MOONFARE

3 Lessons

From the History of Equity Investing

“The four most dangerous words in investing are ‘this time it’s different.’”

— **John Templeton**

Shaquille O'Neal

Introduction

An automaker whose trucks need to be on a hill to roll becomes more valuable than the Ford Motor Company. A company that sells video games in malls becomes one of the most talked-about stocks and sees its valuation soar.

A decorated basketball player helps launch a once-esoteric vehicle for taking companies public. A digital currency that began as a joke surpasses a $88bn valuation. Investors pay millions to own new-fangled assets that have no track record.

We're talking about Nikola Motor Company, GameStop, Shaquille O'Neal's special purpose acquisition company, Dogecoin and non-fungible tokens.

Since the onset of Covid-19 markets have been anything but boring. And to be clear, we have nothing against innovation. Quite the opposite in fact.

At Moonfare, we have been following every twist and turn in the world of markets and investing.

Despite the strangeness and novelty of some of what we have witnessed, we are reminded that the more things change, the more they stay the same.

> Despite the strangeness and novelty of some of what we have witnessed, we are reminded that the more things change, the more they stay the same.

We are offering this white paper to share a few eternal rules of equity investing that seem more important now than ever. These truths have stood the test of time, centuries in some cases, and we expect them to endure.

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3 Lessons

1. Some illiquidity is a good thing.
2. Beware the wisdom of crowds.
3. Know what you are buying.

1

Some illiquidity is a good thing

Not too long ago, equity investors backed a company whose future was uncertain.

There was no guarantee of making a return by holding the company's shares. Its profitability hung in the balance of macroeconomic trends, its ability to penetrate new markets and its managers' skill.

Some original investors backed away from the company and sold their shares on the secondary market. When share prices later rose and became unaffordable, some investors bought fractional shares. Others bet against the company's success by taking a short position or backing the firm's competitors. Still other investors battled for control of the company and accused its directors of serving their own interests first.

It was 17th century Amsterdam, and the company was the Dutch East India Company. The company has become legendary as an early example of many modern phenomena in modern finance: the first recorded company with shares traded on the secondary market, the first stock to trade as fractional shares, the first shorted stock and the first example of shareholder activism.[1]

The investors with the simplest approach carried the day: Those that bought and held their shares over the long-term earned returns that would be difficult to beat.

While Dutch East India Company grew to employ 20,000 people and carved out an important role in global markets around sugar, coffee, spices and textiles, long-term investors earned an annual return of about 22.5% by simply holding their shares.[2]

The firm's competitor, the Dutch West India Company, did not perform as well financially, but it did contribute something to the world: It built up a trading outpost known these days as New York City.

Since the earliest days of equity investing, investors who invest with a long horizon earn the best returns.

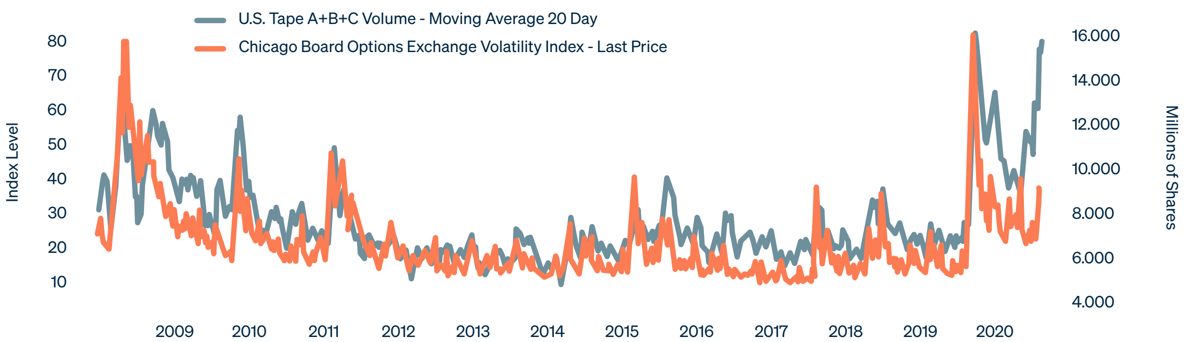
Since the earliest days of equity investing, investors who invest with a long horizon earn the best returns. Long-term investors enjoy the benefits of compounding capital and the curved-not-linear nature of their returns.

Everything flows and nothing abides

Certain aspects of equity investing go against human nature.

The need to take a long-term view, the need to buy things when they become cheaper — these essential needs of equity investors seeking strong returns are sadly not part of human DNA. Things that are: the search for short-term gains, the need for entertainment and the fear of missing out when we see a stock that we don't own rise in value.

The volume of equity trading in the U.S. and volatility both spiked a few times since the onset of Covid-19.



Source: Bloomberg, CBOE.

1 de Jongh J.M. (2011) Shareholder Activists Avant la Lettre: The "Complaining Participants" in the Dutch East India Company, 1622–1625. *Origins of Shareholder Advocacy. Palgrave Macmillan, New York.*
On the rise of shareholder activism, we also recommend "Dear Chairman: Boardroom Battles and the Rise of Shareholder Activism" by hedge fund manager Jeff Gramm.

2 Neal, L. (1991). The Rise of Financial Capitalism: International Capital Markets in the Age of Reason (Studies in Macroeconomic History). *Cambridge: Cambridge University Press.*

John Maynard Keynes

> "A large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations."

Discussing the boom in retail trading at Berkshire Hathaway Inc.'s annual shareholder meeting in early May, Warren Buffet said "The gambling impulse is very strong in people worldwide and … nobody tells you when the clock's going to strike 12, and it all turns to pumpkins and mice."

Even John Maynard Keynes who in 1936 coined the expression "animal spirits" to describe the emotional dimension of markets had trouble mastering these forces.

He used the earnings from his book *The Economic Consequences of the Peace* to move into first currency trading and commodities before switching to equities, which in the 1930s became his main source of income.

Researchers are currently analysing how Mr. Keynes traded his own portfolio of stocks compared with the portfolio he managed for King's College at Cambridge. Privately he was more spontaneous; as an institutional investor he was more disciplined, buying and holding.[3]

"A large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations," he wrote. These contradictions have become so important for investors that they have spawned an entire discipline: behavioural finance.

Siren song

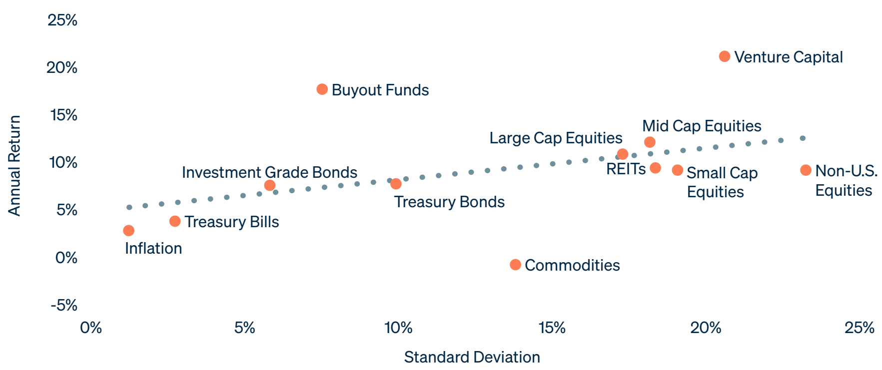
With the risks of trading in mind, we think some illiquidity is a good thing. Illiquidity forces investors to stick to their guns and take a long-term view. Illiquidity can offer investors the kind of Ulysses pact — pre-empting the siren song that induces more active trading by lashing oneself to the mast — that helps them take a long-term view. [4]

Private equity funds provide an interesting point of comparison to stocks, or publicly traded equities. Investors' capital remains locked in private equity funds for years, and illiquidity appears frequently as a downside of private markets investing.

But the benefit is in the returns: Illiquid investments, like private equity buyout funds and venture capital funds, have historically offered higher risk-adjusted returns than their more liquid peers, according to financial research. [5]

And while we say some illiquidity is a good thing, some liquidity is too. It is one of many reasons why we built the Moonfare Secondary Market to give investors flexibility to enter and exit fund investments, just in case.

Less liquid investments assets like private equity buyout funds offer relatively high risk-adjusted returns.



3 Sanfilippo, E. (2021). "Keynes's trading on Wall Street: did he follow the same behaviour when investing for himself and for King's?" *Financial History Review, 1, 1-25.*

4 For more on the Ulysses pact and behavioural finance, we recommend "Laws of Wealth" by Daniel Crosby

5 Maboussin, M. and Dan Callahan (2020). "Public to Private Equity in the United States: A Long-Term Look." *Morgan Stanley*. Maboussin and Callahan drew upon analysis from Robert S. Harris, Tim Jenkinson, and Steven N. Kaplan, "How Do Private Equity Investments Perform Compared to Public Equity?" Journal of Investment Management, Vol. 14, No. 3, Third Quarter 2016, 1-24; Steve Kaplan, "What Do We Know About Private Equity Performance?" Guest Lecture at Miami Herbert Business School, January 31, 2020; Steve Kaplan, "What Do Venture Capitalists Do? How Well Have They Done?" University of Chicago Booth School of Business; FactSet; NAREIT; Refinitiv; and Aswath Damodaran. Past performance is no guarantee of future returns; All asset classes reflect 1984-2015 except for VC, which reflects 1984-2013; Return for Buyout and VC is measured by weighted average internal rate of return (IRR); All asset classes are for the U.S. except for Non-U.S. Equities and Commodities (Buyout and VC have a North American focus).

2

Beware the wisdom of crowds

Joseph P. Kennedy, a financier and father to an American president, invented a trick for timing the stock market about 100 years ago. “You know it’s time to sell when shoeshine boys give you stock tips,” Mr. Kennedy said.

Joseph P. Kennedy Sr.

It was the 1920s. Bombastic optimism in the stock market drove mass participation in stock trading. Shoeshine boys turned into part-time equity analysts.

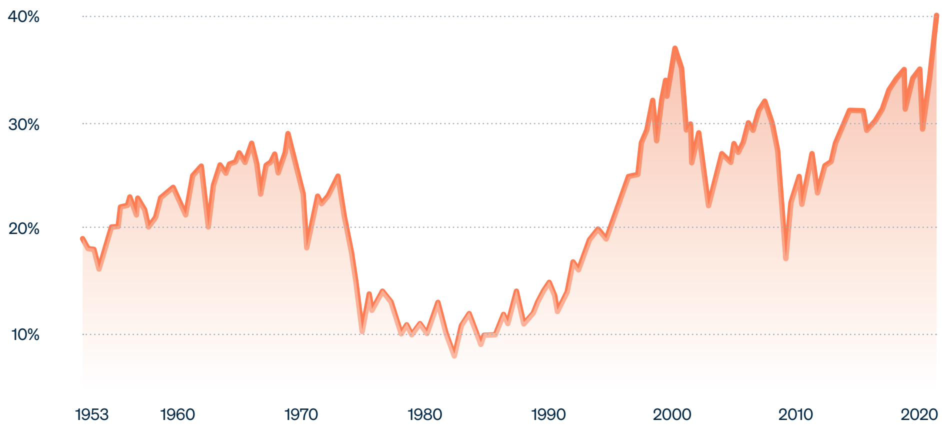
These trends gave way in 1929 to the worst stock market crash in history. Mr. Kennedy, the legend goes, took all of his money out before the bubble popped, the Dow Jones Industrial Average dropped almost 25% in two days, and the Great Depression began.

Five years later, Mr. Kennedy became the first chairman of the U.S. Securities and Exchange Commission (SEC), a watchdog setup as part of President Franklin D. Roosevelt’s New Deal package of depression-era legislation.

The goal: protect smaller retail investors from making dangerous wagers in the stock market. From the top of the market to the bottom in 1932, the Dow had fallen nearly 90%. For an average saver in the market, it means 90 cents of every dollar vanished.

With the SEC came increasing market oversight and a safer, more transparent environment for investors, who have flocked to the stock market in droves in the last century.

Across decades, American households have increasingly invested their wealth in the stock market.



Sum of equities held as a percentage of total financial assets

Source: JPMorgan via The Wall Street Journal.

In the 1920s about 10% of US households held stock investments, according to the Federal Deposit Insurance Corporation, another New Deal invention designed to buttress the US economy and markets. In 2020, 55% of US households owned shares of public companies, according to the pollster Gallup.

Call of Duty

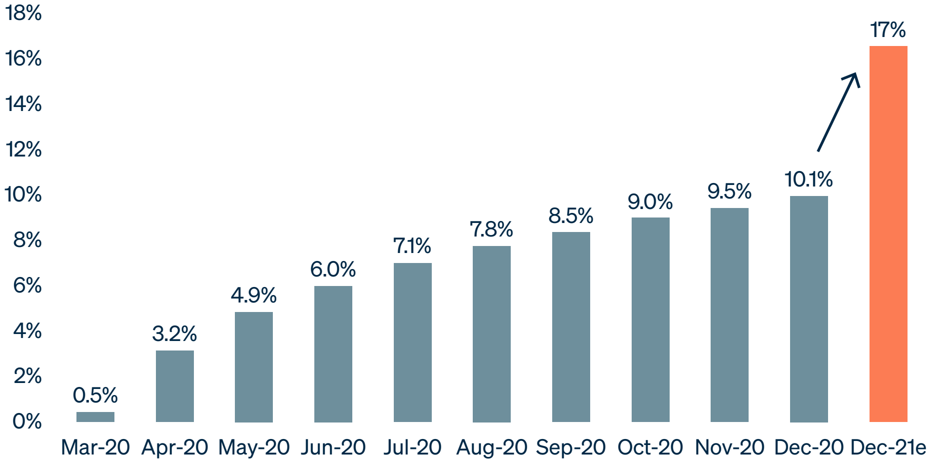
The increasing interest in equity investing since the beginning of 2020 has been one of the silver linings of the Covid-19 pandemic. Stuck at home with excess savings and stimulus checks, millions of investors opened new accounts.

Bloomberg's Matt Levine, one of our favourite financial columnists, coined what he calls the Boredom Markets Hypothesis, or the idea that people trade more when there's nothing else to do.

> The weird thing about the coronavirus crisis is that it simultaneously (1) caused a stock market crash and (2) eliminated most forms of fun.

"The weird thing about the coronavirus crisis is that it simultaneously (1) caused a stock market crash and (2) eliminated most forms of fun," Levine wrote.[6]

Pandemic stimulus has flown to households under lockdown with fewer expenditures. The result? Excess savings.



Cumulative 'Excess Savings' as a % of 2019 personal consumption expenditure*

*Excess savings = Savings in excess of a 7.7% run-rate savings rate (based on the 2018-19 average). e = KKR Global Macro & Asset Allocation estimates. Data as at February, 26, 2021 from Bureau of Economic Analysis, Haver Analytics.
McVey, H. (2021) 2021: Another Voice. KKR Global Perspectives, KKR.

Call of Duty

In some ways, the stock market has become everyone's favourite video game or sport to bet on.

"When you're in 'Call of Duty,'" — a popular shoot-'em-up video game — "there's a rush when you win your match, and you're doing well," said one Robinhood investor in a recent interview with *The Wall Street Journal.* "With Robinhood, you're seeing your account go up, and it's that same euphoric feeling." [6]

We have to give points for honesty. Every investor has a side that loves gambling. That is not a new phenomenon. But millions of new investors being locked at home with excess savings and commission-free trading accounts on their phones is.

And when those two forces combine, it creates a kind of en masse adrenaline-fuelled price discovery in the stock market that inflates values.

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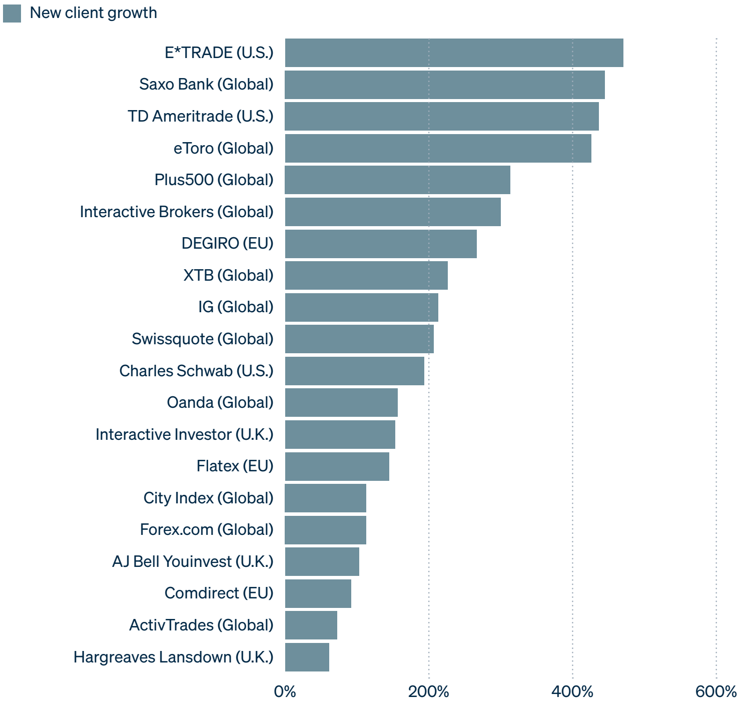
6 Ensign, RL (2021) "Robinhood, Three Friends and the Fortune That Got Away." *Wall Street Journal,* April 22.

7 Levine, Matt (2020). "If You're Bored You Can Trade Stocks." *Bloomberg*, April 30.

"Many investors seemed to have the feeling that they were in an environment devoid of risk, which is worrisome," wrote Byron Wien, vice-chairman of Blackstone's Private Wealth Solutions group, in a recent note.

Several retail stock brokers saw their client base increase by 100% or more during the beginning of the pandemic.



Note: Percent change in new client number in H1 2020 compared to the same period 2019.

More than three million people opened Robinhood accounts in the first four months of 2021, according to reporting by Sheelah Kolhatkar in The New Yorker. The new users bring the total number of Robinhood users to more than thirteen million, half of whom are first-time investors. Among users the median age is 31. Source: BrokerChooser via Bloomberg; Kolhatkar, Sheelah (2021) "Robinhood's Big Gamble." *The New Yorker,* May 10.

Warren Buffett

Mr. Market

Warren Buffet's professor and value investing sage Benjamin Graham invented a character to describe market behaviour like we have seen in the last year or so in his 1949 book *The Intelligent Investor*. He called the character Mr. Market.

"Mr. Market does not always price stocks the way an appraiser or a private buyer would value a business," Mr. Graham wrote. "Instead, when stocks are going up, he happily pays more than their objective value; and, when they are going down, he is desperate to dump them for less than their true worth."

Don't give the crowd, Mr. Market or the shoe shine boy more credit than any of them deserves.

At Moonfare we believe, of course, that public stocks play an important role in a diversified portfolio. But we also question the wisdom of crowds that can often take a mob-like approach to pricing in the stock market. We believe that putting money in the hands of experienced, hard-working investors like the managers running the best private equity funds is one of the smartest ways to invest and an antidote to the at times herd-like behaviour in the stock market.

3

Know what you are buying

Equity is a claim on a company's profits. It sounds painfully obvious, but in the current market – one that is defined by liquidity and not fundamentals – we are seeing more and more confusion about what equity investments are really worth.

Disaster Girl

Is an equity investment worth what the next person will pay for it? Is it worth the bragging rights of telling friends? Is it worth as much as it will make you laugh?

The answers to any of these questions could be yes, especially if you are talking about owning a watch, a painting, a vintage sports car, a stock popular on social media or — we have to say — the rights to a digital reproduction of a photograph that has been used for a lot of memes.[8]

Call us old fashioned. When we are talking about equity investments in companies, we prefer a more buttoned-up definition of equity.

Equity investors own a claim on a company's profits, after the company has paid all other claims: The company pays its expenses, the company pays its debts, and then the equity investors own what is left. To be slightly more technical: The stock price is the pro-rata value of all future cash flows discounted to the present and net of debt.

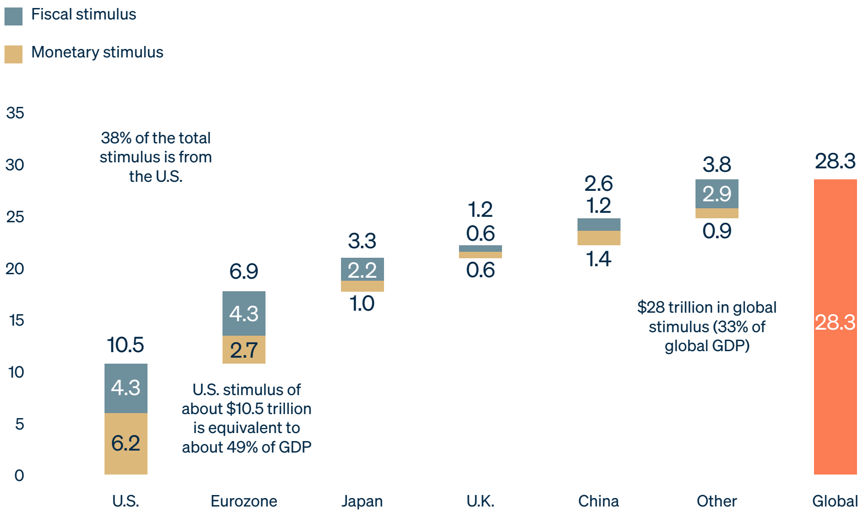
Bottom line is that if the company's present and future profits are worthless, so is its equity.

Not even god

Right now, the price of stocks has become detached from the profits of the underlying companies more than is normal. One way to measure this detachment of profits and share prices is through price-to-earnings multiples.

Jonathan Gray, the president of private equity giant Blackstone, spoke recently with Morgan Stanley about the risks associated with "companies that don't produce positive cash flow and are trading on very high multiples of revenues."[9]

The pandemic unleashed nearly $30 trillion in fiscal and monetary stimulus globally.



Global stimulus in response to Covid-19, $trillion

Data as at December 7, 2020.
Source: Macro Hive, Bloomberg.

8 Fazio, M (2021) "The World Knows Her as 'Disaster Girl.' She Just Made $500,000 Off the Meme." *The New York Times*, May 1st.

9 Cyprys, M. (2021) "Exceptional Leaders / Exceptional Ideas: Blackstone's Jonathan Gray." *Morgan Stanley.*

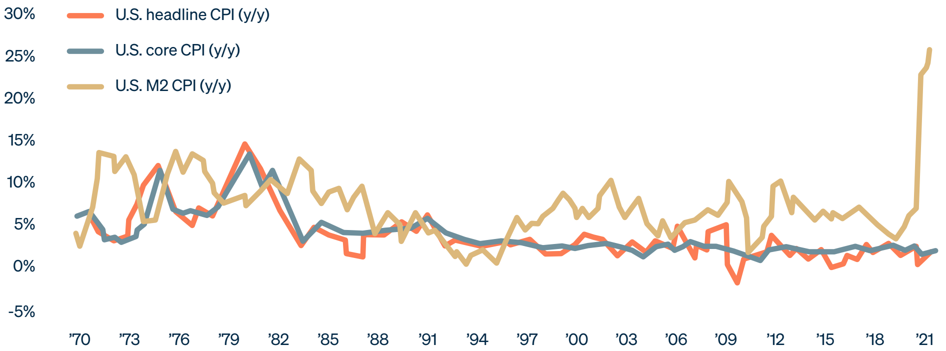
"You want to be a bit cautious when businesses are no longer valued on traditional metrics," Mr. Gray said.

> "You want to be a bit cautious when businesses are no longer valued on traditional metrics."

In March, the S&P 500's price-to-future earnings ratio for the year was roughly 22. The historic average is closer to 15-16. During the peak of the 2000 tech bubble, it was 24.

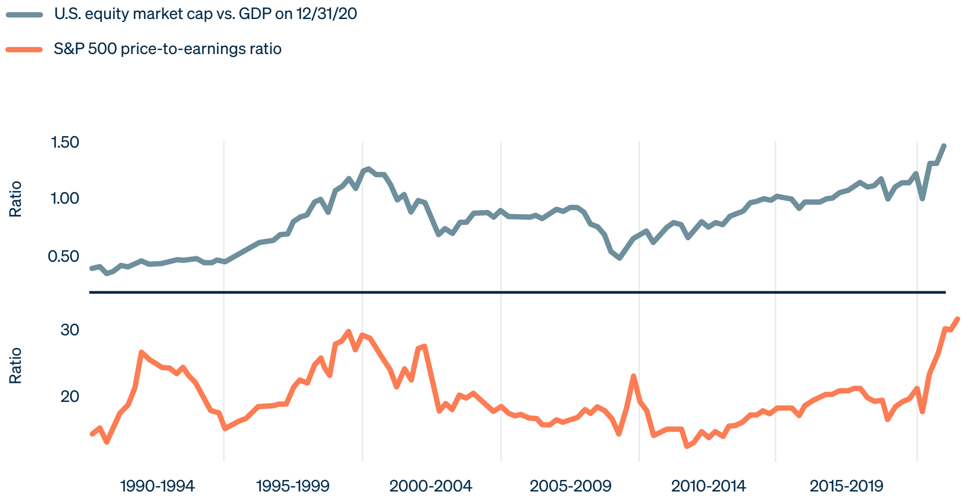
The amount of money in the world is one explanation. In the wake of fiscal and monetary policy deployed globally to combat Covid-19, the amount of cash moving around markets has become the predominant force in equity pricing. But at some point liquidity tightens, for example, through rising interest rates or fears of inflation. Then fundamentals, our old-fashioned valuation, comes back into focus.

And yet inflation has remained relatively low compared with the increased money supply.



Source: Macro Hive, Bloomberg.

Since the start of the pandemic, S&P 500 company valuations have begun to rival the dot-com era, according to some measures.



Source: Bloomberg.

Working from home.

But to be fair, establishing the correct price-to-earnings ratio is one of the hardest parts of equity investing.

"God almighty does not know the proper price-to-earnings ratio of a common stock," said Princeton University economist Burton Malkiel.

It is one reason Moonfare works with fund managers that use rigorous valuation tool kits and deal-sourcing strategies. Before they deploy investors' capital these managers have studied every lever of the company's profitability and every corner of its market. In the case of private equity buyout fund managers, these investors have concrete plans for how they will go into a specific company and increase its profitability before they invest.

In light of the other options out there for valuation — and the fundamental definition of equity — we like this approach. ◑

About Us

Moonfare offers individual investors access to top private markets investment opportunities for the first time. With a technology-powered onboarding process and asset management platform, Moonfare allows clients to register and invest directly in the funds on its platform in as little as 15 minutes and with minimums as low as €50,000.

The Moonfare investment team conducts ground-up due diligence on all funds. Fewer than 5% of available funds pass this process and make it onto the Moonfare platform.

Moonfare was named one of LinkedIn's top 10 German startups in 2020. The company also partners with banks and asset managers, including Berenberg, one of the oldest private banks in Europe, and Fidelity International.

Disclaimer

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