TANARRA

28 January 2021

Dear Investor

2020, the year no one saw coming, reminded us of some fundamental and simple things.

It reminded us of the importance of family. Many of us enjoyed significant unexpected time with family, a one-off gift to be cherished. Many also however experienced the awful consequences of Covid; our thoughts are with all who lost a loved one, experienced illness, had family lives disrupted, lost a job or income, were unable to attend a funeral or family wedding, or suffered stress and mental health issues.

The year reminded us of the fallacy of human beings' innate tendency to extrapolate the present when imagining the future. Unconscious bias that tomorrow will look essentially like today is one of the greatest risks in investing, and there could be no better example than the events of 2020.

Reasons to be Cheerful

While things have been difficult for so many, there are also many reasons to be positive, globally and specifically for Australia (which I will deal with towards the end of this letter).

Without diminishing the impact of the Covid pandemic and its personal consequences in any way, the fact that it has resulted in only around two million deaths to date - one twenty-fifth the number its predecessor caused 100 years ago to a world population one quarter of the size - is another compelling data point on the long-term upwards march of humankind.

Modern health management was decisive (for the most part), but so was consumer technology. This was the year that video truly saved the world. If the pandemic had hit just a decade ago, the world would have been frozen in its tracks with vastly more serious consequences. School lessons by conference call, anyone?

Markets and Tanarra in 2020

Major global crises have historically represented a moment in time when strong investors differentiate themselves from the rest of the pack. Baron Rothschild famously said "the time to buy is when there's blood in the streets". In truth, these opportunities have become increasingly rare this millennium. The instinctive and immediate response of Governments and central banks everywhere to avert crisis through massive fiscal and monetary loosening has meant that markets bounce back vastly quicker than in times past. Consequently, windows where financial assets are stunningly cheap are rare and short. Moreover, the *belief* held by investors - conditioned by these repeated policy responses - that Governments and central banks will prop up markets means that markets move exceptionally quickly, often well ahead of what would be justified on fundamentals. This explains the 2020 bull market - the fastest in history - which began on 23 March, only five weeks after the bear market had begun and long before Covid vaccines were anywhere near trials.

I am pleased to say that the Tanarra team made good investment decisions this year. Our portfolio covering private equity; PE-style investing in public companies (which we call our "LTV" strategy); venture capital; and private credit all prospered in 2020. We currently sit with 28% mark to market IRRs in PE, 27% IRRs and 10% alpha in LTV, 30% IRRs in VC, and target returns in private credit with a 100% performing portfolio and no credits in workout.

We believe there are many strengths in our diversified alternative assets business model. Exposure to a wide range of asset classes helps inform better investment decisions in everything we do. We believe we're better equity investors by having the perspective of a first-class credit team under the same roof, and we make better investment decisions in large public companies through our knowledge of relevant emerging technologies from our VC portfolio. And it gives our investor base a broader range of investment options, across the equity spectrum from absolute start-up to the largest public companies, and up and down corporate capital stack.

Whatever the form of our investing, we aim to be constructive and value-adding partners for all our investee partners - people they respect and enjoy having around.

There were several highlights of 2020 for our firm.

In May, our largest VC investment the Norwegian video conferencing company Pexip, did an IPO on the Oslo bourse. We made this investment in 2015 and commenced IPO preparations in 2019, well before a global pandemic was a serious possibility in anyone's consciousness. It was a stunning success - this became the largest software IPO in Scandinavian history and was 30 times oversubscribed, delivering us a return many times our investment. We're very proud of our involvement in Pexip; it underscores the global nature of our VC activities, and I cannot speak highly enough of the Norwegians as business partners. The Pexip Board and team were exceptional - very smart, fun to work with, and people you can trust without reservation from the other end of the earth.

We invested well in our LTV fund and took advantage of the market break in February and March, setting the foundation for excellent returns in our first fund of this style. In so doing, we invested as a "draw down" fund should, calling on investor capital to invest at times of high conviction. This is a fundamental difference between this style of investing in public companies and a traditional long-only active equities fund, which is obliged to invest 100% of committed capital at any given moment, forcing managers to invest in lower conviction companies or hug benchmarks.

We also reinforced our reputation for a constructive and positive style of engaging with investee companies in the LTV strategy, while at the same time being unafraid to stand up for important principles of governance and shareholder equity when we considered the circumstances so merited. We have assembled a portfolio of quality companies in the LTV fund, and believe we are adding value to them.

And while we do not ordinarily call out a defeat in a private equity (PE) bidding contest, we were proud of our efforts late in the year in assembling, very quickly, a bidding consortium of leading Australian industry and for-profit funds and an outstanding corporate partner to bid A$630 million for the Lion Dairy and Drinks business being sold by Kirin. This bid, which came second by the narrowest of margins, was one of the largest ever one-off investment partnerships for a corporate PE bid in Australia involving industry funds, continuing the evolution of Australia's capital markets. It is a blueprint for the future - a flexible partnering model with large capital providers, unconstrained by a conventional closed end PE fund model that has essentially remained unchanged since the 1980s.

We made several new VC investments all around the world, including Fraction (Thailand), iSize (UK) and Revela (US). We made follow-on investments in others already in our portfolio, one that is skewed to globally competitive deep tech and life sciences. We took a stake in emerging growth stock investor Frazis Capital which had a stellar year producing returns over 100% with a keen eye on business quality and customer loyalty while remaining cognisant of the risks of lofty equity market valuations discussed elsewhere in this letter. And we made new PE investments in Barambah Organic Dairy and a technology company with a strong market position in the retirement sector.

Looking Ahead - and Words of Caution

The outlook is undoubtedly positive for 2021 notwithstanding the ongoing challenges of Covid. The combination of large fiscal and monetary stimulus, vaccines to defeat Covid-19, a return to global economic growth, low inflation and low unemployment by historical standards augurs very well for financial markets. The opportunity cost of staying underinvested and long cash looks high.

From a longer-term perspective however, risk is building and is now at unprecedented levels in the financial system.

2020 saw a 50% increase in major central bank assets and a 20% increase in world money supply, an unprecedented financial expansion. Money is now essentially free, meaning a lot of capital has little or no cost. With interest rates near zero or even negative, it is entirely rational for governments to borrow in scale to fund infrastructure development projects or even their operating budgets - annual debt servicing costs barely increase, so the blowout in public debt ratios is hardly surprising.

Conventional economics from the last century would say that two consequences will flow inevitably from money printing and a debt splurge: one, a surge in asset prices, and two, a resurgence of inflation.

The first has been evident to all.

The second is nowhere to be seen, and hard to see happening any time soon. Wage costs have shown anaemic growth relative to GDP for many years due to technology, the shift to automation, the casualisation of the workforce and reduced job security, which will only increase because of Covid. Oil prices seem headed on a long-term downwards trajectory due to the shift to renewables, which at least will be a positive force in reducing global conflict. And corporate pricing power and margins in traditional industries are being steadily eaten by start-ups funded by capital with no servicing cost and which are rewarded in their valuations solely on revenue growth, not profits - although somewhat counter-intuitively, the corporate profit share relative to GDP in several countries has been increasing, reflecting increasing industry concentration.

No one leading our global financial system - no central banker, national President, Prime Minister or Treasurer - knows where this journey into the financial unknown will end, or what is the exit strategy. That is not a criticism - the counterfactual of standing by while industries and jobs are crushed is not easy to defend. It’s easy to understand the choice of this path with all the short-term pressures on our elected officials and the wisdom of today’s central bankers gleaned from studying the mistakes of the 1930s.

But meantime, several potential consequences loom.

General investor risk awareness is diminishing, in the belief that asset prices are only likely to go ever upwards and that governments and central banks are committed to seeing that happen (with a few dips along the way). History suggests that when this mindset sets in, investor complacency and overconfidence grow. Lifestyles start to be funded, or leverage assumed, on the assumption that paper profits are permanent. Risk builds in the system in ways that are not immediately apparent. As the Queen of England pointedly observed, no one except for a prescient few saw the global financial crisis of 2007-8 coming.

With the compression in interest rates and long-term discount rates, today's investment returns are in many respects borrowed from the future. An increase in asset prices because long-term projected cash flows have greater value when discounted back to today's equivalent value using lower interest rates is a one-off and cannot be repeated, especially as interest rates converge towards zero. It's great for asset owners of our generation, less so for future ones or first home buyers today.

And the traditional vital role of financial markets in capital allocation, discriminating prudently between good and poor businesses, is incrementally relegated to the back seat as investor enthusiasm about "the next big thing" - called speculation in more sober times - becomes ever more pervasive. FOMO today is driving a loss of the sort of fundamental investor scepticism that's essential to preserving capital. Never before have so many insubstantial businesses been valued at such astronomical valuations.

There is a crude logic to this investor behaviour however - when money is free, why not punt on the next big thing that could be a 10 or 100 bagger, rather than a boring yield stock that might deliver 10% gains?

This is not just occurring in the listed markets. An epic bubble has developed in private venture capital. This may seem a surprising thing to say for a firm that invests in venture capital, but we tread exceptionally carefully with the mindset we're investing our money, not other people's. Many high-potential businesses will take decades or more to grow into the valuations they're being ascribed today, if they ever do prove they can survive, grow and make a profit.

All is often not what it seems with publicly disclosed valuations for early-stage private companies. Stunning headline valuations are often as much a function of enhanced investment rights for the most recent round of investors relative to earlier round investors than they are of the companies' commercial prospects. This is in a sense an inversion of traditional capitalism, as those who take the true early risks of a new venture - the real risk takers - often wind up with the worst deal. We've seen quality business founders being washed out financially by later stage capital that took little risk in building a business. That's dispiriting and confronting. It also means that many early-stage private companies are in truth worth nowhere near the big valuations disclosed publicly.

We are also conscious that current financial market conditions increase the risk equation for private equity. More money continues to be allocated to PE given the strong performance of the asset class over the past decade, but deals today are being struck at very high long-term multiples by traditional benchmarks. PE investors today are assuming medium term illiquidity risk for a projected gain on sale of a business by trade sale or IPO five years or so down the road. This assumes that financial markets will remain at least at today's elevated levels to provide those exits and investor profits. This is an uncontrollable risk which relies on the continuation of today's extraordinarily loose financial conditions. There is a good argument that investors in PE funds today are not being compensated adequately for that risk.

So it's a challenging time for investors in unlisted alternative assets, seeking a return premium for the illiquidity risk. It's essential to bring the A game. Investors everywhere would be wise to be exceptionally careful in this environment.

Reasons to be Cheerful Part Two

We're very mindful in everything we do of these elevated risks, but we're not pessimists, we think of ourselves as *conservative optimists* with a strong *instinct for capital preservation*.

So what are those reasons for optimism?

We see three in particular.

Firstly, there is little doubt in our minds that we are still only in the early stages in the rise of Asia. One recent analogy for China that we liked is that of a fully loaded plane which has just taken off and only reached 4,000 feet on its journey to 38,000. China today is only part way towards its urbanisation goals. It has shifted the principal driver of its economy from investment spending to consumer spending, a feat many leading economists thought impossible only a few years ago. It is embracing a competitive battle with the US to dominate the technologies of the future, quickly, or at least be a rival power in them. It is ahead of the West in areas central to modern life such as mobile commerce in a way that was unimaginable just a decade ago. It has only just begun to spawn companies that are little known in Western financial markets today but will be household names to our children's generation. And it is a rising tide that will lift all boats, especially in Asia given the preponderance of trade and investment that is intra-regional.

Secondly, the scientific and technological revolution underway is unleashing Schumpeter's forces of creative destruction everywhere. While this has adverse consequences for people in traditional industries who need to be supported in a sensitive and compassionate way, in the long-term it is a substantial positive for the world economy. These are the green shoots for the future. There is little doubt that the world benefits when talented young people show the courage to form new businesses, innovate and lead the transition to new growth industries rather than working their way up the ranks at a consulting firm.

Thirdly, while America has had its challenges (to say the least) in recent times and became almost unrecognisable to those of us who loved living and working there in the 1980s and 1990s under the sunny optimism of President Reagan, I say: don't bet against the Americans. Predictions of the structural decline of the USA are in my view premature. This is a country where reinvention is in the DNA. A recent report by the financial firm Jefferies on future growth sectors makes interesting reading. The fifteen sectors nominated by Jefferies as the engine for world growth in the next 20 years - AI, cloud computing, renewables, recycling, water infrastructure, cybersecurity, digital health, genomics amongst others - are dominated by American companies. Most barely existed ten years ago or were a fraction of their current size.

Reasons to be Cheerful Part Three - Australia

We believe the outlook is generally very positive for Australia. Despite the negativity that is so often felt in our country, Australia is in so many ways the miracle country. We have had economic growth 29 years out of the last 30. Our debt to GDP *exiting* Covid will be less than half the ratio with which a lot of other developed nations *entered* the crisis. Our low mortality rate from Covid will enhance our image as a clean and healthy country that's a great place to live and raise a family or just visit as a tourist. Good relations will in due course be restored with our largest trading partner, China - it's in both parties' interests. We have a social safety net that is the envy of many countries, yet taxes as a percentage of GDP are less than half of many major European nations. We have a robust set of institutions and democracy, although arguably too many layers of government with too short electoral time horizons resulting in blame-shifting, turf wars, a mismatch between incentives and accountability, and bureaucratic wastage.

Overall, while there are no winners from a global pandemic, Australia emerges in a very strong position and stronger relative to other countries than pre-pandemic.

From the standpoint of our sector and our business, recent years have shown it is possible to build a first class global funds management business from Australia. The rise of cheap, ubiquitous and high-reliability video conferencing is a clear structural shift in local and global business. It has shrunk the world even further and smashed the tyranny of distance that made it challenging in times past to build a world class fund manager from Australian shores. Full credit to Hamish Douglass, Macquarie, Industry Funds Management and Platinum in particular for showing what can be done. This is a good thing for Australian investors, giving access to a vastly larger and deeper pool of interesting companies and long-term economic growth. The next generation, including our team at Tanarra and fund managers in which we have invested, Frazis Capital and Continuity Capital, are keen to follow in their footsteps.

Finally, we believe Australian investors are well served by our industry funds and large member-owned superannuation funds. They have a multi-faceted positive impact on our economy and financial markets. They have the size and investment time horizon to provide long-term patient capital for businesses and industries of the future which create new jobs; they provide members with greater proportionate exposure to international assets than many local funds; they provide long-term nation-building capital for essential infrastructure projects that also provide Australians with growing dividend-paying investments; they're low cost; and are the leading source of fee pressure on the retail funds management industry which helps maximise net long-term compound returns to members. They are set to become a larger force in our capital markets, something to be welcomed not feared.

Tanarra - 2021 and Our People

For Tanarra, 2021 is shaping up as an important and exciting year.

We will be raising substantial second funds in both LTV and private credit as we have practically committed most of the capital from the initial funds in both.

We will be looking to raise a long-term investment fund in private equity that avoids the time-based problems of traditional funds with defined buying and selling periods. Warren Buffett did not become the world's best investor for decades by being an obliged buyer or seller during pre-prescribed time periods.

Our team continues to grow. We are blessed with exceptional people at Tanarra, and a positive, team-oriented culture that is nonetheless performance-based. I attach a photo profile of the members of our team.

We are delighted to have formed a global Advisory Board, chaired by the Hon Paul Keating, former Prime Minister of Australia. Paul is joined by Archie Norman former Chair of Lazard UK and current Chair of Marks & Spencer PLC (based in London); Melanie Brock Chair Emeritus of the Australia New Zealand Chamber of Commerce in Japan (based in Tokyo); Garry Weaven founder of Australia's Industry Funds Management and its successful global funds management operation; and Lindsay

Maxsted one of Australia's leading company directors and financial professionals. Another corporate leader with deep global expertise in technology and finance will also provide advice behind the scenes through the Board, and we look forward to her contribution.

Finally, we are incredibly proud of Lisa Kingman, Director of our pro bono charity advisory arm Tanarra Philanthropic Advisors (TPA) for being awarded a Medal of the Order of Australia in the 2021 Australia Day honours list. This is a richly deserved award. Through both her career and personal capacity, Lisa has made countless contributions to the not-for-profit sector and corporate philanthropy. Since joining Tanarra two years ago Lisa, together with Tom Forde and members of the Tanarra team, has done wonderful work through TPA. TPA harnesses the commercial skills and ideas of the Tanarra team to help charity leaders and boards develop sharper strategy and business models so they can achieve maximum impact and deliver the best possible social and economic outcomes. Over 2,400 hours of free business advice has been given to 72 organisations, equating to $1.3 million of donated Tanarra commercial time. Projects range from helping bring a $12 million ecotourism enterprise called **Wildlife Wonders** to commercial reality, enabling state school alumni charity **Ourschool** to become less grant dependent, to a strategic plan and new revenue cost model for The Aboriginal and Torres Strait Islander **Maths Alliance**. In 2021 TPA will launch a free Board Health Check available to every registered charity in Australia, with questions that will get past the usual bland politeness of these questionnaires and tease out the really important issues for organisational effectiveness. You can read more about **TPA's impact** here.

Well done Lisa and thank you for all the wonderful things you do for our country.

The Last Word

For those of you who have invested with us, we thank you for your support. We appreciate it immensely and enjoy the insights we get from you when we speak with you.

I finish with some simple hopes for 2021.

I hope the vaccines conquer Covid, quickly.

I hope America rediscovers some unity and its light on the hill, so it provides the leadership and example of the virtues of democracy that the world needs so keenly in an age of rising authoritarianism.

And in view of my recently concluded eight year tenure as Chair of the Australian Sports Commission, I hope that our remarkable young Olympians and Paralympians get the chance to achieve their dreams in Tokyo this year, for which they have trained and competed over the past four and a half years. To put the singularity of their opportunity into proper context, elite tennis and golf players have had by contrast no less than 15 opportunities to win the pinnacle events in their sports (the Grand Slam events) since the Olympic flame was extinguished in Rio de Janeiro in 2016. Our young Olympians and Paralympians are courageous and inspiring people, and fully deserve their chance.

Our very best wishes for 2021 to you and your loved ones.

John Wylie
Founder and Principal

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