



The Tale of Two Markets

August 11, 2020

Dear Client,

In our Q1 2019 commentary we expressed how “COVID-19 will kick off one of the most profound reshaping of our world any of us will see in our lifetime,” accompanied by our road map for the large changes and constants we expect to play out. The oft-stated phrase that “markets are a discounting mechanism” and as such price adjusts to incorporate future expectations certainly applies, though we never imagined prices moving this far, this fast in measuring and valuing the impact of COVID-19. In fact, we strongly felt that “for opportunity, you must be willing and able to look out several years.” Little did we know that years would play out over months.

Few people know how to handle these uncertain times on multiple levels. As for the virus itself and the public health response, it is nearly impossible to speak with conviction about what will and will not happen from here. Many responsibilities lie in the hands of policymakers on two key playing fields: economic and healthcare. On the economic front, the response has been robust, while the healthcare side has been incredibly disappointing and challenging to handicap. Simply put, our federal government has managed this crisis with woeful incompetence and is either malicious or ignorant in its oversight of our nation’s COVID defense. Federal issues have led to inconsistent responses across states, leading to numerous questions about what the cadence and shape of reopenings and subsequent closures will look like. From our seat, we can merely make educated guesses and adjust our hypotheses accordingly as new information comes to light. We do so in a Bayesian way, because we don’t want to overweight the new over what we thought earlier as events transpire rapidly. Which information do we weigh? To what degree?

In times of great volatility, stock prices try to tempt you into action. We all become more prone to behavioral biases and must therefore temper our inclination to act. In speaking with peers and colleagues, we see that we are not alone in experiencing tremendous degrees of frustration at some positions not working, fears of something collapsing due to factors outside the normal distribution of events, enthusiasm at something rising which can either beget stronger conviction despite price/value worsening, or temptation to sell a stock whose future has improved proportionate to the accompanying stock price move. Through it all, our greatest responsibility is maintaining a level head and focusing on the facts alone.

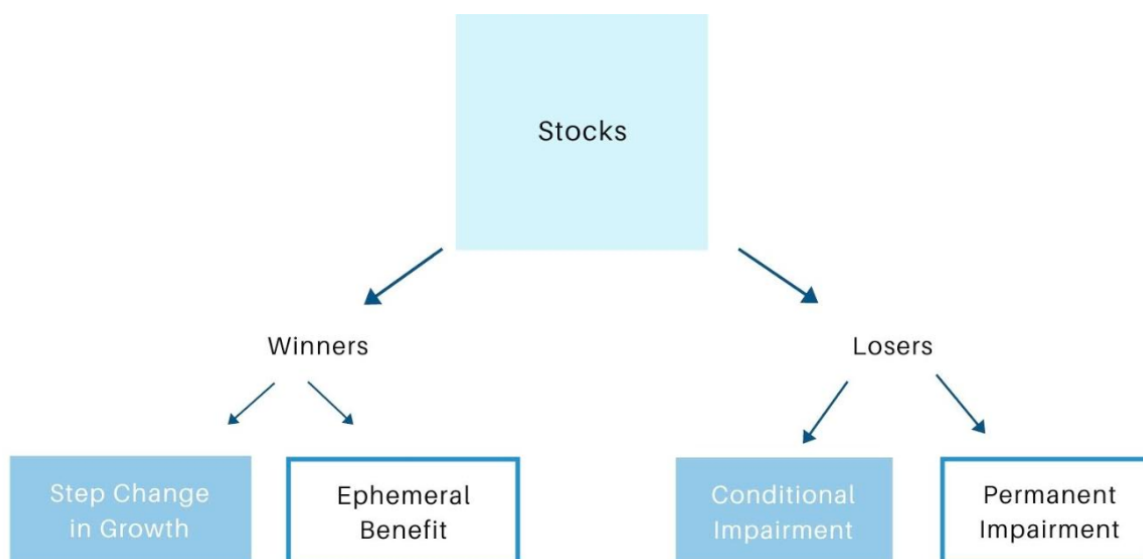
Fortunately, as it comes to managing our portfolios, we have reached a point in time where we have enough information on all of our companies in order to assess both their ongoing business’ earnings prowess and each company’s respective capacities to withstand a crisis of great magnitude for a prolonged period of time, but we do not want to lull ourselves into complacency right now. We are honed in on companies who can control their own destinies without needing capital markets for ongoing financing needs and who are in position to invest and accelerate their advantages during this challenging period of time. We have started to build a little barbell in our portfolio where on one side, we have companies whose advantages are accelerated by COVID, and on the other side, we have positions in companies whose businesses are hurt by COVID, but whose advantages in their respective businesses will not change.



The Tale of Two Markets:

In effect, since the March bottom, we have seen the market bifurcate into two baskets: the COVID winners and the COVID losers. The winners (losers) are presumed to benefit (suffer) from some combination of demand tailwinds (headwinds) and/or a strengthened (weakened) competitive position. Many of these first-order thoughts make sense. For example, it is obvious that any company involved in air travel today is experiencing a severe drop off in business, while any company who sells bicycles is experiencing increased demand. The problem as far as markets are concerned is how simplistic the determination of winners and losers has been to date. In our Q1 commentary, we stated that “We expect high dispersion from here, with some large winners and losers emerging. The obvious losers from COVID-19 are already down considerably in the stock market, consequently, some of the biggest losers from here will be companies where the impact of covid-19 related shutdowns is non-obvious.”¹

The expectation for dispersion was spot-on; however, the non-obvious impacts have yet to emerge. We have revised our expectation and think within this bifurcation of winners and losers there will be a bifurcation in each branch of the tree.



Dividing the Winners:

Within the winners we expect to see two kinds of companies emerge: those whose benefit is ephemeral in nature whereby demand will eventually revert to pre-COVID trends; and, those whose benefit leads to a step-change in growth, from a sustainably higher plateau. As always, when ascribing labels there is room for nuance, with some companies who do not neatly fit into these labels. For example, one sub-category of “winner” is unquestionably suffering on the demand side today, but a disruptive technology-driven solution has led investors to impute

¹ <https://www.rgaia.com/q12020-investment-commentary/>



permanent share gain that will result in a rapidly accelerating earnings growth rate once COVID subsides. Such situations are inherently tougher to analyze and will take time to resolve.

As for the core bifurcation within the winner category, PayPal, which we own, is a strong example of a company experiencing a step-change in growth. PayPal is both bringing on new customers at a much faster rate than before COVID hit and customers are using PayPal for checkout far more frequently than before. For several years now, we has been hammering away at the idea that PayPal's biggest opportunity has been to accelerate the level of engagement from existing users². COVID has been catalytic on this front. As Nick Sleep of Nomad Partners observed:

When investors value a business they have in their minds, consciously or not, a decision tree with the various branches leading to all possible futures and probabilities attached to those branches. The share price can be thought of as an aggregate of the probability weighted value of these branches. The problem, as Santa-Fe Institute scientist Ole Peters most recently pointed out (SFI Bulletin 2009, volume 24), is that this is not an accurate representation of what the future will be! The next step for the company will not be to visit all of those branches simultaneously. In reality the firm in question will only visit one of those branches before proceeding to the next and so on. Short-term investors spend their time trying to handicap the odds of each branch.

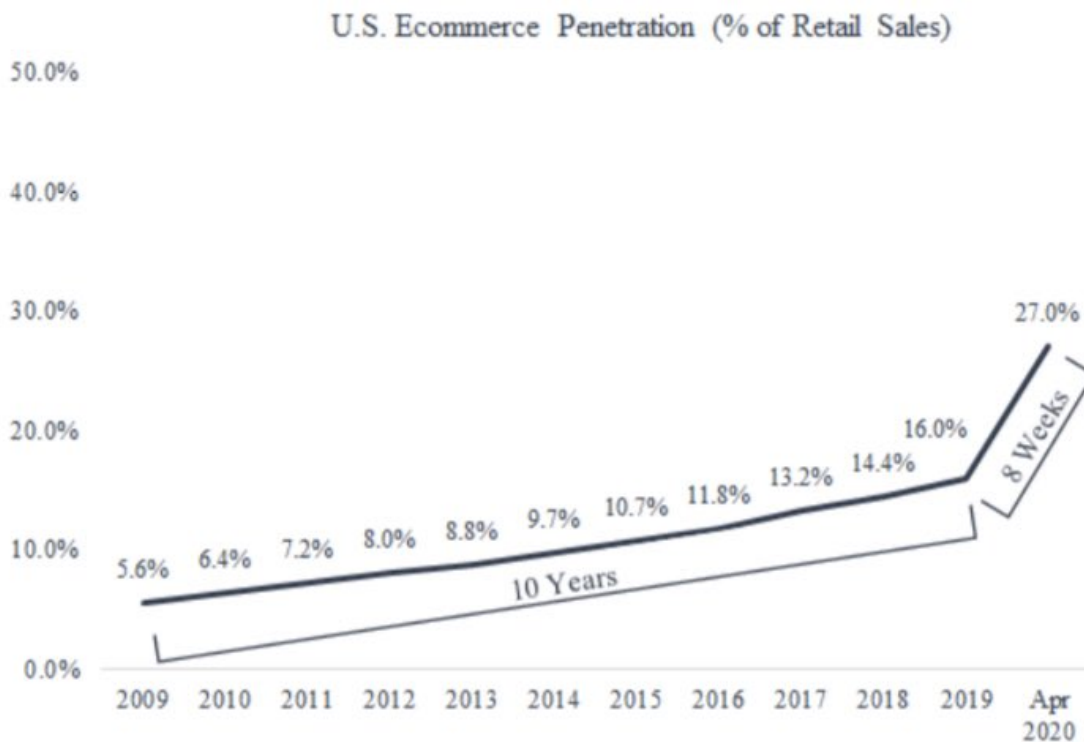
Guessing which-branch-next can be a crowded trade, but it's fine, as far as it goes. However, it rather misses the big picture, in our opinion. We would propose that some businesses, once they have progressed down the first favorable branch, stand a much greater chance of progressing down the second favorable branch, and then the third, as a virtuous feedback loop builds. The process takes time, but a favorable result at any one stage increases the chances of success further down the line, as it were. Think of it as a business' culture.³

² [https://moiglobal.com/elliott-turner-201901/#:~:text=Elliot%20Turner%20of%20RGA%20Investment,ROKU\)%20at%20Best%20Ideas%202019.&text=PayPal%20suffers%20from%20an%20over,flowing%20around%20increasing%20user%20engagement](https://moiglobal.com/elliott-turner-201901/#:~:text=Elliot%20Turner%20of%20RGA%20Investment,ROKU)%20at%20Best%20Ideas%202019.&text=PayPal%20suffers%20from%20an%20over,flowing%20around%20increasing%20user%20engagement)

³ Sleep, Nick. Nomad Investment Partnership Letters to Partners 2001-2013, p. 56.



PayPal is right now traveling down a decisively more favorable branch. As Dan Schulman said on the company’s Q2 earnings call, “In the first half of 2020, the penetration of e-commerce as a percentage of retail sales outpaced prior external forecast by an astonishing 3 to 5 years.” This chart from Dennis Hong⁴ of ShawSpring Partners offers Schulman’s line in stunning visual form:



Source: Bank of America, U.S. Department of Commerce, ShawSpring Research

In this environment, the degree to which PayPal is earning commitment and shaping behavior with customers builds in a level of inertia that will both perpetuate the growth it is experiencing and entrench PayPal’s solution versus competitors. Management offered some helpful early evidence that this is the case: “And a couple of the markets that we had a keen eye on are some of the markets that relaxed their shelter-in-place measures earlier than others, so examples would be Austria or Germany. And at the sort of -- if we look at like April results, the growth rates in those countries were 2 to 3x what they were going into the period right before coronavirus.”

On the other hand, early “winners” like toilet paper manufacturers will not experience any long-term effects. Put rather simply, households use the exact amount of toilet paper that they need each and every year. The stocking

⁴ <https://twitter.com/DennisHong17/status/1261492532690763777>



effect for fear of supply chain disruption will eventually wear off as houses return their toilet paper inventory to more normal levels. Eventually, there will be a period of lower demand to offset the inventory depletion. Another example to consider are bicycle manufacturers. Bikes are in short supply nationwide as mobility is limited and people seek out new activities for leisure or sport. Eventually, everyone who needs a bike will have one and demand will revert to a normal level.

Dividing the Losers:

Within the losers we see companies who are experiencing either a conditional impairment that will subside once we conquer COVID or companies who are experiencing permanent impairments that they will never recover from. Late last quarter and early in the quarter, we commenced positions in three companies suffering conditional impairments, who will retain their strong competitive position despite the down period and emerge at least as dominant as before once conditions normalize. The three companies are Vail Resorts (MTN), Safran SA (SAF.PA) and CDK Global, Inc (CDK).

Vail Resorts owns some of the world's best ski resorts--the kind of assets that cannot and will not be built again due to a variety of geographic, regulatory and capital constraints. Vail has built a tremendous business around its Epic Pass whereby they have reduced the seasonality associated with snow conditions and exercised scale purchasing power benefits to continually invest in and improve the quality of their resorts. To some, skiing is merely an activity, while to many it is a lifestyle. Someone living the lifestyle may not ski amidst COVID shutdowns, but will quickly return to normal once life permits. Plus, as a lifestyle industry, 60% of skier visits at the North American resorts stem from locals visiting their nearby favorite mountain. This kind of travel and leisure will resume well before other verities. The company has the kind of strong balance sheet necessary to weather the storm and emerge on the other side of COVID in position to capitalize on demographic headwinds turned into tailwinds that only became clear in the past year.

Safran is the world's leading narrowbody jet engine manufacturer. Safran makes some money selling new engines, but most of their earnings come from the aftermarket service tied to engine placements. With reduced travel of all kinds, Safran unquestionably suffers in this environment from both lower levels of new aircraft (and thus engine) orders and lower servicing revenues from the lower flight hours logged with their already placed engines. Importantly, the servicing of engines is an expense that airlines cannot spare, irrespective of the seat utilization on a plane. If a plane travels with 5 passengers instead of 200, that engine still requires servicing and parts from time-to-time. As a result, unlike the airlines themselves, Safran will continue to generate free cash flow during this calamitous situation.

CDK is similar insofar as the company's software powers car dealers and so long as dealers are open, they need the company's mission-critical Dealer Management System (DMS). Dealers were forced to shudder amidst stay-at-home orders in many states, and as a result, CDK offered a 25% reduction one quarter discount and added on some layered apps for free to help their customers through this challenging time. With dealers once again reopening nationwide and the discounts rolling off, CDK will return to their normal level of revenues.

On the permanent impairment side of the ledger (to which we remain unexposed) are companies like Diamond Offshore, J.Crew, J.C. Penney and Hertz. We have forever stayed away from these kinds of companies. This list could



be much longer and continues to lengthen by the day; however, there are two common traits amongst all of the companies here. First, these companies are in industries where the pain was palpable even before COVID emerged as a threat. COVID merely served as a rapid accelerant of their demise. Second, these companies had balance sheets ill-equipped to defend sustainability through a prolonged downturn. The combination of these two elements makes the impairment permanent. We would be remiss to point out that one need not end up in bankruptcy for permanent impairment-the airlines fit the bill because of how ill-equipped (at no fault of their own) their balance sheets are to handle the magnitude of the crisis.

Building it all into the portfolio:

Given the uncertain nature of this situation, we have sized our positions in COVID losers smaller than most. Collectively these positions share the single largest risk factor each faces and thus we view the aggregate impact in our portfolio similarly to one large position, though each possesses plenty of esoteric risk and opportunity. When COVID eventually recedes as a risk, these companies will disproportionately benefit. We do not want to wait until it becomes clear the risks are receding, because these companies are built to withstand this situation and on normalized earnings power would be worth far more. If the situation worsens and the duration of the risk lengthens, we will be in position to buy more at lower prices. Conversely, if the situation improves, we expect price to adjust upwards though at a slower rate than business reality would warrant. This would afford us the opportunity to buy more at higher prices, though at what may be cheaper valuations on a one to two-year out earnings outlook.

The single biggest move we made during the quarter, across all portfolios, was maxing out our position in IAC following the consummation of the Match Group spinoff. We like Match as an asset, but have been awaiting an opportunity for more direct exposure to rest of IAC. Our interest is multifaceted:

1. The stub discount, which on the day of the spin made all assets beyond the ~84% stake in ANGI Homeservices Inc. and \$4 billion in net cash effectively free.
2. Vimeo-we think Vimeo is one of the most under-the-radar and underappreciated assets today. With upwards of \$220m in ARR and revenue growth accelerating into the mid-40 percent over the last quarter, Vimeo is poised to provide critical video production tools to creatives large and small alike. This asset alone could represent half of the market cap of the newly formed IAC stub in short order.
3. More exposure to ANGI Homeservices which we already hold as a core position and wrote about in our New Year letter.⁵
4. Dotdash-while everyone else in publishing online is running on the treadmill of ephemeral content, Dotdash builds enduring though regularly updated, high value and informative content across verticals that continues to grow its attraction to advertisers even during the COVID crisis.
5. Asymmetric optionality from Care.com who has an incredible opportunity with better strategy, execution and more resources to change the nature of how people find capable care for children and older relatives alike.

Importantly, for the most part, IAC's portfolio benefits from tailwinds in digital adoption during stay-at-home orders and the transition to work from home. By and large, these are the enduring kinds of tailwinds. Beyond this specific

⁵ <https://www.rgaia.com/q42019-investment-commentary-2019-in-review/>



moment, the \$4b net cash war chest is a critical asset for IAC's incredibly competent team led by Joey Levin. We inevitably expect a good portion of this cash stash to go towards smart acquisitions consistent with the IAC thesis succinctly outlined in their Q4 2017 shareholder letter.

"Our thesis has been consistent: we combine operating control, investment discipline and capital markets expertise with specific category experience, a permanent balance sheet and a long-term investment horizon to build great companies. We de-risk our bets in a number of ways. We recruit, guide and help entrepreneurs avoid the mistakes that we have made ourselves, and provide them enormous incentive on the upside performance. We encourage and reward ambition. Operators get more leverage because they can use our balance sheet and deal experience, and don't have to worry as much about the mundane finance, accounting, or other back office functions. Our breadth is wide enough that we see lots of opportunities, and our scale affords us a cheaper cost of capital than smaller companies who may compete in a particular category. Most importantly, unlike many investors, we have permanent capital, allowing us to operate and invest without a fixed timeline, and the ability (though rarely exercised) to print our own currency."⁶

We are excited to see what the future holds!

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

A handwritten signature in cursive script, appearing to read "Jason Gilbert".

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⁶ <https://ir.iac.com/static-files/1fb1c3ff-d062-4c5b-ab7e-2f8dc346ede0>



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