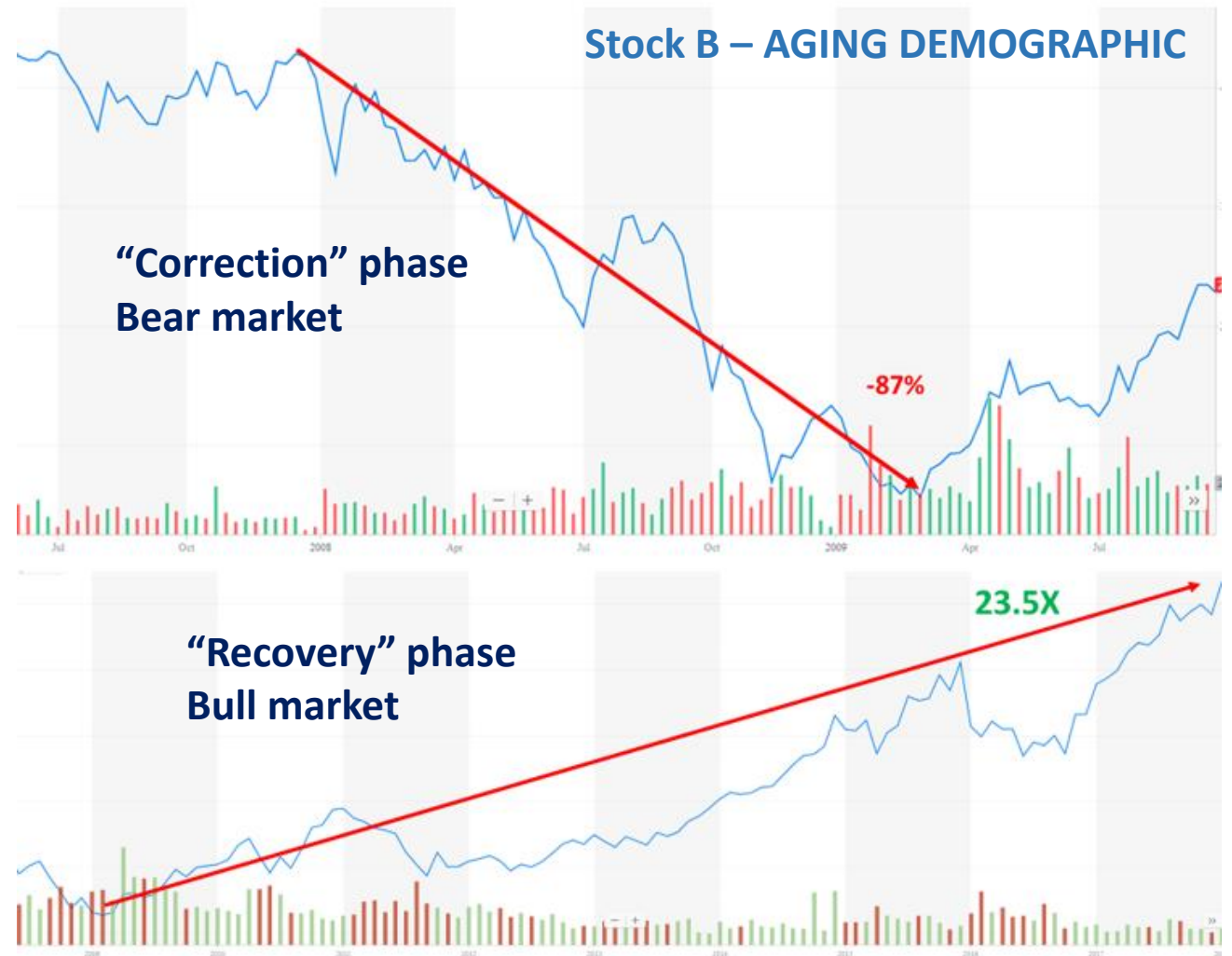
Stock B – AGING DEMOGRAPHIC

We do not own it
It is a great company but....
Price reflects cheery outlook

In last storm

Smart investors were rewarded with 23.5X
No guarantee history will rhyme/repeat

*We must **BUY** when fundamentals are at their **trough** and emotions are **most negative***



Historic slide we presented Nov 2019

WE ARE LOOKING FOR...

- LONG-TERM (5,10,15 YEARS)
- THEMATIC
- **COMPOUNDERS**



REPEATABLE, LOGICAL PROCESS – no changes

HOW WE INVEST – OUR PROCESS

LOGICAL - REPEATABLE

- Identify investment opportunities
- Complete fundamental analysis
- Quantify Investment thesis
- Consider macro-economic environment
- Determine portfolio weighting
- Maintain selling discipline

NOT BROKEN



PRIVATE INVESTMENT and MARKET generally

Private investment

- Operations halted due to government trading restrictions – like many non-essential services.
- Business able to go into hibernation and we will reopen when government allows it.
- Do not believe any permanent impairment

Market for private investments generally – should we consider buying other businesses?

- See opportunities as good co./bad balance sheet dynamics play out in Australia
- Expect distress in operations especially around working capital and credit lines on re-opening of economy
- See major **listed** companies refinancing on markets at steep discounts
- Implies private operators will need to raise capital too
- Operators with 2-3 assets all under duress may sell 1 to simplify
- There will be opportunities

BUYBACK UPDATE

CAPITAL ALLOCATION

Buyback - ongoing

- Cash flows from private investment
- We have bought back and cancelled 68,647 shares
- Provided liquidity

KGI MODEL

KGI's business model aims to;

- Achieve a high real rate of return for Shareholders comprising both income and capital growth;
- Preserve capital of the Company; and,
- Deliver Shareholders a growing stream of fully franked dividends.

KGI's Investment Strategy

- Invest majority of assets in diverse portfolio consisting 30-60 internationally listed equities (shares).
- Invest with long-term horizon (3-5 years plus).
- Utilise a fundamental, stock-picking approach.
- Invest in companies with thematic tailwinds.
- Can utilise strategies, such as shorting, to protect downside risk.
- May also invest part of the portfolio in unlisted Australian companies and re-invest excess cash flows.

OUTLOOK: ALWAYS OPPORTUNITIES ESPECIALLY IN STORMS

OUTLOOK – In the LONG-TERM there are ALWAYS OPPORTUNITIES

- We've been cautious (and perhaps right to be);
- We are beginning to see attractive opportunities in heavily beaten down sectors;
- We will act based on price (reward/risk) not sentiment;
- **We think there is a 50% chance of a U-shaped recovery which is not priced into markets**
- We are analysing the situation based on continued new data and will make judgements based on that information.

