LOMBARD ODIER
INVESTMENT MANAGERS

LO Funds
Global FinTech
Newsletter

Thematic Equities • Equities

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PERFORMANCE COMMENTS

In June, LO Funds–Global FinTech was down in both absolute and relative terms. The FinTech theme was unfortunately out of favour despite another strong Q1 earnings season. The market remains dominated by the USD 100 bn plus market capitalisation contingent, where we are strongly underrepresented given our FinTech purity constraint.

Valuations in the small- and mid-cap space are getting more attractive by the day. According to research published by Barclays ("Long-only sponsorship has fallen off a cliff in payments", 17 June 2024), there was a mass divestiture of long-only investors out of payment stocks over the last five years of the study. We believe it is fair to say that, generally speaking, this money has either gone to money-market funds or (when re-invested) to the Magnificent 7/AI themes. Simplified even further: the money just followed momentum. This finding is complementary to the argument we have been making for some time – that there is a disconnect between fundamentals and valuations. This effect is especially easy to observe within the payments sector. Anyone with a Bloomberg account can pull up a chart, e.g. for global payments, and see earnings forecasts climbing while stock prices keep falling due to multiple compression. Obviously, this cannot continue indefinitely. As long as fundamentals remain solid (and we have no reason to doubt that), at some point, these companies become too cheap to ignore. Since we are in a trend-following market regime, the thesis is obvious. When contrarians and first-movers start to buy into these quality-growth companies to benefit from their extremely low valuations, it has the potential to turn momentum around. When that happens, the quants and generalists move back into the bottomed-out names, and other parts of the market are used for funding. Unfortunately, there is no crystal ball to tell us when exactly the turnaround will happen, but it is becoming clearer by the day that the upside return potential outweighs the downside risks. This thesis does not conceal the ugly truth of this year's performance, but it paints a picture (both absolute and relative to the benchmark) of investor positioning and possible turnaround potential.

Furthermore, the month was dominated by ongoing political turmoil across the world, with the first presidential debate in the US, the first election round in France and the run-up to the UK elections driving market sentiment. We have learned over many years of managing publicly listed funds that investing based on politics is almost impossible (besides momentum trading). Therefore, analysing the impact of new rules and regulations on company fundamentals is the only way to go. This is not something that can be done overnight; hence, during election times, it is best to limit trading and continue to focus on fundamentals. Given the summer holidays and low liquidity, market volatility could rise.

During the month, the sector allocation effect was negative, especially within Financials. The selection effect explained two-thirds of June's underperformance, again dominated by the Financial sector. The stocks that contributed most to the Fund's relative performance in June were CyberArk (+19.3%), Intuit (+14.0%) and Endava (+8.5%). Worldline (-18.4%), PayPal (-7.9%) and Global Payments (-4.9%) detracted most from relative performance. The portfolio's current positioning comprises 42% Established FinTech, 41% Enabling Technology and 17% Upcoming FinTech.

MARKET REVIEW

The US 10-year bond yield was flat at around 4.4%, with most European rates up despite rate cuts by the ECB. The Bloomberg Commodity index dropped 2% during June, driven by natural gas and metals like copper and silver. Gold was flat for the month and oil was up. The VIX was flat at around 13.

THEMATIC INSIGHTS

FinTech stocks provide natural hedges against rising inflation and a potential economic slowdown. Physical payment companies (payment processors and merchant acquirers that focus on physical stores as opposed to e-commerce) tend to benefit most from this natural hedge. Fundamentals for payment companies have been strong and the outlook remains positive. We do see a slowdown on the software side, which is why we have repositioned the portfolio away from the more expensive software names and towards the cheaper, quality payment companies.

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We also believe high-quality companies will benefit more than their loss-making hyper-growth peers, as long as access to credit is declining and borrowing costs are rising. This is because quality companies can fund growth from their profits and cash reserves. Management can also make a substantial difference, and most high-quality companies have a team that has gone through several economic cycles and can navigate most market conditions.

C-suite level discussions are focused on digital strategy, which has moved from “nice to have” to “must have” to remain competitive and meet the needs of all stakeholders. Shareholder rewards have gone to digital leaders: clients expect services to be able to continue in the event of another lockdown, and staff expect the right tools to perform their jobs in a work-from-home environment.

PORTFOLIO ACTIVITY

In June, we did not buy or sell any new positions. We used fund flows to add and reduce some positions back to model weight. Our trading remains low, with an average holding period of more than five years.

OUTLOOK

The FinTech sector benefits from strong secular growth trends, such as the move away from physical cash, the digitalisation of financial services and the rising role of cybersecurity. The pandemic accelerated these trends through both push and pull forces – businesses have started to invest more in digital infrastructure so they can remain open during any future lockdowns, and consumers are demanding digital services for reasons of health, user experience or convenience.

Our investment process aims to select the highest-quality companies that can benefit from these trends to build a well-diversified portfolio. We believe the most important factors to watch are company-specific fundamentals such as revenue and earnings growth, return on equity (ROE), cash flow return on investment (CFROI) and balance sheet conditions. We also monitor macroeconomic factors such as interest rates, inflation and growth. We diversify between Financial and Technology companies, aiming to create a stable, disciplined portfolio that can weather a multitude of market conditions. Within our FinTech mandate, our portfolio management style is best described as “quality growth at a reasonable price”.

Certain segments of the FinTech market are extremely interesting from a valuation perspective. Payments, for example, is a segment that has been sold by many generalists and is only held by a handful of specialist long-only funds. Despite the extremely good fundamentals, active managers and passives all accumulate positions around the Magnificent 7 stocks. As a result, the quality growth at a reasonable price strategy proliferates, particularly in the payments sub-sector where growth (both earnings and topline) is higher than the market; quality is extremely high (this segment produces the top 10% of CFROIs globally) and valuations show a discount to the market.

Sincerely,

LO Funds–FinTech investment team

PERFORMANCE

30.06.2024	INCEPTION	AUM	MONTH-TO-DATE	YEAR-TO-DATE	INCEPTION-TO-DATE	2023	2022	2021
LO Funds – Global FinTech PA	6 April 2020	USD 82 mn	-1.25%	-5.20%	25.29%	15.29%	-28.90%	9.97%
LO Funds – Global FinTech NA			-1.19%	-4.80%	29.87%	16.27%	-28.29%	10.91%
Benchmark [3]			2.23%	11.30%	91.80%	22.20%	-18.36%	18.54%

Past performance is not a guarantee of future results. Performance is presented net of fees.
[1] Dividend accumulated private client share, net performance in USD.
[2] Dividend accumulated institutional client share, net performance in USD.
[3] MSCI All Countries World USD ND

RISK AND REWARD PROFILE

1	2	3	4	5	6	7

Lower Risk — Higher Risk

The following risks may be materially relevant but may not always be adequately captured by the synthetic risk indicator and may cause additional loss:

Concentration risk: To the extent that the fund's investments are concentrated in a particular country, market, industry, sector or asset class, the fund may be susceptible to loss due to adverse occurrences affecting that country, market, industry, sector or asset class.

Emerging market risk: Significant investment in emerging markets may expose to difficulties when buying and selling investments. Emerging markets are also more likely to experience political uncertainty and investments held in these countries may not have the same protection as those held in more developed countries.

Active management risk: Active management relies on anticipating various market developments and/or security selection. There is a risk at any given time that the fund may not be invested in the highest-performing markets or securities. The fund's net asset value may also decline.

Before taking any investment decision, please read the latest version of the prospectus, the articles of incorporation, the Key Information Documents (KIDs) and the latest annual report and semi-annual report. Please pay attention to the Appendix B "Risk Factors Annex" of the prospectus.

Incorporation of extra-financial risks into the investment decision process may result in underweighting of profitable investments from the sub-fund’s investment universe and may also lead the management of the sub-fund to underweight investments that will continue to perform. Sustainability risks may lead to a significant deterioration in the financial profile, profitability or reputation of an underlying investment and may therefore have a significant impact on its market price or liquidity.

The Fund has been classified as a financial product subject to Article 8 of Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial sector (the “SFDR”). The Fund promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.

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