Dear partners and friends,

On March 16, 2020, the coronavirus outbreak nearly shattered the financial markets. These are exceptionally uncertain and difficult times, and all of it can be confusing and overwhelming to wrap one's head around. We have been seeing so many cases of the virus much so many terrible stories about loss and suffering.

The Center for Disease Control and Prevention, the CDC, recently attempted to offer a real estimate of the overall death rate for COVID-19, and under its most likely scenario, the number is 0.25%, as opposed to the 3.4% estimate offered by the World Health Organization, which instigated the initial panic and the lockdowns.

There are experts out there, and though I am most certainly not one of them, who state that ultimately that number might be lower, perhaps as less as 0.2%, exactly the rate of fatality Dr. John P.A. Ionnidis of Stanford University projected. And even that number might be inflated with people who died only with COVID-19 and not because of it.

COVID-19 has brought suffering to people everywhere, but its impact, the loss of life and the emotional trauma for families and even health care providers, is not shared equally. Words fall short of expressing my sorrow.

Efforts across the globe to deal with COVID-19 have sent the global economy into a tailspin, and financial markets have been hit along with it. There is no question that the global economy is now in the midst of a crisis, of an unprecedented kind.

One must remember that this is not the first market crash in history. We have lived through many others. But for investors like me, it's a wakeup call and it reminds me once again of the importance of investing in strong companies, with sustainable competitive advantages and healthy balance sheets with the capacity to weather recessions.

In that respect, you could argue that investing in companies with too much debt, for e.g. Veritiv, is questionable. I remember that I prioritized the uniqueness of the investment thesis, a Seth Klarman holding, above their indebtedness. Just think of what might have happened to debt-overloaded companies like Veritiv if governments decided to keep the economy in lockdown until a vaccine was found. Considering that, I will no longer invest in companies with a weak balance sheet, regardless of how unique the investment thesis or the investment manager that the idea was cloned from is. Here is an overview of the heftiest stock market corrections since 1929.

When	Correction	Rebound
1929 – 1932	–86%	15
1937 – 1938	–52%	10
1946 – 1946	–26%	5
1956 – 1957	–21%	3
1962 – 1963	–27%	2
1968 – 1970	–33%	4
1973 – 1974	–48%	8
1980 – 1982	–26%	2
1987 – 1987	–33%	2
2000 – 2002	–48%	7
2007 – 2008	–56%	6
2020 – 2020	–32%	?

For instance, during the crash of 1987, the S&P500 crashed 33% and rebounded within two years. On average, the markets rebound within five years and four months since the Great Depression, and most of the time, it has returned to record territory. Thus, it makes a lot of sense to buy when the markets are way down, although it is impossible to buy exactly at the lowest point.

Recently, an article titled "Bankrupt in Just Two Weeks" appeared in The Wall Street Journal. It concerned William Mark, a private investor, who decided to return to investing after the 2008 financial crisis. Needing to play catch-up with his retirement portfolio, he made a bet on a leveraged exchange-traded note. It worked so well—earning him 18% a year in dividends, on average—that he eventually poured $800,000 into these notes. However, when the coronavirus pandemic hit, he almost lost everything.

Intelligent Cloning

The harsh reality of "cloning", which comes with this connotation of being simple and easy, is that it can leave you dazed and confused. Just try it for a few years, and you will know what I mean. Copying great investors is not easy and perhaps best illustrated by a metaphor that Howard Marks once used, but I will use it with a twist:

Cloning is like a bowl full of lottery tickets. And every lottery ticket represents a stock pick from a superior investor. So you actually have a bowl where there is a high probability that most of the lottery tickets turn out to be winners in the long run. Let's say 70% winners and 30% losers. Then you reach into the bowl and pull out a ticket. Once or twice a year.

Then there are probabilities and outcomes. We can get the probabilities on our side, but that does not ensure a favorable outcome. But it's the only thing we can try to do. And that's what cloning is all about.

To identify a single company in the portfolios of a handful of superior investors you admire and to build up the conviction that indeed this company will probably outperform in the long run, requires tremendous research and it takes, as far as I am aware, many, many months. And the confusing part of the deal is that there is a chance that if you just forget about all the hard work and randomly pick a high conviction stock of a superior investor, you not only put your trust in the hard work of this investor but also to a greater degree you acknowledge that there is a reason why this investor is superior and you are not, and you might actually end up doing even better.

If you don't know jewelry, know your jeweler.
Warren Buffett.

Let's have a look at the Intelligent Cloning Portfolio and let me remind you once again that these are not actual fund results, but the table illustrates what the results could have been if we indeed started an investment partnership in 2H '16. The stocks are selected with the view to hold on to these companies for several years, preferably decades, as long as the company remains a good company.

Current positions

When	Company	Price	Return
2H '16	Deere	87 USD	83%
2H '16	Allison Transmission	29 USD	35%
1H '17	Davita	65 USD	22%
1H '17	Verisign	83 USD	147%
2H '17	Monro	47 USD	25%
2H '18	StoneCo	17 USD	123%
2H '18	Veritiv	24 USD	-36%
1H '19	Liberty Global	22 USD	5%
1H '20	Graftech	12 USD	-34%
1H '20	eBay	30 USD	70%

Closed positions

When	Company	Price	Sold	Return
2H '17	Tegna	13 USD	2H '18	3 %
1H '18	Esterline Corp.	72 USD	2H '18	70 %
1H '18	Sinclair Broadcast	44 USD	2H '19	46 %

For example, Sinclair Broadcast was added to the Intelligent Cloning Portfolio in the first half of 2018, at a stock price of 44 USD, and closed in the second half of 2019 with a 46% return. The rationale behind closing the Sinclair Broadcast stock was that Seth Klarman closed this position, so there was no backing anymore from this superior investor.

Further, Mohnish Pabrai closed one of his positions, Graftech, during the corona crisis, only a few months after buying this stock. I have not closed this position as of yet. I hope for a rebound of the markets, and a (partial) rebound of Graftech as well, and then I will sell it, sooner rather than later.

By the way, Graftech is another example of a company that I was lured into by the uniqueness of the investment thesis that I prioritized above balance sheet strength. I don't consider Veritiv and Graftech as "mistakes", but from now on, I will focus much more on the original investment guidelines as presented in my first write-up on intelligent cloning:

- A "balanced" balance sheet.
- Consistency in the per-share figures.
- Substantial free cash flow.
- Consistently high return on capital.
- Margin of safety.

Arlington Value Capital

There are numerous reasons for being cautious before starting a new fund, and in my 2018 Investment Letter, I gave the example of investment manager Whitney Tilson, who outperformed the markets for several years, before ultimately being compelled to close his fund due to underperformance. This year we will have a look at Arlington Capital Management, a very successful fund managed by Allan Mecham, the 400% man. He also ultimately had to close shop due to underperformance. Are there lessons to be learned here?

On June 22, 2014, Forbes published an article entitled "Is This The Next Warren Buffett?". It is indeed about the young, unknown college dropout in Salt Lake City known as Allan Mecham, who was, in terms of investment performance, "shooting the lights out" and crushing his competitors, as well as the indexes, since he launched his investment firm, Arlington Value Management, in the final days of 1999. Here are the rules they lived by.

- We believe that vigilance toward risk is central to achieving strong returns.
- We consider stock as ownership in a business.
- We let market volatility work to our advantage.
- We strive to be conservative, and invest with a margin of safety.
- We exercise patience and discipline to only invest in exceptional opportunities.
- We focus on businesses we thoroughly understand.
- We focus on companies with staying power. We look for long-term durability and low rates of change.
- We look for honest, intelligent management teams with proven track records.
- We only invest when the price is attractive, which provides both margin of safety and favorable prospective returns.

These rules resonate very well with me and are also illustrative of my investment approach. Below are three additional insights:

We will continue to follow a common sense based approach to investing, holding intellectual honesty and rigorous analysis as the keystones to success. We think our philosophy is an intelligent way to invest — regardless of whether we're characterized as 'growth' or 'value' investors. Such style-box definitions are not germane to stock picking success. Success is based, first, on the accuracy of analysis, not style categorization, and second, upon not overpaying for the business in question. The traditional 'margin of safety' concept, often emphasized by 'value investors', has utility and something I consistently apply, even if it is secondary. And the value is dependent on solid business analysis.

We think successful investing is less complicated, and for us, It boils down to taking a few simple tenets seriously: patience, discipline, long-term orientation, valuation, independent thinking, and an ethos of not fooling ourselves. Such simple investment principles seem obvious and easy to apply, much like the notion of eating healthy: everyone understands the benefits, yet few can resist indulging in the abundance of high calorie eatery options. Implementation is easier said than done.

We also don't engage in short selling. We're not fans of shorting stocks for two reasons: One, we don't like the math; shorting exposes you to unlimited liability with potential for gain—the opposite equation of investing "long." Two, shorting has the potential to cause distracting agitation that could create unintended consequences.

From 2007 to 2019, Arlington Value posted a compound annual growth rate (CAGR) of slightly above 18%. In 2012, it was reported that investors who invested with Mecham a decade earlier would have increased their capital by 400%.

In April 2020, with an estimated $1.5 billion assets under management, Allan Mecham announced to the winding up of his fund in the following six to nine months due to health issues, citing the fund's underperformance of major indexes by a "wide margin" and the stress caused by managing money during this exceptionally volatile COVID-19 crisis.

Here are the top 6 positions, as of 31 December 2019, weighing up for approximately 85% of his portfolio. The price decline during the COVID-19 crash is measured by the highest stock price in 2020 against the lowest.

Company	Allocation	Price decline
Berkshire Hathaway	30%	–30%
Cimpress	17%	–64%
Spectrum Brands	12%	–62%
AutoNation	9%	–54%
Alliance Data Systems	9%	–80%
Monro	8%	–48%

So what happened? According to dataroma.com, Allan Mecham reduced all these positions in Q1 2020, by 26.4%, 19.7%, 35.7%, 14.1%, 43.5% and 7.8% respectively.

If you monitor his stock positions over the years, you wonder how he could double or triple the performance of his underlying stock picks without using significant leverage. And he admits in one of his write ups that he actually used leverage. Leverage can be dangerous, especially in times of market turbulence like COVID-19.

Recently, based on the 13F activity dated 3 March 2020, whalewisdom.com reported a current fund market value of $688 million and a prior market value of $1.472 billion. That's a minus $784 million in 3 months for Arlington Value Capital. Oops! Are these redemptions during a market crash or what? If he was "hefty on leverage" during this crisis, I would not be surprised if he received "margin calls". I don't have any proof of that, and I wonder if we will ever know the rationale behind what actually happened.

Just like Whitney Tilson, in the end, Allan Mecham wasn't able to outperform— both extremely intelligent and respectable investors. Then we have Jeff Ubben quitting his job at ValueAct. It makes you wonder if there is a future for this fund industry at all. Or to quote Jeff Ubben:

Finance is, like, done. Everybody's bought everybody else with low-cost debt. Everybody's maximised their margin. They've bought all their shares back . . . There's nothing there. Every industry has about three players. Elizabeth Warren is right.

Even Berkshire Hathaway's chief stock pickers, Ted Weschler and Todd Combs, have failed to beat the index. It is just exceedingly difficult and that makes the Warren Buffett track record of 19 to 20% over a 50+ year time frame highly exceptional.

Let me give you another intriguing example. After beating the S&P 500 every year from 1991–2005, Bill Miller's Legg Mason's Value Trust collapsed and wiped out the fund's record streak. If you look at his experience alongside many other legendary fund managers who eventually destroyed themselves and their records, it is hard not to conclude that ultimately, no strategy works in all markets and no strategy works forever. Bill Miller now runs Miller Value Partners, which is, I believe, a very interesting firm to follow.

Even the best investment managers would go through severe down years or even blow up their funds. A terrific long-term track record is by no means a guarantee for favorable future results.

I have witnessed so many funds ultimately suffer the fate of utter failure. Therefore, before I start a fund, I want to ensure that I do possess the experience to consistently deliver good returns over an extremely long period of time, and that in the end, I do NOT blow up the fund. The learning process requires a lot of time, and you might even question if the traditional Warren Buffett type investing skills are the ones you really need to succeed in the future. Moreover, you could even question the value of the "yet to be developed skills" in the context of the COVID-19 pandemic. Or to quote Guy Spier:

But what good are these skills to investors who are drowning in a sea of fear that utterly overwhelms the rational neocortex?

I am in no hurry whatsoever to start a fund.

Quants

Every now and then, a crash year will happen. The year 2020 was one such year. Here are the results of the midyear quants in the year of the COVID-19 crash:

- 9 out of the 21 midyear quants ended up in the negative territory.
- The India quants are without a doubt the winners. Q26: +20.0%, Q27: +18.0%, Q28: +21.4%, Q29: +19.8%, Q30: +17.8%, Q31: +21.2%, Q32: +9.2%.

Below, you will find the most recent overview of the concentrated quants. Q1 to Q4 are the Mohnish Pabrai related Free Lunch Portfolio quants. The other quants are the Hermione Granger quants.

New year Quants

Quant	Description
Q1	The Mohnish Pabrai Free Lunch Portfolio (FLP).
Q2	The conservative version of the FLP.
Q3	The conservative FLP, no spinoffs. Sell at +40%.
Q4	The conservative FLP, only spinoffs. Sell at +40%.
Q5	The US new year quant. Sell at –20% or +40%.
Q6	The US new year quant. Sell at –20% or +50%
Q7	The US new year quant. Sell at –20% or +60%.
Q8	The US new year quant. Sell at +40%.
Q9	The US new year quant. Sell at +50%.
Q10	The US new year quant. Sell at +60%.
Q11	The US new year quant. No conditional selling.

Midyear Quants

Quant	Description
Q12	The US midyear quant. Sell at –20% or +40%.
Q13	The US midyear quant. Sell at –20% or +50%.
Q14	The US midyear quant. Sell at –20% or +60%
Q15	The US midyear quant. Sell at +40%.
Q16	The US midyear quant. Sell at +50%.
Q17	The US midyear quant. Sell at +60%
Q18	The US midyear quant. No conditional selling
Q19	The China midyear quant. Sell at –20% or +40%.
Q20	The China midyear quant. Sell at –20% or +50%.
Q21	The China midyear quant. Sell at –20% or +60%.
Q22	The China midyear quant. Sell at +40%.
Q23	The China midyear quant. Sell at +50%.
Q24	The China midyear quant. Sell at +60%.
Q25	The China midyear quant, No conditional selling.
Q26	The India midyear quant. Sell at –20% 0r +40%.
Q27	The India midyear quant. Sell at –20% or +50%.
Q28	The India midyear quant. Sell at –20% or +60%.
Q29	The India midyear quant. Sell at +40%.
Q30	The India midyear quant. Sell at +50%.
Q31	The India midyear quant. Sell at +60%.
Q32	The India midyear quant. No conditional selling.

Now, let's have a look at quant Q28, to illustrate how these conditional selling rules actually function. You buy the three constituents of this quant, Sonata Software, Persistent Systems and NIIT Technologies, on the 1st of August and you put in place the conditional selling orders at –20% and at +60%.

- Sonata Software triggered the conditional downside selling order and was sold at –20%.
- Persistent Systems did not trigger a conditional selling order and ended up +24%.
- NIIT Technologies triggered the conditional upside selling orders: +40%, +50% and +60%.

Wingardium Leviosa! Here are the new constituents of the 2020 – 2021 midyear quants, to be added on 1st of August:

United States	Enova International, Innoviva, Lantheus Holdings.
China	Dongyue Group, Yadea Group, Bright Scholar Education.
India	eClerx services, Expleo Solutions, Accelya Solutions.

In the attachment you find the full results. I granted myself an unfair advantage just by skipping the negative midyear quants for this exceptional COVID-19 year.

However, let me remind you that this quant approach, though backed by considerable investing intelligence, is in truth "just an experiment".

- First of all, investing intelligence comes from the pre-COVID-19 era. Thus, one may question if this investing intelligence is still relevant in the world we live in today.
- Second, investing intelligence is based on the United States financial markets. There are no guarantees that this investing intelligence will be applicable in China and India.
- Third, fraud is significantly more rampant in the Indian and Chinese markets, and that makes the China and India quants inherently riskier.

Ultimately, if all of these quants fail, then that's just the way it is.

So here we are

I started this letter with a quote from Seth Klarman: "On Wall Street, anything can happen." Early March, most global markets reported severe contractions, primarily in response to the COVID-19 pandemic and an oil price war between Russia and the OPEC countries steered by Saudi Arabia. At the time, it constituted the worst market drop since the Great Recession in 2008.

After the 2008 near-meltdown, Seth Klarman described 20 lessons from the financial crisis 2008, which, he says, "were either never learned or else were immediately forgotten by most market participants." Here are three of them:

Things that have never happened before are bound to occur with some regularity. You must always be prepared for the unexpected, including sudden, sharp downward swings in markets and the economy. Whatever adverse scenario you can contemplate, reality can be far worse.

Beware of leverage in all its forms. Borrowers must always remember that capital markets can be extremely fickle and that it is never safe to assume a maturing loan can be rolled over.

Having clients with long-term orientation is crucial. Nothing else is as important to the success of an investment firm.

So what's next for the financial markets? I certainly don't know. Nobody knows. Uncertainty has seldom been higher. Buffett and Munger are actually quite bearish right now, and Ray Dalio's Bridgewater Associates warned about the possibility of a "lost decade" for stocks.

At times, I look at the Buffett Indicator chart, which you will find below, to get an idea of where we might be in terms of market valuation. It indicates that the markets are strongly overvalued. With the recent strong rebound of the stock markets, it seems that we will not see a multiyear 1929 like recession, but I do not rule out any possibility. I just do not know what's going to happen.

Source: currentmarketvaluation.com.

The COVID-19 pandemic will probably cause fundamental shifts for economies, societies and companies in the coming years. Along with the threats, new exciting opportunities are knocking on the door. Technology companies like ZOOM benefitted tremendously from the accelerated trend towards digitizing the economy, and for those willing to do the hard work, opportunities will be found in rapidly growing new economy businesses.

I hope you have found my communication lucid up until now, and if not, let me state once again right here that I am "just" a student of value investing and I am not managing any outside money up until now. Actually, with the knowledge and experience that I have as of today, in a way, I am glad I did not start a fund yet.

What I have learned over the years is that if I start a fund after all, it should be there for only a few extremely trustworthy clients or institutions, and I should only invest in a handful of excellent companies. No shorts. No leverage. No bullshit. Just a few stocks for the long run. That's it. Nothing more, nothing less.

The Value Firm B.V. as a company is still in its nascent years of becoming an independent investment firm. The funding of the company has been secured by one investment in a company that, I believe, in the long run will do very well. But if that company fails, my company might get into trouble as well. Don't count on the latter one though. My company is built to last for a very long time.

I am excited about the Intelligent Cloning Portfolio, the Quant Approach and the Risk Rating Algorithm. The latter two rely on access to the historical financials of many tens of thousands of companies globally. Hopefully, we will find a few quants that will just shoot the lights out and leave these index huggers flabbergasted in the shade.

If you want to join a fund or separately managed account, it's best that you stay with my company for at least for a decade, preferably longer. Since I am a one-man investment operation, I only serve a limited number of clients. 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 apartment house in partnership with members of your family. The original Buffett Partnership fee arrangement will be in place: no management fee, just a performance fee of 25% above a 6% annual performance hurdle with high water mark.

It makes a lot of sense to wait a few years before starting an investment partnership with me. Conversely, if markets indeed continue the rebound, you might miss out on a few years of interesting returns. It's completely up to you.

I will continue what I do best, and that's cloning superior investors. And once again, uncertainty has never been higher. The only thing I am quite sure of right now is that in the very long run, a concentrated portfolio of cloned investment ideas from a handful of carefully selected superior investors, acquired at a price that makes sense, will do just fine.

Thank you for reading my letter!
Stay safe.

Peter

Peter Coenen
Founder and CEO,
The Value Firm®
28 June 2020
E-mail: peter@thevaluefirm.com

QUANTS

		2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	CAGR
Q1	The Mohnish Pabrai Free Lunch Portfolio (FLP).	-17.0%	21.7%									0.0%
Q2	The conservative version of the FLP.	-9.7%	28.4%									7.7%
Q3	The conservative FLP, no spinoffs. Sell at +40%.	21.7%	35.2%									28.2%
Q4	The conservative FLP, only spinoffs. Sell at +40%.											
Q5	The US new year quant. Sell at –20% or +40%.	40.0%	40.0%	-20.0%								16.2%
Q6	The US new year quant. Sell at –20% or +50%	50.0%	35.6%	-20.0%								17.6%
Q7	The US new year quant. Sell at –20% or +60%.	60.0%	42.3%	-20.0%								22.1%
Q8	The US new year quant. Sell at +40%.	40.0%	40.0%									40.0%
Q9	The US new year quant. Sell at +50%.	50.0%	35.6%									42.6%
Q10	The US new year quant. Sell at +60%.	60.0%	42.3%									50.9%
Q11	The US new year quant. No conditional selling.	18.4%	27.5%									22.9%
Q12	The US midyear quant. Sell at –20% or +40%.											
Q13	The US midyear quant. Sell at –20% or +50%.											
Q14	The US midyear quant. Sell at –20% or +60%											
Q15	The US midyear quant. Sell at +40%.											
Q16	The US midyear quant. Sell at +50%.											
Q17	The US midyear quant. Sell at +60%											
Q18	The US midyear quant. No conditional selling											
Q19	The China midyear quant. Sell at –20% or +40%.											
Q20	The China midyear quant. Sell at –20% or +50%.											
Q21	The China midyear quant. Sell at –20% or +60%.											
Q22	The China midyear quant. Sell at +40%.											
Q23	The China midyear quant. Sell at +50%.											
Q24	The China midyear quant. Sell at +60%.											
Q25	The China midyear quant, No conditional selling.											
Q26	The India midyear quant. Sell at –20% 0r +40%.			20.0%								20.0%
Q27	The India midyear quant. Sell at –20% or +50%.			18.6%								18.6%
Q28	The India midyear quant. Sell at –20% or +60%.			21.9%								21.9%
Q29	The India midyear quant. Sell at +40%.			21.1%								21.1%
Q30	The India midyear quant. Sell at +50%.			19.6%								19.6%
Q31	The India midyear quant. Sell at +60%.			22.9%								22.9%
Q32	The India midyear quant. No conditional selling.			9.5%								9.5%

After three years the compound annual growth rate (CAGR) of the quants Q4, Q5 and Q6 is 16.2%, 17.6% and 22.1%. And it looks as if the results of the quants Q7, Q8 and Q9 will end up even better than that by the end of the year.

These results, I believe, are remarkable. My goal is to find just one quant that consistently outperforms with a 15% CAGR. Why do I believe that the current CAGR results are sustainable?

2020 was the year of the COVID-19 crash. History shows that once every eight years a 20+% crash will occur. So statistically the upcoming five years will be “20+% crash free” and that leads me to believe that it is very doable to maintain these exceptional CAGR results.

Latest update: 24 August 2020. If you find any errors, please let me know: peter@thevaluefirm.com.

The results exclude transaction costs and dividend tax. A “red year”, like 2020, is a “market crash > 20%” year.

If you want to do your own due diligence on these results, send me an email: peter@thevaluefirm.com, and I will send you the data.

Please be advised to wait for 2025 or even beyond, before drawing any meaningful conclusion from these numbers. Thank you.

Dear partners & friends,

"Generally speaking, if you get a chance to buy a wonderful business — and by that, I would mean one that has economic characteristics that lead you to believe, with a high degree of certainty, that they will be earning unusual returns on capital over time — unusually high — and, better yet, if they get the chance to employ more capital at — again, at high rates of return — that's the best of all businesses."

This is a quote from Warren Buffet, the Oracle of Omaha. He looks for dominant businesses with a high degree of predictability of future performance, measured by return on capital (ROC).

Let's start this letter with the yearly disappointments and/or mistakes. And rest assured that there won't be a shortage of those.

Veritiv

Veritiv still remains an uncomfortable position in my portfolio. It is in fact a great example of the agonizing choice a long-term investor faces when the stock of a company is in, what seems to be, a structural decline. If you still believe in the long-term business potential of the company, as I do, you just hold on to the stock for many, many years, knowing that there always is a chance that ultimately your decision to hold on to the stock might turn out to be a mistake.

Investing is about being imprecise and accepting being wrong 30 – 40% of the time. If you find that hard to accept, you are much better off staying out of the investing game.

Veritiv Corporation is a Fortune 500® company and its long-term strategy remains the same – shift the portfolio mix to higher growth and higher margin businesses by investing in packaging and services; protecting the leading market positions in facility solutions, print and publishing; and optimizing the business processes across their commercial, supply chain, and back office operations. Veritiv ended 2018 with 8.7B USD in revenue and currently trades below tangible book and at a price-to-sales ratio of 0.05.

The Veritiv packaging business as a "stand-alone business" is a 3.5B USD revenue business with an adjusted EBITDA of 250M USD and a sales growth of approximately 10% a year.

Veritiv Packaging	**2016**	**2017**	**2018**
Net Sales	2854	3158	3547
Net Sales growth		*10,7%*	*12,3%*
Adj. EBITDA	221	238	247
Adj. EBITDA growth		*7,7%*	*3,8%*
(in millions USD)			

Under the conservative assumption that the company grows at a 4 – 5% rate over the next 15 years, we will see an adjusted EBITDA of 450M – 500M USD. With a reasonable multiple of 8, you could argue that this stand-alone business represents a market cap of 4B USD, 15 years from now. Currently, Veritiv trades at a market cap of 320M USD.

What will drive the 4 – 5% long-term growth? Veritiv has officially joined the Amazon Packaging Support and Supplier Network. If they succeed, and obviously I believe they will, an exceptional business operation emerges with a unique competitive advantage in the North American packaging business, much of it closely tight to the ongoing boom in the fast-growing e-commerce strategy across major North American markets. I would not be surprised if Amazon ultimately buys the Veritiv packaging business.

I am not worried about the substantial debt position of Veritiv, neither am I worried about the decline in revenues. I am optimistic about their ability to generate free cash flow this year, and many years to come. Veritiv will remain in my portfolio, unless Baupost decides to substantially trim their position in this company. As of today, both Seth Klarman (Baupost), who owns 25% of the company, and Amazon are "Veritiv believers".

One additional remark for the sake of clarity – I run two portfolios; the first one is my personal account. I added Veritiv to this portfolio at 40 USD and used options to generate additional income from the declining stock price. The second is the Intelligent Cloning Portfolio, where I added Veritiv at 24 USD.

Intelligent Cloning

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. 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 properly treating their stakeholders.

Current positions

When	Company	Price	Return
2H '16	Deere	87 USD	97.9 %
2H '16	Allison Transmission	29 USD	65.0 %
1H '17	Davita	65 USD	(13.4 %)
1H '17	Verisign	83 USD	152.0 %
2H '17	Monro	47 USD	84.3 %
1H '18	Sinclair Broadcast	30 USD	81.3 %
2H '18	StoneCo	17 USD	74.0 %
2H '18	Veritiv	24 USD	(19.1) %
1H '19	Liberty Global	22 USD	22.7 %

Closed positions

When	Company	Price	Sold	Return
2H '17	Tegna	13 USD	2H '18	2,7 %
1H '18	Esterline Corp.	72 USD	2H '18	69,5 %

These are not actual fund results, but it illustrates what the results could have been if we indeed started an investment partnership in 2H '16. It's called "**The Intelligent Cloning Portfolio**". The stocks are selected with the idea to hold on to these companies for many, many years, preferably decades, as long as the company remains a good company.

Just as important as picking the right company to invest in, is using the downturns of the markets. StoneCo, Veritiv, and Liberty Global were added to this portfolio just after the 20% market correction from its 52-week high.

In 2H '18, I sold both Tegna and Esterline Corporation at 13 USD and 122 USD, respectively. The rationale behind selling Tegna is that David Einhorn sold the stock, so there was no backing from one or more of the superinvestors I admire. The rationale behind selling Esterline Corporation is that TransDigm announced their acquisition of Esterline for 122.50 USD per share in cash.

Just copying successful investors is fascinating. On 22nd August, 2012, Mohnish Pabrai talked to the UC Davis's MBA Value Investing class where he explained the mental model of "cloning."

"There is this true story about two gas stations in California several decades ago. These two gas stations were diagnosed opposite each other. They were both self service gas stations. In one of the gas stations, the owner would come out every hour or two, pick a random car and tell the driver to just sit in the car as he pumped the gas, cleaned the wind shields, checked the oil and so on and all of this at no additional charge. Just a kind of "add on service" for free.

The guy across the street would see all this happening. He thought that this was stupid, because you can't do it for everyone. It's self served. Why do you want to do it for few people and set expectations that are way off base? So he never copied it.

And over time, he noticed that his business had going down and the person opposite him was actually doing more business. He saw his business go down. He also knew the reason why his business went down. And even after knowing the reason, there was no reaction. He did not change his approach of doing business.

Management consultant Tom Peters once explained that if you run a business, you can sit down with your direct competitors and you can lay out all your competitive advantages for them. And tell them exactly how you gain advantages, make money, etc. And they will listen to you carefully, but when they leave there will be no behavior change. Clearly there is something in the human gene that is stopping you from adopting things that are to your benefit.

I found that some of the biggest businesses on the planet were based on cloning. Because there is a sliver of humans, basically 1 or 2%, who actually look at what the competitors are doing and adopt it and run with it."

What I try to do with the Intelligent Cloning portfolio is just that – adopt what other great investors are doing and run with it.

Still confused

By the time I entered this business, the unchartered waters of the business of investment and stock picking, I bought *The Interpretation of Financial Statements* by Benjamin Graham. And I started to learn. One step at a time. I enjoyed the learning process very much and I never really understood why, until I read the comments from Howard Marks in the Fall 2017 Graham & Doddsville Letter.

"I think that investment management is fascinating, because it's not easy; it's challenging. In Fooled by Randomness, Nassim Taleb talks about the difference between investing and dentistry. There's no randomness in dentistry, and if you do the same things to fill a tooth,

you'll be successful every time. That's not true of investing. First of all, there's no magic formula. There are no physical laws at work. Number two, there's a lot of randomness. Those things make it interesting. It's an intellectual puzzle with partial information. The process is messy and imprecise. To me, that's fascinating. You can have guidelines developed over a career, but they sure don't work every day. I love it for that reason."

Indeed, I love investing. And boy, did I learn a lot! At the same time, I am still confused. Or to quote the Italian and naturalized-American physicist Enrico Fermi, "Still confused, but at a much higher level."

The business of investment currently has a problem they can't fix, and that is that index funds have come along, and they basically beat everybody. Even Ted Weschler and Todd Combs, the two Warren Buffett investing lieutenants, weren't able to beat the S&P 500. You could argue, and recently Charlie Munger did just that, that we have a whole profession that is basically being paid for accomplishing practically nothing.

The investment world is characterized by an enormous amount of high IQ people trying to be more skillful. They work so hard and they just can't do what they are supposed to do – get better than average results. This is an industry in complete denial. There is this belief that if we send our most talented students to these elite MBA institutions, they will learn the right skills and become great investors. Well…

Charlie Munger recently gave this interesting example. There was once this investment company that reasoned that since they have all these brilliant young people from top notch business schools, if they could just ask each one of those brilliant young men for their single best idea, they would outperform averages by a big amount. So they tried it out, and, of course, they failed utterly. And they tried it again and failed utterly. And they tried it the third time and also failed. Actually, this investment company was looking for the equivalent of turning lead into gold and obviously it didn't work. Why did that plausible idea fail?

If you figured that out, just let me know. My best guess is that these youngsters lack the experience of a veteran investor like Lou Simpson. And I doubt if all the academic stuff they teach them really helps. Let me give you an example.

The EV/EBITDA multiple

In September 2018, Michael Mauboussin, Director of Research at BlueMountain Capital Management, wrote an in-depth article on valuing businesses. Nearly 80% of all equity analysts use Enterprise Value relative to EBITDA (the EV/EBITDA multiple) to measure the value of a corporation. Many investors and analysts deem it the best metric for measuring valuation. Here is my question to you. How much time did Warren Buffett spend contemplating this multiple when he bought the Apple stock?

But anyhow, the write-up contends that the ratio can be seen as a capital structure-neutral alternative for the P/E ratio. When valuations of different companies are compared with each other, the enterprise multiple is often considered more suitable than P/E.

The table below lists the S&P 500 Enterprise Multiples (EV/EBITDA) by sector. The data is provided by Siblis Research. Comparing the current enterprise multiple of a sector/industry to its historical average value can be used to estimate if the sector is currently undervalued or overvalued.

Sector	2015	2016	2017	2018
Communications	11.6	10.6	11.5	10.0
Consumer discretionary	12.4	11.7	14.2	13.1
Consumer staples	12.8	13.1	13.2	13.1
Energy	13.0	35.1(*)	12.3	7.4
Health care	13.6	11.8	14.9	14.3
Industrials	11.2	11.4	13.1	11.9
Information Technology	10.0	12.0	13.6	11.5
Materials	12.1	13.8	14.3	10.6
Unitilities	9.8	12.0	12.0	11.2

(*) The number of 35.1 seems to me to be out of sync.

Interestingly enough, James O'Shaughnessy has extensively analyzed investment strategies over the last 50 years and found that a strategy which includes the group of shares with the lowest EV/EBITDA ratio would have obtained an annual return of 16.6%.

Nevertheless, I don't use this multiple at all. Most of the arguments against the use of EV/EBITDA are actually in this article of Michael Mauboussin and it seems that I put a different weight on these arguments than most of the investment community.

If you assess two companies with the same financials, with the only difference that company A has a lower debt, then this EV/EBITDA multiple would direct you to an investment decision in favor of company A. If company B was run by a fellow named Warren Buffett, I would most certainly favor company B.

If you use EBITDA as a measure for cash flow, you actually ignore a business's capital needs. While technically considered a non-cash expense for accounting purposes, depreciation and amortization are actually real costs of capital needed to maintain a business. There is this famous quote by Charlie Munger where he states that whenever he sees EBITDA Earnings, he substitutes it with "Bull Shit Earnings". So what happens when you come up with a ratio based upon Enterprise Value (EV) relative to "Bull Shit Earnings"?

The first pitfall to using EV/EBITDA is that there is not a proper reckoning for the investment needs of the business. The second pitfall is that multiples, including EV/EBITDA, do not explicitly reflect business risk. And the final problem, according to Michael Mauboussin, has to do with dissimilar tax rates for different companies.

Probably most investors will argue that the EBITDA critics may be overstating their case. Obviously, I disagree. My skepticism grows when I read about all kinds of "EBITDA innovations", like the horrors of EBITDAC (with a change in acquisition costs used by insurers), EBITDAO (with an option expense, a cost of paying management), EBITDAP (pension and other retirement benefits), EBITDAR (the costs of leasing real estate or airplanes, depending on the industry), EBITDARE (losses, gains, and other adjustments on real estate), EBITDAS or EBITDASC (stock-based pay for management), EBITDAX (exploration costs for oil and gas companies), and community adjusted EBITDA (excludes basic costs of doing business as marketing, development, and administrative expenses). With compliments to the Jason Zweig's article "How Companies Use the Latest Profit Fad to Fool You" in the Wall Street Journal (June 1, 2018).

And there are some arguments against the use of Enterprise Value (EV) as well. Most investors define EV as the sum of Net Debt and the Market Capitalization of a company. There are several ways in which you can underestimate EV:

- Cash is often valued at face value and that might not be correct. One reason is taxes on dividends and other distributions and another reason is that not all cash is excess cash. Part of it is operating cash, that is tied up in the business forever and should not be added to the EV.
- Another risk with EV is the underestimation of the value of debt. Many data providers just take the book value as a proxy for market value of debt. The true economic value of debt may be much higher, due to recent rating increases or interest rate decreases.

My best guess is that Warren Buffett doesn't use this EV/EBITDA multiple at all. There is this Buffett quote that says it all: "We don't use complicated valuation models, because we want investments that are so obvious that you don't need one". Warren Buffett has this extraordinary ability to identify companies with very long term staying power and sustainable future cash flows. He started learning valuing companies early, with his mentor and teacher Benjamin Graham; he expanded his circle of competence with the wisdom and insights from Charles Munger and Phil Fisher and he continues compounding knowledge and experience up until today. He has been on 19 boards valuing companies and industries and has a business network of hundreds of CEOs and businessmen. This accumulated wealth of experience and insights will be very hard to beat.

In a 3-hour interview with CNBC's Becky Quick (beginning 2018), Warren Buffett once again made it very clear how he values a business.

"If you buy a 30-year government bond, it has a whole bunch of coupons attached. And the coupon pays 3%, or whatever it may say. And you know that's what you're going to get between now and 30 years from now. And then they're going to give you the money back.

What is a stock? A stock is the same sort of thing. It has a bunch of coupons. It's just they haven't printed the numbers on them yet. And it's your job as an investor to print those numbers on it. If those numbers say 10%, and most American businesses earn over 10% on tangible equity, that "bond" is worth a hell of a lot more money than a bond that says 3% on it. But if that government bond goes to 10%, it changes the value of this equity bond that, in effect, you're buying.

When you buy an interest in General Motors or Berkshire Hathaway or anything, you are buying something that, over time, is going to return cash to you. And those are the coupons. And your job as an investor is to decide what you think those coupons will be, because that's what you're buying. And you're buying the discounted value. The higher the yardstick goes, and the yardstick is government bonds, the less attractive these "other bonds" look. That's just fundamental economics.

So in 1982 or '83, when the long government bond got to 15%, a company that was earning 15% on equity was worth no more than book value under those circumstances because you could buy a 30-year strip of bonds and guarantee yourself for 15% a year. And a business that earned 12%, it was a sub-par business then. But a business that earned 12% when the government bond is 3% is one hell of a business now."

Return on Capital

As a long-term investor, I value company performance by the cash flow relative to its capital base, defined by "tangible identifiable assets". As I wrote in my first investor letter, there are many ways to calculate ROC and all these versions tell their own stories. You might want to study the writings of Michael Mauboussin, David Trainer, Ensemble Capital, Basehit Investing (John Huber) and Aswath Damodaran. You can also consider *Valuation: Measuring and Managing the Value of Companies* by McKinsey, *The Quest for Value* by G. Bennett Stewart, and *Inside the Investments of Warren Buffett* by Yefei Lu.

In my 2017 letter to shareholders, I stated that as the numerator, I use a cash flow version which is defined by the operational cash flow minus the maintenance capex, where it is assumed that depreciation and amortization expenses are roughly equal to maintenance capital spending.

I abandoned that approach and use just operating earnings (EBIT). The reason why I abandoned the 2017 numerator version is that the assumption that depreciation and amortization expenses are roughly equal to maintenance capital spending is way too fuzzy.

For instance, some companies tend to artificially inflate earnings by:

- Failing to allocate sufficient costs to the appropriate period through depreciating fixed assets too slowly;
- Amortizing intangible assets or leasehold improvements over too long a period;
- Changing to a longer period to depreciate or amortize an asset;
- Amortizing inventory, marketing, and software costs too slowly.

While Generally Accepted Accounting Principles (GAAP) encourage companies to write off costs quickly as benefits are received, there is, I believe, too much uncertainty in representing maintenance capital by depreciation and amortization expenses.

Moreover, Warren Buffett advices to focus on operating earnings, also known as Earnings Before Interest and Taxes (EBIT). In his latest annual letter, Warren Buffett stresses the influence of new GAAP on the income statement of Berkshire Hathaway and believed that wide swings in their quarterly GAAP earnings will inevitably continue. Just focus on the EBIT.

As always, there are exceptions. Palo Alto, the world's leading cybersecurity company, has a negative EBIT, but a positive operational cash flow (CFFO) and positive free cash flow (FCF). In practice, I look at all three of them – the EBIT ROC, the CFFO ROC, and the FCF ROC – and I don't bother too much about the exact value or definition. The only thing I want to know is, if the company indeed is a consistently high profitable one.

There are indeed many practices of calculating return on capital. And you have to be careful to take a company's reported return on capital for granted. Historically, the British multinational groceries and general merchandise retailer Tesco Plc managed eight changes in the definition of return on capital over the period 1998 – 2011.

Here is an illustrating example of the ROC version that AutoZone uses (from their annual reports). ROC is calculated as after-tax operating profit (excluding rent) divided by invested capital (which includes a factor to capitalize operating leases). For FY2018, after-tax operating profit was adjusted for impairment charges, pension settlement charges, the impact of the revaluation of deferred tax liabilities, and net of repatriation tax.

(in thousands, except percentages)	**2018**
Net income	$ 1,337,536
Adjustments:	
Impairment before tax impact	193,162
Pension termination charges before tax impact	130,263
Interest expense	174,527
Rent expense	315,580
Tax effect(1)	(211,806)
Deferred tax liabilities, net of repatriation tax	(132,113)
After-tax return	$ 1,807,149
Average debt(2)	$ 5,013,678
Average (deficit)(3)	(1,433,196)
Rent x 6(4)	1,893,480
Average capital lease obligations(5)	156,198
Invested capital	$ 5,630,160
ROIC	32.1%

(1) *The effective tax rate during FY2018 was 24.2% for impairment, 28.1% for pension termination, and 26.2% for interest and rent expense.*

(2) *Average debt is equal to the average of the debt measured as of the previous five quarters.*

(3) *Average deficit is equal to the average of the stockholders' (deficit) measured as of the previous five quarters.*

(4) *Rent is multiplied by a factor of six to capitalize operating leases in the determination of pre-tax invested capital.*

(5) *Average capital lease obligations are computed as the average of the capital lease obligations over the previous five quarters.*

Keep in mind that a return on capital assessment, no matter what definition you want to use, is an evaluation of the past performance of the company. More important than the exact outcome of the return on capital calculation is the ability of the company to generate substantial future free cash flows relative to its capital base. That's what you should care about most and that is, as far as I am concerned, the quintessence of business valuation.

A fun exercise to do is to calculate every ROC definition and practice for e.g. Amazon over the last 20 years.

Quants

I started this letter with a quote from Warren Buffett: "We don't buy anything just by the numbers". Well. That's exactly the opposite of what "quants" actually do. Quant Q4, as described in the Spring Edition 2019 on Intelligent Cloning, is already up 40%, and by that, defining the end result for this quant for the year. This is a 40% return for the second year in a row.

Is it luck? Is it skill? Or just a statistical coincidence? It is at least the trigger for some further examination of these quants. Let's put them under a thorough stress test. Here is the idea.

Not once, but twice a year, I come up with the new constituents for these quants. Every quant has a holding period of 1 year, and if, during the year a constituent is up e.g. 40%, I sell it.

And I will add a new selling rule. Let me explain. If you look at the back-test results of the Mohnish Pabrai Free Lunch Portfolio (FLP), you will find every now and then an extreme negative result, e.g. in 2008, -54.4% for the Shameless Cloning portfolio. These bad years will most certainly happen again, and since I focus on the more volatile small cap stocks, results could even get worse, e.g. all the way to -80%, with severe consequences for the final result.

The rule I want to add is that I will sell a stock if it is down 20%, and with that I will limit the maximum downside to 20% a year. The obvious disadvantage of this approach is that if a stock is down more than 20% and after that rises to positive territory during the year, it will be sold anyhow at -20%. But that is the disadvantage I am willing to accept.

And I will add some new quants. Let's test this approach in China and India as well. Here are the 2019 midyear constituents:

- **United States:** TrueBlue, Comfort Systems and Genesco.
- **China:** IGG Inc, Tianneng Power International and Consun Pharmaceutical.
- **India:** Sonata Software, Persistent Systems and NIIT Technologies.

Some of you may question why anyone would even think about setting up such a complex scheme for something where there is a very reasonable chance that, in the long run, it will underperform the index. The answer to that question is that it is a lot of fun, that there is a lot to learn by just doing all this and, finally, who knows, it might work after all. Here are the company profiles of the constituents who might happen to be great long-term buy-and-hold stocks as well:

TrueBlue (TBI) works with businesses to provide the workforce solutions they need to succeed. TrueBlue currently puts more than 840,000 people to work each year and partners with 130,000 companies around the world. TrueBlue is a 870M USD market cap company, trading at 7.7 times cash flow (where cash flow is defined by the 2 year average operational cash flow).

Comfort Systems USA (FIX) offers business solutions in workplace comfort, building environments and energy efficiency. Their services and solutions fall into three main categories: construction, building service and maintenance and retrofit (when systems age and become less reliable or energy-efficient, they can recommend and install upgrades and replacements). Comfort Systems is a 1.8B USD market cap company, trading at 13.8 times cash flow.

Genesco Inc. (GCO), a Nashville-based specialty retailer, sells footwear and accessories in more than 1,500 retail stores through the U.S., Canada, the United Kingdom, and the Republic of Ireland, principally under the names Journeys, Journeys Kidz, Schuh, Schuh Kids, Little Burgundy, Johnston & Murphy, and on many internet websites. Genesco is a 780M USD market cap company, trading at 4.7 times cash flow.

IGG Inc (0799.HK) is a renowned developer and publisher of mobile games with a strong global presence and international customer base. As at 31 December 2018, the user community of the Group consisted of approximately 620 million registered players around the world, with a total MAU (monthly active user) of over 19 million. For the year, 46%, 27% and 23% of the Group's total revenue were generated from Asia, North America and Europe respectively. IGG Inc is a 10.7B HKD market cap company, trading at 6.6 times cash flow.

Consun Pharmaceutical Group (1681.HK) is an investment holding company principally engaged in the manufacture and sale of pharmaceuticals. The pharmaceutical products of the Company include kidney medicines, contrast medium and others. The Company's subsidiaries include Brilliant Reach Group Limited, Century International Develop Limited and Grand Reach Company Limited. Through its subsidiaries, the Company is also engaged in the research and development of pharmaceutical products.

Tianneng Power International (0819.HK) adheres to the belief of "New Energy New World" in the People's Republic of China and aims at achieving the goal of becoming "a world leading new energy solution provider". After 32 years of development, the Group has developed into a new energy high-tech company engaging in businesses such as motive batteries for electric vehicles, smart energy solutions as well as recycling of resources. Tianneng is a 6.9B HKD market cap company, trading at 2.7 times cash flow.

Sonata Software (SONATSOFTW.NS) is a global technology company, that enables successful platform based digital transformation initiatives for enterprises, to create businesses that are connected, open, intelligent and scalable. Sonata's solution portfolio includes its own digital platform and best-in-class capabilities on ISV digital technology platforms such as Microsoft Dynamics 365, Microsoft Azure, SAP Hybris, Cloud Engineering and Managed Services, as well as new digital applications like IoT, Artificial Intelligence, Machine Learning, Robotic Process Automation, Chatbots, Block Chain and Cyber Security. Sonata is a 36.7B INR market cap company, trading at 15.2 times cash flow.

Persistent Systems Limited (PERSISTENT) is engaged in the business of building software products. The Company offers complete product life cycle services. The Company's segments include Infrastructure and Systems, Telecom and Wireless, Life science and Healthcare, and Financial Services. Persistent is a 47.2B INR company, trading at 13.4 times cash flow.

NIIT Technologies (NIITTECH) is a leading global IT solutions organization, enabling its clients to transform at the intersect of unparalleled domain expertise and emerging technologies to achieve real-world business impact. The Company focuses on three key verticals: Banking and Financial services, Insurance, Travel and Transportation. This domain strength is combined with leading-edge capabilities in Data & Analytics, Automation, Cloud, and Digital. NITT is a 83.2B INR market cap company, trading at 11.0 times cash flow.

So here we are

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 that capitalism is a relentless cycle of depressions, panics, recessions, bubbles – from the Roman empire through tulip manias, South Sea Bubbles, Great Depressions down to the "Great Deleveraging of 2008".

If you want to join a fund or separately managed account, it's best that you stay with my company for at least 10 years, preferably longer. Since I am a one-man investment operation, I only serve a limited number of clients. 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 apartment house 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 however long you elect to be a partner.

I only serve professional investors. Just send in the legally required Customer Due Diligence documentation, and confirm that you read, understood, and agree with the Owner's Manual on my website. And then, let's talk.

Thank you for reading my letter!

Cordially,

Peter

Peter Coenen

Founder & CEO,
The Value Firm®
30 June 2019
Contact me: peter@thevaluefirm.com

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

Dear (future) partner,

"Almost all of the successful company founders began as poor men. It was through hard work and wits that they climbed the economic ladder."

This quote is from the letter addressed to shareholders from Mr. Ronnie C. Chan, Chairman of the Hong Kong based Hang Lung Group in 2016, better known as the Warren Buffett of Hong Kong. I added Hang Lung Group to my portfolio just to find out a few months later why it was a too perilous investment for me at this time.

Value investing is a risk averse investment approach. Focus on the downside risk, and only if the chance of losing money is small, you look at the upside potential. There is no room for Tesla and Bitcoin in my approach. I am perfectly happy that people get rich from this type of speculation. In the Dutch Golden Age, people became very wealthy from buying tulip bulbs.

Value investing is not a contest of who makes the most money. It's a very conservative approach for capital preservation. You just want to make sure that you don't lose money. Recently, I did buy some tulip bulbs, although. I enjoy gardening.

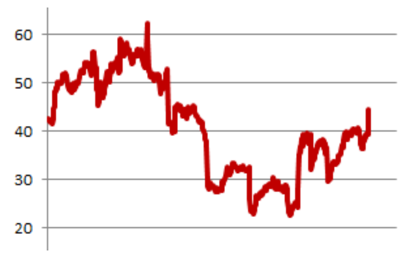
Veritiv

Veritiv is not an investment opportunity that hits you over the head immediately. It took me quite some time studying the company just to find out that in fact, it is a very exceptional investment opportunity for those who are willing to be very, very patient. If you want to receive the full write-up on Veritiv, drop me an email: peter@thevaluefirm.com.

The Veritiv business will change materially over the course of time. In the long run, approximately 95% of the adjusted EBITDA will be comprised of the packaging & services business (80%) and facility solutions (15%). The packaging & services market are poised to experience steady growth; much of it is closely tight to the ongoing boom in the swift growing e-commerce strategy across major North American markets. Veritiv is already the market leader of the growing packaging market in North America and will become more and more dominant as a result of their unmatched competitive advantages and their power to lead this market with customer tailored innovations & smart acquisitions.

Nowadays, leading brands are leveraging packaging and supply-chain efficiencies as a competitive advantage. By making packaging a part of the product development process and implementing strategic improvements throughout the supply chain, businesses around the world are boosting their top and bottom lines through strategic packaging—and, Veritiv aims to be at the forefront to help these businesses thrive. Once Veritiv is deeply ingrained in the supply chains of these S&P 500 companies, these companies will not switch to competitors easily, especially knowing that there are hardly any competitors offering the kind of service solutions that Veritiv does.

Let's have a look at the price movements since I bought the stock:



Initially I bought stock at $42. The stock went all the way up to $62 and, then, all the way down to $28. And, I informed you about the $30 hedge I had in place, up until 19 January 2018. After I published my 2017 letter to partners, I bought more stock in Veritiv at $28.

On 7 November 2017, as a result of a disappointing Q3 2017 financial update, the stock went down 20%, and a day later, even further to $20.40. I exercised the put options at $30 and invested the money to buy more stock at $22.40. If you sell at $30, you can buy back approximately 30% more stocks at $22.40. As a result, the Veritiv investment will be 15% more profitable beyond the break-even point, which is at $35.

This is a company getting ready for optimization and long-term growth. I just love free cash flow, and I am more than happy to read that Veritiv is ready to generate free cash flow of at least $30m in 2018. The leadership team has shown before that they have the ability and courage to execute, and I do believe they will be able meet their 2018 free cash flow target.

The ability not to sell a stock during times of adversity is very important. Suppose you did your thorough due diligence on Veritiv and bought stock at $55, I am quite sure that most of the investors would sell the stock when it went down to $20.8 (more than 50% decline in just a few months). I did not sell the stock. In fact, I bought more. And believe me, that is a very painful mental exercise because you are never 100% sure that you are right on your investment thesis.

The reason why I write in such a detail on the price movements of the Veritiv stock is that I want (future) investors to understand and realize that this type of hefty volatility is common in a portfolio of stocks that I prefer, and it will most certainly happen again and again.

As Mike Tyson famously said, "Everyone has a plan until they get punched in the face." Are you willing and able to stay the course when adversity and stock price turbulence takes over? It takes a lot of conviction and mental courage to buy more, when the stock goes down. It is a crucial skill for successful investing.

Veritiv seems to be a classic low-risk high-uncertainty stock and the Street hates uncertainty. The long-term investment thesis remains strong and intact, and I will continue surfing the waves of short-term uncertainty.

Take the Buffett road

In the 1993 annual report of Berkshire Hathaway, Warren Buffett sums up his criteria for evaluating the risk of an investment. Here are four of them: the certainty with which the long-term economic characteristics of the business can be evaluated, the certainty with which management can be evaluated, both as to its ability to realize the full potential of the business and wisely deploy its cash flows, the certainty with which management can be counted on to channel the rewards from the business to shareholders rather than itself, and the purchase price of the business (the company has to trade at a price that makes sense).

Buffett looks for well-run, dominant enterprises producing consistent results. He considers "economic reality" over accounting statements, and he values business simplicity, managerial expertise and reputation highly.

You could argue that all of these aspects are covered in the "Buffett & Munger four-filter system", which I consider to be a very compelling approach.

Filter 1. Understanding.

The first filter is often taken too lightly. How can you possibly make any intelligent and informed decisions about the potential and success of the company if you do not understand the business and its business environment? It is not just about the companies' products and services (business model, customer loyalty, and pricing power). It is also about the industry outlook and the competitive dynamics of the industry, and these can be very hard to assess.

Filter 2. Durable competitive advantages.

Charlie Munger and Warren Buffett are undoubtedly the pioneers of "moat investing". Buffett called companies "economic castles" and used a medieval analogy for what he looks for in a business and the managers running it. In capitalism, people are going to try to take that castle from you; so, you want a moat around it as well as a knight in that castle who is pretty darn good at warding off marauders.

Charlie Munger stresses the importance of figuring out how big a moat there is around the business. "What I love, of course, is a big castle and a big moat with piranhas and crocodiles. The problem is that it's relatively easy to identify a company that is doing well. It's much harder to look into the future and determine if that company will continue to do well. Identifying a wide and durable moat is a tough task and a task that's hardly an exact science."

Filter 3. A high caliber leadership team.

One of the most important investment criteria Buffett uses is a high caliber CEO. During the 2016 Berkshire Hathaway Annual Shareholders Meeting, Warren & Charlie discussed why they were willing to pay such a high price for the Precision Castparts acquisition, and they mentioned their confidence in CEO, Mark Donegan.

“A business, like Precision Castparts, requires a very superior management that’s going to stay superior for a long time. It’s simply amazing how well it works. I think, to some extent, we’ve gotten almost as good at picking superior managers as we were in the old days of picking the no-brainer businesses. It’s very important that you have somebody there with enormous skill running this business, and their reputation among aircraft and engine manufacturers is absolutely unparalleled.”

Another great example of the importance of an exceptional CEO is the unconventional conglomerateur, Henry Singleton of Teledyne. If you can find a Henry Singleton look-alike… go for it!

Filter 4. A price that makes sense.

Buffett welcomes lower market prices of stocks as an opportunity to acquire even more of a good thing at a better price. Or, in his own words, “Our experience has been that pro-rata portions of truly outstanding businesses sometimes sell in the securities markets at very large discounts from the prices they would command in negotiated transactions involving entire companies. Consequently, bargains in business ownership, which simply are not available directly through corporate acquisition, can be obtained indirectly through stock ownership.”

Often underestimated, when figuring out if a stock is cheap or expensive, are the interest rate levels. If interest rates are low, it makes any stream of earnings from investments worth more money. “The bogey is always what government bonds yield.”

In a 2017 interview video clip found using the CNBC's Warren Buffett Archive, Buffett explains why rates matter so much for stock investors. "Any investment is worth all the cash you're going to get out between now and judgment day discounted back. The discounting back is affected by whether you choose interests rates like those of Japan or interest rates like those we had in 1982,” Buffett said in 2017. “When we had 15% short-term rates in 1982, it was silly to pay 20 times earnings for stocks.”

Buffett and Munger have been using these same four filters since 1972 and, obviously, it is working for them. If you’re interested in studying the investment approach of Warren Buffett, just go to buffett.cnbc.com. It’s an amazing collection of videos, documents, and insights.

Never borrow money

If you study the investment style of Warren Buffett, you will probably find that he uses leverage and that he advocates not to do that. It seems paradoxical, but in fact it is not.

For example, in his 1962 letter, he states, “I believe in using borrowed money to offset a portion of our workout portfolio, as there is a high degree of safety in this category in terms of both eventual results and intermediate market behavior.” And, then, we have a 2012 study from AQR Capital Management that says that the real secret behind Warren Buffett's stellar track record is not great stock selection, it’s portfolio leverage.

In his early years, Munger was also happy to borrow money to accelerate his returns. It has been stated that he did enormous trades with borrowed money, like British Columbia Power, which was selling at around $19 and being taken over by the Canadian government at a little more than $22. Munger did not only put his whole partnership, but also all the money he had and all that he could borrow into an arbitrage on this single stock—but only because there was almost no chance that this deal would fall apart. You could easily question if Munger’s success by then was a result of his extreme genius or just pure luck.

Warren Buffett is very clear about the dangers of using leverage: “Leverage is the only way a smart guy can go broke. History tells us that leverage, all too often, produces zeroes, even when it is employed by very smart people.” (LTCM and Lehman Brothers).

The mistake many investors make is that they try to emulate Buffett’s use of leverage with a margin account. That’s a very dangerous approach for using leverage. “Margin trading is dangerous because the person giving you credit can wipe you out at the bottom tick just because he feels nervous. Berkshire avoids that stuff where someone else can sell your securities, because they feel nervous.”—Quote Charlie Munger.

Instead, Buffett prefers the following alternative sources of leverage: float and deferred taxes. These alternatives are cost-free, have no covenants or due dates attached and, thus, are much safer sources of leverage. Unless you have an insurance company in your backyard, you will not be able to emulate that. Buffett will not receive any margin calls, and if you use a margin account, you are subject to the risk of margin calls.

You might argue that you can use hedging techniques for limiting the downside risks of using leverage in a margin account. That doesn't make it less dangerous, and it is certainly not easy. And, here is my argument against it. Everybody makes mistakes now and then. Perhaps you remember the very experienced derivatives trader, Nick Leese? If you make a hedging mistake during times of severe market turbulence, the results can be disastrous and wipe you out for good.

What happens when the stock exchanges shut down in response to a panic? During the panic of 1873 (by then nearly 10.000 businesses failed), there was a 10-day closure followed the failure of Jay Cooke & Company bank. If that happens, you will not have access to your margin account for preventing margin calls (add cash, add hedging, roll over options, etc.). Your broker won't hesitate to just close your account if you violated their adjusted margin rules. Some investors have been shocked to find out the hard way that the brokerage firm has the right to sell their securities that were bought on margin—without any notification, and at times, leaving their customers in personal bankruptcy.

Brokers use "sophisticated" liquidation software to automatically close down accounts that violate the margin rules. And brokers can and must adjust the margin requirements during times of turbulence. In fact, they use real-time margining software, and during volatile trading periods, margins can be increased a little or a lot without any notice to you. There are several lawsuits against brokers that accuse the broker, for e.g., of unlawful management of a number of portfolio margin accounts. And there is an example of a brokerage firm's system for selling securities from clients' accounts to pay margin debt that backfired, leaving a fund with hefty losses.

Now, you might think this will not happen to you, because you are a professional. Recently I received an erroneous warning on a margin cushion: "-100% remaining". Just think about that for a moment. This happened as a result of a problem the broker had with "position display" and, fortunately, there were no financial consequences. This was a software problem during times of market stability. Try to imagine what can happen during times of market turbulence, when markets move up and down very, very nervously? Or what can happen to this liquidation software, when a cyber security incident hits the brokers trading platform?

Buying stocks on margin is one of those things that might appear on the surface to be a great way of making money. Investing on margin is essentially investing with borrowed money. This inherently risky method of investing can lead to total bankruptcy and ruin your financial, personal, and business life.

Even if the account blows up, you are on the hook for the money immediately. No payment plan. No negotiating terms. If you don't pay, the broker can haul you into court to start getting judgments for seizing your other holdings, ultimately requiring you to throw yourself at the mercy of a bankruptcy judge.

During the Crash of 1929 proceeding the Great Depression, maintenance requirements were only 10% of the amount of the margin loan! If an investor wanted to purchase $20,000 worth of stock, he would only be required to deposit $2,000 upfront. This wasn't a problem until the market crashed, causing stock prices to collapse. When brokers made their margin calls, they found that no one could repay them, as most of their customers' wealth was in the stock market. Thus, the brokers sold the stock to pay back the margin loans. This created a cycle that fed on itself until, eventually, prices were battered down and the entire market was demolished. It also resulted in the suspension of margin trading for many years.

There are many examples of entire retirement accounts that were wiped out and some investors talking about contemplating suicide.

You should read Buffett's latest letter to shareholders, where he stresses, once again, his aversion to leverage. "A stock market crash can happen anytime. No one can tell you when. The light can, at any time, go from green to red without pausing at yellow. When the market starts to go down, a lot of people overreact and start to panic. An unsettled mind will not make good decisions."

Seth Klarman (who doesn't have an insurance company in his backyard, as far as I know) once said, "I side with those who are unwilling to incur the added risks that come with margin debt. Avoiding leverage may seem overly conservative, until it becomes the only sane course."

Hang Lung Group

When I bought stock in Hang Lung Group, it traded at less than 0.5 times tangible book. The company, by then, had a market cap of 37.2B HKD (the equivalent of 4.2B

USD), a very solid balance sheet, a multi-year gross margin around 70%, and a unique business model with almost no debt. It grows free cash flow through the long-term holding of the best commercial properties in several promising cities in China. Actually, I "cloned" this investment from the New York-based investment company, Tweedy Browne.

Hang Lung specializes in luxury shopping malls in China. The company is controlled by the Chan family, which built the business in China practically from scratch in about 15 years. They have a great eye for location and, then, step-by-step they develop the mall. And, often, they are surrounding real estate with an eye to attract high-profile retailers and high-quality office tenants that drive additional traffic to the mall. Over the past ten years, the company's book value has grown from just under 19 HKD per share to over 55 HKD per share.

The strategy of the Hang Lung Group is clear: to follow the success of their Shanghai developments with stunning world-class shopping malls and office towers in some of China's fastest growing cities. And, they have the strengths for achieving these goals with a competitive advantage that will make them Mainland's leading commercial real estate developer, owner, and manager. Having spent years in researching the cities poised for spectacular growth and developing the relationships that are needed to bring their plans to fruition, they are now poised to make the China market the center of their future growth and expansion plans. In this endeavor, the Hang Lung Group is way ahead of Hong Kong and Mainland developers because the vision is something that they have honed from scratch, based on their solid experience and expertise.

Global luxury brands came into China hand in hand with Hang Lung. In the early days, you could find the flagship stores of most luxury brands in Shanghai's Plaza 66. Through years of cooperation, Hang Lung has cultivated great relationships with global brands. You can now find similar brands in Hang Lung's new projects in second-tier cities. Hang Lung has clearly positioned itself as the host of global high-end brands, and there is massive growth potential in the long term.

What I also like about Hang Lung is that they prioritize commitment to integrate sustainability into every facet of its business. They remain focused on building and operating their properties in a sustainable fashion. "We are not running a for-profit business just for ourselves, but for the wider benefit of the communities in which we operate, creating value for the economy, society, and the environment, which we consider essential to sustaining long-term growth."

Perhaps you have some doubts about this investment, and you are afraid that the property bubble in China will burst. Property prices have been moving in big cycles, especially in the emerging markets and are highly correlated with the monetary policy. For a company with almost no debt and a predictable management team like Hang Lung, it is easier to look into the long term. Hang Lung's China portfolio consists of best properties at best locations in cities with over 10 million people. A "hard landing" will actually be positive to Hang Lung in the long term. Managements' track record suggests that they will definitely use the strong cash flow and balance sheet to take advantage of the crisis. An investment in Hang Lung is one where long-term investors should be happy to see a crash.

In general, you could argue that China is one of the best places for business. One Belt and Road Initiative, the modern-day version of the old Silk Road, enunciated by President Xi Jinping, should help keep China's economy growing for many years to come. The aim of this 900 billion USD scheme is to kindle a "new era of globalization", a golden age of commerce that will benefit all.

Thinking about this "New Silk Road", there are two companies I added to my "watch list". **China Merchants Port Holdings**, the largest public port operator in China, has been actively extending its reach down the tendrils of the Belt and Road. With investments in 29 ports around the world, the shipping giant is planning to move deeper into Southeast Asia, Turkey, Africa, the Baltics, and Russia over the next three years.

And, then, there is the **China Railway Construction Corporation**. It has been rumored that it is a Li Lu holding. The company currently has 111 projects underway in 37 countries along the Belt and Road that are worth more than $15 billion combined. The company also recently signed a deal to build a $12 billion rail line in Nigeria, inked an MOU with Thailand for a new railway, and is currently working out the details with India for a high-speed rail line that will stretch from Delhi to Chennai. It is also gunning for the proposed $60 billion Moscow to Beijing high-speed rail line.

Although China looks very attractive as a destination for investments, I still sold the Hang Lung Group stock after a few months. The main reason for doing this is not that I doubt the long-term prospects of the Hang Lung Group, but because of the risk of high leverage in the Chinese financial system.

High leverage is the ultimate origin of macro financial vulnerability, and according to central bank governor, Zhou Xiaochuan, China's financial system is becoming significantly more vulnerable due to high leverage. He warns of sudden, contagious, and hazardous financial risks.

Some high-risk activities are creating market bubbles under the cover of "financial innovation". Some Internet companies that claim to help people access finance are actually Ponzi schemes, and some regulators are too close to the firms and people they are supposed to oversee. But, one of the main concern is the majority of the financial action taking place beyond the reach of regulators. China's shadow banking sector, unregulated loans mostly, is hard to quantify with any precision; but, analysts agree it has the potential to put the financial system at risk.

Kyle Bass, founder of Hayman Capital Management, has warned of a looming crisis. Jim Chanos, the hedge fund manager who predicted the 2001 collapse of Enron Corp., stated that Chinese banks are showing signs of loan stress. The International Monetary Fund warned that China might eventually suffer a "sharp adjustment" unless it addresses its indebtedness. And, both S&P Global Ratings and Moody's Investors Service cut China's sovereign credit rating in 2017 for the first time during the current millennium, citing the risks from soaring debt.

The optimists argue that the authorities would bail out distressed lenders before any crisis threatens the financial system. Failed banks might even be dealt with quietly before anyone outside China knew, and some argue there's little chance of a financial meltdown because the biggest slice of China's debt pile is carried by state-owned enterprises. In the worst case, the government could take over some liabilities.

Seth Klarman frets about Chinese leverage and wealth management products that seem to have adopted a page from the 2008 opaque derivatives playbook. Klarman recognized the issues and addressed them in his 2017 year-end review and warned of a potential "bloodbath". And, that's the reason why I think that an investment in Hang Lung Group at this time is too risky to me.

My company

When I started The Value Firm®, the idea was to launch a new fund. As of today, I just didn't, and I do not regret that at all. In 2016, I visited the LatticeWork Conference in New York and, in my personal introduction, I wrote that if you envision Warren Buffett and Charlie Munger in stage 10 of successful investing, I felt I was still scratching the surface of the introductory course to stage 1. And up to today, I continue to believe that there still is so much to learn.

What I know by now is that it not only requires a lot of knowledge, studying companies and industries, and learning from mistakes, but also accumulated experience, especially in terms of "the right temperament". As of today, I put an enormous emphasis on understanding and dealing with risk. It's not just how well you do in your investments, but also how much risk you take for getting your return.

What I learned from studying "Capital. The Story of Long-Term Investment Excellence" by Charles D. Ellis is that the best time to start a new fund is when the markets are way down. And that just isn't so.

Bridgewater Associates, the world's largest hedge fund, is already sounding the alarm on nearly every financial asset. "We are bearish on almost all financial assets," the firm said. "2019 is setting up to be a dangerous period for the economy, as the fiscal stimulus rolls off while the impact of the Fed's tightening well be peaking," the firm continued. "And, since asset markets lead the economy, for investors the danger is already here."

If I had to start a fund today, it would be strongly hedged with a lot of cash, waiting at the sidelines for better investment opportunities. If that's of any interest to you, I am happy to discuss that. Just drop me an email and we can start a conversation.

There is a lot of reason for being cautious before starting a new fund. In May 2018, there was a great article in Forbes Magazine, where Whitney Tilson talked candidly about the rise and fall of Kase Capital.

"Tilson beat the market from 1999 through mid-2010 almost every year. The fund grew from $1 million to $200 million under management. But as the economy recovered and stocks rallied, Tilson developed the view that the market was ahead of the fundamentals, so he positioned the fund defensively, holding a lot of cash and carrying a meaningful short book, waiting for the next big downturn.

This conservative positioning led to his fund significantly underperforming this long bull market over the past seven years, which caused his investors to get fatigued and assets to shrink to $50 million. More importantly, he was miserable: month after month, year after year, he felt like he was letting his investors down, so he finally decided to pull the plug last fall."

So, even a very experienced and respected investor like Whitney Tilson closed down his fund as a result of underperformance. By the way, I never understood why investors like Whitney Tilson want to short stocks. Even Li Lu admits that shorting was one of the worst mistakes he has made.

A great reputation and track record is by no means a guarantee for future results. Bill Ackman's hedge fund empire crumbled in less than 3 years from public wrong-way bets on Herbalife, Chipotle. The majority of institutional investors including longtime partner Blackstone Group are leaving Ackman's Pershing Square hedge fund.

And what to think about David Einhorn. Greenlight Capital lost 5.4 percent in the second quarter 2018, bringing the performance of its funds to a year-to-date loss of 18.3 percent. David Einhorn says over the last three years, Greenlight's fund performance has been "far worse than we could have imagined, and it's been a bull market to boot."

And then we have Bruce Berkowitz. His performance between 2000 and 2010 was lauded and he was named Domestic Stock Fund Manager of the decade by Morningstar. However, since 2010 he has suffered long periods of underperformance and in October 2017, Berkowitz started liquidating Fairholme Capital's hedge fund.

Launching and building a successful fund is extremely difficult, especially these days. Growing a fund is really hard and very few people succeed in doing it. Tilson: "I can't tell you how many energetic, talented young investors I've seen over the years launch funds, get to $5-10 million under management and, then, stall out, never growing beyond this. At this size, the business is losing money—not to mention the opportunity cost of not having a job and earning a salary—so these folks are just bleeding, year after year, refusing to give up on their dream… but it never materializes."

Recently, I watched a presentation on YouTube by Brian Bares of Bares Capital Management. And, he reminded me about the importance of building a differentiated investment process that is hard to replicate.

What I prefer doing is running a concentrated portfolio (15 stocks) of very exceptional and unique investment opportunities. Often, I find them by studying the portfolios of successful investors. Veritiv is such an example, which I just copied from Seth Klarman. 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.

Obviously, price is important; but, too much focus on price limits your investment opportunity universe. Coca-Cola was trading at 45 times earnings in the 60's. If you bought it then and hold on to it the next 4 decades, your return would gravitate to the ROE of the business, the longer you hold on to it. So over 4 decades, you probably still would be compounding in the high teens or low twenties.

Another differentiator is the fee structure. 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.

And finally, what differentiates me from many other investors, I believe, is that I spend more time thinking about risk management and hedging. I consider risk management skills just as important as good stock picking skills. If done well, risk management is indeed a competitive advantage. It's key to generating higher returns, setting a bottom for potential losses, improving margins, and raising the confidence of clients, investors, and shareholders.

I always look for "cheap insurance". When appropriate, individual stocks might be hedged with put options; the portfolio might be hedged with index-puts and even currencies might be hedged. What I try to do is overlay the portfolio of value stocks with a kind of disaster insurance.

Charlie Munger reminded us that the most important aspect of risk management is the right temperament. Probably, the biggest risk in investing is “panicking near a market bottom and selling out”. Many, many investors swore that they never ever do such a thing and they do exactly that. There is a lot of value in staying calm when adversity takes over.

So here we are

I started this letter by quoting Mr. Ronnie C. Chan, Chairman of the Hong Kong based Hang Lung Group, and I might as well end with Mr. Chan.

“We should count ourselves fortunate to be doing business in East Asia, particularly in the relatively stable and biggest developing country in the world, China. Economic growth in this country will remain among the highest in the world. The combination of size and speed is unseen in human history and should be advantageous to our business.”

There is this huge and agonizing dilemma of investing in China, where Seth Klarman warns of the risk of a potential “bloodbath”, as a result of Chinese leverage and, where, Warren Buffett reminds us that what the Chinese have done in the last 50 or 60 years is a total economic miracle and that he believes the growth story is far from over. And, with that, I wish you all the best.

Thank you for reading my letter!

Cordially,

Peter

Peter Coenen, 12 August 2018.
Founder & CEO of The Value Firm®
E-mail: peter@thevaluefirm.com

Dear (future) partner,

The Sequoia Fund Investors Day 2017 transcript is a great read. You can get a very good idea of my investment approach just by reading theirs. So what is my investment approach? Well, I just try to find a handful of unique, exceptional and, at times, uncomfortable investing opportunities and then hold on to these companies as long as they remain good companies.

First of all, I am a "cloner". I study successful value investors and if I can understand and agree with the investment thesis, I buy it whether it is a classic Buffett company, spinoff, or whatsoever. Secondly, I look for companies that have their "value creation engine" up and running (companies like Mastercard or Verisign) and if such a company trades at a price that makes sense, I buy it. I work patiently and very hard every day to identify these unique and terrific businesses trading below their intrinsic value and I enjoy every minute of it.

So let's have a look at a pretty uncomfortable situation in my portfolio and how to assess that. And then I will elaborate a little bit more on this value creation engine in "Take the Buffett road". Enjoy!

How uncomfortable are we today?

A year ago I bought stock in Veritiv, a Seth Klarman holding. Probably because of the merger transaction that was implemented immediately after the International Paper spin-off, the misunderstanding and under-appreciation of the company's potential by the market was high by then and still remains high today. There are significant opportunities for growth, synergies, and cost savings due to a large size of the combined business.

On 2 August 2017, Veritiv reported a second-quarter loss of $9.1 million, after reporting a profit in the same period a year earlier. Veritiv shares had a rough ride last year, from $42 all the way up to $62, and all the way down to $28. Is Seth Klarman wrong and should I sell the stock?

I don't think so. During the latest quarterly update, CEO Mary Laschinger stated that the decrease of the consolidated adjusted EBITDA was primarily due to the combination of continuing industry pressures in the print and publishing segment, investment in their growth segments, and slightly higher operating expenses. Nevertheless, she expects a 2017 adjusted EBITDA of $190 to $200 million. (Wall Street loves EBITDA and I just don't. Not treating the depreciation of goods and amortization as "a real cost" is wrong. So I try to avoid EBITDA and try to focus on real cash flows). By the end of the trading day, on 2 August 2017, Veritiv traded at 3.2 times operational cash flow and at tangible book value. That is quite a margin of safety! So why not buy more?

Veritiv previously shared that they knew 2017 would be a challenging year due to the complexity and scale of the integration. Veritiv remains on track with their multiyear integration work and synergy capture plan and despite that, the environment in print and publishing has been more difficult than anticipated. I strongly believe that the growth in packaging and facility solutions more than offsets the decline in print and publishing. I see substantial long-term upside potential for this Fortune 500 stock. Even if things turn out to be worse and let's say that the revenues go down by 50%, it's still a $4B revenue company. With a more than moderate price to sales multiple of 1, you could argue that this company has the potential, if management succeeds, to end up with a market cap of $4B. As per today, 12 August 2017, the market cap is $450M. Veritiv is a small cap generating big cap revenues.

Charlie Munger reminded us that one of the most important aspects of risk management is the right temperament. Many people can articulate a good investment approach in theory. It is far more difficult to remain rational and execute it under conditions of uncertainty and real-world pressures. What's happening to Veritiv today is such an apt example.

Patience is one of the most critical attributes for a long-term investor because you can be right and the market may tell you that you're wrong. There can be times where it looks like an investment might not work out, but in the end it does. However, you must sometimes be willing to endure a period of time (sometimes many years) that is uncomfortably long to reap the benefits of the investment. Peter Lynch has often said that many of his stocks biggest gains come in their 4th or 5th year. American Express was flat from 1985 to 1992 before becoming a multi-bagger. There's this balancing act between too ashamed to admit you are wrong or in denial about being wrong and being stoic. In this case, I choose the latter one. The basic assumption and belief is that management will be able to get the company "up and running" and that Veritiv will be around and doing well many years from now. Neglect the short term volatility. Volatility is the price you pay (if you are right) for long-term outperformance.

I am perfectly ready to be proven wrong. Everybody makes mistakes now and then. My position is hedged at $30 until 19 January 2018. So I have plenty of time to wait and see what's going to happen to the stock and then make up my mind. It looks like a low risk, high uncertainty opportunity: "Heads, I win; tails, I don't lose much".

Take the Buffett road

Value investors do not rely on the discounted cash flow (DCF) and capital asset pricing model (CAPM) approach that business schools teach in introductory corporate finance courses and that are at the core of methodologies like Economic Value Added (EVA), Market Value Added (MVA) and Shareholder Value Added (SVA).

Bruce Greenwald, the Robert Heilbrunn Professor of Finance and Asset Management and director of the Heilbrunn Center of Graham and Dodd Investing explains. "The DCF/CAPM methodology that business schools teach is a theoretical elegant formulation. But in practice, the margin of error makes it worthless for investing. These models depend not only on near-term cash flows, which can be projected reliably, but also on long-term cash flows and terminal values, which cannot. Terminal values rely on highly subjective assumptions of cost of capital and growth rates. Any error, however slight, in these variables can dramatically throw off valuations.

Furthermore, DCF models ignore balance sheets, throwing away some of the most tangible, reliable and therefor valuable information available. In contrast, the value investing approach starts with the balance sheet – first looking at the asset value, then earnings-power value, then competitive advantage and managerial ability and then growth – is in every way more accurate than the DCF method, and value investors tend to do much better than the market as a whole".

It's my understanding that Warren Buffett looks for companies that have very long term staying power and buys them at a price that any reasonable discount rate would give him a great return in the long run. His business partner Charles Munger once said, "Warren often talks about these discounted cash flows, but I've never seen him do one. If it isn't perfectly obvious that it's going to work out well if you do the discounted cash flow calculation, then he tends to go on to the next idea".

In general, I carefully try to avoid the great academic insights like the Capital Asset Pricing Model (CAPM), Black–Scholes, Beta and the weighted average cost of capital (WACC). WACC is used to measure the cost for a company to acquire capital (through a mixture of debt and equity). Once you have found this number, you theoretically have a nice discount in figuring out the present value of a company's cash flow. The problem is that any slight change in WACC will have vast implications on your investment decisions.

If you look at the formula for WACC, you will hopefully start to see some problems. For instance, the tax shield causes many problems, the first of which is that the more debt a company has, the better their cost of capital will be due to this tax shield. A company with a very high debt may sometimes have a very low WACC for this reason. It can definitely be argued that companies with less debt perform much better than their levered peers in the long-term and we are doing the exact opposite here by using WACC.

Then we have the beta problem. Warren Buffett came up with this example in "The Super Investors of Graham and Doddsville" speech: "The Washington Post Company in 1973 was selling for $80 million in the market. At the time, that day, you could have sold the assets to any one of ten buyers for not less than $400 million, probably appreciably more. The company owned the Post, Newsweek, plus several television stations in major markets. Those same properties are worth $2 billion now, so the person who would have paid $400 million would not have been crazy.

Now, if the stock had declined even further to a price that made the valuation $40 million instead of $80 million, its beta would have been greater and to people who think beta measures risk, the cheaper price would have made it look riskier. This is truly Alice in Wonderland. I have never been able to figure out why it's riskier to buy $400 million worth of properties for $40 million than $80 million."

Return on Capital

In his 1987 letter to shareholders, Warren Buffett talks about the value of earnings: "Earnings by itself says nothing about economic performance. To evaluate that, we must know how much total capital - debt and equity - was needed to produce these earnings". This is known as return on capital (ROC).

There are many practices to calculate the ROC and you have to decide which methodology you want to use and why. For instance, you can calculate the rate of return from a financing perspective (e.g. by using long-term debt and equity as capital base), or you can calculate the rate of return from an operating perspective (e.g. by using the net working capital and the net fixed assets as capital base). People tend to think that the financing perspective is the most intuitive place to start because it builds up to the rate of return on capital from the standard return on equity. I definitely prefer to calculate the rate of return on capital from an operating perspective. The reason for that is that you will end up with terrible results if you calculate the rate of return of companies like Verisign and Autozone from a finance perspective. These are great companies, but these companies employ negative equity, which is indeed exceptional.

It's very hard to take just a few good investment decisions during your lifetime and that's all you need. It is probably even more difficult to hold on to a good investment during times of turbulence. So what is a good company? Warren Buffett once said that a good company is one that earns a high rate of return on tangible assets (the ROC from an operating perspective). Also, the best companies are the ones that earn a high rate of return on tangible assets and grow. If you take a closer look at Berkshire Hathaway holdings like Verisign, Precision Castparts or Mastercard, you will find that these are companies that earn a high rate of return on tangible assets (ROC) and demonstrate solid growth in the free cash flow per share (GROWTH). These are the characteristics I look for and I preferably want to buy these kinds of companies in the early stage of their competitive life cycle.

You might question if you want to include net working capital in the capital base. Net working capital was included by Joel Greenblatt because a company has to fund its receivables and inventory, but does not have to lay out money for its payables, as these are effectively an interest-free loan. If you believe that the cash generated on the net working capital is important for a long-term investor, you should include it.

There are choices to be made in the numerator of the ROC equation as well. You can use the classic definition of NOPAT (Net Operating Profit after Taxes), or you might want to use the pretax operating earnings (which is what Joel Greenblatt uses as described in his classic "The Little Book that Beats the Markets"). You might also have a preference for the CFROI Valuation Framework (introduced by Bart Madden and Bob Hendricks in the 70s and which is now owned and used by Credit Suisse) which uses cash flow as the numerator. So, there are actually a lot of choices to be made and I do not believe that there is such a thing as the one and only correct ROC. I guess it depends on your beliefs and convictions.

For the sake of simplicity, I use the following definition of ROC. As the numerator, I use a cash flow version which is defined by the operational cash flow minus the maintenance capex. It is assumed that depreciation and amortization expenses are roughly equal to maintenance capital spending. As the denominator, I just look at the tangible fixed assets as stated on the balance sheet. So, I will exclude intangibles and goodwill. I agree with Aswath Damodaran (Professor of Finance at the Stern School of Business at New York University, where he teaches corporate finance and equity valuation) that "good-will" is probably the most destructing accounting item ever created in history.

The question arises if there is an appropriate benchmark for ROC. Once again, Warren Buffett guides us through the accounting swamp. In his 1987 letter to shareholders, he refers to the Fortune 1988 Investor's Guide, where Fortune reported that among the 500 largest industrial companies and 500 largest service companies, only six had averaged a return on equity of over 30% during the previous decade.

Only 25 of the 1,000 companies met two tests of economic excellence— an average return on equity of over 20% in the ten years, 1977 through 1986, and no year worse than 15%. These business superstars were also stock market superstars. During the decade, 24 of the 25 outperformed the S&P 500. Buffett uses return on equity, because really good businesses usually don't need to borrow. But if a company has debt, you should include debt into the capital base for calculating the ROC. Even better, always use tangible fixed assets as capital base.

Charles Munger also emphasizes the importance of a high ROC in “The Art of Stock Picking”: “If the business earns 6% on capital over 40 years and you hold it for that 40 years, you’re not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you’ll end up with a fine result.”

Growth

There are many ways to calculate GROWTH. You can look at the revenue growth, the EBIT growth, the net income growth, the operational cash flow growth, the EBITDA growth, the free cash flow growth, the dividend growth, the book value growth and the tangible book value growth. And then, for all these items, you can decide to look at the “per share growth”. So that already makes 18 different growth rates. Then, for all these 18 items you can look at 1-year growth, or 3-year growth, 5-year growth, 10-year growth etc.

Although I’m not a big fan of management consultancy firms, I have to admit that McKinsey made some interesting observations on balancing ROC and GROWTH: “When a company's ROC is already high, GROWTH typically generates additional value. But when it comes to GROWTH, companies are very likely to experience substantial declines. Of companies that grew by more than 20 percent in 1994, for example, 56 percent were growing at real rates of less than 5 percent ten years later”.

Many analysts often project companies like these to grow at double-digit rates for many years to come and they are wrong. While some quickly growing companies certainly maintain high growth for a decade or more, the average high growth company simply does not. Only 13 percent of the high-growth companies maintained 20 percent real growth ten years on, and acquisitions probably drove most of it.

The Value Creation Engine

What I prefer to look for are companies that have their value creation engine up and running and are trading at a price that makes sense. So what is the “Value Creation Engine”? Well, it’s ROC times GROWTH. But be careful. I am talking about a very conservative estimate of the long-term growth. As conservative as good old Ronald Reagan.

Margin of Safety

You want to buy these companies when they are trading way below their intrinsic value (margin of safety). And that’s easier said than done. There are many ways to value a company. You can look at replacement costs, book value, present value of future cash flows, price to earnings multiple, price to cash flow multiple, price to sales multiple, sum of the parts, private market value, the PEG ratio, the Bruce Greenwald Earnings Power Value, the Peter Lynch Fair Value, the Ben Graham Number, the Joel Greenblatt Earnings Yield, etc. Some of them do not apply to all companies though. So you have a range of outcomes and if a stock trades below the lowest of that range, it’s perhaps quite interesting.

And you must take into account an estimate of the future interest rates. Warren Buffett talked about the importance of the future interest rates on business valuation in February 2017 on CNBC: “U.S. stock prices are on the cheap side. If rates were to spike, however, then the stock market would be more expensive. If interest rates were 7 or 8 percent, then these prices would look exceptionally high”.

I would rephrase “on the cheap side” as “moderate expensive, but by no means in a bubble”. Howard Marks recently wrote that we are living in a low-return, high-risk world. And that’s the way it is.

Ranking the stocks

Joel Greenblatt came up with a solid approach for ranking the stocks. So you rank e.g. 10 candidates by ROC. The highest gets 1 point and the lowest 10 points. And then you rank them by margin of safety. The highest gets 1 point and the lowest 10. You add the numbers and choose the lowest number.

At times I rank the stocks by multiplying the value creation engine (which is ROC times GROWTH) with the margin of safety and then choose the highest number. If you want to play it safe, use the Joel Greenblatt ranking system. But if you want this extra nuance of high growth companies you might want to try the latter approach. But keep in mind, growth is a very dangerous parameter, both in ranking the stocks as in business valuations.

Reengineering the investment thesis

There is no such thing as an investment without a thorough investment analysis. It takes a lot of time to really understand a business and its environment. I always start with the balance sheet. This might sound old fashioned, but it's a very important step and many value investors nowadays take the balance sheet information too lightly. You want the balance sheet to be as solid as a rock. But that's easier said than done. For instance, how do you assess a balance sheet that has negative equity (like Verisign and Autozone)?

However, I think the most exciting part is the assessment of the long-term growth potential of the company. You have to be certain about the future cash flow streams of a company—very certain. That can be achieved by studying industry trends, the regulatory environment, disruptive technologies, the long-term competitive dynamics of an industry and the durability of the competitive advantages. Where will this company be 15 years from now and what does that mean in terms of market capitalization?

Warren Buffett once said: "If there is risk, we just don't go ahead". What helps are two checklists. The first is in the appendix of Philip Fisher's classic "Common Stocks and Uncommon Profits", entitled "Key Factors in Evaluating Promising firms", where he discusses functional factors, people factors and business characteristics. The second checklist is in appendix A of an article written by Michael J. Mauboussin and Dan Callahan, entitled "Measuring the Moat Assessing the Magnitude and Sustainability of Value Creation", where they discuss e.g. barriers to entry, rivalry, brands, disruption and disintegration, etc. It's also worthwhile studying articles on "The Reinvestment Moat" by Connor Leonard and the comments on that by John Huber. Reinvestment moats are companies that have all the advantages of a legacy moat and earn strong returns on capital plus opportunities to deploy incremental capital at similar high rates.

A high caliber leadership team

Finally, let me stress the importance of good management. This might be the most crucial one. Warren Buffett looks for a proven track record and a history of operational success, the utmost integrity, the ability to allocate capital wisely and people who care deeply about the business that they led. I couldn't agree more.

So here we are

The methodology described thus far, based upon return on capital, growth and a margin of safety, and then reengineering the investment thesis, is, I believe, a very sound framework for stock picking. My talk during The Zürich Project 2017, on "Intelligent Cloning," was well received. I argued that by studying the latest 13Fs of Berkshire Hathaway, Sequoia Fund, Chuck Akre, Lou Simpson and Thomas Russo, my number one stock pick by then was Verisign.

However, companies like Credit Acceptance Corp (which is a Seth Klarman and Sequoia Fund holding), Linamar and Dart Group (both are Meryl Witmer holdings) also showed up by applying this methodology. Isn't that interesting? And it even gets better if these great businesses buy back their own stock at appropriate prices.

I started this memo by referring to the Sequoia Fund Investors Day 2017 transcript and I might as well end with a quote from David Poppe. *"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".*

Cordially,

Peter

Peter Coenen
Founder & CEO of The Value Firm®
12 August 2017

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 partnership, 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.

During my entire life, I really didn't care about money at all. I guess the reason for that can be found in the European tradition of socialism that once existed.

Later in my career I got inspired by the thinking and teachings of Buffett and Munger. So I tried to use these insights to manage my own limited amount of capital, and guess what. It worked!

If you are looking for a money manager, you would be well advised to look for a professional with a proven track record of building a personal fortune by making smart investments. And that includes managing money through a severe bear market. That person is not me.

But it happens to be that my investment results thus far are exceptional indeed. And I believe, that by copying great investors that do have the exceptional track record, you are well off following my approach. If what I do resonates with you, and you want to give it a go, send me the required Customer Due Diligence documents and we will set up a separately managed account.

Don't forget that we are deep into a bull market, with high valuations and few bargains. 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."

By the way, Warren Buffett recently argued that stocks are "ridiculously cheap" if interest rates stay at these levels. 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.

Cordially,

Peter

Peter Coenen
Founder & CEO of The Value Firm®
24 May 2019

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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!