Owner's 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 is a quote from David Poppe, former chief executive of asset manager Ruane, Cunniff & Goldfarb. It 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 would be better off investing in a low-cost index fund, such as the Vanguard S&P 500, and leaving it alone for the rest of their lives. 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 all its costs and risks. Most of us are in full denial of the fact that if you try to do better than the index, there is a 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!

Successful investing is about predicting the future performance of a company. Where will this company be 10 to 15 years from now and what will 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 at 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 buy, you will probably 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, and bubbles—from the Roman empire through tulip manias, South Sea Bubbles, and 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 will definitely 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 an 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 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 whatever period of time you elect to be a partner. I have no interest in large salaries, 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 a 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 of 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 acquisition ideas are. Therefore, I normally do 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 that 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 that 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 in which 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 to predict 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 missed the best 10 days of performance in the S&P 500, a popular US benchmark, your total return would be half of what you would have gotten if you had stayed 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 will I not do? No upfront fees. No nonsense. No debt (leverage) or derivatives. No swaps. No shorting. No market timing. There will be 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 telecommunications, 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 forecasting the economy. More money is lost worrying about or preparing for recessions than 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 is 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 markets 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 of where the economy is going in the short or mid-term.
- I cannot accurately predict what will happen to currency fluctuations in the future.
- If you are not in it for the long haul and do not have "the capacity to suffer", you should not be in the partnership.
- Over the last 55 years, Warren Buffett has 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 loss 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. If you can't handle volatility, don't invest. 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 the 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 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 in specific circumstances, institutions may no longer automatically apply such a simplified CDD. Institutions may only rely on these circumstances as part of a justification for simplified CDD after conducting a risk analysis.

It's 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.

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Cordially,

Peter

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Founder & CEO of The Value Firm®
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