The Value Firm®

Owners Manual

"Performance doesn't happen on a schedule, and I don't care who we are or what we do, over the next one, two, three years, the result we get is unfortunately out of our hands for the most part. The market is going to do whatever the market is going to do".

This a quote from David Poppe, former chief executive of asset manager Ruane, Cunniff & Goldfarb, says it all. It should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.

The majority of professional investors, after accounting for their fees, underperform the index. Most investors are better off buying a low cost index fund, like the Vanguard S&P 500, and leave it there for the rest of your life. In the long run, it's the best low risk, high return proposition on the planet.

Nevertheless, most people want to do better than the index. Well. Then you have to engage in active management with its costs and its risks. Most of us are in full denial of the fact that if you try to do better than the index, there is the risk that you will end up doing worse than the index. And then they get frustrated and forget that it was their own decision to take on the risk. To put it mildly: if you want to beat the index, that's your problem!

Over the years of learning and investing, my admiration for Lou Simpson just grew and grew. Lou Simpson is probably the world's greatest investor you never heard of. The essence of his approach (and thus mine) is simplicity. He only invests in companies he can understand and value. He runs a long-time-horizon portfolio comprised of ten to fifteen stocks. Most of them are U.S.-based, and they all have similar characteristics. Basically, they're good businesses. They have a high return on capital, consistently good returns, and they're run by leaders who want to create long-term value for shareholders while also treating their stakeholders right.

To me, it makes a lot of sense to carefully study the investment portfolios of superinvestors like Lou Simpson. Often I just copy their ideas. I mean, these ideas made it through the exhaustive due diligence process of one of the best investors on the planet. Profit from it!

Just copying successful investors sounds easy, but in fact it is not. The unique differentiator is, I believe, the deep understanding of why the opportunity is so exceptional and why the stock might turn out to be a multibagger. The quantitative aspects in the investment process are important—the best investment decisions are made by focusing on the qualitative differentiators of businesses. You don't want to make a mistake on the business quality and the management quality.

Successful investing is about predicting the future performance of a company. Where will this company be10 to 15 years from now and what does that mean in terms of future cash flow streams. Attached to these cash flow streams are risks. What can go wrong? And finally you have to decide what you are willing to pay for these future cash flow streams in the light of the current interest rate environment and that is much more a matter of experience than the result of an academic discounted cash flow analysis. And it is a very personal matter as well. If you want to buy @ very low prices, there is always the risk that Mr. Market will not offer you these low prices and you will not be able to buy into this wonderful company. And if you pay a price that is high and the markets collapse after you bought, you probably would regret that you bought it at such a high price.

I look for companies with the ability to outperform competition for many years to come. I only invest in businesses with durable competitive advantages and very long-term growth potential. This does not mean growth at any cost. The growth must be profitable of course, generating high returns on the additional capital invested into the business to enable this growth.

Successful investing is very hard. Howard Marks talks a lot about juggling all the insights and experiences necessary to finally come up with just one solid investment decision. And we all know capitalism's relentless cycle of depressions, panics, recessions, bubbles – from the Roman empire through tulip manias, South Sea Bubbles, Great Depressions down to the "Great Delevaraging of 2008". To handle hefty stock market volatility with care and wisdom is by no means easy.

There definitely will be years of fund underperformance. The only way to handle that is to stay calm and be patient. "This too will pass." And remember that depressions offer opportunity to buy more stocks at better prices.

If you want to join the partnership it’s best that you stay with the fund for at least 10 years, preferably longer. I hope you visualize yourself as a part owner of a business that you expect to stay with indefinitely, much as you might if you owned a farm or apartmenthouse in partnership with members of your family.

Your fund manager has a significant portion of his net worth invested in the partnership. As they say: “We eat our own cooking.” I cannot promise you results. But I can guarantee that your financial fortunes will move in lockstep with mine for whatever period of time you elect to be a partner. I have no interest in large salaries or options or other means of gaining an “edge” over you. I want to make money only when my partners do and in exactly the same proportion. Moreover, when I do something dumb, I want you to be able to derive some solace from the fact that my financial suffering is proportional to yours.

Communication with you as a partner will be done in several ways. Through the annual report, I try to give all shareholders as much value-defining information as can be conveyed in a document kept to reasonable length. Still another important occasion for communication is the Annual Meeting, where there will be plenty of time for questions. But there is one way I can’t communicate: on a one-on-one basis.

Despite the policy of candor, I will discuss the activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisitionideas are. Therefore I normally will not talk about specific investment ideas. If you start talking about ideas, you can become “too wedded” to your thesis and that is actually quite dangerous.

I tend to believe that I am not a robot. I am not immune to the emotions and biases that everyone else has. However, it is the awareness of these, and the measures I put in place to control their effects, which will help me to generate superior performance. Examples of these measures include the rules I employ regarding quality and valuation. Or the checklists I use to ensure the features which every company I invest in must exhibit, and to identify specific warning signs e.g. of financial shenanigans. If an investment opportunity doesn’t fit my circle of competence, I will not invest.

Superior investment performance is not my primary goal, but rather superior performance with less-than-commensurate risk. Above average gains in good times are not proof of a manager's skill: it takes superior performance in bad times to prove that those good-time gains were earned through skill, not simply the acceptance of above average risk. Thus, rather than merely searching for prospective profits, I place the highest priority on preventing losses. It is my overriding belief that, especially in the opportunistic markets inwhich I work, "if we avoid the losers, the winners will take care of themselves.”

I believe consistently excellent performance can only be achieved through superior knowledge of companies and their securities, not through attempts at predicting what is in store for the economy, interest rates or the securities markets. Therefore, the investment process is entirely bottom-up, based upon proprietary, company-specific research.

Because I do not believe in the predictive ability required to correctly time markets, I keep portfolios fully invested with approximately 20% cash on hand to be able to invest when markets crash. If you miss a few good days in the market then your overall performance can be seriously impaired. Using the last 15 years as an example, if you had missed the strongest 10 days of performance in the S&P 500, a popular US benchmark, your total return over the period would be half of that achieved by remaining fully invested.

There are many fads in investing which come and go: the Dotcom boom; the mining “supercycle” (which turned out to be just a plain old cycle); the credit bubble; and most recently the cryptocurrency craze, one more example in a continuous stream of ‘new’ ways to make money. I would never knowingly take part in fads such as these. Although I may as a result miss out on seemingly high returns in the short term, you can rest assured that I will be nowhere near the assets in question when the speculative bubble bursts. Which it always does.

What I won’t do? No upfront fees. No nonsense. No debt (leverage) or derivitives. No swaps. No shorting. No market timing. No index hugging. No trading. No hedging. I won’t conduct any currency hedging, nor do I seek to hedge market indices, interest rates or anything else. I also dislike capital intensive industries such as utilities and telecoms which rarely achieve high rates of return on the mountains of capital they invest, especially given the fact that their returns are often limited by government regulation.

I agree with the remarks of Peter Lynch, who said he did not spend 15 minutes a year to forecast the economy. More money is lost worrying about or preparing for recessions than was lost in the recessions themselves.

What do I charge you? To begin with I do not charge an initial fee as many mutual fund providers do. If you want your investment manager to behave with your best interests in mind, you have to ensure that your interests are aligned. The best way to do that, I believe, is the original Buffett Partnership fee arrangement, where the interest provision is set at 6% for everyone, beyond which your investment manager will take 25% of the gains. Since the market are going up 5-7% a year on average, the interest provision is set at a level so the investment manager earns nothing unless he beats the market. I have a "high-water mark" in place—any cumulative deficiency below a 6% annual gain will have to be recouped before I will resume taking fees. But if you prefer a management fee anyhow, we can discuss that.

Before you consider participating in the fund, please read PART I of "Warren Buffett's Ground Rules" by Jeremy C. Miller.

- I am not in the business of predicting general stock market or business fluctuations. If you think I can do this, or think it is essential to an investment program, you should not be in the partnership.
- I do not know what stocks are going to do tomorrow, next week or next year.
- I can't accurately and consistently predict the future or short-term moves in interest rates.
- I am unsure where the economy is going in the short or mid-term.
- I can not accurately predict what will happen to currency fluctuations in the future.
- If you are not in for the long haul and do not have "the capacity to suffer", you should not be in the partnership.
- Over the last 52 years Warren Buffett increased the per-share book value of Berkshire Hathaway at a rate of approximately 20% compounded annually. If you think I will be able to beat Warren Buffett, you should not be in the partnership.
- Most people want to do better than the S&P 500 index, but that is inseparable from the risk of doing worse. What most people want to do is they want to try to do better through no lose positions and I'm afraid that option is not available.
- My approach isn't meant for everyone. I offer this strategy to accredited (professional) investors seeking intelligent exposure to stocks.
- The approach is for long-term investors. Do not invest if you have less than a 10-year time horizon. A long attention span is indeed a unique competitive advantage.
- Volatility is the name of the game. Do not invest if you cannot stomach volatility. The approach will have periods of underperformance. To be right in the long-term, we must be willing to look wrong in the short-term. Periods of underperformance should be expected and viewed opportunistically.

It is of the utmost importance that you and I are on the same page. If you doubt that we are, you should not be in the investment partnership.

Finally, in order to satisfy the Anti-Money Laundering requirements, we need you to provide certified copies of your personal identity (e.g. passport) and address (e.g. Local authority tax bill, valid for current year). And there are new rules on Customer Due Diligence and the reporting of suspicious transactions. In addition, The Netherlands Authority for the Financial Markets announced a stricter monitoring of the reporting of unusual transactions by investment firms and investment funds.

The Dutch Act implementing the Fourth Anti Money Laundering Directive implements the Fourth EU Anti-Money Laundering Directive (4AMLD) by amending the Dutch Act on the prevention of money laundering and financing of terrorism. One of the changes concerns the obligation to carry out customer due diligence. This will continue to be based on a risk-based approach.

Institutions will in all cases be required to conduct a risk analysis. With respect to the possibility to carry out a simplified CDD, institutions may no longer automatically apply such a simplified CDD in specific circumstances. Institutions may only rely on these circumstances as part of a justification for simplified CDD after conducting a risk analysis.

Successful investing is really hard. Over the past few years I learned a lot and the investment results of the Intelligent Cloning Portfolio are exceptional indeed. Nevertheless, there are a few additional insights that I want to try, before I start managing others people money. And don't forget that we are deep into a bull market, with high valuations and few bargains. By the way, Warren Buffett recently argued that stocks are "ridiculously cheap" if interest rates stay at these levels. Charlie Munger recently was asked if he was surprised by how long this expansion (the bull market) has lasted. Here is what he said: "Of course, it's lasted a long time. But what was really remarkable is that we never printed money so much and spent it so fast and bought back so much debt, public and private. So this is total terra incognita in economics." Anyhow, when the bear roars, the stocks may go down rapidly, no matter how intelligently chosen. But I leave it up to you. Will I be able to beat the index over time? Well. I will just give you my most honest answer. I just don't know. If you are convinced that I am ready to manage your money and if you are willing to take on the risks, send me an email: peter@thevaluefirm.com, and let's talk.

Cordially,

Peter

Peter Coenen
Founder & CEO of The Value Firm®
28 April 2019

This presentation and the information contained herein are for educational and informational purposes only and do not constitute, and should not be construed as, an offer to sell, or a solicitation of an offer to buy, any securities or related financial instruments. Responses to any inquiry that may involve the rendering of personalized investment advice or effecting or attempting to effect transactions in securities will not be made absent compliance with applicable laws or regulations (including broker dealer, investment adviser or applicable agent or representative registration requirements), or applicable exemptions or exclusions therefrom. The Value Firm® makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.

Yes. I copied some paragraphs from Berkshire Hathaway, Oaktree Capital Managemen and FundSmith. Imitation is indeed the sincerest form of flattery.

Everybody makes mistakes now and then. If you find any, let me know: peter@thevaluefirm.com. Always do your own research!