Q1 2023

# U ACCESS (IRL) SHANNON RIVER UCITS

Quarterly Comment

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## *Market Comment*

- The first quarter of 2023 saw a continuation of the rally in risk assets that started in Q4 2022, as markets were pricing that peak interest rates are behind us. Markets continued to be volatile over the period however; The quarter started with very strong rally in January, followed by a strong correction in February and was punctuated by the crisis of confidence in US regional banks and the takeover of Credit Suisse by UBS. Government guarantees on deposits and central banks increased dovishness managed to calm down markets, which ended march in positive territory. In terms of regions, Developed Markets outperformed Emerging Markets, with Europe continuing its strong run since the second half of 2022. Fixed Income markets rallied across the board, driven by High Yield, Investment Grade, but also Government bonds and EM debt. Commodity prices ended the quarter in negative territory.
- On the economic front, some positive surprises on global growth, along with the reopening of China had a positive effect on business sentiment, which helped push equity markets higher. Headline inflation continued to ease on the back of low energy prices but core inflation remained stickier, prompting the fed to hike rates further in March, despite the instability within the banking system. Markets continue to be macro driven, focusing on the Fed and economic data. A growing consensus points out to a upcoming recession, which could lead markets to focus on company fundamentals once again and dispersion could return as a result.
- In this disruptive environment, we believe that expanding asymmetric exposure through alternative solutions is a smart asset allocation move today. We are convinced that one efficient way to improve the risk-return profile of a traditional long-only equity portfolio is to favour Long/Short sector specialists like U Access (IRL) Shannon River UCITS. Indeed, technology is present in more and more aspects of our life as it continues to disrupt sectors and companies.

*Sources: UBP, Bloomberg Finance LP, BofA Merrill Lynch*

## *Performance Review*

- For the first quarter of 2023, U Access (IRL) Shannon River Partners returned +10.1% (Class B USD, net of fees). During Q1 2023, the long book added +14.7%, while the short book detracted -4.1% (gross of fees)
- The portfolio’s top contributors in the quarter were Nvidia Corporation (NVDA) +324 bps, InterDigital Inc. (IDCC) at +290 bps, Advanced Micro Devices, Inc. (AMD) at +199 bps, Manhattan Associates,, Inc. (MANH) at +103 bps and NICE Ltd. (NICE) at +86 bps.
- Top detractors for the quarter were two shorts in the semiconductor space at -61 bps, and -57 bps and Vicor Corporation (VICR) at -40 bps.
- Major stock indices rose in the first quarter. The S&P 500 gained 7.03%, and the Russell 2000 gained 2.34% while Nasdaq rose by 16.77%.

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## Portfolio Activity

- U Access (IRL) Shannon River UCITS focuses on companies across the broad technology sectors, and typically invests in the $1-$20 billion market cap range where sell-side research coverage is less efficient. The team takes a company-specific, bottom-up approach to investing, and seeks out asymmetric opportunities that it believes to be temporarily misunderstood or ignored.
- In Q1, the portfolio manager took up Gross and Net exposure to take advantage of a more conducive investing environment. Gross exposure was in the 79-124% range for most of the quarter, while Net exposure was in the 22-42% range.
- Top high conviction long ideas currently include Interdigital Inc. (IDCC), NICE Ltd. (NICE), Flex Ltd (FLEX), Activision Blizzard Inc. (ATVI), and Advanced Micro Devices (AMD).
- Our short book is currently comprised almost entirely of single stock “alpha” shorts with some custom basket and ETF exposure. Areas of focus include consumer services and hardware, semiconductors, and advertising companies.

## Outlook

***Semiconductor sector thoughts***

- During Q1 we benefitted from our positioning in semiconductors, with strong long contributions from NVIDIA (NVDA) and Advanced Micro Devices (AMD) and a continued short contribution from a name we wrote about in our 2022 year-end letter, as well as underperforming hedges in the semi space. As a result, our net return in semis was significant relative to minimal net exposure for the quarter.
- We first started small long positions in NVDA and AMD last October as we felt the names checked several boxes for a “trading” bottom, at least. Both stocks had essentially crashed to 2/3 below their peak stock price and had gone through several quarters of estimate cuts and some inventory write-downs. In addition, our analysis indicated both companies were under-shipping end-demand and inventory was falling throughout the food chain. Our analysis and decades of experience also showed that semiconductor stocks typically bottom several quarters before revenue and earnings bottom. Though both companies faced an uncertain 1H2023, this was very well known, while their design roadmaps and our discussions with customers suggested each company had strong product cycles set for 2H23 at the latest. Finally, though this is not something we’ve encountered before, both stocks had given back the “covid bubble” hyperbolic stock move and looked to be back inline with pre-covid trendlines. While we usually traffic in smaller cap names, given the uncertain macro environment we liked that both NVDA and AMD were extremally liquid should we need to reverse course.
- Fortunately we were long some NVDA and AMD when ChatGPT first started to make news. In hindsight it may seem obvious, but, while the early buzz on ChatGPT was notable, it took some time to build as a news cycle. Lucky for us, we’ve been active in AI research since the days of IBM’s Watson over a decade ago and attended our first AI conference over five years ago. Thus, when we first heard of ChatGPT we immediately put it to use. We had the AI write commercials for us, design weight-lifting routines, guide us on how to train for a marathon, create dinner plans, etc. The results were spectacular and well beyond anything we’d ever seen, to put it mildly. In our view, ChatGPT was a “killer app” moment for AI. We saw a huge market ahead that was not in current estimates. Before ChatGPT, AI was something uncertain and in the future; after ChatGPT the future was now.

- Based on our existing knowledge built over the past decade, we immediately knew NVDA was essentially a monopoly player in AI, with a significant presence in almost every AI project we had ever heard of. We also knew that AMD, with its GPU and processor capabilities, had DNA similar to NVDA, and though AMD didn't have a strong current AI presence, the market would be so large and a second source so needed, that AMD could develop into the area within one to two years. So very shortly after seeing ChatGPT for the first time, we built full-sized investment positions in NVDA and AMD. NVDA and AMD are much larger than the companies we typically focus on, but we invest in companies with free optionality and strong competitive moats where situations are misunderstood. We believed AI was not priced into either stock, the opportunity was highly underestimated, the positive optionality was very, very large, and the competitive moats were highly compelling (even megacap INTC had made almost no progress in the GPUs NVDA and AMD specialize in). So, we made rare forays into the megacap area.
- NVDA and AMD are in our view the cleanest ways to play AI. While the better small and mid-caps will benefit from AI over time and the AI investable universe will expand, for now we see AI development as highly specialized and capital intensive, and so requiring well-capitalized companies and years of specialization. Over the last several months, we have relished seeing article headlines and talking heads on television talk about AI "hype". This provided a fertile skepticism for NVDA and AMD to climb a "wall of worry." It was clear to us that AI was not "hype;" it was real. To check ourselves we listened to industry experts, monitored AI model development and business models, and talked to management teams across many industries. In short, every C-suite we spoke with was aware of AI and had begun thinking about how to incorporate it into their businesses and what the threats and opportunities were. Three months before none of the C-executives gave AI any thought at all. We also saw waiting lists develop for usage of AI cloud computing and the industry was already clearly undersupplied. Where this will lead us exactly, we are not sure. The specific outcome is highly uncertain. But what seems certain is significant changes are ahead across our entire economy – across the entire country really. As we see companies in our universe incorporate AI into their businesses or fall behind, we expect to be fast acting on assessing these changes and investing in winners and avoiding/shorting the losers. This is a dynamic, multiyear trend we were in front of and we will work to remain so.
- As mentioned above, in Q1, we also shorted several semiconductor companies. We benefited from shorting a company that has gone "all in" on making semiconductors out of a new material that are particularly used in EVs. We remain short this company as we see its business model as nowhere near fully-funded and we have to go out to highly uncertain 2027 projections to get any material value for the company. As funding has become more difficult of late and the stock price has fallen, we believe the company remains stuck in a self-reinforcing downward trend. The lower the stock price goes, the harder it will be to raise the money the company needs to feed its business plan; the harder it is to raise money, the lower the stock price should go. During Q1, we also benefited from shorts in several underperforming semi companies, where estimates had not begun to reset and we saw inventory and demand corrections as inevitable. In general, our hit rate on the financial reports of these positions was quite high, on the order of 80%+, but with a strong semi tape overall, some

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of these positions incurred losses. However, the short “basket” overall significantly underperformed our NVDA and AMD longs, helping drive strong returns for our semi book with minimal net exposure.

***Software sector thoughts***

- Over the last 18 months or so software has been a one directional trade, driven initially by the historic move in rates, followed by negative growth revisions due to a weakening demand environment. While starting multiples were extended and even in bubble territory for the highfliers, there has been very little discrimination on the way down and we've seen strong cash generative businesses in real growth markets trade the same way as speculative EV/crypto stocks or other non profitable technology sub-sectors. With rates leveling out, we believe we are getting closer to seeing some real bifurcation of performance and view the space as rich hunting grounds for long and short stock picking.
- Before diving into our thoughts around what might drive software shorter-term, we think it's important to take a step back and remind ourselves what the long term trends look like for the space. There are a few key trends that have driven software over the past decade, and we expect a new key driver to be layered on top of these existing trends (which arguably enhances all the existing trends) going forward:
- 1) Shift to the public cloud: it is hard to overstate how large an impact this has had on software. The three "horsemen" of cloud have been:

  a) Public cloud: After a phase of optimization that may last into 2024, we expect the shift to the public cloud to continue for the next several years. The ability to (somewhat) optimize and ramp spend and cloud capacity to the downside is in fact one of the key selling points of the public cloud and we view this as a cyclical period within the broader secular trend. However, unlike a lot of commentators out there, we expect businesses to form muscle memory and an "on-going discipline" around optimization going forward, instead of a one and done phase.

  b) SaaS: Software as a service has been a wildly successful business model for software and we don't see that changing. However, there are new pricing models besides subscription that have taken off, with "consumption" at the forefront. It remains to be seen how such models evolve but the general direction of travel continues to be to lower friction to on-ramp and off-ramp your spend, which is healthy for long-term adoption penetration.

  c) Architectural shift to "cloud-native": While points a &b get all the attention, we have found that the architectural shift has created some of the best investment opportunities for us that were mispriced/misunderstood. Understanding the nuances of the architectural shift and the advantages/disadvantages of various vendors has been a reliable source of research advantage. With on-going change in the space, we don't expect this to change materially any time soon.
- 2) Cyber security: It goes without saying, that this is only getting ever more important, with the attack surfaces multiplying and both attackers and defenders getting smarter, faster and stronger every day. We expect cyber spend to hold up better than other areas through a downturn.

- 3) Automation and Intelligence/AI: A lot of the ROI software delivers boils down to efficiency and automation, which AI can supercharge, thus making software a natural place for AI's implementation and possible disruption. While ChatGPT as a consumer-oriented tool has conquered imaginations and is certainly driving investment into products and services as we speak, some of the best applications for AI are in the B2B space and we expect a new wave of software companies to try and disrupt the current incumbents, while incumbents can multiply their TAMs and deliver pricing power. A number of application software sectors directly talk to monetization as a function of spend on software vs headcount growing over time and we expect this march to continue and likely accelerate. R&D, Construction, EDA, Customer Service, and Contact Center are just some end-markets where companies are specifically looking to drive and augment employee productivity, solve hiring problems and expand their TAMs by allowing a constrained workforce to produce more. While we see potentially interesting opportunities on both the long and the short side, we are cautious in actioning any software thesis off AI just yet. [[ As we discuss in our Semiconductor review, the technology will first drive real stock performance and investment in the semi layer before we feel the impacts "further up the stack" to software.
- Looking shorter term, heading into 2023 we expected most high-quality names to see estimate revisions bottom soon and likely trend up into 2H23 and into 2024, thus setting up well for a rally. However, with the March banking crisis and the ensuing rate driven rally in software 1Q23 setups are a bit more challenged than previously anticipated. The group needs to contend with tougher positioning into what is to be at least an incrementally worsening environment (banks are big technology spenders). We are actively concerned about deal slippage for March given the twin crises in US regional banks and CS in Europe but the market can look through it as long as it's not widespread. We are still in the process of finishing our due diligence for the quarter, but we have not observed major issues yet. One of the key questions on investors' minds is has all this cost-cutting by software companies adversely impacted sales productivity, and we believe there are several bottoms-up differences that will drive this dynamic. Looking beyond 1Q 2023, 2H continues to look intriguing for dispersion in space. The hardest sectors with a lot of tech exposure are likely to reach a bottom on their negative revisions by approximately 2Q, setting up as favorable hunting grounds for late 2023 and beyond.
- In summary, we continue to expect software to remain a highly dynamic sector with plenty of opportunity to drive long and short returns.

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