NORDIC INVESTMENT PARTNERS

June 2022 update

Major valuation contraction in first half 2022

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Review of first half 2022

2022 is already characterized as a bad investment year. It's the worst start for a year since 1962, but having been long enough in the market I recall some pretty nerve wracking episodes in 1987, 1992, 1997, 2001, 2002, 2008, 2011, 2018 and 2020. It happens every now and then. And most often the period after bear market is a bull market with solid returns.

Bulls walk up the stairs, while bears take the elevator down and the average bear market only last 1/3 of the average bull market.

MSCI World AC peaked late 2021 and is down 21% and it's taken 7 months. The rebound from late March 2020 lows took 21 months, hence confirming the old timer observation.

Major valuation contraction in 1H 2022

Higher interest rates reduce the net present value of future earnings and vice versa.

In 2020-21 when central banks sprayed global with capital, interest rates plunged to record lows and companies with great promises of the future saw significant price increases

Many of these future promise companies have collapsed; Since their peaks Beyond Meat is down 90% and Zoom Video is down 81% just to name two.

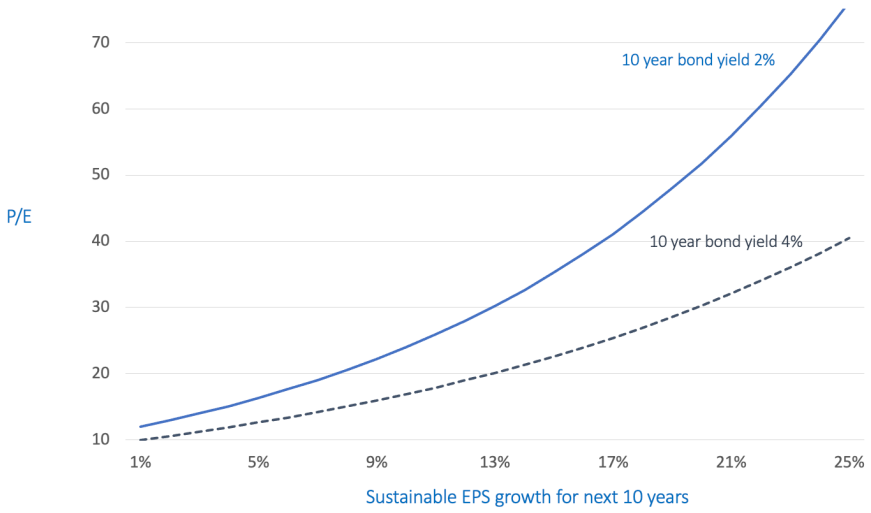
The impact of higher rates is significant for growth companies (fig 1) as the high growth company will see 50% valuation contraction while a slow growth company will only see 10% valuation contraction based when rates increase

Earnings estimates for 2022-24 are almost unchanged over the past 4 months, so the 2022 stock market performance can mainly be explained by the valuation factor. Provided earnings estimates do not change much i.e no deep recession just ahead, then the total shareholder returns should be good in 2023 and 2024

There's a lot on moving parts in the forward picture. And no-one has a clear picture. I've read comments that have good arguments for all over the spectrum. And it reminds me of the 2018 recession that never materialized.

If and when inflation start to fade there's likely to come a sigh of relief provided we're not in a deep recession at that point in time.

Fig 1



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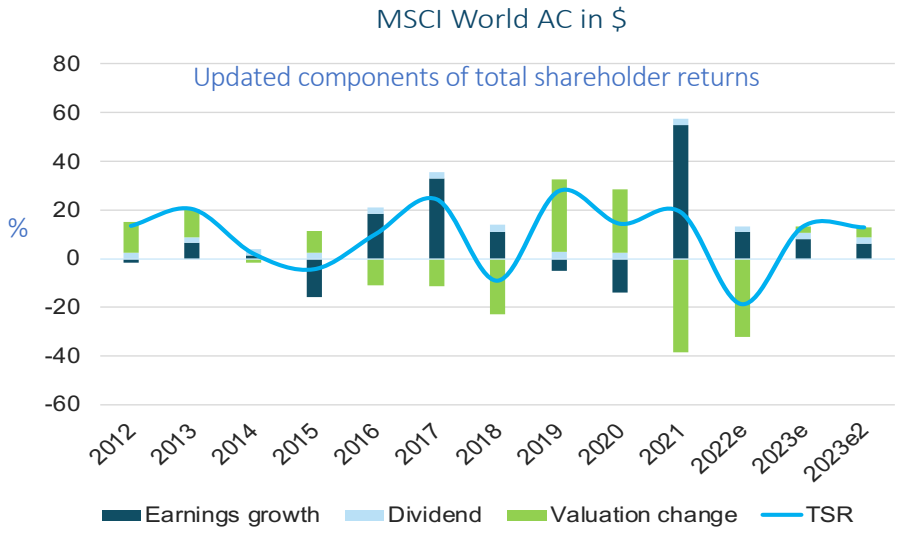


Forward earnings

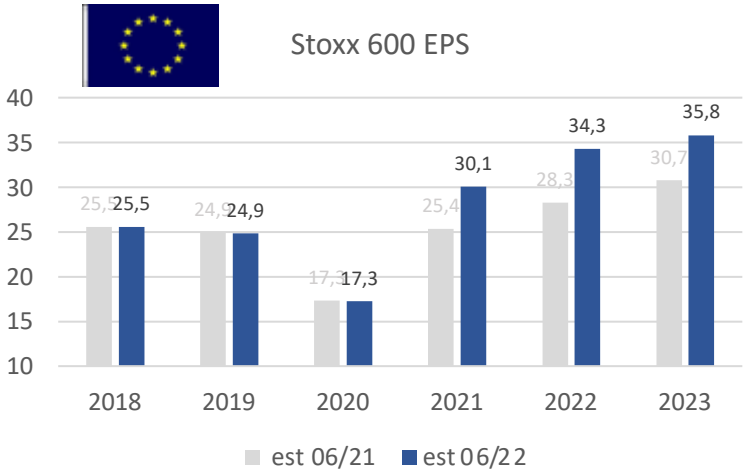
Since summer 2021 corporate performance has exceeded expectations and subsequently earnings estimates for 2022 and 2023 has been raised.

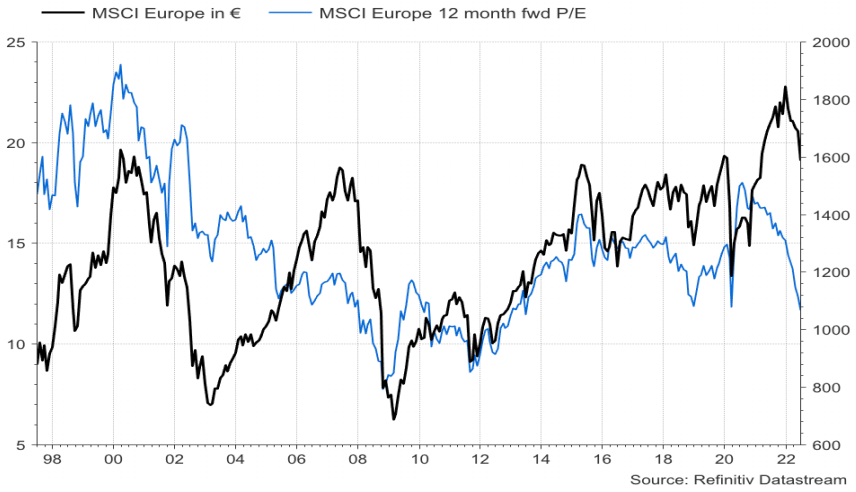
Corporate guidance after the 1Q 2022 performance updates was modest in many cases and by late June 2022 that was prudent.

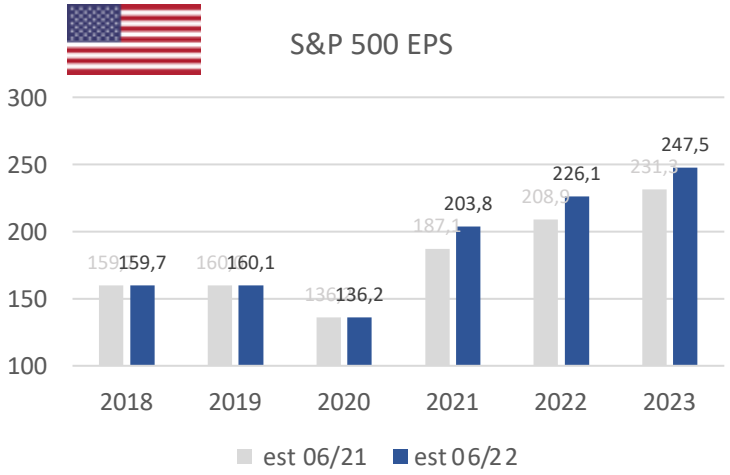
Global activity seem to be cooling down and yet employment and consumers cash reserves are almost as strong as ever. Hence a cooling down period could be short-lived (a mild recession with 1% fall in activity for a few quarters) or it could be longer (a deep recession with more than 3% fall in activity).

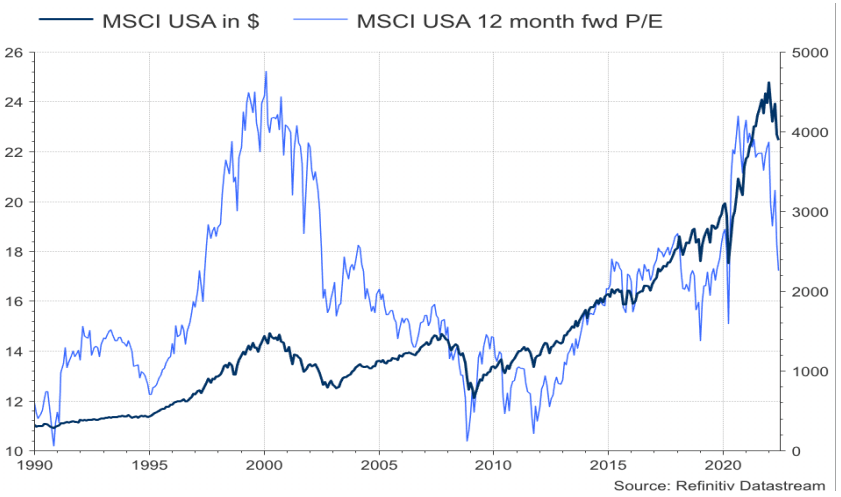
Its very uncertain how this will unfold for the rest of 2022 and into 2023. However good corporate and consumer health should be able to modify a setback.

Some of the better profitability observed since 2020 comes from less business travels and expensive industry fairs. This is expected to normalize but profitability will decline only marginally due to this factor









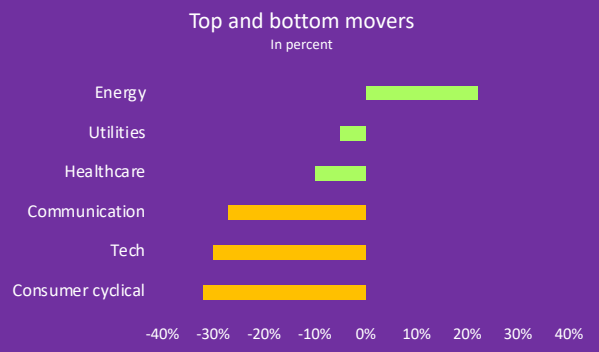
Sector update

2022 is already characterized as a bad investment year. Stock prices are down and same for bonds.

The 2020-21 period was however very unusual due to Covid- related lock downs and very aggressive governmental support and easy monetary conditions. Those conditions inflated stock prices and in 2022 they have just normalized and with the help from higher inflation stock are much better valued today

Earnings estimates are up in 2022, so the stock price decline is mainly a valuation move. And unless earnings decline or interest rates rise significantly then the growth sectors should start to perform in line with their earnings growth

2022 performance for selected sectors (in USD)



What will be the growth pockets of the 2020s?

In early 2000s the tech sector was 15% of the total market cap in USA and operating at 5% EBIT-margin. In 2022 it's 25% weight, but with 25% EBIT-margin. The huge outperformance of US tech especially the last 10 years is hence driven by fundamental performance.

And it's not likely to stop. Just to mention one area; on-line shopping is about 20% of total consumer sales. In the coming decade(s) the share of on-line shopping will not decline. It will increase with better and easier customer interface, omni channel, digital universe experience and not least easier and faster deliveries.

The CEO of Palo Alto, the cybersecurity company that the fund has been invested in, said it this way; by 2030 more than 50% of all business will be digital some way or another and it will continue to go up.

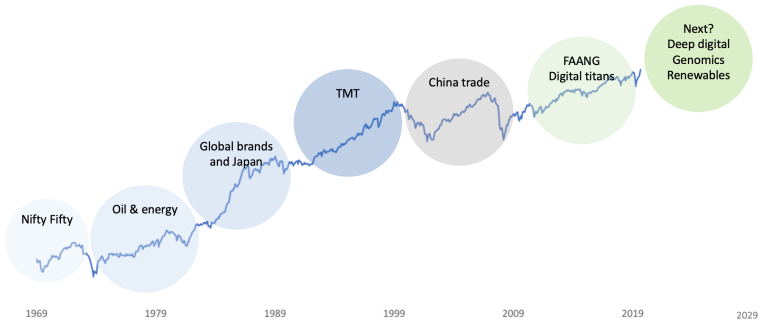
Since the start of the current decade the best sectors have been EV's, renewables, semiconductors and energy. This could well be the outperformance pockets for the rest of the decade. The loosers have been real estate, telecom and travel. The last due to Covid lock downs.

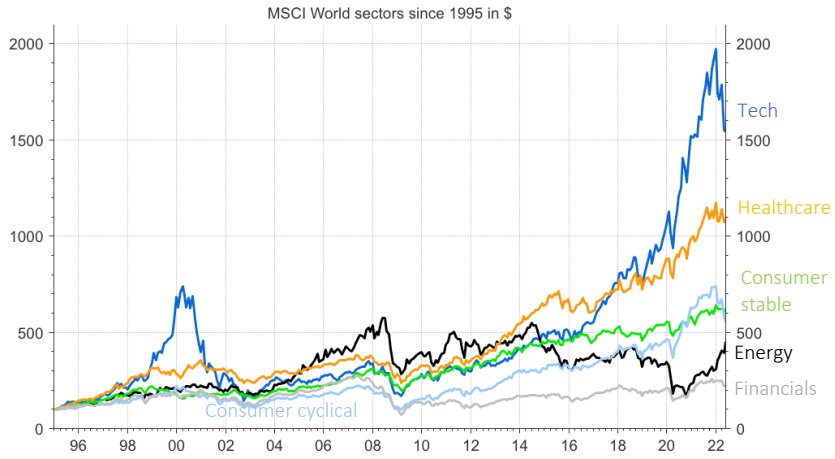
The big question is if oil & gas with very strong performance in 2022 will continue in the lead for several years. Renewables will not be able to replace fossil fuels in this decade and fusion energy is even further out in the future, so oil & gas could be in for a multi-year sprint like in the mid-2000s and 1970s

Renewable innovation moves on and a wise colleague once said; 'the stone age didn't end due to a lack of stones', so accelerated renewables build-out could end fossil fuels current advance

Stock market leadership in the past

Each outperformance pocket is characterized by much higher relative earnings growth





Semiconductor update

The semiconductor stocks are down 38% in 2022 and hence being the worst performing industry this year.

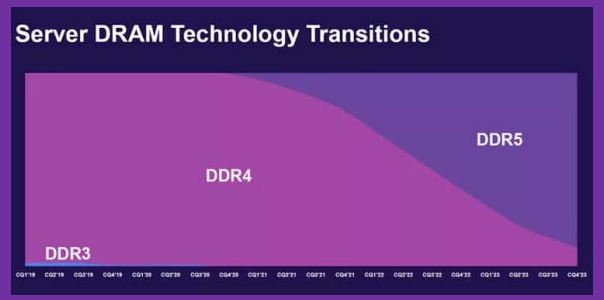
The narrative is that the lock-down motivated boom for new PCs, game consoles and supporting data-centers in 2020 and 2021 will vaporize in 2022-23 just a new capacity hits the market.

There's weakness such as global PC sales going from 340 million units in 2021 to 300 million units expected in 2022.

At the same time large players like Intel, Samsung and TSMC are investing massively in new foundry capacity (making chips for fabless chip makers like Apple M1 chip or Nvidia)

The long term has not changed and the weakness is not in all segments.

Memory chip transition to 5th generation will likely lift profitability



Are we heading into a semiconductor slowdown? If yes, it might already be priced in

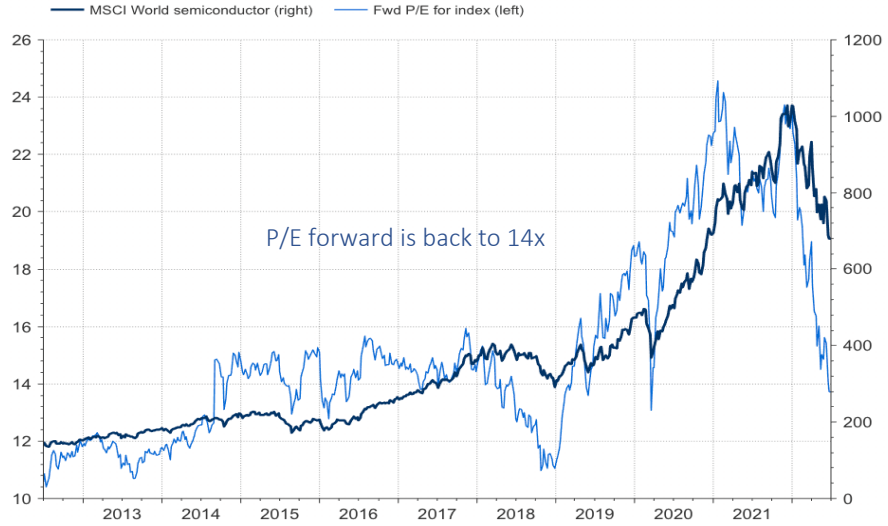
The global semiconductor industry has total revenues of around 625 billion $ or 0.6% of the global GDP. The on-going grind of digitalization means it will be 2-3% of global GDP in 2040ish and hence a solid long term value creator.

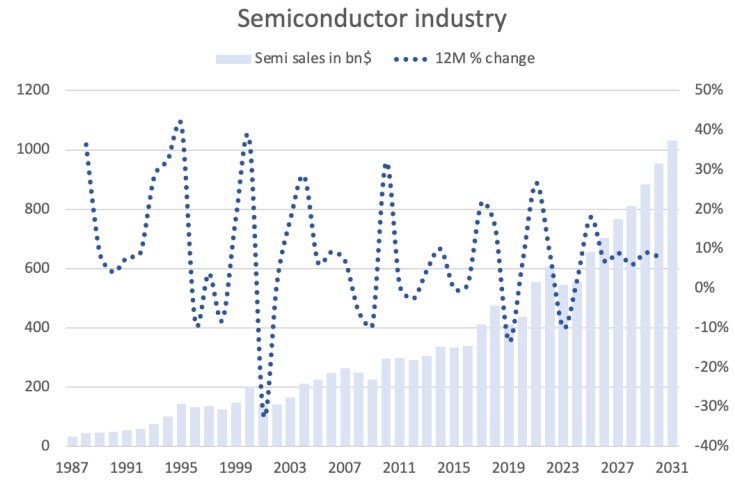
The surge in demand in 2020-21 and subsequent capacity additions has made investors nervous and sent stocks prices down. The latest updates from the companies do confirm softness in consumer electronics, but not in data center, AI or auto

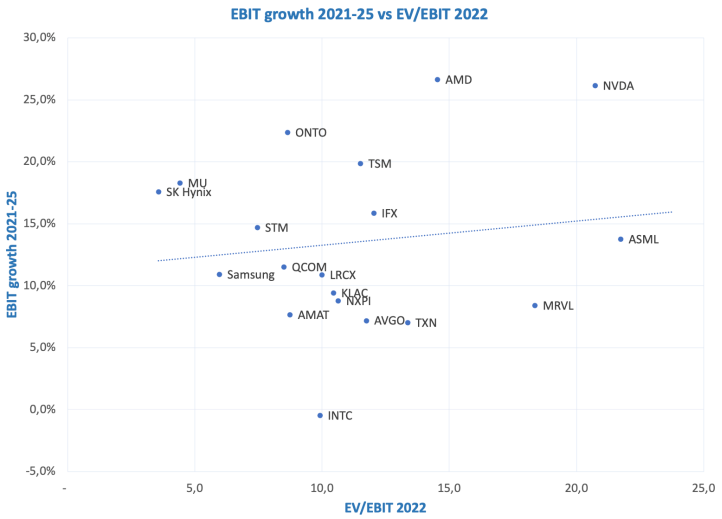
Automotive, Cloud data center and memory continues to grow at 10-25% per year towards 2025 according to Gartner, WSTS and the like.

To test stock price sensitivity I ran a 2023 slump of 10% followed by a 2024 rebound (figure 1) . For memory makers like Samsung and Micron it didn't change the fair value much as the stocks are already trading at very low valuations (see figure 2), while for hyped stocks it could be an issue

The signifant run in semiconductor stocks since 2015 is largely explained by a handfull of large cap technology leaders such as ASML, Nvidia and AMD.







2022 surprises

The fundamental volatility the world consumption and supply chains got exposed to subsequent to the outbreak of Covid is unprecedented.

The retail sales illustration to the right almost looks like a EKG for heart monitoring. If a EKG patient gets the volatility to the right all doctors and nurses would be alert. They are however trained in how to stabilize the patient, while the global supply chains are not trained for this.

Global supply chains are getting better and the 'patient' will eventually normalize. And global supply chains will be more robust in the future, just not yet.

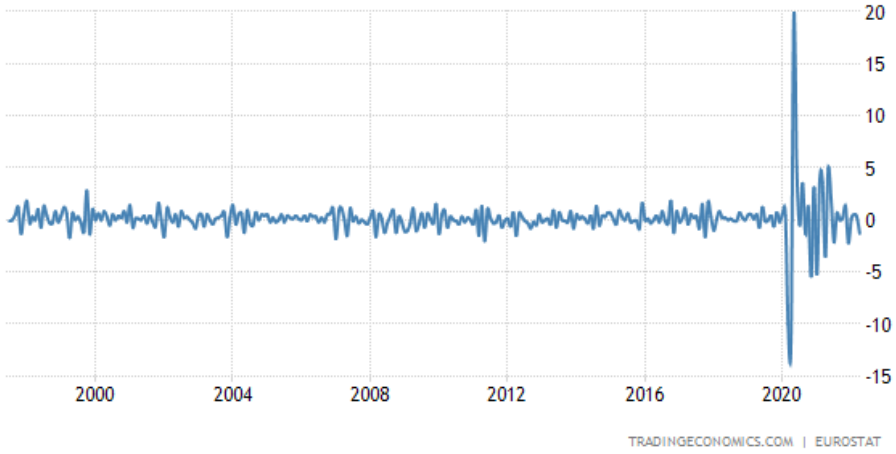
In the meantime, central bankers and politicians are working to kill too high inflation and Mr Market has taken the view that we are somewhere in between the two event surprises in the table to the right.

In periods like this good companies are put on sale, so it's a good entry level provide we do not move into a multi-year deep recession

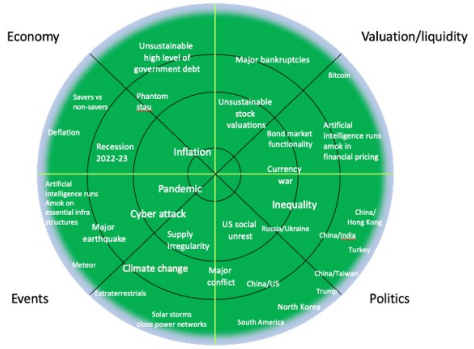
High sales volatility has disrupted supply chains and caused inflation

Its been a very confusing period for consumers, corporates, policy makers and not least the stock market. Roadmaps are never correct, but in the 2022 roadmap there was a section that to some extend describe what we're seen in 2022 so far. Barring a deep recession, we're at attractive entry levels

EU retail sales month on month change since 1997



Risk radar 2022 from December 2021



From Risk radar 2022 negative surprises section

Event	How it unfolds	Action plan
Stocks decline 10-15%	Inflation keeps running at 3-5%, central bank tightening and fear of an earnings recession due to higher wages and continued supply chain disruptions	10-15% correction occur almost every year. All the new investors since 2020 have not tried it before and get afraid. As they run for the exit. Pick up good exposures at good prices
Stocks decline 20-30%	Central banks slam the brakes and stocks tank as you suddenly can get 5% return on a 10-year bond	This will happen slowly at first and then fast. Move a larger portion to cash. Once there's 25% fall and the media narrative is ultra negative. Then you start to redeploy the cash

An observation

Value investment style is said to generate superior investment returns. That is correct if you start in 1970.

Accounting before 2000 was less transparent, so to be better able to compare Growth vs Value a shorter data series from 1996 shows another picture

Including dividends the two investment styles perform more or less in line most of the time.

Companies that grow consistently and profitsbly tend to serious outperform and as such they get highæly valued and moved into the Growth category.

In 2022 companies like Meta Platform (former Facebook) and Netflix has been demoted to Value. That's a good opportunity for GARP investors such as AC Vision Fund.

Over the last months the fund have increased exposure in quality compounders at reasonable prices such as SAP and Simcorp

Style performance since mid 1990s

One more thing

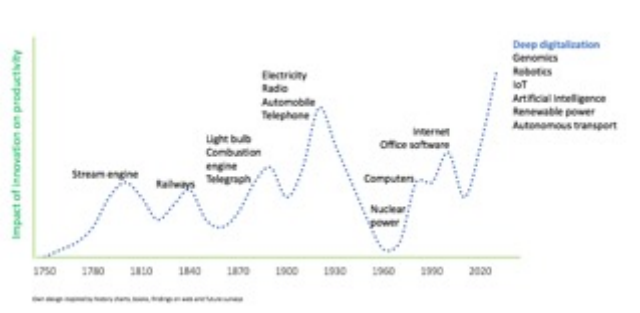
Human innovation has completely changed the Earth over the past 200 years.

Better healthcare, living standards and communication has made Earth smaller and the human population will soon reach 8 billion.

The way humans used to use Earths resources is unsustainable hence there's a big need for innovation in renewable energy, recycling, farming and transportation as well as digitizing almost anything.

It can be quite time consuming to invest in these trends and that's where the strategy fits in.

The fund aim to generate more than 10% return per year via prudent investments in structural growth companies and trends



Key investment view towards 2035

Economic pace since 2010 have been highly dependent on fiscal and monetary stimulus provided in the aftermath of the 2008 crisis. The stimulus have however created imbalances such as government debts. This will probably continue even as it gets beyond sustainable in some countries. Some region run large surpluses and more than enough to finance the government deficits elsewhere. A shift of power is happening at glacial speed.

Global economic growth has been declining from 6% in 1960s to around 3% in 2010s. Productivity and population growth points towards lower economic growth in the coming decades. The underlying growth in global affluence will however continue and with Emerging Markets will be in lead as those economies grow double the speed of developed markets. There will be pockets of innovation growth and that's where Nordic Investment Partners focus the research that is used by AC Vision Fund

There's nothing wrong with modest GDP growth, but many investors have been accustomed to 8% annual earnings growth, while the realistic forward growth towards 2035 is more likely to be around 4%. Dividends of 2% comes on top. Annual swings are likely to remain in the 15-20% interval, so the occasional declines will continue, but recoup times will be longer

In an investment world with that overall outlook Nordic Investment Partners have since 2017 focused on identifying companies and business clusters with unique multi-year structural growth drivers and then invest in these when growth/profitability/valuation triangulation justifies it. The strategy avoid long term sun-set industries despite some of them are deep value from time to time. Advice Capital Vision Fund use this investment method and perspective

The traditional business and inventory cycle still applies, so from period-to-period growth and inflation will change. In a world with evermore data and analytics the efficiency of eco systems will likely reduce the magnitude of economic swings as end-to-end value chains reduce slack and inefficiency.
Risks of financial mis-allocation of capital is the same as humans tend to run in flock

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