Insights, Tacit Thought | Weekly Investment Insights

What could go wrong?

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The Tacit approach to running money focuses very much on growing sustainable cash flows which in turn leads to higher asset prices. This has generated superior returns to our peers in 12 out of the 13 full calendar years since Tacit was launched almost 14 years ago in our Total Return Strategy, which has the highest exposure to equity risk. The 12 months following the onset of the COVID pandemic being the clear outlier and the exception.

In a world in which active management or “smart money” is increasingly under pressure from the momentum of passive investment solutions or “dumb money” most would be content with this largely positive record. Indeed, most investment firms would rather shy away from talking about periods of disappointing performance, instead focusing on the better periods. This plays into the human psychological state which overemphasises recent events above periods further back in history.

Our approach has always been to question why our performance outcomes did not meet our expectations, and in turn client expectations, with a view to enhancing our process from the experience.

During the period 2020 and 2021 many investments rose in value without any rational reasoning other than they played into the narrative of people being at home more. Investors began to believe that changes in behaviour would be permanent and that certain companies would grow exponentially in this new environment. Peloton was one such company.

For those that do not know, Peloton produce cycles and treadmills with an integrated TV monitor which allows you to attend fitness classes from home. The narrative during COVID was that all people that had gym memberships around the world would replace these memberships with a peloton subscription going forward. Quite a neat story and one which investors bought into, literally.

At the end of 2020 Peloton shares were trading at an all-time high of near $150 having risen from below $20 in 2019. Early in 2021 company management realised that there was an opportunity to raise more money from investors and raised $1 billion in cash by selling a convertible bond. A convertible bond is an instrument that combines a fixed income security with an equity option at a future date.

Peloton raised this $1 billion by offering just 1.4% of the company’s share capital which could be exercised at a 60% premium to the already inflated share price. Peloton was in such a strong position to negotiate with investors that the bond element of the convertible bond provided no interest to investors. This means that in practise investors had lent the company $1 billion at no interest rate just for the potential to own some of the company’s shares at a price of $239.

Fast forward to 2024 and Peloton has needed to raise more money from investors. In this instance, to raise $350 million, it has had to pay an interest rate of 5.5%. Alongside this interest rate, it has had to offer an equity option exercisable if the company’s equity trades at $4.58. This is quite a turn around for a company to which investors were willing to lend for free less than three years ago. Unlike in 2021 where just 1.4% of the company’s share capital was offered, this convertible bond represents 17% of Peloton’s total share capital. This is very expensive funding today for a company which was an equity market darling as recently as 2021.

Issuing a regular bond to investors now would have required Peloton to pay interest rate of closer to 12% and this would have proved too costly as the company’s cash flows are already strained.

As we’ve stated above, our approach at Tacit follows cash flows rather than share prices. Looking back at some of the things we got wrong in a particular year is important to reassess our thinking with more recent data and examples.

We hope many of you would agree that the example above is a reminder that investment is not about following stories or buying into the latest trend, but about sticking with sound, tried and tested investment principles that have stood the test of time.