



2022 H1  
Letter to Investors

Guardian Capital Management B.V.  
Concertgebouwplein 21, Amsterdam

July 6, 2022

Dear Partner,

In 2022 H1, the return of the Guardian Fund was -62.61%, measured in euros and net of fees and expenses. This compares to -20.15% for the S&P 500 Index, measured in U.S. dollars, and including dividends.

The return of the Knight Tech Fund - our crossover fund that owns private shares in Epic Games and Databricks - was -56.67%, net of fees and expenses. This compares to -29.22% for the Nasdaq 100, measured in U.S. dollars, and including dividends.

You may wonder what we can write after this extraordinary drawdown. An investor letter could be a humble endeavor to share what investing lessons we have learned over the past few months. It could remind the audience how hard it is not to sell around the bottom after a historic sell-off or share the excitement that comes when seeing good businesses at low valuations. Some might expect to hear how the fund is repositioning to reduce 'risk' or how it can 'make back losses'.

From the beginning, our fund has been a partnership for investors to co-invest alongside us in a few outstanding businesses. Our job is not to sell fear or optimism nor a promise of smooth sailing. While it feels embarrassing to be down so much, the important matter to us is whether we merely experienced a huge market drawdown or did our investment decisions result in a permanent loss of capital? In this letter, we share how we are feeling as co-owners of these businesses.

## **Contemplations**

First, despite a massive change in sentiment driven by adverse macro-economic and political circumstances, surprisingly little has changed in our portfolio. The operational performance and outlook for our businesses remain solid. We are paranoid about being wrong about the quality of a business. So far this year, not a single business we own has shown material red flags that make us think that the long-term earnings power has been impaired. For some firms, especially those that enable secure networking and cloud services, the fundamentals seem stronger than six months ago. Many of these businesses help their clients to reduce costs, risks, and complexity while improving productivity and the potential for individuals as well as organizations to monetize their products and data. Comments made by management during such times of change are often lagging indicators and we expect to see some downward earnings revisions in our portfolio businesses. Nonetheless, our investment thesis on the businesses in which we own shares is largely unchanged from how we viewed things in the autumn of 2021.

Second, our ownership mindset, meaning we do not trade based on global events and projections - just like you would not sell your family business based on the news - did little to sidestep the steep mark-to-market decline this year. In 2020, valuations rose to historically high levels and this reduced the margin of safety. We may have been complacent in not selling shares in great businesses at high valuations and for valuation reasons alone. Rising prices do not necessarily make us happy. If a share price goes up faster than the earnings power of a business, we are basically borrowing price performance from the future. The irony is that over the past decade, our main mistake has been to sell shares of fine businesses based on the argument of valuation. The lessons we learned strengthened our conviction to not sell an exceptional business unless we have doubts about the quality. This philosophy worked well at the start of the pandemic and it seems to have backfired now when taking today's snapshot. Some of the main conclusions will only become clear in 12-36 months because they are determined by how well we judged the quality of individual businesses. There is a non-zero chance that simply owning the shares and going through the full drawdown will get us further ahead than most traders.

Third, the relative underperformance of several major indices this year is especially painful. While the S&P 500 experienced the steepest decline of any first six months since 1970, our investments were concentrated in the field where the sell-off was the most severe. Our portfolio has little in common with the S&P 500 or Nasdaq 100 because we do not own most of the big-tech companies nor mature businesses like PepsiCo and Costco Wholesale that are among the top 10 components of the Nasdaq 100. Over the past few years, we described how we were seeing value in the leading data-driven and cloud-native businesses. Since March 2020, all our investments are in tech-driven businesses. We see the portfolio as diversified because the businesses operate in a vast range of fields. Going forward, leaders in most sectors are likely to be data-driven businesses.

Fourth, this downturn will take time and will continue to test our temperament and patience. Significant drawdowns like the current one typically last about 12-24 months. It is likely that we are not yet at the end of the tunnel in terms of time. None of the various issues driving inflation such as the war and supply chain challenges will be gone overnight. However, because the sell-off was steep we might not be far from the bottom in terms of prices, especially for the strong cash-rich businesses. Plenty of people are recognizing that the risk-adjusted return for some high-quality companies has become compelling. At some point, we expect the market to start making more distinctions between various businesses. In 2022 H1, 'tech' has been puked out as if it were a group of similar companies.

Fifth, we wonder when was the last time when everyone had the same opinion and that this view was right. It seems that every person has now become a macroeconomist. Even if consensus would be correct this time, would that scenario actually change our investment allocation? At some point markets always start rebounding for reasons that people cannot comprehend at that time.

Sixth, we like to reiterate our ownership philosophy. We are convinced that capturing the world’s information to unlock value in every part of life is an enormous opportunity. Our fund will continue to co-own leading businesses that enable better information intelligence and that provide the infrastructure and technology to empower people. Especially after valuations have come down.

## Investment Portfolio

The table below shows the ten largest positions of the Guardian Fund on December 31, 2021, and on June 30, 2022. We largely own the same businesses.

December 31, 2021	% of portfolio	June 30, 2022	% of portfolio	% YTD
Shopify Inc. -A-	14.8%	Alphabet Inc. -A-	16.6%	-24.8%
Spotify Technology SA	14.2%	Spotify Technology SA	15.2%	-59.9%
Sea Limited	11.4%	Shopify Inc. -A-	12.3%	-77.3%
CloudFlare Inc -A-	9.5%	Snowflake Inc -A-	9.4%	-59.0%
Alphabet Inc. -A-	9.2%	CloudFlare Inc -A-	8.0%	-66.7%
Snowflake Inc -A-	8.3%	Palantir Technologies	7.7%	-50.2%
Roku Inc.	7.8%	Roku Inc.	6.9%	-64.0%
Palantir Technologies	5.8%	Elastic NV	5.7%	-45.0%
Roblox	3.9%	Sea Limited	5.6%	-70.1%
Elastic NV	3.7%	StoneCo Ltd	3.5%	-54.3%
	88.5%		90.9%	

We were pleased with the 2022 Q1 operational results and outlook of the businesses given the challenging circumstances. These businesses are thriving, have strong balance sheets, and are run by management teams that have excellent track records in building and/or scaling them. They continue to invest in the future and do not need the capital market to move forward.

Obviously, several firms are experiencing a normalization of growth rates after the strong lockdown years. Like always, business is messy, and each company must cope with a changing world. Every company is dealing with current challenges such as inflation, rising rates, supply chain issues, and other effects of a global recession. However, people adapt and some can cope better than others. We think that these businesses are well-positioned in today’s state of the world and are happy to own these businesses if the stock market would close tomorrow for several years.

Alphabet has become the largest position as the stock declined by “only” 24.8%. We acquired the shares in 2015 and own the same number of shares as at the end of 2021. Alphabet is probably the world’s most advanced company in artificial intelligence. It is both developing powerful models (e.g. GPT-3, DALL-E, LaMDA, PaLM) and building the cloud infrastructure to train them. The superior AI infrastructure can be applied to various operating businesses and fields that go well beyond advertising e.g., life sciences and energy. Since 2017, Google Services’ revenue (93% of total revenues and including Google Search and YouTube), has increased by a CAGR of 22%, a

strong performance given the large revenue base. YouTube is impacted by some temporary headwinds such as lower advertising spending and we think this has zero impact on the competitive position. Google Cloud (7% of total revenue) generates revenue from both the Google Cloud Platform and Google Workspace. Google Cloud is growing rapidly (+44% year-on-year in 2022 Q1) and is facing many years of growth ahead as workloads are transitioning to the public cloud. Alphabet's shares are trading at an earnings yield of about 6%. Since 2018, Alphabet spent USD 124 billion to repurchase shares and the total share count declined by 10%.

A significant part of our portfolio is invested in enterprise software businesses that are levered to the huge growth in cloud spending. For example, Snowflake enables clients to manage all data and workloads in one cloud-neutral platform, meaning without data silos across the three major public cloud providers. The market opportunity is enormous and seems to be constantly underestimated by market observers. Workloads are moving to the public cloud because it is cheaper and safer than doing it on-premise. Cloud machine learning workloads are growing and this is likely to generate almost uncapped demand for deep learning compute. The world of the cloud is profoundly different from the old world. For example, there are firewalls for security in the old world and there is identity-based security in the cloud. The data clouds are increasingly replacing a fragmented vendor landscape. For example, Snowflake is building a partner network that leverages the platform. In the first quarter of 2022, revenue growth was 84% year-over-year and the business is gushing cash that can be reinvested. Snowflake's value proposition is well illustrated by its net retention rate of 176%, which means a given cohort of customers is spending 76% more over a given period than in the preceding period.

In May, Cloudflare, also a business active in cloud services, reported a strong first quarter of 2022 showing an acceleration of revenue growth up to 54% year-over-year, an increase of gross margin to 77.8%, and an increase in net retention rate to 127%. The business has USD 1.7 billion in cash on the balance sheet and is stacking S curves on S curves, which gives the firm a long runway of growth ahead.

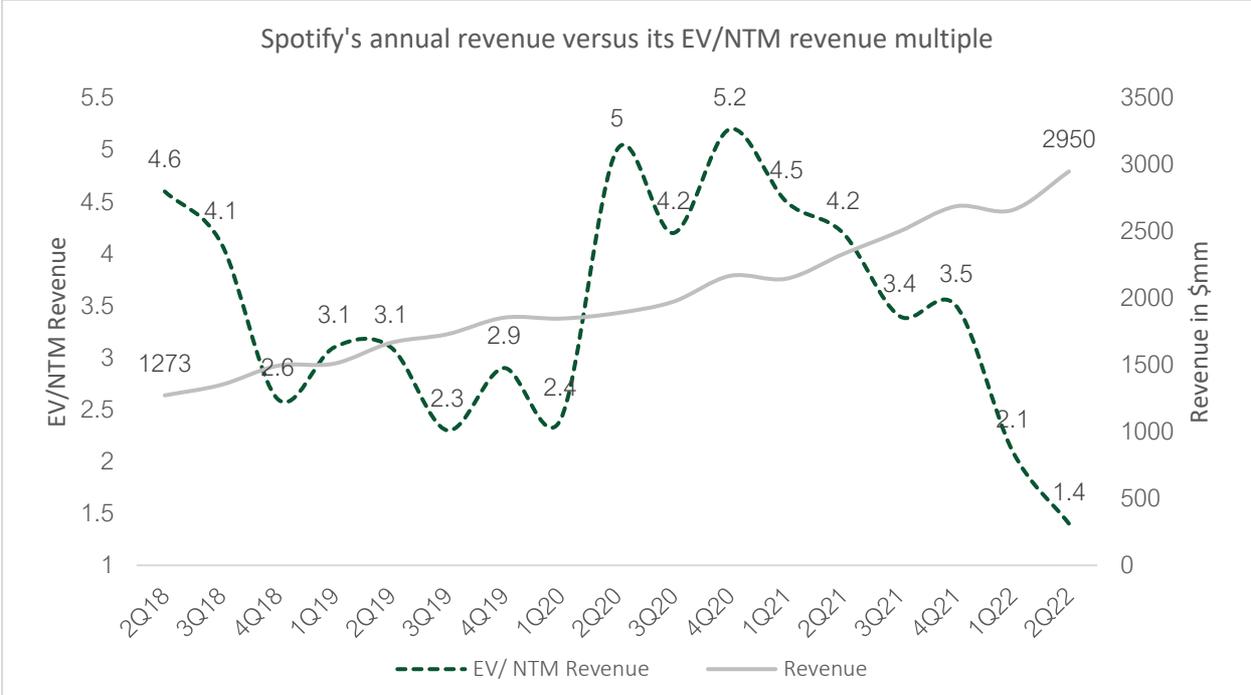
### **Spotify: The Share Price and the Business**

If these businesses are any good, then why have the share prices crashed in 2022? Obviously, driven by a reverse to the mean of valuations due to changing economic factors that are negative for most asset prices. However, certain businesses seem well-positioned to prosper.

In the first quarter of 2022, Spotify grew revenues by 19% year-on-year while generating free cash flow, ad-supported revenues grew by 31% to 11% of total revenues, monthly active users increased by 19% to 422 million people, and cash on the balance sheet was EUR 2.7 billion. Management continues to invest in the significant opportunities right in front of it and does not need the capital market.

Spotify, the stock, was down 59.9% in the first half of 2022 to USD 97/share, or a market capitalization of USD 18 billion. Since the listing in 2018, revenues and margins have expanded while the share price was mostly flat, then more than halved in 2022 to trade at a steep discount to when the business became a public company. As a result, the enterprise value stands at about 1.5 times next twelve-month (NTM) revenues. The market views Spotify as a commoditized music streaming player and seems to think that the business model is to squeeze out some extra margin at the expense of the music labels.

Spotify is one of the cheapest high-quality companies we know. During every major drawdown, there is the yin & yang where the contrary forces of the crashing price and the rising expected return interrelate. While we're at it we would welcome even lower prices. Why doesn't the market sell us the shares for USD 50/share? Or for USD 25? Our investment thesis on this individual business is either right or wrong. However, a declining share price has no impact on the operational performance of this firm.



Source: Company filings

In essence, our investment case is that audio content is hugely under-monetized compared to video content. Audio is one of the last blue oceans out there and the technology to unlock more value did not exist until recently. Spotify is well-positioned to close that gap.

The audio market is growing and especially the younger generation is engaged; in the first quarter of 2022, 18- to 24-year-olds have already played more than 578 billion minutes of music on Spotify – more than any other cohort and roughly 16 billion more minutes than 25- to 34-year-olds. The engagement of this consumer demographic with music, podcasts, playlists, artists, and merchandise is valuable.

Within audio, podcasting has strong momentum. In 2018, when Spotify entered the field, the annual ad spend in the U.S. was approximately \$480 million. At that time, it was projected to hit \$1.1 billion in 2022. Today, podcasting is expected to exceed \$2.1 billion in 2022, almost double the initial projections, representing over 300% growth since 2018.

Spotify is developing technology that is likely to significantly improve monetization. For example, Streaming Ad Insertion provides campaign metrics and audience insights based on confirmed ad impressions. Since 2018, Spotify has gone from less than 7% of listeners on Spotify spending time listening to podcasts to 30%. In the US, when the company bundles music and podcast advertising, the average size of the spend on a campaign is four times that of a music-only campaign. Today, 7% of the listening hours on Spotify come from podcasts, and out of those hours only 14% are being monetized.

The hurdles to creating and publishing work are lower than ever and in this world of abundance more power goes to those that are building technology that enables content discovery. The economics of this data-driven software business on top of audio engagement is different from owning an income stream from monetizing content. It is also different from running a premium subscription service where the main focus is to maximize average revenue per user by optimizing price. Few people realize that Daniel Ek never wanted a premium price tier in the first place.

Spotify is more focused than other players active in the audio market. Over the past few years, Spotify grew engagement despite strong competition with deep pockets. There is a finite number of talented engineers and the best people go to places where they work in the core of the business on hard problems and where they are taken seriously because they are the primary people and get rewarded as such, not just in monetary terms. The DNA of a business is not on the balance sheet yet maybe it is one of the most valuable assets, especially in technology. That is why we think that comparing for example Tesla to most automobile manufacturers is like comparing the latest iPhone with a telephone booth.

In June, Spotify held its first [investor day](#) since 2018. It was one of the better presentations we have seen and we recommend you to listen to parts of it in order to get information from the source. During the four-hour investor day, Daniel Ek shared the target that in one decade Spotify can generate revenues of USD 100 billion annually with a 40% gross margin and a 20% operating margin. We think the Swedish engineering culture at Spotify is quite the opposite of being promotional. Visibility is low for such a long period yet even if revenues would then be USD 50 billion the stock would be worth a multiple and generate an attractive return for shareholders.

It is rare to find an investment opportunity that has limited downside and is likely to generate generational wealth for the shareholders who size the position well.

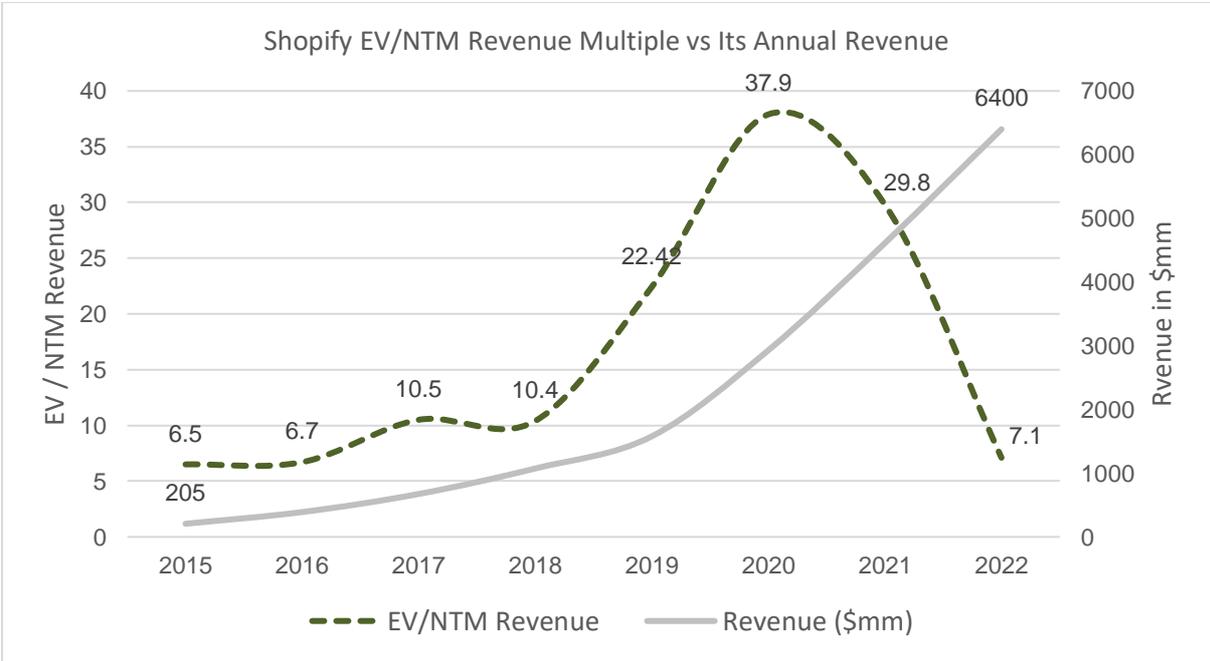
### Shopify: The Share Price and the Business

While Spotify’s valuation never reflected much upside to earnings growth, let’s now look at an example that makes one wonder why we did not sell the stock when the valuation was high.

Since 2016, when we bought shares of Shopify at USD 65 per share, revenues grew from USD 389 million to about USD 6.4 billion over the next twelve months. While revenues increased 16-fold the stock went up 25 times at the peak and is now just 4.8x higher than when we initiated the investment. In 2016, we did not imagine that the business would become so relevant to merchants.

Shopify’s stock went down 77% over the first six months of 2022. While the pandemic accelerated revenues, 2022 is a year of normalization driven by e-commerce penetration going back to the pre-Covid trendline and headwinds that are likely to slow down consumer spending. In the first quarter of 2022, Shopify grew revenues by 22% year-on-year, a material slowdown from a two-year compound annual growth rate of 60%. Nonetheless, over the first quarter, Shopify (and also Amazon) gained more market share.

The graph below shows how Shopify revenues grew and how the multiple (here enterprise value divided by the next twelve-month revenue) expanded in 2020 and contracted in 2021 and 2022.



Source: Company filings

The obvious question is why did we not sell at the peak in valuation? The answer could be that we were complacent. Here is how we are thinking about it.

While normalization of valuation was almost a certainty, it is rare to find exceptional businesses. We like to err on the side of not selling. As our horizon is longer than most market participants, not selling is likely to give a better overall result than trading. For quite a number of businesses, the valuation peaked in 2020 or early 2021 and declined since because the share price was flat while the business continued to grow.

Shopify has become a vital operating system for many merchants that cannot build software in-house. There is a ton of embedded optionality in this business model as new products and services can be added which will expand the addressable market.

The sell-off will separate the best businesses from those that burn cash to generate growth. Capital has become scarcer which means that the highest-quality businesses that are self-financing are able to move forward faster. Since the first seed round in 2006, Shopify raised a total of USD 7.8 billion in funding and now has USD 7.2 billion in cash on the balance sheet. As a result, management can continue to invest even if capital markets would be closed for years.

The graph below shows how the multiples of a larger group of software businesses (those included in the Bessemer Cloud Index) expanded in 2020 and then came down in 2022. The average enterprise value divided by the estimated next twelve-month revenues is now 5.6 times which is about 30% below the pre-Covid average.



Source: Bessemer Venture Partners

It must be frustrating for management teams and employees of many listed businesses that have executed well and grown by a multiple over the past few years, to see not just the valuation but even the market value of the business going down to levels last seen in the later-stage private funding rounds. Even the market value of Amazon is back where it was in 2018. Businesses like Amazon or Alphabet are rare because they continue to grow at scale and are gushing cash. In the current environment, founders must show that their business is one of the few that can achieve scale with strong unit economics.

The technology sector was the first to experience a sell-off and is likely to rebound before general indices, which often are way ahead of the general economy. In the credit crisis, the Nasdaq 100 bottomed on November 12, 2008, while the S&P 500 bottomed on March 9, 2009. Other sectors just started to slow down in 2009 and for example, the bottom in Amsterdam real estate was in 2013. We would not be surprised if the sell-off in tech stocks is largely done despite more expected earnings revisions due to lower revenues and pressure on margins. Even if prices would remain flat for a while, valuations would continue to decrease for those businesses that are growing. Public markets set the ultimate exit values for private businesses and price discovery must still happen in private markets. Few crossover investors will invest incremental capital in a private business today at anything close to previous valuations if excellent public businesses are trading at enormous discounts.

## **Mindset**

Why are there so few billionaires?

Given the power of compounding at even the market rate, the number should be much higher. Macro events such as inflation, war, recession, bankruptcies, etc., are already included in the general stock market's outcome.

The answer is behavior; it is hard to not sell. The Walton family is the richest American family because it never sold Walmart. Almost nobody, especially not institutional investors, can keep owning shares in a good business when there is constant liquidity and no lack of daily opinion from observers about either the valuation or business fundamentals. How many of us have been Amazon shareholders for a significant number of years and were able to ignore opinions about valuation as well as multiple significant drawdowns of the stock?

Wild swings in prices happen occasionally and they tend to shake out the tourists. Activities such as trying to time the market, repositioning portfolios, and switching companies based on macro projections, appear rational in times of 'high uncertainty'. In fact, most of these trades just break the streak of compounding.

This mindset of ownership has contributed to the steep decline in 2022 H1. However, we think it is the right approach to investing in public businesses and especially in scalable tech-driven businesses that are seldom trading at apparently low valuations.

We do not trade the flavor of the day. Investing in public equities is not a game of continuously picking the right stocks for a certain state of the world and then picking the next basket. This trading game to live another day is like shooting heads that pop up at a fair. Would Exxon Mobil be a good trade now that there is a war? Yes, that's likely. Would Altria be a safe haven because people keep smoking and it is paying a nice annual dividend? Probably true. Why do we live in Amsterdam and not in Vienna, Zurich, New York, or Austin?

In addition, to us, the stock market is not an alternative to liquidity. The market enabled us to buy parts of businesses that we would be happy to own if they were in private hands. We do not 'hedge' or 'short' any business nor do we make an effort to smoothen volatility by engaging in actions that we think are pseudo-risk management just to satisfy the misguided demands of a wider audience. We would rather only invest our own capital than have to become traders.

The above means that our investment firm is not for everyone. We are working with multi-generational capital and are investing with a horizon of at least five years. If the investment horizon of an investor in the fund is less than that, then there is a mismatch in duration between our horizon and that of the investor.

Every investment at some point feels like a mistake; after you buy it the price goes down or it goes up (and we did not own enough). Every company must deal with problems, and it is up to the investor to judge if those challenges are material or temporary. In a bear market, the stock prices suggest the investor is wrong and owners of listed securities have to deal with enormous price swings around the intrinsic value of a business. For the rest of our lives, interest rates will fluctuate, inflation will be higher and lower, multiples will rise and fall, businesses will emerge and fade, and the crowd will hate and love our businesses. And we will make real mistakes as well. At any time, we are certainly missing opportunities and the allocation of capital is inferior to what could be possible if we would make perfect choices.

## **Miscellaneous**

In rising markets, it is easy to quote Charlie Munger: "If you're not willing to react with equanimity to a market price decline of 50% two to three times a century, you are not fit to be a common shareholder and you deserve the mediocre result that you are going to get."

While we feel a state of detachment from current mark-to-market losses affecting our private capital, we are exposed to sentiment because investors are riding on our shoulders. However unpleasant this historic sell-off may be, it gives our team energy as well; it comes from recognizing

opportunities to acquire good businesses at low valuations, working with the right partners, and above all from realizing how few people have the mindset to separate price from the fundamentals.

What can you expect from here? We continue to invest like we communicated above and in previous letters. Our investors' interests are aligned with ours and this is how we run our investment firm. We will not do any crazy trades in order to try to 'make back' the negative performance.

We admire the temperament of the investors who were willing to invest additional capital over the past few months. Most were early like we were ourselves. It is the right mindset and we are feeling the responsibility to get through the storm in good shape.

The reality in this business is that one has to size an investment right when a rare opportunity arises. In order to do so, one needs to have a warrior mindset to be offensive and take advantage of this turmoil in the fields we have been studying for years. Over the next summer weeks, I would like our team to ignore prices and news as much as possible and instead learn something new about a business or technology.

The next letter will follow in January 2023. In the meantime, we do not plan to comment about fluctuations in prices. Let's see what the world will look like at the next solstice.

Sincere regards,

Also on behalf of Felicia, Martin, and Louis,

Georg

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