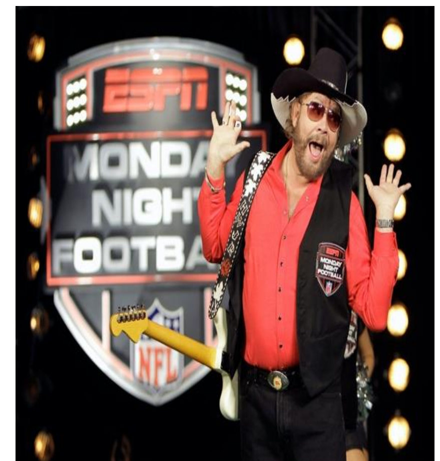
2020 has been "a year to forget" and we can't wait for a better environment in 2021. However, there has been some good to come out of this rotten year. As Lightning season ticket holders, we were thrilled when our Bolts brought home the greatest trophy in all of sports – the Stanley Cup.

Many people (including us) have put on a few pounds during this global pandemic, but the Lightning are coming home from the NHL playoff bubble 34.5 pounds heavier. For some amusing and obscure details about ***The Cup***, take a look at our "Cliff Clavin" section on the last page.

Introduction:

For the first 5 years of Manole Capital's quarterly newsletters, we provided macro commentary and discussed issues like interest rates, inflation, trade, and Fed actions. After we discussed these bigger picture items, we then touched on some issues impacting our FINTECH industry. Starting with last quarter's newsletter, we made a subtle, but noticeable shift. Instead of providing you with macro commentary, we want to spend the vast majority of our quarterly note discussing specific FINTECH issues. We inserted a section called "***What We're Watching in FINTECH"***, but needed to think of something catchier. With this note, we are calling this ***"Manole Capital University"*** and we hope you appreciate some of the bigger trends we are closely monitoring. We know you have access to dozens of economist notes, so having us focus our research on FINTECH seemed appropriate. We simply want to make our quarterly newsletter aligned with our focus, on the emerging FINTECH industry.

For over 20 years, Monday Night Football had a wonderful lead-in theme song titled "*Are You Ready For Some Football?",* sung by Hank Williams Jr. Why do we bring up this obscure, but catchy theme song? As we start the 4th quarter of 2020, we wanted to ask, "*Are You Ready For Some Volatility"?*



How do we prepare for volatility? Well, we own companies that generate significant free cash flow and one's that have sizeable amounts of cash on their balances sheets. Also, many of our holdings dominate their industry and actually have businesses that benefit from this environment of uncertainty. We don't have a magic 8-ball to guide us, but we do rely on our 25-years of asset management experience and our disciplined strategy, process and investment philosophy.

For years, many investors have simply "bought the dip", each time the market encounters a rough patch. With the environment today filled with so much uncertainty, we would advocate using some patience and preparing for elevated volatility. We aren't saying you should rush into cash and hide money in your mattress, but we are attempting to create some downside protection in our FINTECH long/short portfolios.

Today's News:

Manole Capital's quarterly newsletters will always focus on the economic side of the equation and we never will enter the political pool. Rest assured, we will not get political now.

As of today, there seems like an unending list of fears impacting the markets, including resurgence of COVID-19, a very "nasty" election, geopolitical tensions with China and stop-and-start news on another fiscal stimulus package. How markets will react to a Democratic sweep or a Republican resurgence? What if we get a contested result? 2020 has already been a tumultuous year, but a presidential election adds another layer of uncertainty. With a pandemic in full swing, unemployment still high and economic growth at a standstill, the stakes are quite high. The two candidates have vastly different visions about the role of government, tax law, trade and regulation. Who wins the election will absolutely affect the stock market and its performance going forward.

The election is only a week or so away. The old adage of people voting with their pocketbook may not be as powerful as in prior years. It was James Carville in 1992 that famously said, "it's the economy stupid!", when correlating economic conditions to job approval. President's usually win a re-election bid when the economy is doing well in their fourth year in office. From Reagan to Bush to Clinton to GW Bush to Obama, a positive economy led to another four years in the White House. Since we are in the midst of a global pandemic, more voters just might allow COVID-19 into their decision, not just the economy.

Back To Normal?

The stock market's V-shaped recovery, since that March 23rd low, has many investors feeling good about our economy. The market climbed back to new highs as the pandemic's threat to economic growth seemed to moderate. Many investors started looking ahead to a more normalized environment next year, when corporate earnings would recover in earnest. We aren't ready to concede that things are normalizing just yet. The month of September felt like four straight weeks of declines and many of the technology names that have been leading the market higher came under significant pressure.

COVID-19 has fundamentally altered businesses around the world, and companies are trying to deal with unprecedented amount of volatility and uncertainty. We will attempt to lay out the case how some of our companies are actually *benefiting* from this challenging environment. We are 8 to 9 months into this pandemic and we are still not truly back to "normal". As of today, many companies have already figured out how to allow their teams to collaborate and work from home. Employees have adapted and are mostly efficient, except for the occasional dog barking interruption in a Zoom meeting.

Will corporate offices ever return to pre-COVID-19 world? At a recent virtual conference, Larry Fink, the CEO of Blackrock said, "I don't believe BlackRock will be ever 100% back in office. I actually believe maybe 60% or 70%, and maybe that's a rotation of people, but I don't believe we'll ever have a full cadre of people in [the] office." We are slowly coming to the realization that the desirable ol' days might be a year or two or more away. As you read our note, we'd love to hear your thoughts, especially if you disagree or have a counterpoint.

Just a Little Macro Commentary:

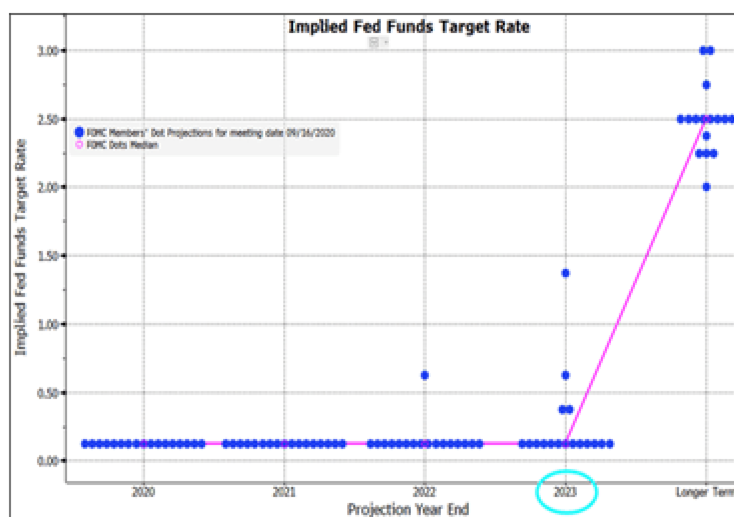
I guess we couldn't resist a few macro thoughts. As we said last quarter, we have tried to alter our quarterly newsletters to focus on the FINTECH sector, leaving the macroeconomic commentary behind.

Just a few weeks ago (at the Fed's annual Jackson Hole, Wyoming event), Fed Chairman Powell said that he does not foresee raising interest rates until 2023. With interest rates likely to stay at their current near zero levels, that really isn't too much to discuss about the yield curve. That is, until it inverts again or we get negative interest rates. Don't laugh, that could happen in the US too. As of today, there is an estimated $17 trillion in negative yielding debt securities issued.

In terms of inflation, the Fed recently took away the 2nd aspect of their dual mandate. As a reminder, the Fed's two mandates are to shoot for full employment and target an inflation rate of 2%. Inflation has been dormant for over a decade and the Fed stated that it is essentially removing the inflation target rate from its policy decisions. Most people do not find "Fed-speak" terribly invigorating (or even interesting), but we found this change to be almost historic. The Fed is now officially untethering itself from a its long-running goal of 2% inflation, as Chairman Powell said this had become "obsolete".

Both Fed Vice Chair Richard Clarida and Chicago Fed President Charles Evans said that rates will not increase until the labor markets fully recovers. Clarida said, "rates will be at the current level, which is basically zero, until actual observed PCE inflation has reached 2%". "That's 'at least'. We could actually keep rates at this level beyond that". With comments like this from important Fed members, we think macro expectations (labor, inflation, interest rates, etc) should not play a major factor in daily stock market moves. Famous last words, right?

Our big macro takeaway is that we envision the Fed keeping its accommodative monetary policy, including additional asset purchases. From our perspective, we believe that the Fed will keep interest rates "lower for longer". The Fed is leaning toward a little more "art than science", when it comes to determining when it is time to raise rates and curtail inflation.

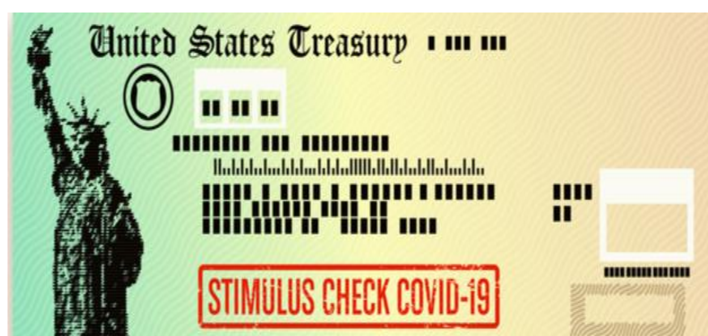


As one can see on this Bloomberg dot chart, even without inflation targeting, the next rate hike is a long way off. 17 Fed officials now believe interest rates should stay near zero until the end of 2021, while 13 "kicked the can" to 2023. Considering there's no inflation and no expected changes to interest rates, we will leave the macro commentary to 1 of 50 expert macro economists out there. With the Fed paused, we want to move on from macro commentary and focus on the fundamentals.

Wall Street vs Main Street:

On August 5, the stock market was essentially flat. However, if you bothered to read the Wall Street Journal that day (something we still do), the headlines were downright scary. Here are 10 of the top stories in the WSJ that:

- Disney Posts First Loss Since 2001
- How Department Stores Lost Flair For Innovation
- Emerging Markets Gird for Defaults
- BP Chops Dividend in Half
- Wynn Resorts Revenue Plunges
- Bayer Posts $11 Billion Loss Due to Litigation
- Parent of Kayak and Priceline Cuts Jobs
- Opioid Maker Weighs Chapter 11
- Coronavirus Squeezes Urban Office Markets
- AIG's Results Look Grim



Why is there such a big disconnect between Wall Street and Main Street? The stock market is focused on current earnings, forward guidance and whether or not a second stimulus package will get passed, before the election. The average American is concerned about their job, dealing with COVID-19 and a host of other social issues. Unfortunately, too many Americans are struggling to pay the bills. Fed Chairman Powell recently said that "more fiscal support is likely to be needed," and that the Fed cannot be alone in rescuing this uncertain economy. Another round of stimulus will be a boost for equity markets, but we feel like it might be like "putting a band-aid on a gunshot wound." While many in Washington seem to agree that more stimulus is needed and that many Americans need help, some political issues are holding up a deal. Unfortunately, political fighting never seems to end.

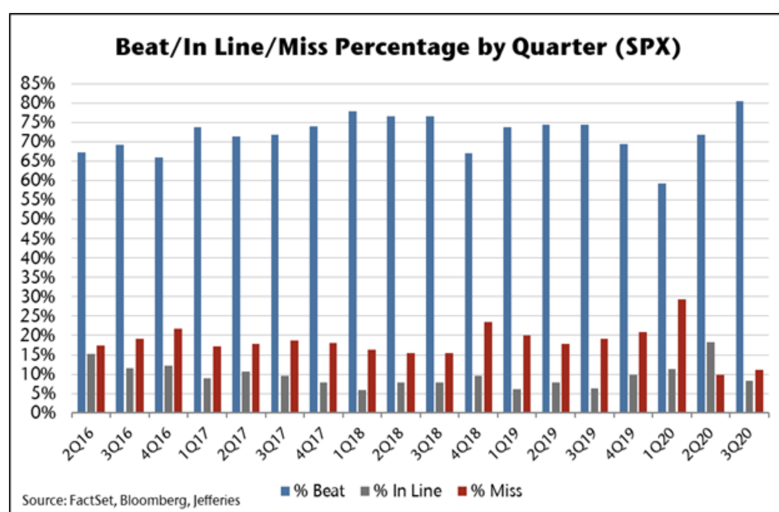
Overall, uncertainty seems to be the word "du jour" for describing our economic, political, and social situation. The economy has made strong gains off the bottom, but it remains a long way off from pre-COVID levels. While some of the gains were from stimulus and a strong Fed response, but more will be needed until we get a vaccine. As we sit here today, the economy is recovering, but it isn't terribly healthy. Some of the tailwinds are starting to fade and the environment is tenuous. The main concept for long-term investors to take away from this environment is that the market always looks forward and moves on expectations (not prior or even the current reality).

We believe valuations of businesses should reflect a company's ability to adapt to uncertainty. How will a business survive in 2021 and beyond? Will conditions improve and growth return? Will we experience a 2nd or 3rd wave of infections? When will a vaccine be ready for mass distribution and will people take it? There are no easy answers to these questions, except for us to realize that the stock market is focused on the prospect that the worst of this crisis is behind us. This dynamic of current events (for Main Street) versus forward expectations (for Wall Street) is critical to understand.

The Earnings "Game":

In July and August, companies reported their 2nd quarter results. Earnings expectations for the S&P 500 were initially expecting a decline (43%), but the actual outcome was much better, down only (32%). Why do we bring this up? Well, as you are reading this, earnings season is in full swing and the "game" has begun. We believe earnings calls are critically important, but our focus is not necessarily on last quarters stated GAAP earnings or whether or not a company beats sell-side numbers. Do we want our companies to exceed the estimates Wall Street is expecting? Oh course! However, instead of looking backwards, we strive to look forward and understand the longer-term opportunity.

Why do we spend so much time modeling companies and understanding how they generate free cash flow? We believe that if a company consistently grows free cash flow (and exceeds EPS expectations), its stock price will follow. We emphasis free cash flow, as we believe that its growth is an excellent indicator for future stock prices. This "game" is important to understand, as the market typically moves higher when results exceed expectations. If a company can report better-than-expected earnings, we would anticipate (all else being equal) for the stock to climb higher.



As this FactSet / Bloomberg chart shows, roughly 2/3rd of companies in the S&P 500 typically "beat" EPS estimates. Just last quarter, 80% of the S&P 500 constituents beat consensus earnings forecasts. Even with revenues down double-digits and earnings falling by over 30%, Wall Street was pleased with results. Since sell-side analysts lowered their projections beforehand, companies were able to handily "beat" sell-side estimates. This is the game that typically occurs each and every quarter on Wall Street.

Expectations:

Now that we have discredited the entire earnings process, let's now look at the soon-to-be reported 3rd quarter. A few months ago, S&P 500 earnings estimates for the 3rd quarter were forecasting a year-over-year decline of (27%). A month later, EPS estimates were guesstimating (24%). As a today, 3rd quarter S&P 500 earnings are expected to decline by (21%) year-over-year. So, expectations are still materially down year-over-year, but they are "less bad" than many were estimating a few months ago. Just like last quarter, companies have hinted at conferences and gotten their sell-side analysts to lower quarterly projections and estimates.

We slowly emerging from those initial pandemic-driven lockdowns, but each city and state is recovering at a different pace. If one deciphers the market into its 11 GICS® (Global Industry Classification Standard) sectors, we can see some big differences between how companies have handled and managed through this global pandemic.

Sector	Today
Consumer Discretionary	-33.7%
Consumer Staples	-3.3%
Energy	-117.4%
Financials	-17.6%
Health Care	-2.1%
Industrials	-65.0%
Materials	-13.9%
Real Estate	-14.2%
Technology	-0.5%
Communication Services	-20.4%
Utilities	-3.8%
S&P 500	**-20.7%**

Source: I/B/E/S data from Refinitiv

As this IBES chart shows, only a few sectors are flattish or showing just modest decreases in forecasted earnings. The sectors that are close to returning to growth are Technology (down 1%), Consumer Staples (down 3%), Healthcare (down 2%) and Utilities (down 4%). On the flip side, certain sectors continue to struggle, like Consumer Discretionary (down 34%), Financials (down 18%), Industrials (down 65%) and Energy (down 117%).

Wall Street is modeling in a "bottoming" of overall revenue and earnings in the 3rd quarter of 2020. Looking forward, revenue will turn positive on a year-over-year basis in the 4th quarter of 2020, with expectations for 2021 being up mid-teens. This type of revenue growth has the sell-side looking for earnings growth next year in the +20% range.

As we look to 2021, the extraordinary global monetary and fiscal stimulus, coupled with expectations for a fast-tracked vaccine / COVID-19 therapy, suggest a positive forward outlook. The amount of stimulus is unprecedented and the world is awash with liquidity, with much of that finding its way to global stock markets. However, we believe that equities will need a sustained economic recovery to support these valuations.

Performance:

During 2020, the S&P 500 has been on quite a roller coaster. From January 1st to February 19th, the S&P 500 was up 5%. Once COVID-19 cases began to accelerate in the US, the S&P 500 ended its decade-long bull market. From February 19th until March 23rd, the S&P 500 fell by (34%). Following the significant actions of the government and Fed, the S&P 500 recovered and experienced a V-shaped recovery of over 53%. This was the largest five month increase in the S&P 500 since 1938. As of today, the S&P 500 is up 6.5% this year, as if there wasn't a global pandemic still raging across the world. In terms of performance this year, only three sectors of the market are positive: Information Technology up 27%, Consumer Discretionary up +24% and Communication Services, up +8%. The other eight sectors are all down, with the worst performing areas being Energy (35%), Financials (24%) and Industrials (14%).

During the 3rd quarter of 2020, the S&P 500 rose 8.9%, which followed the impressive 2nd quarter rebound of 20.5%. This was the best two quarter performance of the S&P 500 since 2009. For the S&P 500, both July and August were positive at +5.6% and +7.2%, but September was down (3.8%), snapping a five month winning streak. This was the worst September since 2011 and it hit certain technology stocks quite hard. In just 2 days, leading into the Labor Day holiday, the Nasdaq market dropped over (6%). In one single day, Apple lost $179.9 billion off of its market capitalization. Not only was the worst one-day loss for a company ever, but that loss was bigger than the individual market capitalizations of 470 of the companies in the entire S&P 500.

Not only did technology get hit, but there was also a subtle shift which many investors might have missed. For the first time in a while, value stocks outperformed growth stocks. Was this a shift from high growth to deep value? Was there some temporary profit taking in technology stocks? Are some investors desperately seeking a dividend yield? Is the market factoring in differences between a Trump versus Biden administration? All of these questions are valid, but unanswerable. For us, we will not market time or chase certain “hot” sectors. We will stay disciplined to our bottoms up, fundamental research process of identifying free cash flowing FINTECH companies.

Valuations:

There are actually 505 companies that constitute the S&P 500, not 500 different firms. Our point is that we find flaws in a simple valuation metric for the entire market. While using the forward P/E might be helpful in understanding bigger picture items, one really has to dive into the details and specific valuations on a company-by-company basis. The S&P truly is an index of various companies, in assorted industries, all with different growth outlooks and prospects.

The 10-year average forward S&P 500 P/E multiple is 15.1x versus today’s 22x, per FactSet. Certain skeptics say that the US stock market has not traded at this high a forward multiple since the late 1990’s. In fact, the last time the S&P 500 sustained a forward P/E of over 20x was during the tech bubble. While there are pockets of the market that are absolutely overvalued, we are still able to identify and own companies we find attractively priced. The key for us and what separates this time period from the tech bubble era is profitability. Two decades ago, many technology companies did not generate any cash flow or earnings. Fast forward to today and many of these technology companies are literally printing free cash flow.

Some stock valuations are incredibly high right now, but let’s take a quick look where long-term Treasuries are trading. If we consider US Treasuries as the world’s “safe haven asset”, then they are shockingly expensive. Compared to 0.70% US Treasury rates, a 5% earnings yield on stocks (the inverse of this P/E multiple) could be considered downright attractive. We continue to believe that secular growing FINTECH companies represents a better risk/reward tradeoff than purchasing fixed income, especially in this low inflation, low-growth environment.

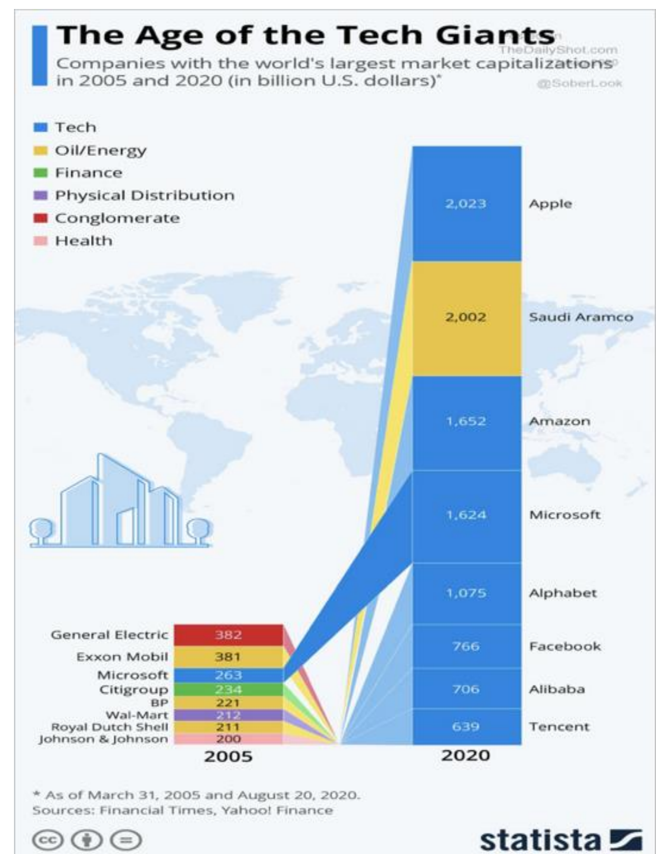
Meager expected returns in fixed income, seem to be leading more and more investors to pile into equities. Those companies that can generate decent growth rates, especially in this lackluster economy, are being rewarded. Those that have promising future growth expectations, are receiving elevated valuations and stock price appreciation. Some of these high-flyers are coming to the market in the form of IPO’s, which we will address in detail, in a few pages. From our perspective, there is clear enthusiasm for certain technology stocks, bordering on exuberance, which has not been experienced in a couple of decades. Some of this “frenzy” is coming from retail investors, which have been trading at elevated levels for decades.

Tech Giants:

Speaking of elevated valuations, we thought we would discuss a few high-flying technology companies. As we mentioned in our 3rd quarter newsletter, the S&P 500 continues to be driven by a select group of tech stocks. FAANGM or Facebook, Apple, Amazon, Netflix, Google and Microsoft continue to dominate the US stock market.

Year-to-date 2020, these stocks have generated impressive returns, with Facebook up +33%, Apple up +67%, Amazon up +82%, Netflix up +68%, Google up +16% and Microsoft up +42%. With these impressive year-to-date returns, 4 of these 6 companies have market capitalizations over a once un-imaginable $1 trillion. Why do we continue to highlight the concentrated returns among this small group of stocks? Maybe we're just jealous, since we do not own any of these 6 companies. Well, the S&P 500 remains the most important US index and it positions and weighs firms by their market capitalization. For example, companies make up more and more of the index, as they get larger and larger.

We saw this Statista graphic and it really struck a chord with us. Looking back 15 years, there was a fairly diversified mix of the world's largest companies, across 6 different sectors. Now, 7 of the 8 largest companies in the world are technology companies. With Apple as the largest company in the S&P 500 right now, it represents 6.6% of the index. If we combine Apple, Microsoft 5.7%, Amazon 4.9%, Alphabet 3.2% and Facebook 2.2%, these five equate to astounding 22.6% of the total S&P 500. A decade ago, the US stock market represented about 40% of the world's total stock market capitalization. With US technology companies continuing to thrive, the US now constitutes roughly 60% of the world's equity value.



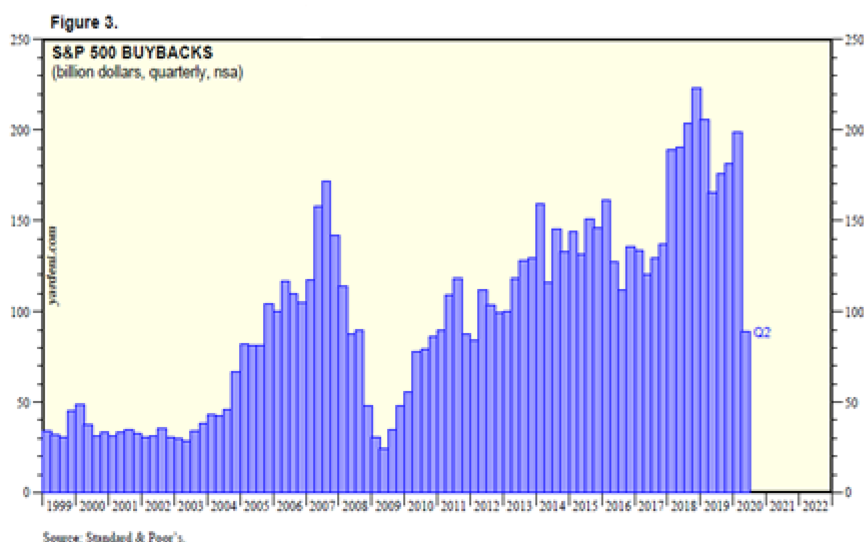
Of the nearly 25,000 companies that have issued common stock between 1925 and July of 2020, only 11 different companies have ever held the title of highest valued company (in terms of market capitalization). According to the Center for Research in Security Prices, in the University of Chicago's Booth School of Business, AT&T held the largest stock title for 43% of the this 95-year period. In 1955, E.I. Dupont de Nemours was on top of the mountain for 11 days, while Philip Morris held the top spot for 34 days in 1991. In 1992, Wal-Mart was the titleholder for only 3 days. In the early 1930's, AT&T actually was 1/8th of the value of the entire US stock market. Even into the 1960's, AT&T was 1/12th of the entire index. Now that was a monopoly!

It isn't just these 6 tech companies that have experienced wonderful 2020 performance, but it sure seems like the whole technology sector has dramatically rallied. The Nasdaq Composite (which is comprised of many tech companies) hasn't had this many stocks increase in value, by over 400%, since 2000. We continue to highlight this because the technology sector and a few of its star performers, are shining brighter than ever. This is creating a stark divide with the rest of the S&P 500 sectors.

Rationally Allocating Capital:

We look for a set of desirable characteristics in each of our positions (click here). One of the areas we focus on, is whether or not management teams are rationing allocation capital. When a business generates free cash flow, management has various ways to spend that money. We obviously want companies to re-invest back into their businesses, especially if they can generate a good return on that investment. When a business has excess capital, it can look at acquisitions, to buyback its stock and/or to pay a dividend.

In the 2nd quarter, according to Janus Henderson, total shareholder dividend payouts fell by $108 billion to $382 billion. This was the lowest 2nd quarter payout since 2012. With record-low interest rates, we are somewhat surprised there isn't more interest in owning dividend paying companies. The S&P 500 Dividend Aristocrats index has 65 companies that have at least a 25-year history of paying out and increasing their dividends. Surprisingly, this index is down (1%) this year, which is its widest underperformance versus the overall market since 2007.

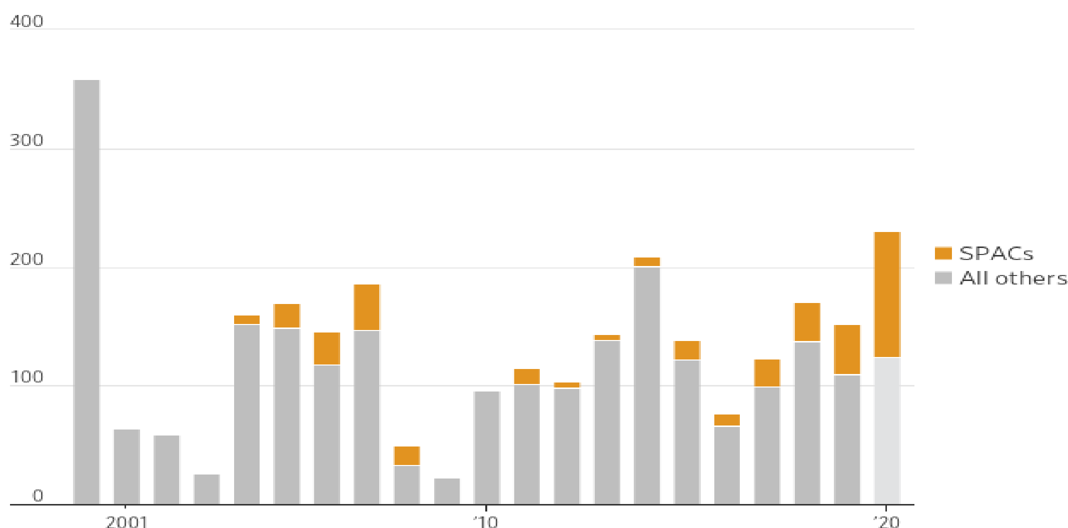


As you can see in this S&P chart, buybacks last quarter were down (48%) year-over-year; down by over (50%) sequentially. In fact, S&P 500 companies only bought $89 billion of their own stock last quarter, which was the lowest level since March of 2012. Over half the companies in market reported no buybacks in the quarter, which was more than double a year ago. Financials are typically one of the strongest sectors for buybacks, but their stock repurchases were down (82%) quarter-over-quarter. Unlike other companies, where management teams can freely allocate their capital, the Fed has asked (more like required) US banks to preserve their capital. This remains one of the unusual aspects of owning financials, as they typically do not have free access and control over their balance sheet, in terms of buybacks or paying out more in dividends.

IPO's & SPAC's & Direct Listings, oh my!:

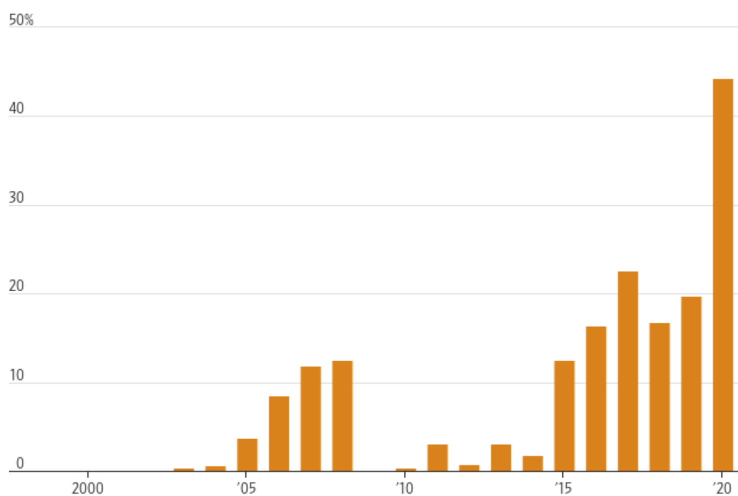
The IPO market is partying like its 1999. According to Dealogic, this is the most concentrated the IPO market has been since 2007, when the "hot" sectors were banks and lending institutions. 80% of the capital raised this year is going into three primary areas, technology, healthcare and SPAC's (special purpose acquisition companies). Investors cannot get enough of these new offerings and the average one-day gain on IPO's is averaging 24%, its highest since early 2000.

As this Dealogic chart shows, with a few months left in 2020, US-listed IPO's just exceeded $200 billion. This exceeds 2014's levels and the highest amount of capital raised since 2000. Many private companies avoided a public listing (and an IPO), because of the regulatory hassle. Now, with the market awash in liquidity and cash, there seems to be a rush to enter the public sphere.



Private companies used to follow a formulaic process of going public. Most would raise capital via funding rounds and then follow a typical IPO roadshow process. In a global pandemic, with social distancing and rules concerning travel, many companies are excited not to traverse the country doing non-stop roadshows. With virtual roadshows, more possible investors can listen to management and participate in the process.

In addition to IPO's, companies can choose to do a "direct listing". With a direct listing, the new public company does not raise new capital, so this process is really only for cash-rich startups, looking to permit founders and early investors to cash out of their stakes. This is largely an untested model, that only a few companies have pursued, but data firm Palantir Technologies (ticker PLTR) and software firm Asana (ticker ASAN) are the latest companies to attempt this process. In 2018, Spotify did a direct listing and in 2019, Slack Technologies followed. To have their direct listing, both Palantir and Asana hired Morgan Stanley as their lead adviser and Citadel as their designated market maker. On the same day (September 30th), both companies simply began trading on the Nasdaq exchange. Instead of paying large fees to investment banks, underwriters and trading firms, direct listings simply begin to trade on their launch date. No new capital is raised and these companies begin to trade, allowing employees and early investors to sell their shares (if they wish). While Palantir has a market capitalization of $21 billion and Asana is at nearly $4 billion, both companies are down from their first trade price.



As this chart from Dealogic shows, the SPAC market has never reached nearly 50% of all annual IPO's. According to SPAC Insider, as of mid-October, there have been 143 SPAC IPO's this year. For some perspective, there were only 13 in all of 2016.

These "blank check" companies turn the traditional IPO market on its head, by raising money *before* developing a business plan. These companies are essentially publicly-traded shells, that use their newly raised proceeds to then make an acquisition. Management teams have 18 months to make a deal, but typically put the money to work sooner than that. Once an acquisition is announced, the target company converts into a publicly-trading stock.

While SPAC's aren't new, today's private companies are particularly attracted to this expeditious route to a public listing. While traditional IPO's can take up to 6 to 12 months to develop, a SPAC can launch and bring a private company to market in just a few months. This is simply today's version of instant gratification. Not only do SPAC's represent efficiency and a speed-to-market approach, but there is significantly less disclosure required. In a traditional IPO, a company must provide a detailed S-1, which is pored over by potential investors (and competitors). In a SPAC, private companies are able to shield their results from the microscope of public curiosity. That is, until a SPAC acquires them, in this version of a reverse merger.

Two of the most high-profile SPAC's in 2020 have been the online sportsbook Draftkings (DKNG) up over 250% and the electric truck manufacturer Nikola (NKLA), up over 100%. In 2020, SPAC Insider reports that the annualized rate of return is +35%, which is significantly higher than the overall market. Before one rushes into this category, some prudence is probably warranted. According to Renaissance Capital, there have been 313 SPAC IPO's since 2015 and only 31% have had positive returns.

Whether a company chooses to have a IPO, get acquired by a SPAC or even do a direct listing, there are clearly multiple ways for private companies to access the public markets. The spectrum of acceptable alternatives is growing and the number of companies accessing the capital markets is brisk. Years ago, many traditional asset managers could only own companies once they were public. Now, firms like T Rowe Price and Fidelity are able to add private securities to some of their funds. Only time will tell if these new listings are successful, but it certainly represents an era of ample liquidity. Now that the "window is open", companies are racing to access capital. As many experienced in February of this year, when the window of capital raising closes, it can slam itself shut!

Manole Capital University:

Education is defined as "the process of receiving or giving systematic instruction", while learning is "the acquisition of knowledge or skills through experience." While often considered synonyms, we think they are very different. Education is often the effort and hustle for a credential or getting a specific certification. While an institution can educate you, it is up to the individual to want to learn.

For us, learning is a lifelong skill that cannot be forced; it requires your active participation and will. We have found that our learning often benefits from experience. One of the few benefits of being an asset manager versus a professional athlete, is that we can get better with time and experience, while the athlete has a short and finite career. That is, excluding the Tampa Bay's ageless QB wonder - Tom Brady.

In this newsletter, we start by hitting some themes in payment land (contactless, eCommerce and "tap to phone" payments). Following that, we discuss the world's largest-ever IPO – Ant Financial. We breakdown their business, review some of our concerns / issues, compare Alipay to PayPal and then we discuss how this platform came to dominate Chinese payments. Then, we revisit our Apple Pay note (from a year ago) and discuss the different approaches that Apple took, compared to Ant / Alipay. Lastly, we will highlight a new equity exchange competitor called MEMX and discuss problems the exchanges are facing with pricing their data.

Payments:

We define FINTECH as ***"anything utilizing technology to improve an established process."*** For us, we consider the payment sector as the quintessential FINTECH industry. Why? Well, our holdings are able to generate predictable, sustainable and recurring revenue; often times, *revenue per swipe*. These payment networks are scalable and they have secular tailwinds driving future growth.

Even before COVID-19, the payment sector was poised to grow. The pandemic has accelerated digital payment growth, which might have taken another decade to get fully embraced. Most of this payment technology has been around for years, but consumers seemed less likely to adopt new changes since the traditional card process worked seamlessly. However, COVID-19 has kickstarted two major payment trends. The first opportunity occurred by mandate, with stay-at-home orders and a shelter-in-place decree. This pushed business away from physical retailers (i.e. brick and mortar) towards eCommerce. The second trend is the continued migration away from cash towards digital forms of payment, like mobile and contactless payments.

In last quarter's newsletter, we highlighted QR codes and how they have taken over the Chinese market. In the US, we think that QR codes might be a tougher sell. Our market seems more inclined to "tap and pay" versus opening up one's phone to scan a QR code. Either way, the payment networks are agnostic to the payment vehicle (card or phone). Whether you swipe a card, tap a contactless card, use your phone or even scan a QR code, these networks simply want more and more transactions to flow over their scalable platform.

eCommerce:

The popularity and convenience of shopping online is not showing any signs of slowing down. Back in 2000, eCommerce represented less than 1% of total US retail sales. By the end of 2019, eCommerce has eclipsed 11%. When the US Census Bureau reports 2020 eCommerce percentage of US retail sales, we expect it will be at an all-time high. Amazon just held its 5th Amazon Prime Day and sales eclipsed $10 billion. Adobe Analytics announced that US online sales in September were up 43% year-over-year, driven by over 40% annual growth in back-to-school shopping.

In a month or so, as you get ready to do your holiday shopping, ask yourself a few simple questions. Are you planning on waiting in line for Black Friday deals? Are you planning on increasing your physical location shopping or will you be doing more online purchases this year? Are you excited about going to malls and dealing with individuals that may or not be wearing a mask? Or, will you look to do more of your holiday shopping online, from the convenience of your couch? We have to assume that your answer is like ours – eCommerce. We believe the vast majority of Americans will be shifting more and more of their holiday spend online, which has to occur over our payment networks.

As we highlighted last quarter, we believe that shifting consumer spending patterns will benefit eCommerce payment gateway providers like PayPal's Braintree, ADYEN and privately held Stripe (we own all three). Consumer spending continues to migrate online, and we are capturing this secular and predictable growth. These payment gateways allow merchants to become omni-channel (both physical and online) and in this environment, curbside pickup has been a retail savior. Bed Bath & Beyond just reported that that 36% of its digital orders were filled with in-store pickups. In September, Adobe Analytics found that buying online and picking up in-store orders grew by 62% year-over-year. Right now, it is estimated that 15% of total retail sales are considered BOPIS (buy-online-pick-up-in-store) and growing. These impressive growth rates show that the trend towards online shopping is not slowing down, but that's a process that needs a better acronym.

Contactless:

The use cases for contactless payments has been around for a decade, but COVID-19 has fast-tracked this touchless technology. COVID-19 has transformed contactless payment from "nice-to-have" to a "must-have.", as both consumers and merchants want to avoid touching payment terminals. The payment networks and processors have all reported increased used of contactless payments and there is ample evidence that COVID-19 has *pulled forward* use. We believe contactless usage will continue to soar.

Even before the lockdown in March, Mastercard reported that global contactless use was up 40% in the 1st quarter of this year. Visa just reported US contactless use increased 150% since March of 2019 and that the number of contactless transactions have more than doubled year-over-year. In a recent Square survey of small and medium sized businesses in the UK, it found that 31% of its merchants have made the move to become totally cashless by mid-July, versus only 8% in early 2020. American Express released a few statistics,

indicating contactless growth continues to accelerate. During the COVID-19 outbreak, AMEX found that 7 in 10 of its consumers have requested contactless capabilities. Also, 73% of AMEX merchants stated that their customers prefer to pay with a card or app, instead of handling cash. We are surprised it isn't higher!

Visa recently announced that it has processed more than half a billion additional touch-free payments, with increased capabilities in 29 countries across Europe. Visa claims that over 75% of its European in-store payments are now contactless. To further increase adoption across Europe, contactless payments are now available for public transit in more than 50 European cities. Visa's CEO of Europe is Charlotte Hogg and she recently said, "the increasing popularity of contactless payments across Europe is not new - the pandemic has only served to accelerate an existing trend, only now touch-free payments are no longer a convenience, but a necessity."

Cash used to be the dominant payment method for small-sized transactions, but this too is changing. It is just as simple, or simpler, to use a contactless card to tap and pay for small transactions, as it is to get out the right paper currency from your wallet. There are not too many positives from this global pandemic, but it seems like consumer habits are beginning to form with contactless and mobile-based payments. We believe that COVID-19 has kickstarted and accelerated the demise of cash in the payment industry.

Maybe you don't believe our research and think we're "talking up" our large payment exposure? Just take a look at last month's cover story in Barron's, as their article highlighted how the pandemic has accelerated the shift towards mobile and contactless payments, away from cash.

Felipe Chacon, is an economist at Square, and he said "Covid has changed the way we pay. Existing trends towards digital and cashless payments and away from cash that have been underway for years have been greatly accelerated as a result of the pandemic. Business owners have had to move fast, quickly adapting to new ways of getting paid. They've had to balance keeping themselves and customers safe and feel safe, alongside making every sale they can."

Visa's "Tap to Phone":

In late-October, Visa announced some new payment functionality called ***"tap to phone"***. This payment process is attempting to turn over two billion Android devices into payment acceptance devices. By replacing those costly POS (point-of-sale) devices, Visa believes it can accelerate mobile-based payments.

"Tap to Phone" has been launched in 15 markets across Europe, the Middle East, Africa, Asia Pacific and Latin America, in countries like Belarus, Malaysia, Peru, Russia and South Africa. Upcoming launches are planned in Brazil, Italy, United Arab Emirates, United Kingdom and then the US. Initially just for NFC-enabled Android devices, we expect it to eventually permit Apple's iPhone too.

In some countries, the in-person shopping payment experience was constrained by a lack of POS devices. Visa has fast tracked this product and reduced the implementation steps from days to minutes. Visa's goal is to bypass those costly POS devices by enabling merchants to use a mobile device to acquire a transaction. It really is as easy as downloading an app and registering a bank to deposit the funds into.

In the midst of COVID-19 and as the world increasingly turns towards digital payments, new initiatives like this can advance the checkout experience. We like the security details too, as this process works with the security of an EMV chip transaction. Each payment contains a dynamic cryptogram, that cannot be re-used. Visa's payment platform is reliable and scalable and can handle over 65,000 transactions per second. For consumers, the "tap to phone" solution allows for mobile-based payments in a quick, convenient and secure manner.

There are over 180 million micro and small merchants globally and less than 10% of these businesses currently accept digital payments. There is no need for merchants to purchase costly, additional hardware or accessories. With so many global small businesses, incorporating the acceptance process to mobile phones is a smart move.

Ant's Upcoming IPO:

Ant is the parent of the widely popular Chinese payment platform Alipay. Alibaba set-up Alipay in 2004 to help Chinese buyers pay for online purchases. From our perspective, this is similar to what eBay did with PayPal a couple of decades ago. In 2011, Alibaba spun off Ant, but kept a 33% ownership stake. Ant initially started as a payment company, with users accessing Alipay (over a mobile phone application). Once it built out a strong user base, it then branched out into other financial services. Over the last decade, it has added numerous services to its platform, like food delivery, transportation, entertainment & asset management. Ant has grown from a trusted and verified way to purchase goods on Alibaba's massive eCommerce site, to the dominant payment method for all Chinese commerce. Ant's CEO is Simon Xiaoming Hu, the company is headquartered in Hangzhou, China and it has 16,600 employees

Ant breakdowns their financial service offering into 3 distinct sectors. It identifies CreditTech, InvestmentTech and InsureTech are three vast opportunities. ***CreditTech*** is offering consumer and SMB credit balances to its users. In 2019, the credit balances were $292.3 billion. ***InvestmentTech*** is similar to an asset management business, with Ant having AuM of $493.2 billion in 2019. By 2025, Ant expects its personal investment products to grow by roughly 50%. Right now, Ant offers high interest bearing savings accounts that yield up to 2.5% annually. The last segment is ***InsureTech.*** Ant's insurance premiums and contributions were $5.5 billion in 2019 and it expects this segment to double its premiums by 2025. In addition to Ant's verticals (explained above), it has an interesting technology stack. These are another way to look at their differentiated technology proficiencies. For example, Ant discusses their advantages with an Intelligent Decisioning System (IDS), dynamic risk management scoring, AI (artificial intelligence), machine-learning algorithms and analytical abilities.

We are impressed by Ant's important user metrics, all as of June 30th, 2020. Ant has over 1 billion Alipay users and the monthly active user base has increased from 499 million in 2017 to a massive 711 million users. Ant handled roughly $10 trillion in digital payment volumes in 2017 and it has grown to $17.1 trillion. Ant not only has a sizeable user base, but it has an enormous merchant base too. It works with 80 million merchants and has over 2,000 financial institution partners. This has driven revenues and profits, which was $20.4 billion and $5.5 billion respectively.

In terms of Ant's main Chinese competitor, we would say it is Tencent's WeChat Pay. To put Ant's potential $250 billion IPO valuation into perspective, Visa has a market capitalization of roughly $425 billion, Mastercard is $345 billion, PayPal is $225 billion and American Express is $85 billion. American Express is the only one of these payment names that also takes credit risk, like Ant does.

For additional perspective versus a US-payment leader, we thought it would be interesting to compare Ant to PayPal. In terms of active accounts or users, Ant has 1 billion versus PayPal's 320 million. In terms of merchants, Ant is nearly 4x larger, with 80 million versus 26 million. Ant dwarfs PayPal's Payment TPV (total purchase volumes), with 2019 volumes of $16.1 trillion versus $712 billion. Despite significantly more volumes, the businesses generated very similar 2019 revenue, $17.5 billion versus $17.8 billion. Looking at payments revenue to total transaction revenue, Ant is much less a payment business than PayPal. Ant generates $7.5 billion from payments or 43% of its 2019 revenue. PayPal generated $16.1 billion in payments in 2019, representing roughly 90% of its total. Lastly, Ant geographic revenue mix is 94% Chinese, while PayPal is only 53% US-based.

One of our worries about Ant, is how Chinese centric the business currently is. Yes, the Chinese opportunity is immense, as the world's largest population. The positives are all well-known. China had 750 million mobile internet users in 2017 and it will probably grow towards 1.1 billion by 2025. Ant's payment platform will be driven by spending, which is on an impressive growth rate. Chinese Personal Consumption Expenditures (PCE) in 2017 were $3.6 trillion and they are expected to be $7.4 trillion by 2025. Chinese Personal Disposable Income was $5.2 trillion in 2017 and will likely grow to $8.7 trillion by 2025. Despite these positive fundamentals, we are concerned with its dependence on the Chinese market and if the model will work outside of China.

First of all, international companies have significantly different regulations and rules than we have here in the US. We are not saying our marketplace is better than another, but the US market does have significantly more transparency and experience monitoring company operations. Ant's credit sensitive business can be viewed in a similar lens as a US bank (in terms of lending). On its "consumer" portfolio, the delinquency rates have nearly doubled this year. At the end of 2019, the 30-day and 90-day delinquency rates were 1.56% and 1.05%. As of the end of July, the 30-day and 90-day delinquency rates were 2.97% and 2.15%. On its "SMB" credit enabled portfolio, the delinquency rates have also significantly increased this year. At the end of 2019, the 30-day and 90-day delinquency rates were 2.03% and 1.57%. As of the end of July, the 30-day and 90-day delinquency rates

were 2.65% and 2.02%. We are always questioning opaque balance sheets and credit sensitivities for lending businesses. We often discount US banks and their ability to properly account for losses. From our perspective, we are especially doubtful that a Chinese entity would utilize ultra conservative estimates for accruing for credit losses.

Another concern of ours is whether or not Ant can successfully transition outside of China. Can Ant take its payment platform and business model outside of mainland China? Even if it works outside of China, we wonder if the US put any restrictions on Ant Group or Tencent. The Trump administration has made some hostile comments towards China and we would not be surprised if it was exploring restrictions on Ant's billionaire founder, Jack Ma.

We do not believe that digital payment platforms could threaten US national security, but we said the same thing about Tik Tok too. If the Trump administration moves against these Chinese payment platforms, it obviously would hamper the sentiment on Ant's prospects. As Bloomberg reported in early October, there is an active debate among senior US officials about whether or not to restrict Ant's IPO. While some US officials might be concerned that Ant and other Chinese FINTECH platforms will dominate global digital payments, we would simply ask for a "level playing field". If Ant and Tencent are allowed to enter the US market, why can't Visa or Mastercard or PayPal enter the Chinese market? We do not believe any of the US payment networks are scared of competition, but they simply want the opportunity and chance to compete.

Ant has already experienced some negative regulatory constraints, as it attempted to exit China and enter the US market. In January of 2017 Ant attempted to acquire publicly-traded Moneygram (ticker MGI) for $880 million. It later increased this bid to $1.2 billion, but price was not the primary issue. This transaction was prevented by the US Committee on Foreign Investment, as a "security threat". On February 14th, 2019, Ant changed it target and announced its acquisition of WorldFirst. Since this company was headquartered in London, it did not receive the same level of scrutiny. WorldFirst is an international cross-border payments and foreign currency company. In our opinion, this is the exact business Ant should be targeting to broaden its business outside of China. As Ant tries to go global, having a multi-currency B-2-B payments platform will be critically important to its future.

Over the last 4 to 5 years, Ant has raised a significant amount of capital. Their Series A was in July 2015, raising $1.9 billion, for an implied valuation of $48 billion. The Series B round was in April 2016, raising $4.5 billion for an implied valuation of $60 billion. In May of 2019, Ant raised a Series C round for $14 billion, implying a valuation of $150 billion. On August 25th, Ant filed a S-1, indicated an intention to have an IPO this year. If it were to raise $35 in an IPO, Ant would have a market valuation approaching $250 billion. For perspective, this would be the world's largest IPO's.

The details concerning size and timetable are still unknown, but Ant has stated that the use of its IPO proceeds are "to pursue its vision to digitize the service industry, enhance its innovation, R&D capabilities, expand its cross-border payment and merchant services initiatives and for working capital and general corporate purposes."

Another issue for us, is that this IPO is only listing on Hong Kong's STAR market and the Stock Exchange of Hong Kong. Why is Ant bypassing a listing on either the NYSE and NASDAQ markets? There are obviously simmering tensions between the US and China, but we think it would be wise to at least have a concurrent ADR for US investors to participate in Ant. Last year, the STAR market launched and it is considered a "pet project" for President Xi. This is the 3rd attempt to build a Chinese equity exchange, similar to NYSE or Nasdaq. For Ant's benefit, it doesn't hurt that the average company on the STAR exchange trades at an astounding 93x earnings.

For Ant to be successful, it needs to continue to drive user engagement and expand its already sizeable user base. It has proven to be very capable at investing in technology and innovation, but this must continue. Ant has made a series of acquisitions in the cross border payment space, which we believe are very smart. This is the only way Ant can take this from a niche Chinese network to a global payment platform. Ant will need to build value with certain global partners (banks, acquirers, networks, merchants, etc), through an open and scalable platform. If Ant can construct a "win win" scenario with certain partners, it just might succeed.

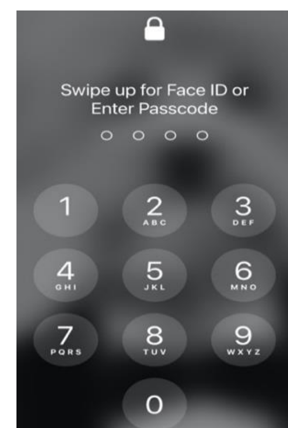
Ant versus Apple:

A little over a year ago, we did a deep dive on Apple's pursuits in the payment industry. To read that 12-page note, visit www.manolecapital.com/research. Alipay has taken a very different approach than Apple, as it relates to payments.

Even before COVID-19, mobile payment platforms were rapidly growing. Apple Pay (here in the US) and Alipay (in China) have changed the way people securely transact over their mobile phones. While both platforms are growing, Alipay has significantly outperformed its US peer. AliPay is much more than just a payment app, as it facilitates thousands of mini-apps providing useful services to both consumers and businesses. Also, when AliPay was introduced, it was taking advantage of China's preference for cash usage versus digital payments. On the other hand, Apple Pay, entered a mature payments market by offering security and convenience for in-person checkouts. While it may not be a terribly fair fight, we find it insightful to look back over the last decade, and try to understand why certain payment companies have succeeded and others have stalled.

Apple's Approach:

Back in 2014, when Apple launched Apple Pay, it focused on the consumer and it attempted to improve the customer experience within payments. From the early days of Apple, Steve Jobs preached beautiful design and a customer-first focus. Apple Pay's premise was to use encrypted NFC (near-field communication) to have one's Apple iPhone interact and transact with a merchant's POS device. The Apple proposition was twofold.



One was to increase security (like this picture) and this has been the focus on many of their advertisements. Secondly, Apple Pay was attempting to speed up transactions versus to taking a card out of one's wallet or purse. While we would argue that Apple succeeded in adding additional layers of security, it has not terribly impacted the already speedy payment process. Paying with one's phone is nice, but it really only saved a few seconds for the average US consumer paying in-store with a card.

Apple attacked the industry by forming partnerships with networks, banks and some select merchants. Apple was looking to drive recurring revenue to its "Service" income statement line-item, as opposed to the +80% of its business that comes from hardware and iPhone sales. When a consumer uses Apple Pay, Apple charges the banks and issuers roughly 0.15% per transaction. The assumption was that loyal iPhone users would quickly adopt the Apple Pay platform and drive sustainable revenues for Apple. From our perspective, Apple did improve the security of the transaction, as fingerprint or facial recognition is much better than a signature. However, Apple was attempting to capitalize on their loyal iPhone ecosystem, without understanding the full dynamic within the payment landscape.

Apple did not focus on the merchant and simply assumed that these businesses would bear the implementation costs to accept NFC payments. At the time of the launch, roughly 10% of all POS devices were equipped to accept NFC payments. It would have been wise for Apple to consider the merchant perspective, especially since the costs (software updates, training, etc) equated to $1,000 per terminal. Also, the retail community was worried about the costs associated with becoming EMV compliant, by the end of 2015.

All of these reasons have led to Apple Pay's lukewarm consumer adoption. Over five years have passed from Apple Pay's much publicized launch, but its usage remains tepid. At the end of last year, only 6% of people who could use Apple Pay were bothering to conduct mobile-based payments. Bain & Company conducted a 2019 survey and it found that only 8% of Americans had adopted Apple Pay. Whether it is 6% or 8% or even 15%, Apple Pay has not reached a level of adoption equaling its US iPhone market share of 50% (per Statista.com).

The transaction count is surely increasing during COVID-19, but Apple Pay's approach to the market negatively impacted their growth. We would agree that Apple Pay has added some improvements to the payment process, especially as it relates to security. However, we do not believe that Apple Pay has been a resounding success, despite our personal regular usage.

Alipay's Approach:

At the opposite end of the spectrum, Alibaba's approach enabled Alipay to flourish and grow exponentially. That same Bain & Company survey found that 81% of Chinese consumers have used Alipay by 2019. From its beginning, Alipay looked to create value and did not aggressively pursue the monetization of its platform. In our opinion, this is similar to how PayPal has grown its Venmo platform. Instead of looking to charge high fees, Venmo was launched as a free payment app. Now that the platform has been widely embraced, PayPal can begin to look to monetize its platform.

Alipay has driven platform adoption by creating value for all of its parties (both consumers and merchants). Ant approached the market with a multi-pronged offering. From the merchant perspective, Ant improved security to help lower fraud and losses. Secondly, Ant provided marketing benefits to merchants, allowing them to increase revenue. Since Alipay controls the transaction data, it can tell small and medium-sized businesses that volumes are higher than cash transactions *would have* been. This is similar to the American Express marketing pitch that merchants will see a lift in sales with AMEX card acceptance. To accept an Alipay transaction, a merchant did not need to purchase a costly POS devices or worry about NFC or contactless acceptance. All a merchant needs is a

mobile phone and it can immediately begin to process transactions, via simple QR codes. The onboarding process was easy, so small businesses embraced Alipay.

Lastly, but maybe the most important, was merchant acceptance costs. To accept a credit card in the US, a merchant can pay over 2.5% on a $100 transaction. Alipay charges a merchant a 0.6% transaction fee, which is roughly half of the fee for processing local, Chinese card transactions. The benefits for merchants was noticeable, so millions of businesses flocked to Alipay. From 2014 to 2018, the number of merchants that accepted Alipay went from 1 million to over 30 million. To understand their dominance, over 70% of all Chinese merchants accept Alipay. With Alipay's enormous growth, Ant then looked to build new partnerships and offer new services to this user base. It did not immediately look to monetize the platform, but it wanted to get users hooked first.

We did not just discuss Alipay versus Apple Pay to poke fun of Apple's entry into the emerging payment landscape. We brought these issues up because there are multiple ways to approach and enter a new industry. Clearly, the US and Chinese market are materially different and each company wanted to cater their offering to their loyal user base. Another big difference was that China was primarily a cash-based society, shifting to one that is mobile-based. The US is migrating from cards (both credit and debit) towards contactless payments.

Before COVID-19, merchants were more concerned with convenience and speed. Now, merchants and consumers are more concerned with health and safety. Apple Pay has adapted, but it seems like it is solving for a different problem than it originally was designed to solve. Apple Pay can still succeed, but its initial approach to the market was somewhat flawed. Both PayPal and Alipay addressed multiple parties pain points, as opposed to simply forcing themselves into a growing industry. Instead of looking to immediately monetize its user base, both PayPal and Alipay took a different tact. Both took a slower approach to revenue, which ultimately will be better for long-term profits.

Exchanges:

The derivative exchanges have been long-term holdings for Manole Capital, but the positions tend to do much better in periods of uncertainty and elevated volatility. One would have thought this environment would be positive for the exchanges, but nearly all of them are down year-to-date. There are a few issues impacting their fundamentals, which we believe are acting as a hangover for the group. From investigations into pricing and heightened competition, the exchanges have underperformed for us this year.

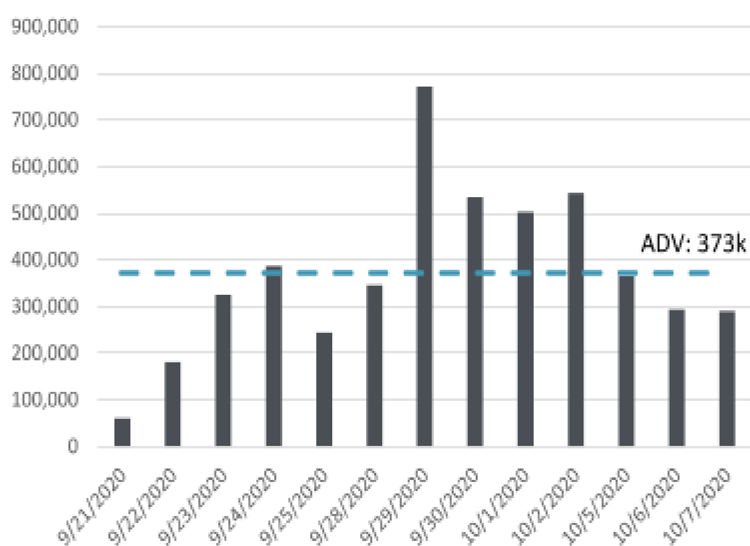
Competition:

One of our all-time favorite movies is *Trading Places*, with Dan Aykroyd and Eddie Murphy. However, the days of pit trading or open outcry trading (seen in this picture) are pretty much over. The NYSE and CME Group still have physical trading venues, but the vast majority of volumes occur electronically, not by voice and hand signals.

Trading volumes have been soaring in 2020, up 55% year-over-year. On a daily basis, the market is averaging 10.9 billion shares traded a day. A decade ago, the percentage of institutional stock-trading orders routed through traditional Wall Street sales desks were roughly half. Back in 2006, institutional trading was 47% of total volumes. By 2018, institutional trading had fallen to only 31% of total volumes (according to Tabb Group). The new driver of trading volumes seems to be retail based, at firms like Robinhood, Schwab, TD Ameritrade, E*Trade, Interactive Brokers, etc. Whether this interest and volumes are because of "free" retail trading or no sports to gamble or people using stimulus checks to invest, there's clearly an explosion in trading not experienced in years. Considering the elevated volatility and trading, this sure seems like an opportune time to launch a new exchange, right?

Over two years ago, some impressive banks, asset managers and trading firms decided to launch a low-cost alternative to the existing stock and option exchanges. The Members Exchange or MEMX is jointly owned by a "who's who" of Wall Street, with Bank of America, Blackrock, Citadel, Citigroup, Charles Schwab, E*Trade, Fidelity Investments, Goldman Sachs, JP Morgan Chase, Morgan Stanley, TD Ameritrade, UBS, Virtu and Wells Fargo as owners. Based in New Jersey, MEMX has a difficult challenge of competing with the New York Stock Exchange, Nasdaq and CBOE. These three exchanges handle roughly 60% of all US equity trading, with NYSE at 22%, Nasdaq at 19% and CBOE having over 16% market share.

On September 21st, after much fanfare, the MEMX trading platform launched. Its first trade was 100 shares of Con Edison at $73.90 per share. On its first day of trading, MEMX traded 61,000 shares. MEMX initially started with only seven stocks, but has plans to rollout trading in all US exchange-listed securities. However, over the last few weeks, MEMX's volumes have not materially increased. From September 21st to October 7th, MEMX averaged only 373,000 shares traded (see chart from Sander Piper). For perspective, during these 13 trading days, the whole industry's ADV (average daily volume) was 9.6 billion shares. After much fanfare, MEMX was able to garner 0.004% of market share.



This powerful consortium backing MEMX is seeking to increase competition and potentially lower their costs. With the advent of "free" trading across all retail channel, it isn't necessarily trading costs that is this group's primary concern. There is widespread frustration among Wall Street firms concerning the fees they pay for data. As more trading occurs via quant and algo shops, the critical inputs are data emanating from these exchanges. These firms claim that the exchanges are abusing their dominant position to overcharge participants for market data.

This isn't the first new exchange to emerge, as the industry has seen IEX launch (with their "speed bumps"), as well as dozens of other off-exchange and dark pool venues. The market has recently seen the launch of LTSE, the Dream Exchange, the Miami Pearl Exchange (MIAX) and the Long-Term Stock Exchange. Many new exchanges fail because they do not garner enough scale or volumes. New exchanges launch and offer traders advantageous pricing-gimmicks to drive volumes. These promotional and pricing schemes rarely work, as exchanges ultimately run out of money paying for basis points of market share.

MEMX owners have probably guaranteed to steer a certain percentage of their volume towards MEMX. The three incumbent exchanges might experience some short-term weakness, as MEMX spends its cash, but they will respond with their own pricing schemes to keep market share. While MEMX has an impressive list of founders and a solid cash hoard, it never is a great idea to pay up for volumes, with expensive rebates. MEMX's CEO is Jonathan Kellner and he recently said, "we're prepared to be aggressive and lose money on every transaction". Call us crazy, but losing money on every trade isn't a solid long-term business model. In the short-term, some traders might seek to benefit from advantageous pricing programs. However, we believe that in the long-term, traders will always trade at exchanges with the tightest spreads and best liquidity.

Data Pricing:

To state the obvious, nothing good usually happens when the DoJ (Department of Justice) launches an inquiry into your pricing programs. The selling of data is important to the exchange industry. In 2019, market data was 2%, 3% and 6% of total revenue for Intercontinental Exchange (ticker ICE), CBOE Global Markets (ticker CBOE) and Nasdaq (ticker NDAQ).

The market continues to be driven by algorithmic and quant traders, as opposed to us dinosaurs – fundamental analysts. As these shops write software to do their proprietary trades, the common input is data from many of the exchanges. When the Intercontinental Exchange purchased the NYSE in December of 2012, one of the primary goals was for ICE to increase its predictable and recurring revenue data streams. Jeff Sprecher, the Chairman and CEO of ICE, even compared the data business to monetizing "the exhaust coming off of a car." All of the data that occurs each day, which equate to billions of quotes, can be sold to quantitative buyside shops looking to improve the efficiency of their trading models. From our perspective, we have no problem with the fees the exchanges charge. These exchanges battle each other every day, to maintain market share (as we discussed above). For maintaining an exchange and permitting billions of bid and ask quotes to "ride their rails", we think the exchanges should be able to monetize this data / output.

The head of the DoJ's Antitrust Division is Makan Delrahim might think differently. He recently stated that he is "paying close attention to the market data that exchanges charge investors, for potential anti-competitive conduct." On June 22nd, a MOU (memorandum of understanding) was signed between the DoJ and the SEC. The MOU was signed to enhance competition in the industry and formalize the exchange of knowledge between these two agencies. This will establish a framework for the two divisions to share information on the industry's pricing plans. At this point in time, we do not know if there will be a formal investigation. This type of oversight, which could lead to pricing caps for the exchanges, is obviously not positive. However, one has to understand that market data only represents a modest amount of total revenues.

Conclusion:

2020 has been unlike anything we have ever experienced and few things have felt “normal”. As we have learned time and again, never more than this year, the stock market loves to climb a wall of worry. Even though US stocks just posted their weakest September in a decade, the S&P 500 index is still up 6.5% this year.

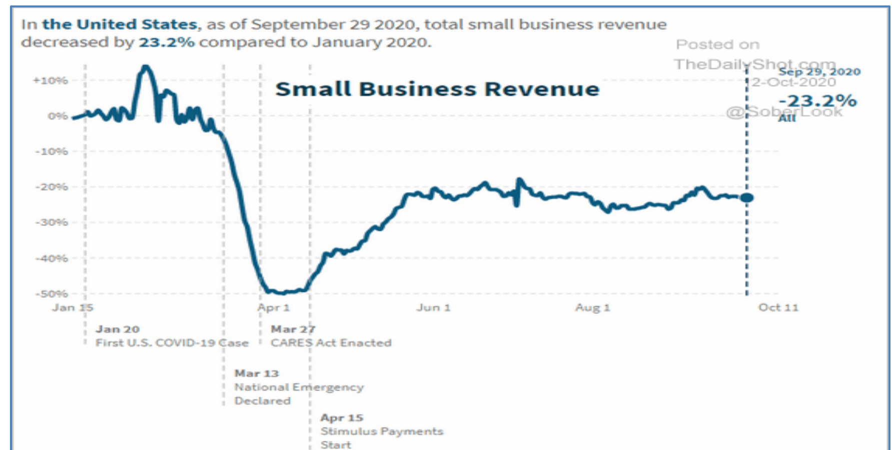
Not since the early 1970’s has the US market been more concentrated. While half of the US population works for small businesses, this is a mega cap and tech focused stock market. The V-shaped recovery from late March has been acutely in technology, consumer goods, certain aspects of manufacturing and the housing market. Many are questioning the market’s positive year-to-date return, considering the awful fundamentals associated with this global pandemic. Is there a disconnect between the S&P 500 and the still struggling economy? Yes, but one has to remember that the stock market anticipates and looks forward, while the economic data (unemployment, GDP, etc) is backward looking. Also, one must consider that interest rates are essentially zero and there is roughly $4.5 trillion in money-market funds earning nothing in the bank. With so much cash on the sidelines, both retail and institutional investors are looking to the equity markets for returns.

We strongly believe that the Fed has done more than anybody could have expected or imagined. If the economy does struggle, we expect the Fed to continue to provide significant support. We continue to believe that 2021 and 2022 will be a more “normalized” environment, but it will require some patience. Economic growth is coming, but it will not be broad based. Rather, it will continue to be concentrated in those businesses that have ample liquidity, capital and dominant market share.

Some companies have prudently managed their balance sheet, focused on free cash flow, and should come through this troubled environment bruised, but fine. Others continue to struggle under burdensome debt loads and lack of growth prospects. We believe the market should start to treat companies differently, based upon their recent results and (more importantly) forward expectations. In the short-term, our economy faces several speed bumps, like the expiration of certain governmental stimulus programs and stubbornly high unemployment. As the market begins to separate winners from losers, we feel Manole Capital will excel.

We don’t have a crystal ball to tell us what will happen over the next few months. We are not epidemiologists or healthcare analysts, so we cannot forecast when we will get a COVID-19 vaccine. As we’ve seen in other states and countries, much of this uncertainty depends on circumstances outside of our control. We are not Washington DC policy experts either, so we are not going to predict who will win the election and what policies will be passed in 2021.

The COVID-19 pandemic is still raging across the globe, small businesses are experiencing over 25% declines in year-over-year revenue and millions are unemployed. While things might appear to be “out of control,” we will get through this difficult time period. However, we believe, it is important to focus on items within our control, as well as those that truly matter. It is this niche or intersection that remains crucial for our investment process.



At Manole Capital, we are long-term investors, taking a long-term perspective. We strive to anticipate, as opposed to react. On a daily basis, we evaluate our holdings and seek to invest in attractively priced, high-quality FINTECH companies. We believe that by owning free cash flowing FINTECH companies, our portfolio(s) will continue to outperform and reward our investors. We continue to analyze a number of fundamental factors, regarding companies' growth prospects, cash flow, and ability to withstand a downturn or recession. During uncertain times like this, we believe our long-term investment horizon is an asset. Manole Capital embraces this challenge and we have positioned our portfolio to “survive and thrive”, in these unprecedented times.

We thank you for the trust you have placed in us. Rest assured, we will always act in the best interest of you, our clients. All the best to you and your colleagues, friends, and families during this challenging and unsettling time. Stay healthy and safe and I look forward to speaking with you soon.

Cliff Clavin:

In the 1980's, one of our favorite TV shows was ***Cheers.*** The "know-it-all" postal worker character was named Cliff Clavin, played by John Ratzenberger. This new segment highlights some useless information that Cliff would be proud of.

Becoming a Billionaire:

Most can remember the wildly popular 1999 show "Who Wants To Be a Millionaire", hosted by the late, great Regis Philbin. While there are over 18 million millionaires in the US right now (per Global Wealth Report) there are significantly fewer billionaires. However, Blaise Aguirre of Massachusetts might have become the fastest person to become billionaire and then lose it.

Aguirre is a Bank of America customer and he was surprised to see that BofA deposited $2.45 billion into his account last month. This banking error wasn't immediately discovered and the money sat in his account for almost a week. Aguirre finally reached out to his BofA relationship manager and the error was fixed. One can hope that Aguirre will receive a waiver for any of those annoying ATM or minimum balance fees.

The Stanley Cup:

The Stanley Cup ("***The Cup***") is named for Lord Stanley of Preston, who was the Governor of Central Canada in 1892. Lord Preston became enthralled with hockey at Montreal's 1889 Winter Carnival. He bought ***The Cup*** on a trip to London for roughly $50 (10 guineas) and later donated it to Canada's top amateur hockey team. Ever since 1926, it has been awarded to the champion of the NHL.

The Cup is 34.5 pounds and 35 inches tall and is passed around from winning team to winning team each year. The NHL gives the winning team 100 off-season days with The Cup, so each player typically gets it for a full day of fun and parties. Since 1991, ***The Cup*** travels with its own security guard, Phil Pritchard, aka "The Keeper of the Cup." Each winning team is allowed to engrave 52 names onto ***The Cup,*** for winning players, coaches, management and staff. The engraving is done by a silversmith in Montreal, Louise St. Jacques. Using special small hammers a letter stamps, Louise takes roughly half an hour to inscribe each name. There are currently 12 women who have their names engraved on ***The Cup*** and the 1st was Marguerite Norris, the President of the Detroit Red Wings in 1954 – 1955. There are no names from the 1928 to 1954 champion teams.

There are actually 3 Stanley Cup's, with the original or "Dominion Hockey Challenge Cup" currently in the Vault Room at the Hockey Hall of Fame in Toronto. The 2nd Cup is called the "Presentation Cup" and it was created in 1963, when the original became too fragile to pass around. The 3rd Cup is the "Replica Cup" and it is used, when Cup #2 already has a date. The only way to really differentiate between #2 and #3 is the Hockey Hall of Fame seal on the bottom of #2. Around the base of ***The Cup***, there are 5 bands of engraved names or champions. Each of these bands is detachable and when a ring becomes full, it is removed and preserved in Lord Stanley's Vault at the Great Esso Hall at the Hall of Fame in Toronto. From 1927 to 1947, a version of ***The Cup*** was used called the "Stovepipe Cup". It simply became too tall to hold, so a newer tiered version was created (with the detachable bands).

There have been thousands of names engraved onto ***The Cup***. Only 2 teams had their rosters etched on the inner bowl of ***The Cup***, the 1906 Montreal Wanderers and the 1914-1915 Vancouver Millionaires. There are more than a few errors engraved onto ***The Cup***, but our favorite is the misspelling of the 1971-1972 Boston Bruins, as Bqstqn Bruins. No names were inscribed in 1919, due to the outbreak of the Spanish Flu and "Season Not Played" was inscribed for 2004-2005, because of the lockout that season. We are thrilled that our Bolts will get their new names engraved onto the best trophy in all of sports.

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