September 2022

Calypso Strategy Special Report

Dear Fellow Investors,

As we write this letter, the Fund returned -0.94% in August 2022, bringing its total decline to approximately 15.70% for the year. 2022 has been the U.S. market's worst start to a year in over a half-century, and, unfortunately, we have seen an abnormally above-average downside index capture for the Fund. The higher than expected downside capture has not been due to a change of strategy or style drift, but rather to the following reasons:

- The interest rate-induced carnage in Non-Profitable Growth stocks affected Quality stocks more than other market segments (e.g., Value). Consequently, our long book initially drew down more than the market. Performance has normalized since late May as Value/Oil/Commodity stocks started underperforming.

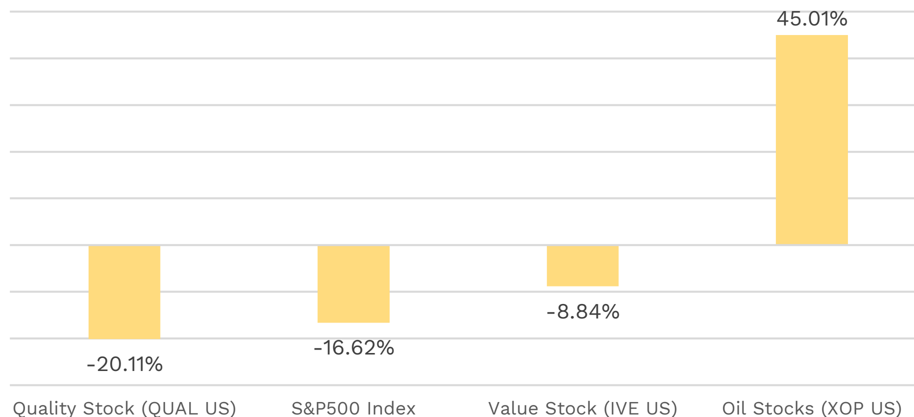


Exhibit 1: YTD Total Returns of Quality Stock vs. Value, Oil and the market
Source: Bloomberg, FAM Analytics

- As a result, S&P500 (which we usually use to hedge our portfolio) has outperformed Quality, driven by Oil/Commodity, "value" stocks that entered a new "super cycle." This meant that our short side was not as capital protective as it was during the COVID-19 correction.

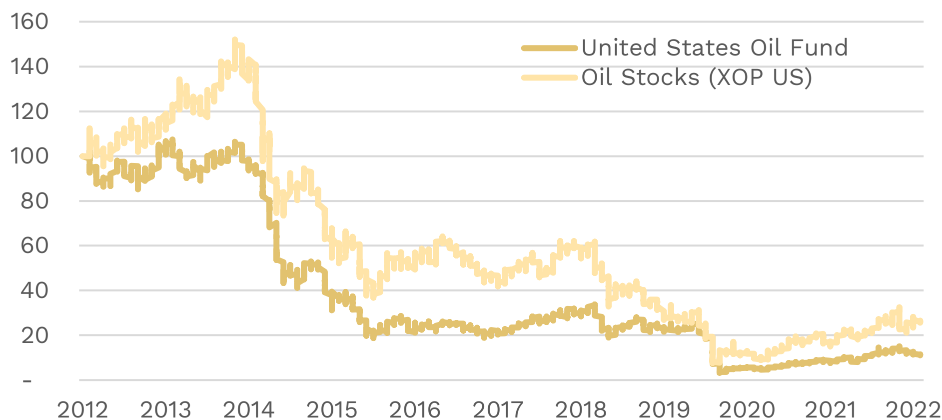


Exhibit 2: Oil Companies, a lost decade of returns...
Source: Bloomberg, FAM Analytics

- Our U.S. treasury book (which we typically use to receive a carry plus stability when volatile markets) drew down as much or even more than Equity markets. Mixed Allocation managers do rely on the typical negative correlation of U.S. treasuries (Exhibit 3).

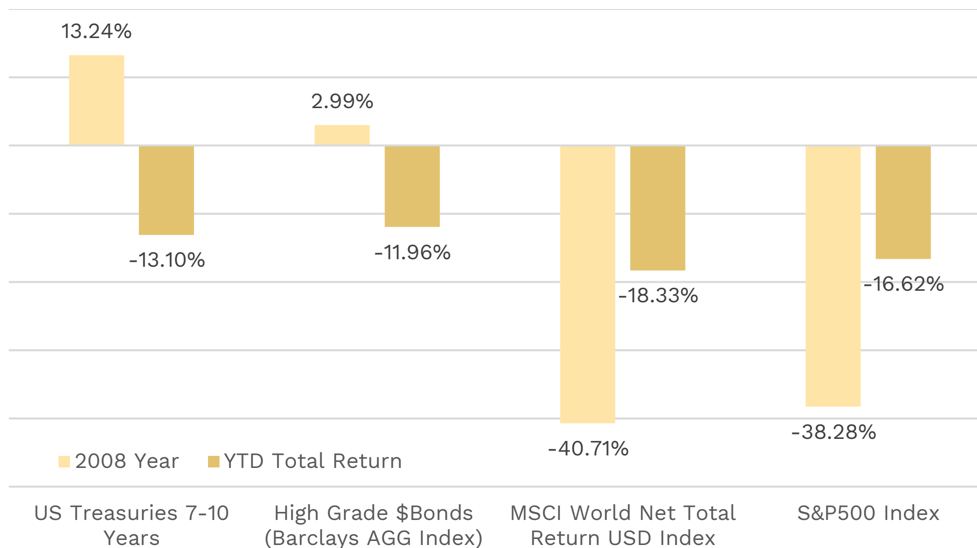


Exhibit 3: Total Return of Stock and Bond Indices YTD vs. 2008 YR. Bond
Source: Bloomberg, FAM Analytics

- Our gross and net exposure in January/February was higher than it normally is in a risky macro environment. This resulted from the fact that our macro model is less sensitive to short-term macro developments as opposed to longer term ones. Most of our leading indicators started turning negative from March onwards. Nevertheless, employment numbers remain robust in the U.S.

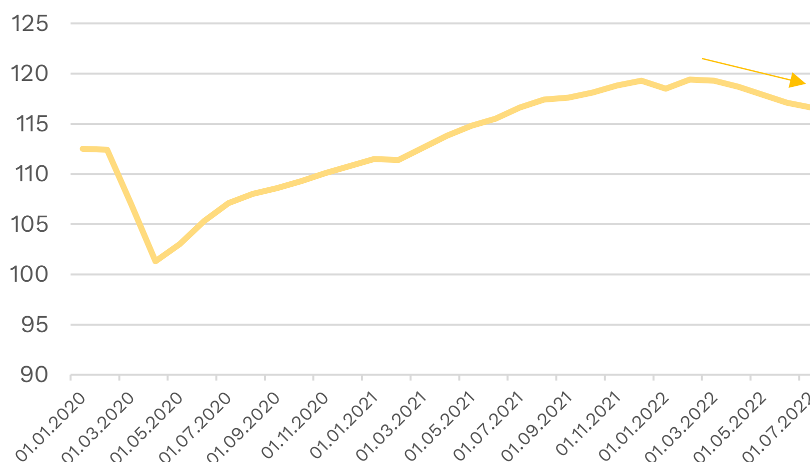


Exhibit 4: Leading Indicators rolled over after March 2022
Source: Bloomberg, FAM Analytics

We are frustrated by our returns, but every style/strategy has an “Achilles’ heel,” and every period has something to add to our model. Most importantly, we have learned that not having exposure to traditional Oil companies may come back and bite us, exactly what has happened this year.

However, it is also important to note that these losses are not permanent. As we will outline later in this letter, the businesses we own are far healthier than their recent share prices indicate. As such, the price declines have been driven not by business deterioration but primarily by multiple compression.

Portfolio Positioning as of August 31st

- Index Shorts (S&P500 and Nasdaq): ≈ 30%
- Long Exposure: ≈ 80%
- US Treasuries/Cash: ≈ 20%
- Net Equity Exposure (beta adj.): ≈ 50%
- No. of Stocks: 45
- Largest revenue and domicile exposure: U.S.

Our factor correlations (betas) can be seen below:

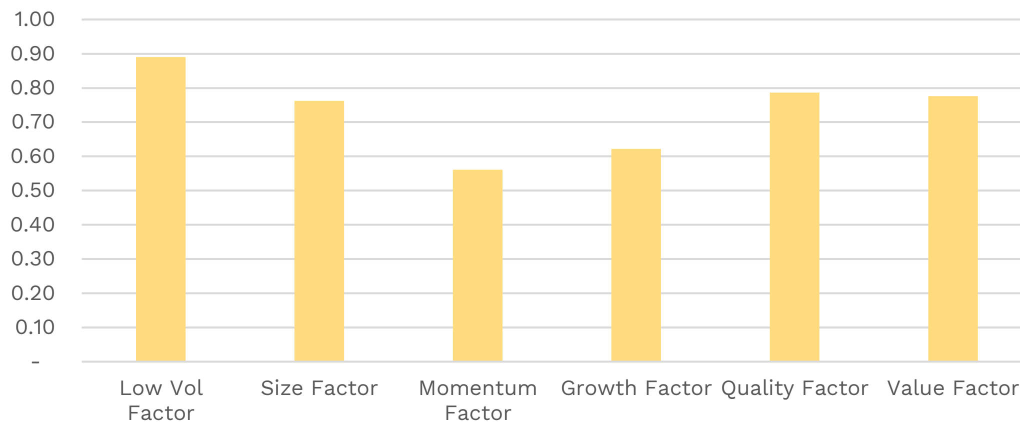


Exhibit 4: Portfolio positioning in relation to factor proxies
Source: Bloomberg, FAM Analytics

In the next sections, we provide more details on two of our top five positions in the portfolio.

Fiserv and the concept of “forced buyers”

As we are facing a possible recession, a view of the resilience of the companies we own is essential. In addition, mission-critical products and services should fare better on the demand side than discretionary purchases. For example, restaurant owners may not want to pay for their POS (point of sale) systems, but if they want to serve customers, delivering the POS bill is akin to “keeping the lights on”: the restaurant owner is effectively a forced buyer.

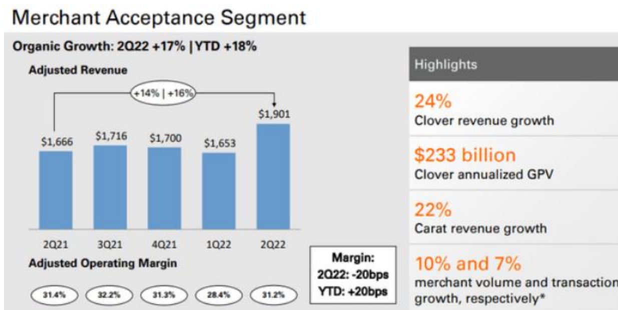
Fiserv’s Clover Flex handheld POS system
Source: Fiserv

Of course, having forced buyers does not mean that a weakening economy will not create headwinds, but not all businesses are created equal, and not all demand is created equal. This theme of “forced buyers” can be found throughout our portfolio.

Fiserv has been among the slow-growing businesses in an industry marked by disruption, crypto and new entrants. Often seen as a legacy player heading to extinction, Fiserv has become a typical value stock of little to no interest to most retail investors, given their focus on more “popular” names such as Block, PayPal and a number of Blockchain “disruptors”. After all, why go for a slow-growth legacy business when you can be part of the digital transformation with the likes of PayPal and Block? It turns out that Fiserv has become one of the best-performing stocks in its peer group, coming a close second after Visa, another one of our holdings.

Fiserv has already increased its guidance for fiscal year 2022 from 7-9% to 9-11%. The company indicated in its Q2 2022 earnings call that “Looking into the remainder of the year, our year-to-date organic revenue growth outperformance of 11% puts us in a very good position to beat our

prior organic revenue growth guidance for the full year. Given the strength in the first half of the year, we are raising our full year organic revenue growth outlook to a range of 9% to 11%, up from 7% to 9% previously."[1]



Fiserv's Clover platform comps jumped substantially during Q2 2022.
Source: Fiserv

This year's revenue growth was primarily driven by the Merchant Acceptance segment, including revenues from the Clover platform. In our view, Clover holds significant potential as a leading point of sale platform that has surpassed Block's Square offering in terms of gross payment volume. The company is also moving towards a "stickier" revenue model by not only selling POS terminals but also delivering operating systems, which will expand the size of its total addressable market.

Fiserv's solid operational performance and unique strategic positioning come in at one of the lowest multiples within the company's peer group. Fiserv's forward P/E ratio has also declined significantly over the past two years, while as we see below, the company has made significant progress on its capital allocation strategy. In the meantime, Fiserv's operating margins of 14.1% are comparable to those of PayPal (16.8%), which is still valued at a substantial premium even after its abysmal share price performance.

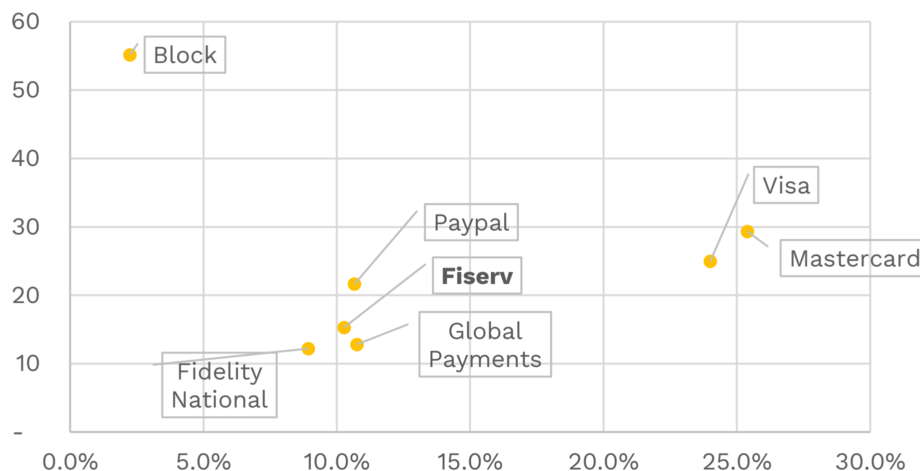


Exhibit 6: Revenue growth rates (x-axis) vs forward Non-GAAP Price-to-Earnings ratios (y-axis)
Source: Bloomberg, FAM Analytics

Fiserv is quietly becoming a Fintech powerhouse and is a well-run company in the core banking and payments segments with a long runway ahead with Clover and Carat, some of the best merchant service offerings, and a highly profitable payments business. At the same time, profitability is not sacrificed to meet short-term growth expectations, which appears to be the case for some of its major peers. Fiserv is our fund's 5th largest position (3%).

Who is NextEra?

A word on our 2nd largest holding (3%). NextEra has always been among our top holdings due to its track record of outstanding execution, revenue visibility and its leadership position in renewables. Renewables support energy independence and help stimulate economic growth, including domestic job creation. Renewables offer low-cost energy to help customers reduce their bills, and demand is being driven by a number of factors. With a market cap of $179 billion, Juno Beach, Florida-based NextEra Energy is the largest regulated electric utility in the United States. The utility sector has an important role to play in the road to decarbonizing the economy. NextEra

[1] Fiserv Reports Second Quarter 2022 Results, https://investors.fiserv.com/

Energy Resources is leading the way as the world's most significant wind and solar energy generator and a leader in battery storage. NEE's segments for financial reporting purposes are FPL (Florida Power & Light) and NEER (NextEra Energy Resources). NEER is the world leader in electricity generated from wind and solar sources.

Solar and Wind farms operated by NEER
Source: NextEra Energy

As of December 31, 2021, NextEra's electric generation for the year was 28 megawatts. 20GW was provided by wind energy, followed by 4GW of solar, 2GW of nuclear energy, and 2GW from natural gas/oil sources. In order to achieve the Paris Climate Agreement goals for 2050, the US economy will need at least 7'000GW of renewables and storage capacity.[2] In 2020, that number was 170GW. Approximately half of this is expected to come from wind power and hydrogen is expected to be approximately 10%. NextEra is actively pursuing hydrogen opportunities as it has the infrastructure to produce green hydrogen. NextEra is also aggressively investing in new businesses to expand its clean energy footprint. For example, the Wall Street Journal reported that a Nebraska-based startup looking to produce hydrogen with natural gas while capturing its emissions is getting funding from major players in the industry. "We continue to see strong market demand for renewables, especially in light of the environment of high gas and power prices that we believe will persist going forward. Renewables are not just the most economic form of generation – they are deflationary and Countercyclical"[3]

2022 has seen a wave of high fossil fuel prices have also resulted in a significant increase in energy prices. This was caused by the "reopening of the economy" after the COVID-19 pandemic and the ongoing geopolitical tension in the Eastern European region. As the duration of the conflict and its aftermath is highly uncertain, we believe that fossil fuel prices will remain elevated for the rest of 2022. In addition, although OPEC+ has agreed to increase oil production by a higher than planned amount in July and August to increase supply and potentially reduce prices, several other factors are causing the price levels to remain elevated, e.g., the incident in the Freeport LNG plant and the uncertain energy security of Europe driven by the fears of supply interruptions from Russia.

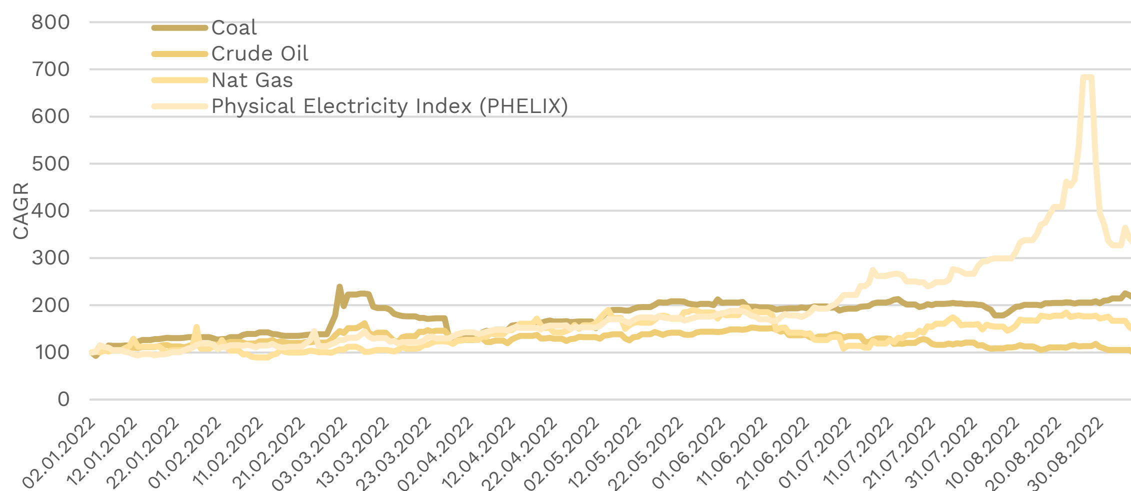


Exhibit 7: Fossil fuels have risen substantially on YTD basis
Source: Bloomberg, FAM Analytics

When prices of fossil fuels are high, investments in renewable energy projects become significantly more attractive. Such could eventually lead to a substantial share gain of the renewable energy sources in the energy mix.

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[2] UN Climate Change News, 1 December 2021, https://unfccc.int/news/renewables-growth-must-double-to-achieve-paris-goals-iea
[3] Kirk Crews, NextEra CFO, NextEra 2Q 2022 Earnings Conference Call

NextEra has a strong track record of returning value to its shareholders through dividend payments. The firm has been consecutively paying dividends to its shareholders for the last 32 years, while they have also managed to increase the amount paid out each year during the last 27 years. NextEra has a low-volatility profile as a stock, outperforming capital gains provided by solid EPS growth, a healthy balance sheet, and a future-proof business model.

Looking ahead

As outlined above the fund is currently defensively positioned and invested into companies with high earnings visibility, strong and seasoned management in oligopolistic markets that have a high barrier to entry. There are many reasons to believe demand will be resilient in the potentially trying times ahead. It is also worth noting that none of our holdings require additional capital. As a result, they are not beholden to the generosity of the markets; they are either profitable or fully funded under just about any scenario.

The macro backdrop is undoubtedly not a source of optimism at the moment. We see no indication that Russia's war in Ukraine will end soon; inflation is raging, oil prices remain elevated, and interest rates are headed up, up, up. Fortunately, markets often bottom before the economy does. The stocks in our book that fit closer to the growth quintile are currently at multi-year lows. Multiples certainly can compress further, but we think our portfolio is structured to generate attractive returns when this contraction stops and better returns should be the tailwind of multiple expansion returns to any of our holdings.

Life Imitates Art. Investing Imitates Baseball….

Mickey Mantle Having a Bad Day at Yankee Stadium, 1965 by John Dominis

As a respected investor once said, investing does indeed imitate baseball. We measure everything. The pressure never ends. The worry never ends. If you do a good job (or a bad job), the numbers say so. Yet unlike baseball, there isn't an off-season. And the game is never over.

Investing is a beautiful thing!

Thank you for your continued trust.

John, Alessia, Alessio & Team

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