

Transcript

The Ideas Exchange

Episode 11: Investing in disruptive businesses

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[00:00:01] **Introduction** Welcome to the Monthly Ideas Exchange podcast brought to you by ASX, the heart of Australia's financial markets. Each month we'll connect you to a range of leading industry experts, who'll give you a look into the finance industry and deliver valuable insights. Hear about important market events, industry research, tips for your own market research, as well as innovative products to help you diversify your investment portfolio.

[00:00:30] **Martin Dinh** Hi everyone, welcome to the Ideas Exchange podcast. In today's episode, I speak with Alex Pollak from Loftus Peak as we cover a range of very interesting topics, including what type of disruptive companies Alex looks out for, real life stock stories involving disruptive companies, how Loftus Peak are navigating rising inflation, and China's recent crackdown on tech firms and a whole lot more. So a great episode ahead. Let's get into it with Alex.

[00:00:56] **Martin Dinh** Hi, Alex. Welcome to the Ideas Exchange podcast. It's great to finally have you on today.

[00:01:00] **Alex Pollak** Great to be here.

[00:01:01] **Martin Dinh** Also happy one year anniversary. I worked on your products a year ago, but happy one year anniversary. I believe we've just reached that, right?

[00:01:08] **Alex Pollak** Yeah, yeah. Yesterday, in fact. And it's been a fantastic process, actually.

[00:01:12] **Martin Dinh** So today's topic is disruption. It's a theme that's been really popular with investors this year, and we've actually seen a record number of investors flock to ETFs that provide exposure to what I consider as disruptive themes, such as cloud computing, battery technology, hydrogen and clean energy. What we've seen is more investors have been looking to take advantage of some of these long term disruptive trends. So, Alex, I wanted to spend a bit of time today to learn more about the investment case for disruptive businesses, which I know that this is at the heart of the Loftus Peak team, as well as the Loftus Peak Global Disruption Fund, as you mentioned, which is an active ETF available on ASX. Now, Alex, I think a good place to start is to get a better understanding of disruptive businesses and I think a good way to answer this question is maybe if you could walk us through what sort of companies you look for or focus on in the Loftus Peak Global Disruption Fund?

[00:02:04] **Alex Pollak** Thanks for that question, Marty. So we're a disruption fund, we're not a technology fund. So, the way we always talk about how this works is to say that, you know, thinking about the car for argument's sake and the invention of the car 100 years ago, we've had 100 years of innovation in cars. You know, the first ones weren't that good, power steering, power brakes, great stereos, air conditioning, automatic transmissions, et cetera. And that's all part of innovation. And you know, loosely speaking, it's kind of an improvement in technology. We're a disruption fund, meaning that we buy companies that don't do that. We buy the companies that disrupt that 100 year model and essentially render everything that went before it obsolete. So the hundred years of cars was disrupted by the battery electric vehicle, which is changing the very architecture and delivery proposition of cars globally. And that's disruption. But it's not just disruption of the car companies, because all of those, you know, innovations in terms of automatic gearboxes and turbos, et cetera. Electric cars don't require any of that. So all of that technology, as it were, is swept away. It's disruptive. In addition to that, obviously, if the car doesn't run on oil or fossil fuels anymore, but runs on electricity, which is sustainably sourced, then the oil industry as well, the energy industry, as it stands, is also effectively disrupted. So we look for companies that are using the latest available tools in order to disrupt existing fifty, a hundred year models, and grow therefore much faster because they are on the absolutely most modern wave of tools to execute their business model. And that's how we've found some success.

[00:03:48] **Martin Dinh** Yeah, that's a good summary, Alex. And you know, when I think of the disruptive theme, I kind of think you can think of it in terms of either a small company that's, you know, fast and growing, it gets a lot of revenues, but at the same time, it's operating at a loss and does have a chance of going bust. Or on the flip side, I can think of a large company that's well-established, strong cash flows and less downside risk. But the downside is that it doesn't have the revenue growth potential like a small company. So I guess my question to you is, hypothetically, suppose you have these two disruptive businesses, one that can grow ten times but also has a chance of going bust. And then you have another one, this well-established company that grows 50 percent, but only 20 per cent downside, which is the one that you would pick and why?

[00:04:30] **Alex Pollak** It's not a hypothetical question, Marty. It's question that we deal with every day, and the answer is really simple. The biggest positions are reserved for the companies with the best returns, but the least chance of something going horribly wrong, and the smallest positions we own, we own in companies where things can go horribly wrong and that's why we own them at very small positions. So the thinking behind that simply put is, we have a return budget, so to speak, that we try to make every year, fifteen plus, whatever it is, we don't mind taking a couple of one or two per cent positions in the fund in companies that are more speculative without great cash flows, knowing that we've got 85 or 80 per cent of the company of the fund invested in these more... I won't say stable, but very well performing, big cap offerings that offer great safety. So the biggest positions are in the companies with the best risk adjusted returns and the smallest positions are in companies that can grow ten times. But we only have them at small positions because they only go broke. Tesla was a

company like that when we first owned it five years ago, it could have gone broke, so we only held it at a one to two percent position. And then as it rolled out and factories were built and they started to hit their milestones in terms of cars being created, we increased the position, et cetera, et cetera. So that's how we do it.

[00:05:55] **Martin Dinh** Let's turn to a practical example. So I did a bit of homework before this podcast, and I looked at your most recent portfolio disclosure for the Loftus Peak Global Disruption Fund, and I can see that your biggest position is currently in a company called Qualcomm, which I think is a company that creates semiconductors, software and services for wireless technology. And it looks like this company represents around 14 per cent of the portfolio, and it looks like you've held this company for quite a number of years. So could you go through some reasons why you like this company so much?

[00:06:25] **Alex Pollak** You're absolutely right. It is the biggest position, and we've held it all the way since around about \$50, or possibly even more. It's \$160 now, and we held it because of their absolutely dominant position in 2G, 3G, 4G and now 5G modems and chipsets for the mobile phone industry. It's completely fair to say that, but for Qualcomm, the mobile phone industry would not be a fraction of what it is today, and we held it at those weights because we saw, as the largest position, because we saw it's an absolute imperative that this company will be very much a part of the 5G rollout and internet of things and the inclusion of chips in automotive, in cars, et cetera, et cetera. And it's worked for us, and it was a company that was really actually quite cheap, in fact, really very cheap. And so for us, it held the most, the best risk adjusted return profile. In other words, it had a commanding, an important position in mobile technology, and its risks of going down were very, very minimal. And so it has been and it's really powered the fund in this year, you know we closed on 20 per cent return for the year to date, and Qualcomm is a significant part of that return. So exactly as you say.

[00:07:41] **Martin Dinh** You mentioned about 5G technology and Qualcomm, and we've seen a huge rise in demand from semiconductors, right? So that's been a good tailwind for companies like Qualcomm that focus on semiconductors. I read an interesting story just recently that some companies are looking to fabricate their own 5G chips. So that, I see, is a headwind against Qualcomm. So Apple is an example. What are your thoughts on that?

[00:08:03] **Alex Pollak** There's a reason that only a couple of companies in the world have been successful in rolling out 2G, 3G, 4G, 5G and Qualcomm has been one of those companies. It is not a trivial exercise, and I'll tell you how non-trivial it is, and I don't know whether you're aware of this, but Intel had a very large division, a couple of thousand engineers and a multi-billion dollar budget trying to do 5G modems for Intel, for supply to Apple. And in the end, they were not able to do it and they sold, actually really gave that division to Apple for Apple to develop the 5G chip itself. That should give you a clue as to how difficult it is, that Intel itself couldn't make a 5G chip, certainly not in time and not to the specifications that Apple wanted. Apple is now trying to do it itself, and we think that's fine. But the success or otherwise of Qualcomm doesn't rely just on Apple chips. There are

a number of pieces to that, you know, modems and chipset business for Qualcomm. And again, we have a model that says what it would look like if Apple was making its own chips and that's priced in, and it doesn't worry us at all to be honest.

[00:09:09] **Martin Dinh** So, Alex, you know, we've spoken about some of the companies that you look out for. So let's look on the other side of the coin. How do you determine when is the right time to sell one of these companies that you own?

[00:09:19] **Alex Pollak** We have a really disciplined DCF process. We don't operate on single period measures. That was a kind of start-up thing that we did when I was an analyst at Macquarie Bank for a number of years. We don't operate on those things. We operate on DCFs because DCFs really, I don't think anyone in finance actually argues this, DCFs are actually the appropriate way to consider the valuation of companies. And so it's very simple, when a company exceeds in its share price the value of our DCF, we will start trimming. Maybe not exactly on that day, maybe a month later or a week later or something like that but we will start trimming, and we may even sell out. When a company falls below our DCF valuation, and it's a 10 plus years discounted cash flow valuation that we do, when it falls below that DCF valuation, we will most likely buy it. Again not immediately that day necessarily, but we'll probably start to open a position. And that discipline of all the companies being put on the same, as it were framework, for valuation has really enabled us to be very analytical and precise in terms of the companies that we buy and sell. We leave money on the table. You know, we bought Tesla at one price. We sold it 10 times higher and it's since doubled from that point. But we're not uncomfortable about that because it went through our valuation and we can't hold a company that's through the valuation because it's not true to our process. And it's the process that we have is what's enabled us to generate these returns over the last seven years. So we're highly disinclined to not follow the process after all the success it's brought.

[00:10:56] **Martin Dinh** So speaking of Tesla, you've mentioned it a couple of times and you've actually answered one of my questions, which is great, about Tesla and you know why you've reduced that position and why you eventually sold out of it. And I'm not sure if this is a coincidence or not and feel free to correct me if not. But I noticed that when looking at your fund reports, Tesla jumped out of the report and then, you know, I think it was like a couple of months later, I subsequently saw Volkswagen, which is a company that I think is quite similar to Tesla. It's a producer of vehicles, and I believe that they entering the electric vehicle space. So I guess my question to you is what was the motivating factor behind buying into Volkswagen?

[00:11:33] **Alex Pollak** We are in Volkswagen. Quite simply, Volkswagen is the largest producer of motor cars in the world, at around 10 million units a year across a family of brands. They own Porsche, SEAT, Skoda, VW itself, Audi and a bunch of others and some truck brands as well. And the answer to the question is they have completely effectively marked an end by date for the production of all fossil fuel motors. They're pushed along by the German government in this, because the German government doesn't want to see VW go broke. They've

marked an end date, which is only a couple of years away, for the production of all internal combustion engine cars, and they have produced the first few hundred thousand of a modularised electric motor, with only a couple of dozen moving parts in it. It fits in a duffle bag, and they are on their way to producing 20 million of those units for one to three years production, so they have designed and built their own electric motor, it's modularised. The answer to the question is because the electric motor, if you think about an electric car, it really doesn't have anything like the number of engine parts that an internal combustion engine has. I mean, you know this because when you open up the bonnet where the motors supposed to be, there's nothing there. You can put your luggage in there just like you can put it in the back, so all those parts are gone. So what is clear from watching the Tesla margins, is that the margins for electric cars are going to be significantly higher and particularly for a scale producer like VW. People think that Tesla will get to 10 million cars in 5 or 10 years, we think that VW will get to 5 or 10 million electric cars in three to four years. That's why we're playing it for the economies of scale that come to that. So we're very excited about that investment, actually. We don't hold a big position in it because, you know, we're still working through some issues, etc. But that will be the scale player we believe.

[00:13:34] **Martin Dinh** Yeah, some interesting insights there, Alex. Continuing on the topic of cars, I looked at the entire holdings of the Loftus Peak Disruption Fund and I noticed that there was a company that wasn't in there, Uber. You know, in my view, I think this company, Uber, it seems to fit the profile of a global disruptive business. You know, it's revolutionised the transport sector, you know, such as taxis. I can't remember the last time I ordered a taxi. Only a couple of days ago, I ordered Uber Eats. You know, it's really changed that whole transport sector. So I'm curious, how come you don't own Uber in the portfolio?

[00:14:09] **Alex Pollak** That's a very good question, Marty. We don't own it because for the longest time, it was just a rideshare company and there were plenty of rideshare companies coming, Didi, Ola, Grab. Then there was a whole bunch of stuff going on around rideshare safety, et cetera, et cetera. And it required a pivot on the part of Uber into things like eats and food and a bunch of other horizontals as well. To be honest, we sort of think of it as a company in search of a business because there's plenty of eats businesses. I mean, there's Menulog and DoorDash, and there's a stack of them. So, it's a very low barrier to entry space. The rideshare business itself is a low barriers to entry space, and so we were never really all that comfortable with the amount of pivoting that the company had to do. And if you look at that business, it's a very, very different business from a number of the other things that we hold, which have much more concrete holds on the business that they're actually rolling out. So, you know, we could have made money out of Uber, but it didn't really fit. We can't make money on everything. You know, we have to choose the 30 best companies, so to speak, and they just didn't make the cut. That's not to say anything about Uber. I think they've done a great job frankly, pivoting as fast as they did, but it didn't make our metrics. So we didn't

[00:15:34] **Martin Dinh** Don't worry Alex, you've won me over. So, Alex, there is a part of the portfolio, and this is going to be, I think, a bit of a curve ball. There is a

part of the portfolio we haven't covered and that's really your exposure to China, which I believe is a key theme in disruption. You know, given China's size and its power. You know, looking at the portfolio, I believe the portfolio has 10 percent exposure to China. You hold positions in companies such as Alibaba and Tencent. So I was curious, you know, there's a lot of going on with China, you know, with Evergrande, that default and in particular, the Chinese government looking to crack down on some of its largest companies. You've mentioned Didi, that's one example, Tencent as well. What are some of the potential impacts of the situations of all these events occurring on your portfolio?

[00:16:19] **Alex Pollak** Terrific question. By the way, we're no longer at 10 percent. We've significantly cut that position, in fact it's under half that, and we cut that position for a very simple reason. We used to hold 25 percent of the portfolio in China stocks. We made great returns out of that for a number of years. The Politburo Chinese Government has basically said... And I have no argument with this right, this is just the way it is. They have said that the cult of the entrepreneur is not appropriate under the Communist Party system. So what they are saying is more of the return that's generated by these companies has to come back to the Chinese people and the Chinese Government, and less has to go to the shareholders. Well, we were shareholders. So as that rhetoric became increasingly the case, what it actually did is that it raised the discount rate for us. It forced us to raise the discount of Chinese investments, that lowered the valuation. And we started selling and sold quite a number of them. So the answer to the question is, Chinese Government changed the bargain away from the shareholders, us, towards the people of China and that's fair enough. But it meant that it was no longer as attractive as it had been.

[00:17:33] **Martin Dinh** About to throw you another curveball. One of my favourite topics and something that seems to pop up in the AFR every day, you guessed it, it's inflation. Hot topic at the moment for many investors. And you know, while central banks such as the RBA and the Fed, they've been pretty adamant that inflation is transitory. You know, once those supply shocks have resolved themselves, inflation will be within that target. But they don't think interest rate rises will occur until sometime in 2024. But, you know, it's been interesting watching the battle between the RBA and investors. Investors seem to think otherwise. Bond yields at record highs, leave a 10 year Treasury bond reached its highest yield since pre-pandemic. So I guess my question to you is, you know, with the current rising inflation and pressure, you know, and because you use that DCF model and likely if inflation rises, you'll have to apply a higher discount rate, are there any themes or sectors that you're either avoiding or considering, Alex?

[00:18:25] **Alex Pollak** You're absolutely correct. The rise in inflation means a higher discount rate and a higher discount rate results in lower valuations. But the most important part about that is that it results in the lowest valuations on the companies with the most risk. The companies with the least risk, in other words, with earnings that are close not far, have the least negative impact. So in this environment, our approach with respect to rising inflation is to push towards companies with good and growing cash flows over companies that have got very long duration business models that might take 5 to 10 years to emerge. That's not

to say that we won't still hold a couple of these businesses at low rates one or two percent, but the best protection against inflation, well, real estate is one, gold is another, maybe. But then if you're going to be in the stock market and returns in the stock market are traditionally good. If you're going to be the stock market then the best place to be is at the companies with the best business models. They will outperform those because they'll have less medium term impact from a rise in interest rates. Plus, they're not borrowers. The best companies are not borrowers, and they don't really require any equity funding either, so they are not likely to be diluted. I mean, Amazon, Apple, you name it, they haven't had an equity issue since they listed. So I'm not just saying we're in those companies, although we are, obviously, we're in a stack of others besides. But there are, Qualcomm is a great example, right? Qualcomm hasn't had an issue in, I don't know, 10, 15 years. So we think it will weather an inflationary spike better than companies that say, don't have earnings for three or four or five years from now.

[00:20:10] **Martin Dinh** So inflation isn't keeping you up at night?

[00:20:14] **Alex Pollak** No. I mean, it's definitely something that we are thinking about a lot, but we've managed through Trump, rising bond yields, chip shortages, China problems a few years ago with the trade wars. I mean, we managed through all this stuff and we generate return notwithstanding those problems. So we will manage through it. We're actively moving the portfolio right now, literally overnight and have been for a number of weeks to manage for this.

[00:20:46] **Martin Dinh** Alex, it's been a really insightful conversation, I've learnt a lot today and hopefully our listeners have learnt a lot today as well. For anyone here that's looking to follow your work and learn a bit more about Loftus Peak and your active ETF, can you tell us where they can go to?

[00:20:59] **Alex Pollak** Yes. Well, the active ETF and the code is LPGD - Loftus Peak Global Disruption, is available on the ASX. You just type in 'LPGD' and you buy it just like you buy a share. So what we say to people is, if you want access to Qualcomm or Apple or Roku or any one of the 30 different stocks, you could go and buy them yourself, sure, and that would be terrific. But you could just buy one security and all the stocks are in there in one go and got exposure to it, and that's good. We do a little bit on LinkedIn and the website itself, loftuspeak.com.au, has lots and lots of resources that explains who we are and what we think. Plus it's got seven years of return data, et cetera.

[00:21:44] **Martin Dinh** Alex, that pretty much wraps up this month's episode. Again, happy one year anniversary. Thanks for coming on and having a chat. Hopefully, we can do this again sometime in the future.

[00:21:52] **Alex Pollak** Thanks, Marty. Really appreciate it.

[00:21:56] **Martin Dinh** Well, I hope you enjoyed my chat with Alex and learnt a bit about disruptive companies, as well as the investment case for these type of companies. In next month's episode, I'll be joined by Morgan Potter and Gordon Reid from Nine Mile Financial, who are one of Australia's key market makers in the ETF ecosystem. As we learn more about a common question that we often

get from investors, who in the world are market makers and what do they do? Until then, stay safe and we'll see you next month.

[00:22:26] **Outro** Are you keen to learn more? Why not visit the ASX blog? [Asx.com.au/blog](https://asx.com.au/blog) for a wide range of articles, videos and insights from ASX experts, listed companies and investment professionals.

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