Investment Letter 2021

Investing is looking at the business itself, and saying "what will this do over time?"

Truly successful businesses are exceptionally hard to find. Warren Buffett has been studying businesses for decades. He knows what makes a good company and what does not. One of his disciples, Li Lu, recently pointed out the characteristics of a great business.

To quote Li Lu, "Great businesses are the ones who really have above average returns on invested capital. But that kind of a business traditionally attracts imitators, competitors, everybody wants to have above average returns on reinvested capital. And so truly good businesses are the ones who can fend off competitors, who can really have an enduring competitive advantage and have that higher-than-average return on invested capital and hopefully also have a long run-rate of continuous growth. Those are the businesses we're looking for.

Maintaining a business that generates above average returns over a long time, in a compounded fashion, is really against the natural order of things. Only a small slice of all businesses belong to this category.

So, if you're lucky enough to find one of those long-term compounders, all you have to do is to own them for the longest period of time. Now, it really helps if you buy them when they happen to be traded at a discount to their intrinsic value. So, if you were wrong about them, you won't lose money, and if you're right, you will have more returns over time.

But over the long term, if you do own them through the ups and downs, your return roughly approximates the actual business return to actual capital invested. The two tend to really converge pretty closely.

Understanding the nature of such a business, the dynamic of its competition is, in fact, the most important thing for an investor and a student of the business. And as I have mentioned earlier, there are no fixed set of factors which have resulted in such kind of businesses. Every business builds itself in a unique way. Hence, you just have to honestly study them from every possible angle, until you're really convinced that they are actually enjoying truly enduring competitive advantages and have a long runway ahead of them. And if they turn out exactly as you had predicted, over the years, you would really want to stay with them through thick and thin, without getting dissuaded easily."

However, if you believe that a company which is successful today will remain successful for decades to come, you had better revisit the latest Berkshire Hathaway shareholder meeting on Yahoo Finance. Warren Buffett started the meeting with an overview of the top companies in terms of market capitalization in 1989 and how many of them where on the list roughly 30 years later. The answer was zero. Indeed, the world can change in very, very dramatic ways. Warren Buffett still feels that the best way to invest is via index funds.

Given below is Warren Buffett's overview of the top companies in terms of market capitalization in 1989 and 2021:

1989	2021
Industrial Bank of Japan	Apple
Sumitomo Bank	Saudi Aramco
Fuji Bank	Microsoft
Dai-Ichi Kangyo Bank	Amazon
Exxon Corp	Alphabet
General Electric	Facebook
Tokyo Electric Power	Tencent
IBM Corp	Tesla
Toyota Motor Corp	Alibaba
American Tel & Tel	Berkshire Hathaway
Nomura Securities	Taiwan Semiconductor
Royal Dutch Petroleum	Visa
Philip Morris Cos	JP Morgan Chase
Nippon Steel	Johnson & Johnson
Tokai Bank	Samsun Electronics
Mitsui Bank	Kweichow Moutai
Matsushita Elect Ind'l	Walmart
Kansai Electric Power	Mastercard
Hitachi Ltd	United Health
Merck & Co	LVMH Moet

The Intelligent Cloning Portfolio

Let me remind you once again that these are not actual fund results. The table below illustrates what the results could have been if we had indeed started an investment partnership in 2H '16. The stocks have been selected with the intention of holding on to these companies for several years, preferably decades, as long as the company remains successful.

Current positions

When	Company	Price	Return
2H ‘16	Deere	87 USD	319%
2H ‘16	Allison Transmission	29 USD	47%
1H ‘17	Davita	65 USD	87%
1H ‘17	Verisign	83 USD	175%
2H ‘17	Monro	47 USD	40%
2H ‘18	StoneCo	17 USD	299%
2H ‘18	Veritiv	24 USD	147%
1H ‘20	eBay	30 USD	131%
2H ‘20	XPEL	15 USD	453%

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 %
1H ‘19	Liberty Global	22 USD	2H ‘20	5 %
1H ‘20	Graftech	12 USD	1H ‘21	2 %

I’m comfortable with the portfolio as it is. I don’t expect many changes in the upcoming years, except for perhaps one or two additions/replacements. The most important criterion for this new investment is that the company represents an investment opportunity, which is substantially more compelling than what’s already there in the portfolio, both in terms of long-term growth and of valuation. I would not be surprised if I find more powerful ideas than for instance Allison Transmission and Monro.

Patience

The greatest skillset you can bring to bear as an investor, according to Mohnish Pabrai, is patience. Extreme patience. If you love to watch paint dry, or grass grow, you will be a great investor. So if that’s the excitement you are looking for in life, join the club.

But there is more to the “self-chastisement” required to become a great investor. You need to have the ability to stay unemotional when a stock goes down substantially. Along with that, you need to bring to the table the capacity to suffer, without giving in to the temptation of selling the stock of a great business.

The Veritiv investment, thus far, has been quite an adventure. I remember putting the investment thesis together, which is always a daunting challenge, and uploading it to the SumZero website. Further, I sent it to Guy Spier and Mohnish Pabrai, in the belief that this company, in which Seth Klarman holds a 22% majority stake, had to be the ultimate panacea!

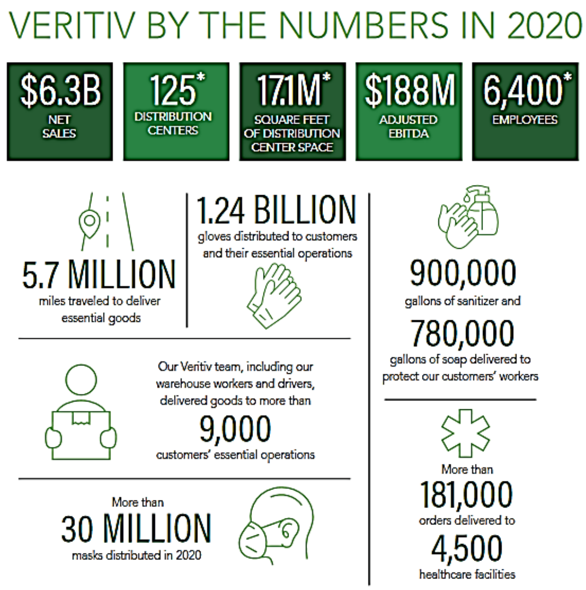
I bought the stock for my private portfolio in 2018 at 40 USD and added it to the Intelligent Cloning Portfolio at 24 USD. The stock went all the way down to 7 USD. That was a more than minus 80% fall for my private portfolio investment.

I don’t know of many investors who have the ability to stay unemotional under these circumstances, with their personal money on the line. But that’s what it takes. Seth Klarman did not sell Veritiv stock. Neither did I. The stock currently trades at 59 USD, or a plus 147%, for the Veritiv holding in the Intelligent Cloning portfolio.

Veritiv, currently a 930M USD market cap company, trading at a P/S ratio of 0.15, is headquartered in Atlanta. It’s a Fortune 500®company, and a full-service provider of packaging, JanSan and hygiene products, services and solutions. Additionally, Veritiv provides print and publishing products, and logistics and supply chain management solutions.

Serving customers in a wide range of industries both in North America and across the globe, Veritiv has distribution centers throughout the U.S., Canada and Mexico, and team members around the world, who help shape the success of customers.

Veritiv has around 6,400 employees and several decades of industry knowledge, expertise, and a proven supply chain ingenuity for catering to customers across a wide range of industries and businesses – including more than half of the Fortune 500® companies. Its focus is on the success of its customers' businesses and their brands. Driving customers' business success is at the heart of everything Veritiv does.



Despite a turbulent year, Veritiv took significant steps toward their vision of being a leading provider of packaging goods and services. The operational changes they made this year produced a systematic improvement in their 2020 financial results and established a strong foundation for the future. Collectively, these efforts drove year-over-year improvement in Adjusted EBITDA to 20%, compared to 188 million USD in 2019. Their proactive measures to improve the quality of customer portfolio resulted in margin improvements, operating efficiencies, and a reduction in bad debt expenses compared to previous years. Several years of efforts to improve working capital have had a positive impact on cash flow, which is reflected in the 2020 free cash flow of 266 million USD and a combined free cash flow of 513 million USD, over the last two years.

In 2021, it's expected that the company will remain focused on their strategy to invest in higher-growth, higher-margin businesses and continue work to transform the company into ***a leading provider of value-added packaging goods and services, from concept to delivery.***

The structural changes and strategic choices they've made over the last two years have moved them even closer toward this vision. Their significantly improved business fundamentals and the flexibility of their business model are helping them to successfully weather current challenging market dynamics. These should serve them well as they make the right choices for the long-term sustainability and success of the company.

Veritiv's "packaging business" provides 53% of their revenues and 77% of their adjusted EBITDA. Veritiv works directly with customers to identify and implement packaging solutions which deliver, in both form and function. Their packaging specialists are experts at discovering untapped efficiencies in designing, sourcing, and delivering standard and custom packaging for customers across a range of industries – including consumer packaged goods, fulfillment, food processing, retail, and manufacturing.

Veritiv's packaging solutions are not restricted to one particular substrate – they evaluate every project with a material-neutral approach. They have longstanding relationships with box plants, sheet plants, and other international material sources, thus providing them with access to a wide range of material inputs. Their packaging solutions span food-grade packaging, industrial packaging, point-of-sale displays, and shipping supplies. Their exclusive TUFflex® line of packaging essentials delivers enduring performance, maximum efficiency, and unmatched value. They also sell and distribute single-function and fully automated packaging equipment. In addition, they offer assembly and fulfillment services, such as kitting – which help customers manage seasonal spikes, new market testing, and promotions.

Veritiv's packaging business combines the best in form and function for customers, through their experienced teams of designers, engineers, and marketers. These teams provide expertise for custom improvements in cost and waste reduction, logistics, structural and graphical integrity, and testing processes.

What one hopes for in a company like Veritiv, undergoing a major restructuring program during a period with COVID-19 headwinds, is a leadership team that not only nurtures customer relationships and innovation, but perhaps even more importantly, "micromanages" their cash flows. In this regard, the team headed by the current CEO Salvatore A. Abbate (Sal) really delivers.

During the second quarter of 2020, the Company initiated a restructuring plan, in response to the impact of the COVID-19 pandemic on its business operations, and the ongoing secular changes in its Print and Publishing segments. During the fourth quarter of 2020, the Company expanded the initial plan to further align its cost structure with ongoing business needs, even as it executed its stated corporate strategy.

The 2020 Restructuring Plan will result in

- the reduction of the Company's U.S. salaried workforce by approximately 15% across all business segments and corporate functions,
- the closure of certain warehouse facilities and retail stores,
- adjustments to various compensation plans,
- repositioning of inventory to expand the Company's service radius, and
- other actions.

The Company estimates it will now incur total restructuring charges of between 77 to 101 million USD, in connection with the 2020 Restructuring Plan. The Company expects to substantially complete the 2020 Restructuring Plan by the end of 2021.

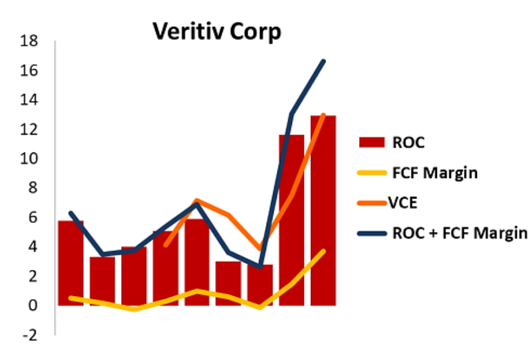
The Company ended 2020 with 120.6 million USD in cash and cash equivalents, an increase of 82.6 million USD over the previous year-end balance. Cash flow from operations was 289.2 million USD in 2020, compared to 281.0 million USD in 2019. Net cash provided by operating activities increased by 8.2 million USD as compared to the previous year. This was primarily due to improvements in operating results, partially offset by lower cash flows from operating assets and liabilities. Further, lower cash flows from inventory, accounts receivable and supplier purchase incentives were offset by improvements in cash flows from accounts payable, deferred payroll taxes and restructuring accruals.

The decrease in working capital was driven by the decline in net sales, primarily due to the COVID-19 pandemic and the continued secular decline in the paper industry. The factors driving cash flow from operating activities in 2020 were:

- an 89.7 million USD decrease in inventories,
- a 56.5 million USD decrease in accounts receivable and related party receivable and
- net income of 34.2 USD million.

Net cash used for investing activities decreased by 28.3 million USD as compared to the previous year, due to cash proceeds received from the sale of two properties and lower capital expenditures. The primary cash utilization for financing activities during 2020 was the 153.2 million USD used to pay outstanding revolving loan borrowings under the ABL (asset-based lending) facility. This was a net decrease of 107.3 million USD compared to the previous year. Additionally, beginning in the second quarter of 2020, in response to the COVID-19 pandemic, the Company invested 75.0 million USD of its cash in highly-liquid investments, instead of paying down its long-term debt.

Finally, the Board of Directors has authorized a 25 million USD stock repurchase program, thus proving their commitment to returning value to their shareholders, as well as to prudent management of their capital structure.



The long-term investment thesis over here is that, nobody matches the Veritiv experience, expertise and supply chain ingenuity in serving more than half of the Fortune 500® companies. Packaging will be with us for a very long time. Additionally, the intertwining with Amazon, as an Amazon Packaging Support and Supplier (APASS) Network member, is indeed an exceptional and durable competitive advantage.

Holy Crab

The dumbest money story of the year happened within just a few days. No individual has lost so much money so quickly. The sudden implosion of Archegos Capital Management, a family office managed by Bill Hwang, in late March 2021, has been compared to the meltdown caused by Nobel laureates owned Long Term Capital Management. In a 2019 video for his Grace & Mercy Foundation Mr. Hwang said: “I try to invest according to the word of God and the power of the Holy Spirit”.

Bill Hwang was a “Tiger cub,” an alumnus of Tiger Management, the hedge fund powerhouse that Julian Robertson founded. Many of Hwang’s colleagues went on to start several of the world’s most successful hedge funds, including Andreas Halvorsen’s Viking Global Investors, Philippe Laffont’s Coatue Management, and Chase Coleman’s Tiger Global Management. Hwang ran his own fund, Tiger Asia Management, which peaked at about 10 billion USD in assets.

The Bill Hwang Fund was heavily leveraged and did business with multiple banks, which were likely unaware of Archegos' large positions held by other banks. When someone trades on margin—with borrowed money—they may have to maintain a certain amount of collateral to satisfy their lenders. If the value of a stock holding goes down, the investor needs more collateral. A lack of collateral triggers a margin call, wherein the lender can force a sell-off of the stock, in order to bring the investor back into compliance with margin requirements.

On March 26, 2021, Archegos defaulted on margin calls from several global investment banks, including Credit Suisse and Nomura Holdings, as well as Goldman Sachs and Morgan Stanley. The firm had large, concentrated positions in ViacomCBS, Baidu, Vipshop, Farfetch, and other companies. The firm's use of total return swaps had helped to hide its high exposure from lending banks. Its derivative contracts "exposed the firm to severe losses when the trades went bad."

- On April 6, 2021, Credit Suisse reported losses of 4.7 billion USD linked to its involvement with Archegos. The bank announced that it would have to raise up to 2 billion USD in fresh capital to support its equity base.
- On April 16, 2021, Morgan Stanley reported a loss of nearly 1 billion USD related to the Archegos collapse, 644 million USD by selling stocks it held related to Archegos' positions, and another 267 million USD trying to "derisk" them.
- Credit Suisse Group AG and Japan's Nomura Holdings Inc took the main hit, with losses of 4.7 billion USD and 2.8 billion USD, respectively.
- On April 27, 2021, UBS Group AG, Switzerland’s biggest bank by assets, reported that it lost 774 million USD in connection with Archegos’ failure.

The swift fall of Archegos Capital Management is one of the most embarrassing financial plotlines in many years. It reminds me of a quote by Seth Klarman: “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”. Amen.

Quants

You can find the results of the midyear quants Q12 to Q32 in the attachment. Last year, the first year of the midyear quants, I got frustrated by the Covid-19 quant results, so I left the China and United States quant results out. That was a mistake. You will now find the full results of the midyear quants in the attachment.

It’s way too early to draw any meaningful results from these midyear quants. Please be advised to wait a few years. The Indian midyear quant results are way above expectation, for now. Here are the new constituents of the 2021 - 2022 midyear quants, to be added on the 1st of August:

- **United States:** GMS Inc., Patrick Industries, LCI Industries.
- **China:** Jiayuan International Group Ltd, Pax Global Technology Ltd, Homeland Interactive Technology Ltd.
- **India:** Affle (India) Ltd, Redington (India) Ltd, Deepak Nitrite Ltd.

The Value Firm®

The Wizard against the Oracle

The Winter 2020 Edition on Intelligent Cloning ended with this phrase: "It's Dumbledore versus the investing grandmaster Warren Buffett. It's the Wizard against the Oracle!", referring to the algorithm that was handed over to me by the headmaster of the wizarding school Hogwarts.

Will there ever be an algorithm which consistently beats the markets over decades? Just think about it for a moment. Think about software which outsmarts the world's greatest investors not only during their active careers, but way beyond. That question intrigues me and I have spent many years of research trying to find the answer to it. In other words, what you are trying to build is the ultimate compounding machine, that can "replace", or even better "outperform" Warren Buffett. Several great investors seriously doubt if such an algorithm exists. A daunting challenge indeed!

The solution that might fit the ultimate quest for the holy grail is an algorithm with outstanding back test results, as described in the Winter 2021 Edition of Intelligent Cloning. The algorithm focusses on the best United States Hyper Value Creators (HVCs) and, once again, here are the rules that should do the job:

1. Every decade you have 5 buying opportunities to buy the top 6 stocks generated by the algorithm, e.g. once every two years. You're not allowed to buy into the same company twice.
2. If a major crash occurs, you are forced to buy into the top 6 stocks by then, bringing down the number of buying opportunities by one.
3. Each stock will stay in the portfolio for at least 10 years, preferably longer.
4. Once a year every stock in the portfolio will be assessed in terms of its margins and its VCE. If both deteriorate rapidly, the stock will be removed. No questions asked.

I ran the algorithm on the United States data from 2005–2009, 2006–2010, 2007–2011 and 2008–2012, and here are, once again, the results:

Time frame	Top 3	Top 5	Top 10	Top 15	Top 20
2005–2009	31.5%	31.2%	27.2%	24.2%	22.1%
2006–2010	42.3%	40.3%	35.4%	32.9%	30.0%
2007–2011	42.6%	39.8%	34.5%	30.7%	28.0%
2008–2012	19.5%	20.3%	25.7%	21.7%	20.2%

For instance, if you just bought the top 10 from the 2008 – 2012 time frame blindly on 18 November 2013, you would have compounded your money with 25.7% annually, over a 7 year period.

Out of the 2020 Top 25 United States Hyper Value Creators, 6 companies were finally selected by the algorithm and added to "The Wizard Portfolio" on 1 June 2020:

Date added	Company
1 June 2020	Medifast
1 June 2020	Ulta Beauty
1 June 2020	XPEL
1 June 2020	Domino's Pizza
1 June 2020	Nova Measurement
1 June 2020	Fortinet

So here we have the "June 2020 Basket". According to the rules, if no crash happens between now and 1 June 2022, then that will be the day when the new 2022 basket of 6 United States businesses will be added to the portfolio.

Beating the 55 year Warren Buffett compounding track record of 20% CAGR with an algorithm is probably beyond dreams, but given its back test results, I believe, it would be a glorious act of omission not to give it a go. For sure, the world can change in very, very dramatic ways, but if you don't mind, I will try it anyhow.

If you are an entrepreneur and want to give this exceptional algorithm a go, I would most certainly recommend you to try it out and set up a new algorithmic fund. You can contact me at peter@thevaluefirm.com. The downside risk is very, very limited. In the worst-case scenario, the fund will end up with a portfolio of high-quality, buy-and-hold United States stocks.

So here we are

If you want to join a fund or a 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.

There are several options for launching a fund: Intelligent Cloning, a new global small cap fund, or the algorithmic fund. I would be more than delighted if there is an entrepreneur who would choose the last one.

I am looking for a professional investor/financial institution who has the courage to give it a go, and who provides a critical mass of capital in exchange for economic participation in the new fund. I am open to discussing a seed model based upon revenue sharing.

The location for domiciling the fund, the jurisdiction, the fund service providers, and dealing with the costs of setting up and maintaining the fund are up for discussion. There is, I believe, a great opportunity, once the fund is established, to join the SumZero Cap Intro Program. It's a great online platform for attracting new Limited Partners (LPs).

Thank you for reading my letter! Stay safe.

Peter

Peter Coenen
Founder & CEO
The Value Firm®
29 June 2021

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

QUANTS

In search of a quant that consistently outperforms the markets with a >15% CAGR

		2018	2019	2020	2021	2022	2023	CAGR
Q1	The Mohnish Pabrai Free Lunch Portfolio (FLP).	-17.0%	21.7%	3.0%	-			1.3%
Q2	The conservative version of the FLP.	-9.7%	28.4%	15.4%	-			10.2%
Q3	The conservative version of the FLP. Sell at +40%.	21.7%	35.2%	20.3%	-			25.6%
Q4	The FLP. Spawners only.	-	-	-	-			-
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%	-2.8%	-			24.0%
Q9	The US new year quant. Sell at +50%.	50.0%	35.6%	-2.8%	-			25.5%
Q10	The US new year quant. Sell at +60%.	60.0%	42.3%	-2.8%	-			30.3%
Q11	The US new year quant. No conditional selling.	18.4%	27.5%	-2.8%	-			13.6%
Q12	The US midyear quant. Sell at –20% or +40%.	-	-	0.0%	20.0%			9.5%
Q13	The US midyear quant. Sell at –20% or +50%.	-	-	-20.0%	26.7%			0.7%
Q14	The US midyear quant. Sell at –20% or +60%	-	-	-20.0%	33.3%			3.3%
Q15	The US midyear quant. Sell at +40%.	-	-	3.0%	26.4%			14.1%
Q16	The US midyear quant. Sell at +50%.	-	-	-26.5%	33.1%			-1.1%
Q17	The US midyear quant. Sell at +60%	-	-	-26.5%	39.8%			1.4%
Q18	The US midyear quant. No conditional selling	-	-	-26.5%	70.9%			12.1%
Q19	The China midyear quant. Sell at –20% or +40%.	-	-	-20.0%	20.0%			-2.0%
Q20	The China midyear quant. Sell at –20% or +50%.	-	-	-20.0%	26.7%			0.7%
Q21	The China midyear quant. Sell at –20% or +60%.	-	-	-20.0%	33.3%			3.3%
Q22	The China midyear quant. Sell at +40%.	-	-	-0.1%	13.4%			6.4%
Q23	The China midyear quant. Sell at +50%.	-	-	3.2%	20.0%			11.3%
Q24	The China midyear quant. Sell at +60%.	-	-	6.5%	26.7%			16.2%
Q25	The China midyear quant. No conditional selling.	-	-	21.0%	61.4%			39.7%
Q26	The India midyear quant. Sell at –20% or +40%.	-	-	20.0%	32.8%			26.2%
Q27	The India midyear quant. Sell at –20% or +50%.	-	-	18.6%	39.5%			28.6%
Q28	The India midyear quant. Sell at –20% or +60%.	-	-	21.9%	46.1%			33.5%
Q29	The India midyear quant. Sell at +40%.	-	-	21.1%	33.8%			27.3%
Q30	The India midyear quant. Sell at +50%.	-	-	19.6%	39.5%			29.9%
Q31	The India midyear quant. Sell at +60%.	-	-	22.9%	46.1%			34.0%
Q32	The India midyear quant. No conditional selling.	-	-	9.5%	150.4%			65.6%

Latest update: 29 June 2021. A "red year", like 2020, is a "market crash > 20%" year. These results are the gross results (excluding tax, provision, etc). Please be advised to wait a few years before drawing any meaningful conclusion from these numbers. If you find any errors or disagree with the results, please let me know: peter@thevaluefirm.com.

The midyear quants, especially the Chinese and United States midyear quants, were off to a bad start. I do expect the CAGR of these quants to improve over time, assuming that there will be more "green years" than "red years".

I am considering moving the threshold of the "conditional sell order at -20%" to "-25%". I've seen some cases where you might argue, based upon the exact buying price, whether the stock triggered the conditional -20% sell order or not.