August 2023

Calypso Strategy Special Report

Dear Fellow Investors,

Time flies! It is August again, the time of the year when we typically write our special report. Indeed, this time last year the picture in the markets looked completely different to today. One of Wall Street's infamous proverbs - the market does what it needs to do to prove the majority wrong - came true again. As we write this letter, the Fund returned +2.26% in July 2022, bringing its total incline to approximately +8.40% for the year. The last 2 years have been to say the least an emotional rollercoaster for investors. For the first 6-months of 2023, the S&P 500 gained a whopping +15.91%, the second-best first half of this century. However, given the index's decline of -19.44% in 2022, the S&P 500 is still down -6.63% over the last 18 months.

Since the beginning of 2023 most professional forecasters predicted a "doom and gloom" global scenario, for the year and have missed out again. In 2023, a Bloomberg survey of Wall Street strategists showed a negative S&P 500 target for the first time since its inception in 1999. Rather unsurprisingly they still get paid a lot of money for not being right most of the time. Warren Buffett got it (again) right when he said: "Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."

Equity Markets continued to demonstrate strength in the second quarter and are up robustly year-to-date. We underline three factors that have supported markets are:

- An expected recession that has not materialized
- The hype around artificial intelligence (AI)
- A pause in interest rate hikes by the FED

However, the recent rise in US market cap concentration has been the steepest on record based on >60 years of history to the extent that Nasdaq announced special rebalancing for the Nasdaq Index to address overconcentration by capping and redistributing the weights among the individual index constituents. The last time such an event happened was back in 2011. The peak in this concentration episode could coincide with a diminishing interest in the AI theme.

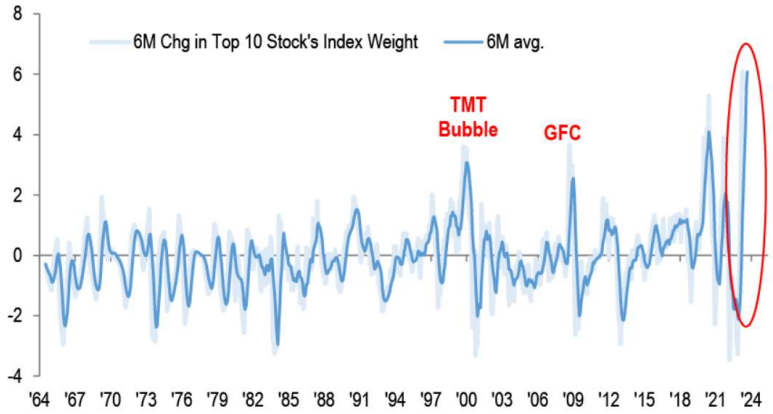

Exhibit 1: The recent rise in market cap concentration had been the steepest on record in 60yrs.
Source: JP Morgan US Equity Strategy

We are still mindful that rising rates could lead to slower economic growth or even a recession. However, we remain confident that our Portfolio is well-positioned to deliver strong earnings per share (EPS) growth this year and beyond.

The case of NVDIA

NVDIA was a relative headwind to our Portfolio as unfortunately we do not own this "AI darling." NVDIA shares increased a staggering 2.1x[1] for the year at the time of writing. NVDIA supplies graphics processing units (GPUs), which are necessary semiconductors for machine learning and AI. Management recently announced that they expect a significant increase in GPU demand for data center customers beginning this quarter and lasting at least through the end of this year. NVDIA's data center business, which has grown from nothing - eight years ago - to $16Bln p.a., is now the company's most important business. NVDIA has substantial competitive advantages around its technology, because of its full-stack solutions, highly integrated hardware, software, networking equipment, and developer ecosystem.

Nevertheless, with a $1 trillion valuation, many things must go right for NVDIA shares to further advance. With all the hype around AI, it is challenging to know how sustainable the demand for NVDIA's technology will be. NVDIA has positioned itself as a significant and advantaged winner, but to what degree? NVDIA is seeing strong demand for its AI chips as large cloud service providers and consumer internet companies must build the foundations of AI capabilities utilizing GPUs as the base "ingredient." However, consumer applications using AI are still in the very early stages. Companies know they need to build AI into their offerings, but most need to know exactly how or how much it will cost. According to another portfolio holding, Accenture, about half of their large enterprise customers cannot meaningfully deploy AI because of the architecture of their data stack and IT infrastructure. Interestingly, AI engagements account for less than 1% of Accenture's revenue today. Most recently, they announced that they would double AI talent to 80,000 people "to accelerate clients' reinvention" (of IT architecture) and adapt to technological change.[2]

Portfolio Activity during the 1st half of 2023:

During the 1st half, we bought three new positions: IBM, Corteva, and Checkpoint Software, while we added to our position in UnitedHealth. To fund these purchases, we sold out of KKR, Johnson and Johnson, FedEx, and Markel Group whilst we halved our position in Ecolab. Whilst we have made a range of other smaller adjustments to the size of other existing positions.

Portfolio Positioning as of July 31st[3]

- Index Shorts (S&P500 and Nasdaq): ≈ 20%
- Long Exposure: ≈ 82%
- US Treasuries/Cash: ≈ 20%
- Net Equity Exposure (beta adj.): ≈ 62%
- No. of Stocks: 44
- Largest revenue and domicile exposure: U.S.

[1] 9th of August 2023
[2] Accenture Newsroom, https://newsroom.accenture.com/news/accenture-to-invest-3-billion-in-ai-to-accelerate-clients-reinvention.htm
[3] Figures are approximate and unaudited.

Our factor correlations (betas) can be seen below:

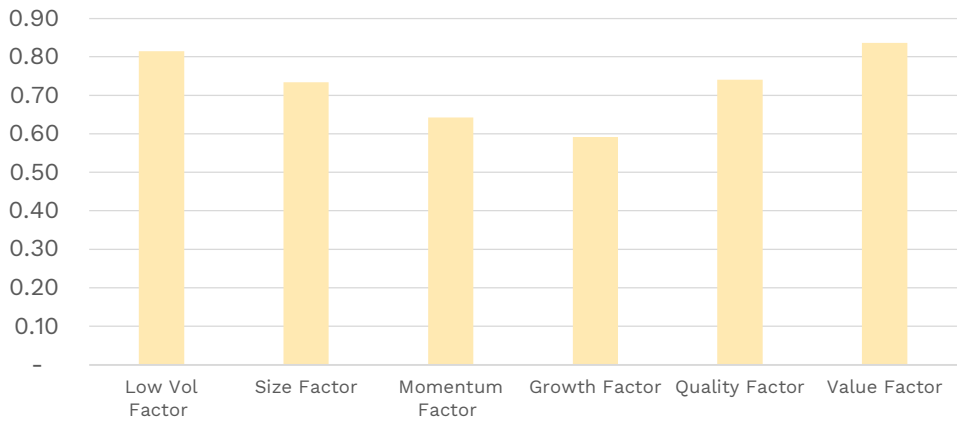

Exhibit 2: Portfolio positioning in relation to factor proxies.
Source: Bloomberg, FAM Analytics

In the next sections, we provide more details on one of our new positions in the portfolio.

Firewalls to the test...

Checkpoint Software Technologies is a cybersecurity business founded in Israel (Ramat Gan) in 1993. Its legendary founder and CEO Gil Schwed is largely seen as the "inventor" of modern computer firewall.

Since 1993, Checkpoint has continued innovating while keeping its margins and debt level at bay. Increasing global connectivity and introducing AI have resulted in a proliferation of cyberattacks, causing yearly trillions of dollars of damage. According to Fortune BI, the Cyber Security market is forecasted to grow at a rapid 13.4% compounded annual growth rate and be worth $376 billion by 2029, while McKinsey & Co. argues that available commercial solutions do not fully meet customer demands in terms of automation, pricing, services, and other capabilities.[4] At approximately 10 percent penetration of security solutions today, the total opportunity amounts to a staggering $1.5 trillion to $2.0 trillion addressable market. McKinsey argues that this does not imply the market will reach such a size anytime soon, but rather that such a massive "delta" requires providers and investors to "unlock" more impact with customers by better meeting the needs of underserved segments, continuously improving technology, and reducing complexity. Such may, in turn, pose a unique moment in time for innovation in the cybersecurity industry.[5]

Checkpoint's portfolio includes:

- Quantum - network security
- CloudGuard - cloud security
- Harmony - endpoint and access security
- Horizon - unified management and security operations

Increased encrypted traffic in recent years has increased the importance of SSL inspection. According to ZScaler, encryption can hide data exfiltration, and 54% of advanced threats hide behind SSL. Similarly, traditional firewalls were not designed to decrypt your traffic.

[4] Fortune BI on the Cybersecurity market size, RID: FBI101165, https://www.fortunebusinessinsights.com/industry-reports/cyber-security-market-101165

[5] McKinsey Cybersecurity Survey 2021, https://www.mckinsey.com/capabilities/risk-and-resilience/our-insights/cybersecurity/new-survey-reveals-2-trillion-dollar-market-opportunity-for-cybersecurity-technology-and-service-providers

SSL inspection is processor intensive, most firewall appliances can not handle it, and performance grinds to a halt when they try.[6] SSL[7] inspection is processor intensive, and most firewall appliances need help to handle it. In comparison, ZScaler Cloud Firewall is built upon a scalable proxy architecture that can conduct SSL inspection at scale. Fortinet may be better placed than Checkpoint in this regard, as Zero Trust Network Access (ZTNA) is built-in in its hardware (Forticare), and using ASICSs with hardware accelerators enables SSL decryption at scale.

Perimeter 81 acquisition may be the game changer for Checkpoint.[8]

Checkpoint recently announced the acquisition of Perimeter 81 for $490 million for its SSE solution. Perimeter 81 combines cloud and on-device protection in its SSE solution and offers capabilities like ZTNA and full mesh connectivity between users, branches, and applications. Perimeter 81's technology will be integrated into Checkpoint Infinity architecture.

	The Good					The not so Good
Company	EV/EBIT DA	Free Cash Flow Yield	Profit Margin	Net Debt ($Mln)	P/E 2024	Revenue Growth YoY
CROWDSTRIKE HOLDINGS INC - A	49.3	2%	-8%	(1,921.8)	48.4	54%
CHECK POINT SOFTWARE TECH	**10.9**	**7%**	**34%**	**(3,482.9)**	**14.7**	**8%**
ZSCALER INC	54.2	2%	-36%	(685.6)	67.2	62%
FORTINET INC	27.1	4%	19%	(1,124.9)	33.4	32%
PALO ALTO NETWORKS INC	28.5	4%	-5%	(733.5)	42.8	29%
CYBERARK SOFTWARE LTD/ISRAEL	101.5	0%	-22%	(576.0)	113.9	18%
Average	**45.3**	**3%**	**-3%**	**(1,420.8)**	**53.4**	**34%**

Exhibit 3: Whilst Checkpoint screens strong in many financial metrics, it seems to lag materially in terms of revenue growth vs. peers.
Source: Bloomberg, FAM Analytics

In Ex.3, one can see that Checkpoint is an inexpensive stock compared to the valuations in the cybersecurity ecosystem. However, one can observe that the company has largely missed out on the cybersecurity opportunity over the past ten years as revenue growth is both weak in relative terms and has markedly decelerated over the years (Ex.5). Companies like Fortinet and Palo Alto Networks may appear overvalued in comparison. However, they are better positioned competitively and likely to generate more robust growth in the future. We think that such could progressively change, catalyzed by the acquisition of Perimeter 81, and Checkpoint has invested heavily in its sales and marketing capacity over the past 18 months. Management believes it has seen a significant change in customer engagement levels over the past three months.

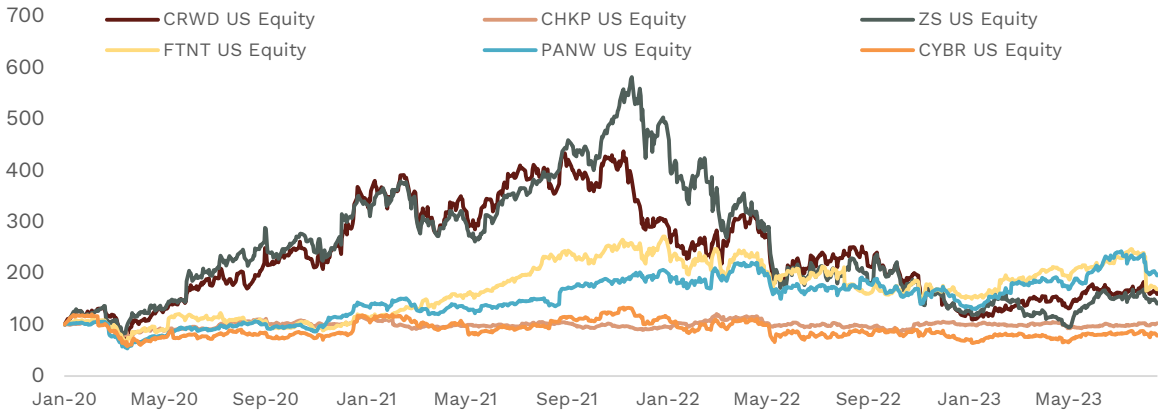

Exhibit 4: Checkpoint has lagged in terms of performance vs. its peers since 2020.
Source: Bloomberg, FAM Analytics

[6] ZScaler Report, https://www.zscaler.com/products/proxy-vs-firewall
[7] An SSL certificate is a digital certificate that authenticates a website's identity and enables an encrypted connection. SSL stands for Secure Sockets Layer, a security protocol that creates an encrypted link between a web server and a web browser.
[8] Checkpoint acquisition announcement, https://www.checkpoint.com/press-releases/check-point-to-acquire-perimeter-81-to-deliver-the-fastest-and-most-secure-sase-solution-in-the-industry/

Most importantly, the company operates with a best-in-class Free Cash Flow yield (>7%) and practically zero debt (as seen from its net debt position). Checkpoint is trading at approximately 11x Est. EV/EBITDA mutliple, which represents a significant discount to the peers' median of 45x. It should be noted that the valuation of Palo Alto, Fortinet and Crowd Strike picked up noticeably since the beginning of the year, which is in line with the accelerated development of AI. However, Checkpoint has not seen the benefits of the same as off yet.

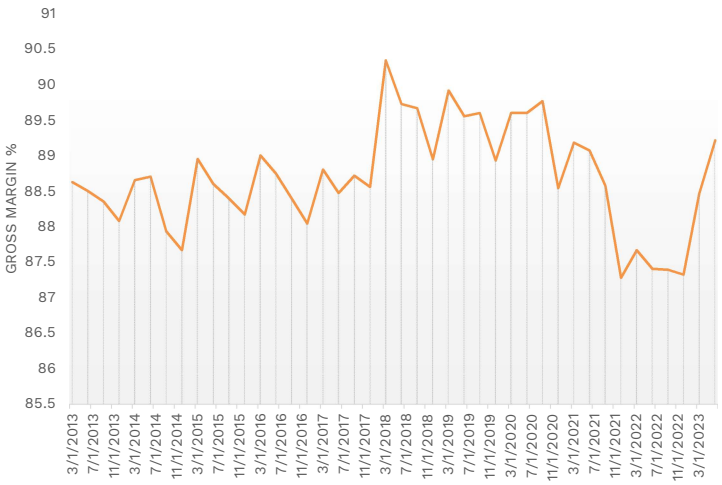

Exhibit 5: Checkpoint experienced significant Gross Margin deceleration in 2022 but has been recovering in 2023.
Source: Bloomberg, FAM Analytics

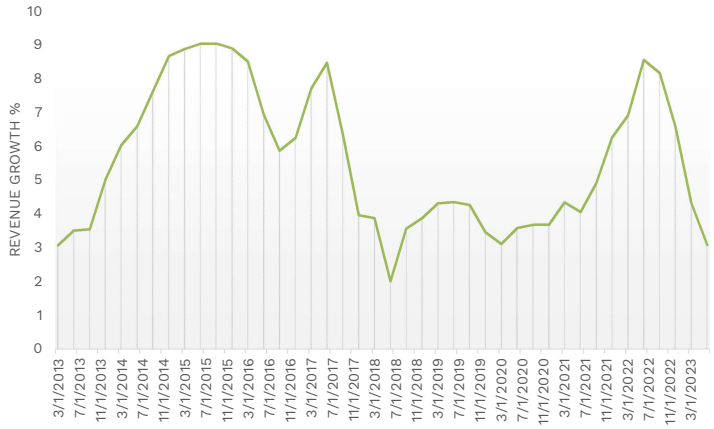

Exhibit 6: Checkpoint experienced significant Revenue Growth deceleration since 2021. We think that we are seeing the bottom of this deceleration trend, partly instigated by re-achieving market share in ZTNA space.
Source: Bloomberg, FAM Analytics

In our view, Checkpoint's valuation and growth prospects do not currently reflect the company's strong cybersecurity offering, giving them an edge over the competition. Despite the hidden "moat" in Checkpoint's comprehensive cybersecurity stack, the company seems to consistently receive little optimism in analysts' forecasts (Ex.7). In addition, in terms of its balance sheet, a strong cash position coupled with resilient cash flow generation capacity allows the company to drive organic growth and further M&A activity, as well as capital return to shareholders through buyback programs.

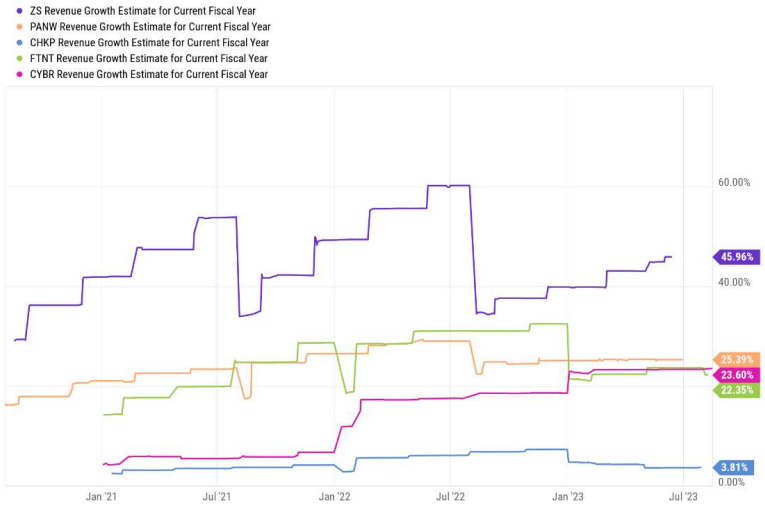

Exhibit 7: Checkpoint is largely neglected by analysts.
Source: YCharts

Outlook

Numerous investors justifiably ask, after a brutal 2022, considering the current and looming geopolitical and macro-economic risks present in the U.S. and Globally, why would anyone take the leap of faith and invest in Equity markets? A lesson we've learned over the years is a proverb: high returns are typically made in highly uncertain environments. We think that "art" lies in taking suitable risks. For instance, investing in U.S. technology seemed challenging in September 2022. Inflation was climbing uphill, interest rates were rocketing, and the tech earning had begun their (arduous) post-COVID normalization path. The magnitude of uncertainty was discernible, a feeling that resonated deeply within us. However, under such conditions, the Nasdaq realized 20%+ returns in the following few months until today. However, despite the numerous unknowns, we continue to feel good about our conservative approach of buying high-quality businesses that we believe will compound value over the long term. Furthermore, considering that opportunity is typically born out of volatility, we are comfortable with much of the portfolio's positioning, including our futures hedging activity developed to offset a portion of the market's potential downside.

While we navigate these rough seas, we find comfort in the fact that the companies in our portfolio are seasoned "survivors" used to exhibiting stability regardless of the macroeconomic environment. This is due to the margin of safety embedded in their business models and the high integrity of their management teams.

Thank you for your continued trust.

The FAM Team

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