Q2
June2022

Investment Objective: To achieve long-term capital appreciation and to exceed the returns of the MSCI All Country World (ex U.S.) Index through the active management of a focussed portfolio of listed equity investments in family-backed holding companies.

As George W. Bush once said: "*I think we agree, the past is over*".

This has been the message from markets over the last few months. The benign environment and era of ever easing monetary policy appears behind us. US equities have endured their worst first half of the year in more than 50 years; global equities have fared better but are still down double digits.

Within this context FHC returned -14.1% in the second quarter, which compares to a -8.2% return for the benchmark, the MSCI ACWI ex-US (€). Year to date we have returned -20.9% vs. -11.3% for the benchmark, with the portfolio suffering from a double whammy of declining NAVs and discount widening.

Performance review

Whilst FHC's performance – both absolute and relative – is disappointing, the portfolio largely behaved as one would expect in times of market stress.

NAV weakness has been compounded by significant discount widening, as the generally illiquid, under-researched and misunderstood areas of the market on which we focus have been punished. This is consistent with our expectations and experience in similar market environments historically in 2020, the Eurozone crisis and the global financial crisis.

Within this context performance was weak across the board. Five holdings – Eurazeo, EXOR, IAC, Investor and Pershing Square Holdings – all detracted more than 100bps from returns, with local share price total returns of between -14% and -25%.

As we have noted at various points this year, whilst discounts have been widening in the main, they haven't yet reached the screamingly cheap levels observed in other market corrections. **EXOR** on the other hand is now approaching such a level. The shares declined -14% in during the second quarter as a -5% fall in the NAV was exacerbated by a widening of the discount from 41% to 47%.

Starting with the NAV side of the equation the key culprit was Stellantis (20% of NAV), shares in which declined -14% over the quarter, bringing year to date returns to -24%. Investors have grown increasingly cautious over the state of the global economy generally, and the US consumer specifically, whilst there is a broader debate in autos as to whether current record high margins and low dealer incentives will stick when volumes (hitherto restricted by shortages of semiconductor chips) return. Stellantis now trades at 3x consensus 2022 earnings – a ~40-60% discount to Ford and GM once adjusting for accounting differences. As one sell side analyst put it in a recent note: "What does the market fear? Clearly the answer is "a lot". With such low expectations there appears ample room for surprise on the upside – much to the benefit of EXOR's NAV.

Turning to the discount, the potential discount returns from such extreme levels are powerful: a return to the 35% five year average takes the shares +23% higher, whilst a re-rating to the low 20s (where EXOR traded, albeit rather briefly, pre-pandemic) yields a return of +50%.

So what events might lead to this happening? In our view, it likely all comes down to the allocation of the ($9bn) Partner Re proceeds. Holding companies must give investors a "reason" to own their shares and as such diversification into attractive quality unlisted assets is an important step in sustainably reducing the discount at which EXOR trades. Shortly after quarter-end it was announced that EXOR will invest €833m (3% of NAV) for a 10% stake in Institut Mérieux, the unlisted healthcare-focused holding company of the Mérieux family. The vast bulk (~80%) of Institut Mérieux's value lies in a 59% listed stake in bioMérieux, the in vitro diagnostics business focused on infectious diseases. We expect EXOR to continue to allocate capital to higher growth, less cyclical and industrial assets such as this, which over time will help shift investor perception and the discount. Combined with the prospects for NAV growth, prospective returns appear attractive.

In terms of positive contributors Mandarin Oriental was the only one of note, adding +26bps to returns during a period in which we exited our position in the company. The shares had held up better than the market and as such were a good source of capital as we sought to build a buffer to take advantage of dislocated opportunities in the current volatile environment. Over the life of the investment Mandarin Oriental generated an ROI of +25% in euro terms, compared with +7% for the MSCI ACWI ex-US over the same period.

Trading activity

Trading activity has been limited. As well as exiting Mandarin Oriental, we modestly added to FEMSA.

During the period we started to build a new position in a European holding company that is currently trading ~60% below its 52-week high, with attractive quality assets and potential for significant value-unlocking corporate events. We are still accumulating shares across our funds but expect to discuss the company in the next quarterly letter.

Outlook

Inflation and central banks' attempts to cure it have dominated investor thinking so far this year. Higher bond yields and their reverberation along the risk curve has created significant volatility and downward pressure on valuations of risk assets.

The consensus has now become that central banks will do "whatever it takes" to rid us of inflation – with the "whatever" part including causing a recession. Meanwhile inflation and higher energy prices are squeezing consumer budgets and putting pressure on corporate profit margins.

All of this provides an uncomfortable backdrop for equities. As a long-only equity fund we expect to be bashed and bruised by the market over the short-run, and this has certainly been the case of the last six months.

Over the longer run however our experience shows that key to generating excess returns is to focus on the stock level fundamentals – not the macro. We have assembled a concentrated yet diverse portfolio of high quality assets, managed by skilled active owners. Valuations - as indicated by the portfolio weighted average discount which has widened from 26% to 34% so far this year – are becoming increasingly attractive, with a rich opportunity set of both new and existing names to add to. Although the immediate path ahead is riddled with uncertainty these are strong foundations for attractive long-term returns.

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