ASHVA
Capital Management LLC

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Reflecting on the first six months of 2024, two primary trends stand out in the economic landscape:

1. The US economy has demonstrated robust growth, marked by strong earnings and sustained profit margins across key sectors.
2. Responding to this earnings strength, the US equity market has maintained its upward trajectory in a bull market that began in October 2022.

<u>Star, Stripes, and Bull Markets: Unpacking the Resilience of the US Economy</u>

The current bull market that began in October 2022 is now 21 months into its course without showing any signs of abatement. Despite the absence of major corrections–although 10% corrections are frequent and considered normal in bull markets–the market remains robust. The persistence of recession forecasts since the COVID-19 lows has not deterred its momentum. Even with the most aggressive Federal Reserve rate hiking regime in over 40 years and ongoing conflicts in Ukraine and the Middle East, the S&P500 has risen by 14.5% Year to Date as of June 30, 2024.

The stock market's continuing strong performance in 2024 shouldn't be surprising. It is primarily propelled by a robust job market in the US, which bolsters personal consumption and, subsequently, earnings growth and share prices.

In my view, the strength of the equity market largely stems from the foundational strength of the US economy, with the US consumer continuing to be the principal driver of economic growth. Job gains, rising incomes, and improving growth collectively bolster consumer spending. The US unemployment rate edged higher to 4.1% in June as can be seen in Figure 1. However, we can see in Figure 2, the US labor participation rate increased to 83.7% in June, the highest level since 2001. The combination of a low unemployment rate with a high labor participation rate confirms that the job market remains robust.

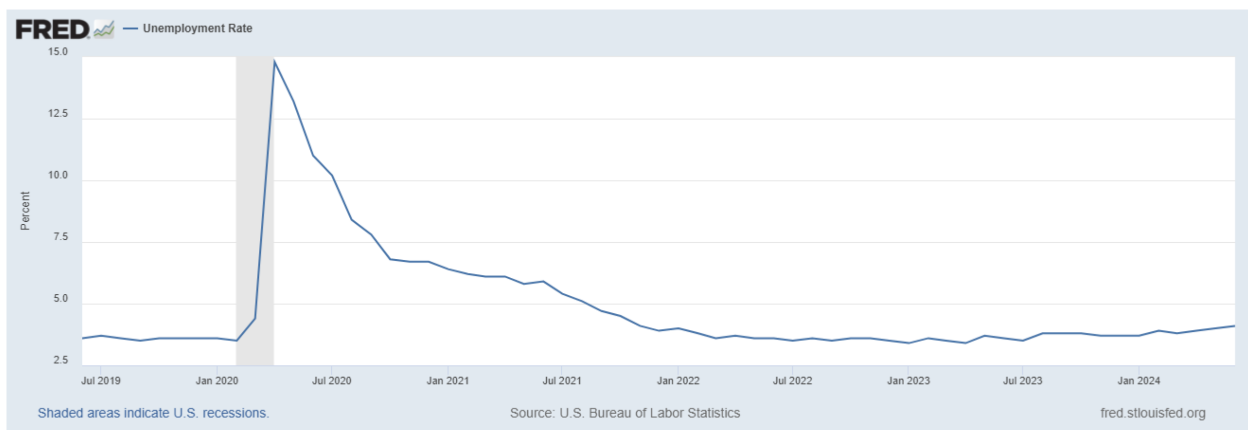

Figure 1 US Unemployment Rate

Figure 2 US Labor Participation Rate

Additionally, inflation continues to moderate as can be seen in Figure 3, below. In June 2024, the Consumer Price Index (CPI) for all items excluding food and energy rose by only 3.3%. This increment represents the smallest year-over-year increase since April 2021.

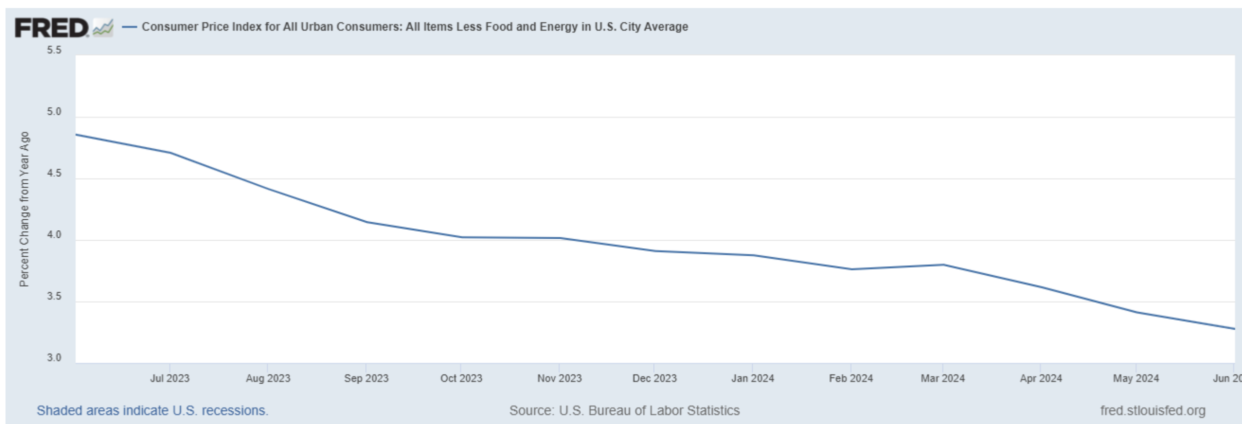

Figure 3 US CPI

Inflation has become predominantly a concern of the past year. At its July 2023 meeting, the Federal Open Market Committee (FOMC) raised interest rates to a range of 5.25% - 5.50%, marking the culmination of 11 rate hikes in an aggressive cycle aimed at curbing inflation. As of the latest FOMC meeting in June 2024, the Fed has maintained steady rates. Economists and investors are anticipating a modest rate cut of 25 basis points by September. It is expected that discussions in the financial media will persist, focusing on how the fate of the current bull market is in the Fed's hands.

In my opinion, the timing of the anticipated rate cut is irrelevant. Inflation is under control, and the intense cycle of rate hikes has evidently concluded. The economy continues to perform robustly, supported by a strong labor market that underpins ongoing earnings growth. The primary risk to this optimistic outlook is an unexpected global economic shock that could trigger a resurgence in inflation, potentially prompting the Fed to reverse course and raise rates. However, this scenario remains unlikely and represents a minimal risk.

Our Performance – Cracking Buffett's Alpha Code

The S&P500 is up 14.5% Year to Date (YTD) through June 30, 2024. **In comparison, the Ashva Capital LP fund has increased by 21% net of fees over the same period**. Our notable outperformance in a market often deemed challenging for active stock pickers has led many of our fans and critics to question our methods for achieving such significant gains.

Despite extensive discussions of Warren Buffett's strategies by the financial media, there has been surprisingly little rigorous empirical analysis of his performance. In Q4 2018, Andrea Frazzini, David Kabiller, and Lasse Pedersen published an article titled "Buffett's Alpha" in the *Financial Analysts Journal,* marking the first comprehensive analysis of how Buffett selects both private and public companies by examining factor exposures.

Their research began with an analysis of Buffett's overall returns using Berkshire Hathaway's 13-F filings. From 1976 to 2017, Buffett generated an average annual return of 18.6%, surpassing the US Treasury bill rate and significantly outperforming the general stock market's average excess return of 7.5%. Buffett is considered the greatest of all time ("GOAT") because no one else has managed to compound capital at such a high rate of return for as long as he has.

For those interested in quantitative investing, I recommend reading the entire paper. However, for the majority who have other priorities, I will summarize the key findings. Buffett's success was largely due to his preferences for stocks that are cheap, safe, and high-quality - all factors proven to yield market-beating returns. The authors defined "safe" as having low Beta and low volatility, "cheap" as value stocks with a low price-to-book (P/B) ratio, and "high-quality" as profitable, stable, and growing companies.

An interesting aspect of their findings was Buffett's strategic use of Berkshire Hathaway's insurance float. The premiums paid at the policy's outset are essentially loans that need repayment only if a claim is made. By effectively managing this float, Buffett enhanced his returns by using a leverage ratio of approximately 1.6x.

Interestingly, similar benefits can be achieved without owning a reinsurance business. By investing in long-dated call options, you can control a larger position for a relatively small premium. Deep-in-the-money calls minimize extrinsic value, providing cost-effective leverage compared to other sources.

For example, we have taken a long position in GM using long-dated call options. GM generates significant free cash flow (FCF) from its core ICE trucks and SUVs while gradually expanding its EV business. In June 2024, GM announced a new $6 billion stock repurchase program, roughly 11% of its total market capitalization. This followed the completion of a $10 billion share repurchase program announced in November 2023. Despite these developments, GM shares, up 38% YTD, remain significantly undervalued, trading at five times the FY24 estimated EPS.

Through our options strategy, we achieved a leverage of 2x, effectively doubling the YTD return compared to the shares themselves. However, leverage has its risks; losses can also double if the wrong stocks are chosen. I highlight GM as it represents a position with limited downside and substantial

upside potential. We only engage in long option positions when the odds are clearly in our favor. My aim is to demonstrate how leveraging up on quality, undervalued stocks can yield significant returns.

My foundational assumption is that the US economy will continue its sustained expansion. Our investment strategy, Quality at a Reasonable Price (QARP), focuses on well-managed businesses with competitive advantages, robust free cash flow, and reasonable valuations. This approach, akin to Buffet's, has proven successful over his career and, I believe, will continue to produce excellent results for our own portfolio moving forward.

Sincerely,

Ankur Shah
Managing Member
Ashva Capital Management LLC

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