

Aion Investment First Half 2023

The first half of 2023 was marked by a **recovery across global equity indices**, particularly within **the technology sector**, following the correction experienced in 2022. **The MSCI World Index in euros** delivered a return of **9.4%**, while the **S&P 500** advanced **13.6%**, driven primarily by seven large technology companies: **Apple, Microsoft, Google, Amazon, Nvidia, Meta, and Tesla**, with **Nvidia standing out with a remarkable 170% appreciation**.

One of the most widely discussed events of the period was **the collapse of several U.S. regional banks, including Silicon Valley Bank and First Republic**. These failures were the result of **poor risk management**, exposed by the **rapid increase in interest rates** and exacerbated by an **accelerated withdrawal of deposits**. While we have no direct exposure to banks, we hold positions in **Fairfax** and **Markel**, two insurance companies with **sensitivity to interest rate movements**, as well as in **Apollo**, an alternative asset manager focused on providing capital.

These three companies were initially impacted by the deterioration in market sentiment following the collapse of Silicon Valley Bank. However, the market **quickly differentiated between the various business models**, and as a result, these positions have recovered strongly and are **currently trading close to new highs**.

In this context, **our portfolio delivered a return of 13.4%** during the first half of the year, a solid performance that, on an annualized basis, **exceeds our long term objective of generating 15 percent per year**. The main contributors were companies that had been heavily impacted the previous year, such as **Spotify**, which appreciated by more than 90%, and **Airbnb**, which advanced close to 50 %, while Markel posted a flat return due to its exposure to interest rates.

However, beyond short term performance, what truly shapes our decision making is the principle that guides every step of our strategy: **capital preservation**.

What do we mean by capital preservation?

At **Aion Investment**, capital preservation means **maintaining the real value of our investments** and avoiding losses that could compromise the continuity of our strategy. Beyond market volatility, the essential objective is **to ensure that capital remains available to seize future opportunities and generate long term value**.

For this reason, **we avoid leverage**. Increasing exposure through debt **raises the probability that a market decline turns into an irreversible loss**. A significant loss not only **reduces capital**, it **also consumes time**. For example, a 30 percent loss requires a subsequent return of more than 42 percent just to break even, an effort **that can take several years to achieve**.



That said, it is important to emphasize that a **30 percent decline in a company's market price does not necessarily imply a permanent loss of capital**. In a portfolio like ours, which is concentrated and includes positions with low liquidity, it is normal to experience periods of higher volatility, even drawdowns greater than those of the broader market, without implying a higher fundamental risk.

Imagine purchasing a high quality company, debt free, well managed, and at a fair price. One year later, the central bank raises interest rates and the market declines by 10 percent. The share price of our company falls by 20 percent, not because the business is performing worse, but because its lower liquidity causes larger price movements.

Even so, **the business remains unchanged or may even be stronger**. It produces the same output, employs more people, and generates higher sales. Under traditional risk models, it would appear to be a riskier investment because its price fluctuates more widely, with volatility increasing from 15 percent to 40 percent. However, **the risk is lower**, because the same business, or an even better one, can now be purchased at a **20 percent discount**.

Market volatility is inevitable and is often amplified by a deeply human trait: the desire for immediate rewards and quick results. This impatience leads many investors to make rushed decisions, selling during periods of panic and buying during moments of euphoria, **turning temporary losses** into permanent ones and ultimately causing **unnecessary destruction of capital**.

In this context, one of the most powerful tools for improving long term investment outcomes is **patience**. This quality shields us from daily market noise and helps us avoid impulsive decisions. A clear illustration of this effect is Morningstar's Mind the Gap study, based on data as of December 31, 2022. While the funds and ETFs in which investors were invested generated an annual return of 7.7 percent, the average investor earned only 6.0 percent, largely due to poorly timed inflows and outflows. Although a difference of 1.7 percentage points per year may seem modest, over a ten year period it leads to materially different outcomes: 100 dollars invested in the funds grew to approximately 210 dollars, whereas the average investor saw the same investment grow to only 179 dollars. **This example highlights how patience and discipline can meaningfully enhance long term returns**.

In summary, by **thinking differently from the broader market, cultivating patience, and focusing on the long term** development of our companies, volatility ceases to be a problem and instead becomes a **source of opportunity**. When we are able to identify price declines driven by panic or irrational behavior, we can take advantage of them by **purchasing at a discount**, which in turn **reduces portfolio risk and enhances return potential**.

Portfolio as of 30/06/2023

Company	Weight
Fairfax Financial	20.76%
Markel	19.17%



Airbnb	17.76%
Spotify Tech	14.83%
Apollo Global Management A	13.10%
MedCap	8.24%
Rightmove	6.14%

In this first report, I would like to highlight a portfolio company that clearly reflects what we look for in a business: **Fairfax**. It is an insurance company recognized for its outstanding ability to **allocate capital efficiently**, supported by a **highly experienced management team and an exemplary level of transparency**.

One of the best ways to understand this discipline in capital allocation is to examine how Fairfax managed its fixed income portfolio in the years leading up to 2022. To do so, it is helpful to start with a simple idea: a bond is essentially **a long term loan that pays a fixed interest rate**.

When interest rates are low, it is tempting to commit capital for long periods in exchange for a slightly higher yield. The risk emerges when rates rise. At that point, newly issued bonds offer higher interest, and older bonds with lower coupons lose value. The longer the time remaining to maturity, the greater this loss. **This effect is known in investing as duration**.

In 2022, many insurers held fixed income portfolios with an average duration of around **4.3 years**, leaving them particularly exposed when interest rates rose sharply. Fairfax, by contrast, had chosen a far more conservative approach, maintaining a **short duration of just 1.2 years**, even at the cost of accepting lower returns for several years.

This conservative decision is **proving its value as the environment changes**. By maintaining shorter maturities, Fairfax is in a **privileged position to reinvest its capital at higher interest rates**, reducing the negative impact that rising rates have had on much of the insurance industry. The effect in 2022 was clear: while a large portion of the sector saw book value decline by **15% to 20%**, **Fairfax not only avoided this deterioration but actually increased its book value by 6%**.

Despite this strong execution, the market has yet to fully reflect Fairfax's intrinsic value. From our perspective, the company continues to trade at an attractive valuation of approximately **0.9 times book value, meaning below the stated value of its net assets**. This allows us to invest with a meaningful margin of safety, purchasing high quality assets at a discount and with significant upside potential as the market comes to recognize their true worth.

The most compelling opportunity, however, lies within the **fixed income portfolio** itself, which at the end of 2022 totaled roughly **\$40 billion** and represented close to **70% of the group's investment assets**. At that time, the portfolio was generating an average yield of only about **1% to 1.5%**, consistent with the interest rate environment of 2021 and early 2022.



Following the rise in interest rates, the outlook changes materially. Over the course of 2023, nearly all of the low rate debt is expected to mature, and **by 2024 this same portfolio could be producing yields of approximately 4% to 4.5%** on that \$40 billion. In absolute terms, this implies that annual fixed income income could **increase from roughly \$600 million to close to \$1.8 billion, equivalent to approximately 15% of the company's net asset value.**

In other words, we are buying the company at 90 when its intrinsic value is 100. Since the business generates 15 of annual cash flow on that true value of 100, an investor who pays 90 receives the same 15, which translates into **an effective return of close to 17%**. This dynamic acts as a form of **natural leverage**, as purchasing at a discount increases returns without taking on additional risk.

Based on both sector comparables and the company's own historical average valuation over the past decade, we estimate that an insurer of Fairfax's quality **should trade at no less than 1.25 times book value.** This implies **upside potential of approximately 40%** from current levels. While we wait for this valuation normalization to occur, we believe we can remain patient and earn annual returns above 15%, supported by an uncommon combination of **capital preservation, structural earnings improvement, and disciplined capital allocation.**

Another example of a company in our portfolio is **Spotify**, where **we increased our position at the beginning of the year.** The company was among the hardest hit during the 2022 technology sell off, when central banks adopted much tighter monetary policies than initially expected. Because Spotify continues to report accounting losses, many investors mistakenly group it with companies that "burn cash and will never be profitable." We believe this view is superficial. Spotify operates a **strong business**, with a base of **roughly 500 million active users growing at around 20% annually**, and a long term profitability potential that we believe is underestimated by the market.

At first glance, its financial results may appear disappointing. In 2022, Spotify **reported an operating loss of approximately \$600 million.** However, a closer look shows that about **\$1.5 billion was spent on advertising and marketing**, expenses that are better viewed as investments in future growth and in improving the user experience. In addition, this accounting treatment generates tax assets that will benefit results in coming years.

One of the most common arguments among **skeptics investors** is that Spotify **has limited ability to improve its gross margins.** We agree that there is little room for expansion at that level. However, the company **benefits from significant operating leverage.** Each incremental user contributes **nearly 100% of its gross profit to net income**, as the marginal cost of an additional user is close to zero. Over the long term, this dynamic could **translate into net margins approaching 20%.**

Under this scenario, we are buying a company that today **is valued at approximately \$30 billion**, while earlier this year we were able to increase our position at a valuation below \$25 billion. Looking ahead, **Spotify could generate more than \$25 billion in annual revenue and over \$5 billion in earnings within four to five years.** In other words, **we are acquiring a high quality business at only five to six times its future earnings**, a valuation we consider highly attractive. If we compare this to other software companies such as Netflix, a



reasonable multiple would be **17 to 18 times earnings, implying a valuation of around \$90 billion, or roughly 200% upside from current levels.**

In addition, **Spotify has several additional levers that could further enhance profitability**, and which we have not even included in our base case. These include the **renegotiation of royalty agreements**, which could allow Spotify to increase its share of industry revenues by leveraging the data and insights it provides to record labels, as well as the **continued growth of independent labels with lower bargaining power**. Furthermore, Spotify's **Marketplace enables labels to pay for greater visibility within the platform**, generating incremental revenue at very high margins.

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