



# LVS ADVISORY

Investment Results	Full Year 2019	Full Year 2020	Full Year 2021	Full Year 2022	YTD 2023	Since Inception <sup>1</sup>
<b>LVS Defensive Portfolio (net of fees)</b>	<b>7.0%</b>	<b>13.2%</b>	<b>9.1%</b>	<b>3.8%</b>	<b>0.6%</b>	<b>38.0%</b>
<i>Benchmark: High-Yield Bond Index</i>	<i>13.4%</i>	<i>5.0%</i>	<i>4.0%</i>	<i>(11.4%)</i>	<i>4.2%</i>	<i>14.3%</i>
<b>LVS Growth Portfolio (net of fees)</b>	-	<b>61.8%</b>	<b>16.1%</b>	<b>(35.8%)</b>	<b>8.1%</b>	<b>30.4%</b>
<i>Benchmark: S&amp;P 500 Total Return Index</i>	-	<i>18.4%</i>	<i>28.7%</i>	<i>(18.1%)</i>	<i>7.5%</i>	<i>34.2%</i>

Note: investment performance is presented net of all fees and expenses. Investment results are as of March 31, 2023.

(1) LVS Defensive was inceptioned on January 1, 2019. LVS Growth was inceptioned on January 1, 2020.

April 13, 2023

Dear Investors,

For the first three months of 2023, the Defensive Portfolio gained 0.6% (net of all fees and expenses) and the Growth Portfolio gained 8.1% (net).

## The cure for high interest rates... high interest rates

The defining moment of Q1 2023 was undoubtedly the week several major banks failed. The bank failures prompted swift action from the Federal Reserve Bank which has contained the crisis for now.

Deposit runs on the banks catalyzed the failures we saw in March; however, the underlying cause of the crisis is the sharp rise in interest rates we have experienced over the past year. While interest rates primarily increased in 2022, there is typically a 12 to 18 month lag before interest rate hikes are felt in the real economy. This “lag effect” occurs because capital projects are financed in advance and it takes time for capital providers to adjust to the higher cost of capital.

The first interest rate hike occurred in March 2022 and Silicon Valley Bank failed exactly one year later. Although the banking crisis appears contained, other ripples from the rate increases are still likely to manifest. A higher cost of capital translates into corporations cutting back on new investments, new home purchases becoming less affordable, and borrowers eating the higher cost of interest. This is a black hole sucking capital out of the system.

Monthly economic data can be volatile but directionally it is clear that inflation is cooling. March 2023 saw the slowest rate of job growth since the summer of 2020. Inflation is still running high but has been gradually decelerating since the peak readings observed in 2021/early 2022.

The repercussions of the banking crisis are yet to be seen, but a [study conducted by Jefferies](#) of every financial crisis since 1987 shows that crisis tends to precede periods of disinflation. The same study suggests that forward stock market returns have historically been attractive in the 3 to 5 years following a financial crisis.



My read is that the Federal Reserve's interest rate hikes appear to be working. Future interest rate hikes are likely limited from here as the worry shifts from high inflation to an economic hard landing. Interest rate cuts are becoming more likely than interest rate hikes especially if one looks out over a 6 to 12 month time frame.

## Defensive Portfolio: mispriced options and a 34x return opportunity

The Defensive Portfolio focuses on making event-driven investments with most of the investments involving a corporate merger or acquisition. Conceptually I think about event-driven investing as expressing an options bet. For example, a merger arbitrage bet on a cash deal is akin to selling a put option; there is fixed consideration earned if a deal closes but a large potential downside if a deal fails.

What many investors overlook is that there are often multiple embedded options layered into an event. In the case of betting on an M&A deal, investors not only receive consideration from "writing the put option" but also gain a call option on another acquirer stepping in to pay a higher price. This call option is rarely assigned value by the market because it is a low-probability event although it happens more often than the market seems to imply. In 2022 the Defensive Portfolio benefited from multiple situations where deal values were revised higher.

Things get more interesting when complexity is introduced to events. For example, as part of Pfizer's acquisition of Biohaven last year, the target company agreed to spin out a small portfolio of stage 3 clinical trial drugs. The market was focused on the regulatory risk surrounding the acquisition and ignored the spin-off. We were able to purchase Biohaven at a discount to the cash deal price and received shares in the spin-off for free. In other words, the market was focused on the risk/reward of *selling the put option* on the merger and ignored the *embedded call option* presented by the spin-off.

We stumbled upon another interesting situation at the end of 2022 where the market ignored a call option that could yield a 34x return.

In November, Johnson & Johnson agreed to acquire Abiomed for \$380 per share in cash. In addition to receiving cash, Abiomed shareholders received a contingent value right ("CVR") which pays out additional cash based on the achievement of commercial milestones for the company's development stage medical device products. The CVR could pay up to an additional \$35 per share in cash by the end of 2029 based on three separate milestones.

CVR investors typically wait until a deal is about to close before making an explicit bet on a CVR. The price of the stock in excess of the cash deal price represents the value investors have assigned the CVR. On Abiomed's last day of trading, the stock closed at \$381.02. This implied a value of just \$1.02 for the CVR after subtracting the \$380 cash value of the deal. The full payout of \$35 could net a 34x return on the \$1.02 CVR entry price.

Abiomed's CVR Milestones:

- A \$17.50 milestone payment if Abiomed's annual revenue exceeds \$3.7 billion by 2029
- A \$7.50 milestone payment if the FDA approves Abiomed's Impella products in STEMI patients without cardiogenic shock by 2028
- A \$10.00 milestone payment if Abiomed receives a Class I recommendation for the use of Impella products in high-risk PCI or STEMI patients without cardiogenic shock



# LVS ADVISORY

---

Based on our research, we believe there is a high probability of achieving the \$7.50 milestone, a greater than 50% probability of hitting the \$17.50 milestone, and roughly a 50% probability of hitting the \$10.00 milestone. It is worth noting that each of these milestones represents different shots on goal although they are correlated to each other.

Just as in our Biohaven bet, we purchased shares of Abiomed at a discount to the cash deal price and received the CVR for free. We were happy to stay invested in the CVR at deal close given the attractive risk to reward ratio of the security. Better yet, the outcome of this bet will have little to do with what happens with interest rates or an economic recession in the next year.

## Growth Portfolio: visualizing 18 months into the future

Unlike the Defensive Portfolio which isn't very correlated to the overall macroeconomic environment, the Growth Portfolio fluctuates as economic sentiment shifts. That does not mean we should sell our portfolio just because a recession could be around the corner. Instead, we should focus on finding securities that appear mispriced because everyone else is overreacting to the macro uncertainty.

Stanley Druckenmiller has generated one of the best investment track records over the past four decades. In discussing how he learned to invest during the bear market in the 1970s, Druckenmiller made the following comments ([source](#)):

“Never, ever invest in the present. It doesn't matter what a company's earning, what they have earned... You have to visualize the situation 18 months from now, and whatever that is, that's where the price will be, not where it is today. And too many people tend to look at the present, oh this is a great company, they've done this or this central bank is doing all the right things. But you have to look to the future. If you invest in the present, you're going to get run over.”

Many economically-sensitive stocks get thrown out when the market begins to anticipate an economic downturn – we have seen this occur to several of our core holdings over the past year. At some point, the market will shift from worrying about the recession to anticipating the recovery.

There is nothing necessarily magical about the 18 month timeframe but it does provide enough cover to look through the other side of the current economic prognostications. Most investors over-index to how much corporate earnings could temporarily decline in 2023 or 2024 due to a near-term recession instead of visualizing where normalized earnings will shake out in 2025, 2026, or beyond.



## Growth Portfolio Review

Growth Portfolio Top Holdings	%
Interactive Brokers (IBKR)	10.6%
Netflix (NFLX)	10.0%
BJ's Wholesale (BJ)	8.5%
SS&C (SSNC)	8.4%
The Joint (JYNT)	6.7%
<b>Total Top 5 Positions</b>	<b>44.2%</b>
<b>Total Top 10 Positions</b>	<b>73.1%</b>

There were several notable changes to the Growth Portfolio in Q1.

### **Exited Investments: Avid (AVID) and Charles Schwab (SCHW).**

We invested in Avid in early 2021 and I [outlined our investment thesis here](#). Avid is the leading provider of technology solutions for creating professional audio and video entertainment content (Hollywood movies, studio albums, etc.). Our investment thesis was that Avid is the 'arms dealer' to the streaming war and would benefit to the extent that Netflix, Disney, HBO, and others ramp up spending on content. Our view today is that the streaming war is over and Netflix won. Most of the major streaming platforms have announced plans to contain spending growth which could limit Avid's growth in the coming years. Furthermore, Avid's stock price has performed well and currently sports a valuation at the high end of its historical range. Our investment in Avid was successful and while we continue to admire the company, we feel that there are better investments that we can make elsewhere among the companies we follow.

We exited Charles Schwab during the week leading up to the Silicon Valley Bank failure at a price in the high \$60s. I sent an ad hoc note to partners on March 11 discussing our decision to sell the stock but I will add some additional context here. We invested in Charles Schwab during the summer of 2022 ([discussed in our Q3 2022 letter](#)) shortly after making our investment in Interactive Brokers. While Interactive Brokers is focused on faster-growing international markets and more sophisticated traders, Charles Schwab is a more mature US business focused on retirement accounts and wealth managers. Our investment thesis was that Schwab would benefit from higher interest rates and after years of investment would begin returning a significant amount of capital to shareholders.

My view changed when it became clear that liquidity would become a greater issue for all banks in early March. We believe Schwab has enough liquidity to operate its business, but we no longer believe the company is in a position to return capital. Furthermore, Schwab saw a higher degree of deposit flight in Q4 than we expected leading us to believe the problem could get worse before it gets better. Schwab may even need to raise additional equity capital to reassure the market of its liquidity position which would drastically change the risk/reward calculation of investing in the stock. While we realized a ~6% loss on our investment, our ability to quickly recalibrate our views during the early stages of the March banking crisis prevented us from losing an additional 20%+ if we had held on until today.



# LVS ADVISORY

---

This episode strengthened our conviction in Interactive Brokers (our largest holding), which we view as having a superior business model. Schwab's model relies on capturing a disproportionate share of the upside from higher interest rates because it does not charge additional fees. Interactive Brokers shares most of the upside from higher interest rates because it primarily monetizes accounts with low-cost commission revenue. IB is now offering an industry-leading rate of 4.33% on uninvested cash which they are proudly advertising on TV and radio. The cherry on top is that Interactive Brokers does all this while taking virtually zero risk with its balance sheet. This allows Interactive Brokers to play offense and take market share while its competitors scramble to preserve liquidity.

## **Increased Investments: Netflix (NFLX), BJ's (BJ), and The Joint (JYNT).**

Selling Avid and Charles Schwab provided a significant amount of cash that we primarily used to add to existing holdings.

We initiated our investment in Netflix during the summer of 2022 ([discussed in our Q3 2022 letter](#)). Netflix was a baby thrown out with the bath water by the market last year. We found Netflix attractive because the company signaled that it would hold expenses flat while better monetizing its account base via an advertising tier and paid sharing. Despite an impeccable track record of execution, the market didn't believe Netflix could navigate this transition. While the market now appears to buy into the expense story the market doesn't fully appreciate the revenue growth story that will play out from the new monetization initiatives. Furthermore, the stock's pullback during the banking crisis provided an attractive entry point for us to make Netflix an overweight position.

We discussed our BJ's investment in [our Q4 letter](#). The company has delivered strong financial results yet the market continues to underappreciate the quality and long-term earnings growth potential of this business. BJ's stock has also been punished due to results at Costco and Walmart where weakness in the general merchandise category has negatively impacted same store comps. However, the market appears to be missing that BJ's is primarily a grocer today and general merchandise represents more of a growth opportunity than a headwind. Furthermore, we expect BJ's to raise membership prices at some point in the next 1-2 years which will serve as a strong additional catalyst to earnings and is not currently baked into estimates.

We also added to our holding in The Joint. We have owned The Joint on and off since May 2020. We re-entered the stock last spring after a 70% decline in the price. We have gradually added over the past year due to our belief in the quality of the asset and the long-term growth prospects of the business. I plan to share a more detailed analysis later this year.

## **New Investment: Gogo (GOGO).**

We made a new investment in Gogo during the quarter. Gogo is likely a familiar brand as it used to provide internet on commercial airplanes; however, the company divested its commercial airline business in 2020 to focus on the much more profitable and fast-growing business of providing internet for business jets.

Gogo has a monopoly on the internet connectivity business for private jets in North America. The company's air-to-ground network consists of over 150 cell towers broadcasting internet straight up into the sky. Roughly one-third of private jets in the US have internet connectivity today but the penetration rate is expected to approach 100% within the next 10 to 15 years as new jets are line-fit with connectivity equipment right out of the factory and





# LVS ADVISORY

---

existing jets are gradually upgraded. Just like a cable plan, customers pay monthly internet subscription fees. In the coming years, Gogo will benefit from higher prices as customers upgrade to its 5G service (launching at the end of 2023) and its low earth orbit satellite service (launching in 2024). The company expects revenue to more than double over the next 5 years as it rides these tailwinds.

Gogo is also a very profitable business because it is already at scale with over 6,000 customers and its expenses are largely fixed. In 2022, GOGO generated a 43% Adj. EBITDA margin and will likely see margins expand to over 55% within the next 7 years as the business requires almost no maintenance capex and stands to benefit from operating leverage.

We believe Gogo's stock is significantly undervalued because investors are worried about Elon Musk's Starlink entering the connectivity market in the next 1-2 years. However, Starlink would need to overcome extremely high switching costs and several important barriers to entry before it could make a dent in the aviation connectivity market. Furthermore, the solution Starlink has proposed for aviation isn't commercially viable as it is more than double the cost of Gogo's current solution and would only work on a small number of large jet models. Starlink appears to be more focused on cracking the commercial airline market which Gogo no longer serves.

Gogo isn't just standing idle while satellite companies attempt to disrupt its niche. Gogo has a partnership with Starlink competitor OneWeb to launch its own low earth orbit satellite product that will likely be a superior product compared to Starlink. Launching a satellite product will expand Gogo's TAM to include the international jet market and allow the company to upcharge existing customers for a bolt-on product.

Gogo is also facing a patent infringement lawsuit from competitor SmartSky. SmartSky has been trying to compete with Gogo for nearly a decade and has failed to gain any material market share. The lawsuit appears to be a desperate attempt for the company to monetize its otherwise struggling network. The lawsuit is limited in scope to Gogo's 5G product and is based on 6 patents where 3 patents are set to expire in 2025. There is a risk that Gogo will be forced to pay a small royalty on some of these patents. A judge has already thrown out a request by SmartSky to place an injunction on the launch of Gogo's 5G network. Given the circumstances surrounding the lawsuit, we believe Gogo will have a favorable outcome.

Gogo checks most of the boxes we look for in an investment. It is a high-quality business with attractive reinvestment opportunities. Insiders own a significant amount of stock and have demonstrated sound execution. Finally, the stock is attractively priced because the market hasn't fully appreciated the business transformation story and misunderstands the competitive risks. The SmartSky lawsuit does represent a wildcard risk but we believe that the potential damages are limited and the upside from the secular growth of the aviation connectivity industry outweighs potential adverse court outcomes.



# LVS ADVISORY

---

Until next time

Thank you for your continued support and confidence.

Best regards,



Luis V. Sanchez CFA

## ABOUT LVS ADVISORY



LVS Advisory is a boutique investment firm focused on providing active investment management services for individuals, families, and institutions. The LVS Defensive Portfolio is an absolute return strategy focused on capital preservation. The LVS Growth Portfolio is a global equity strategy focused on capital appreciation. Luis V. Sanchez CFA is the Founder and Managing Partner of LVS Advisory. Luis is a licensed Investment Adviser Representative and a CFA Charterholder. LVS Advisory is a Registered Investment Adviser based in New York City.





# LVS ADVISORY

---

## LEGAL DISCLAIMER

The information and statistical data contained herein have been obtained from sources, which we believe to be reliable, but in no way are warranted by us to accuracy or completeness. We do not undertake to advise you as to any change in figures or our views.

This is not a solicitation of any order to buy or sell. We, any officer, or any member of their families, may have a position in and may from time to time purchase or sell any of the above mentioned or related securities. Past results are no guarantee of future results.

This report includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. These comments may also include the expression of opinions that are speculative in nature and should not be relied upon as statements of fact.

LVS Advisory LLC is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy, investment process, stock selection methodology and investor temperament. Our views and opinions include “forward-looking statements” which may or may not be accurate over the long term.

You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security.

