MILKWOOD CAPITAL

18 April 2016

To our partners in the Milkwood Fund

You may be surprised to hear from us so soon after the year end. The reason for this short update is that we have replaced the monthly performance factsheet with a slightly more detailed quarterly update, and full half-yearly and annual letters (all can be found on website www.milkwoodcap.com). The reason is two-fold. Firstly, our partners need to continue to focus on the long-term. Secondly, we can provide a more valuable update on a quarterly basis.

Having said that, I must thank all our partners for their tolerance of volatility. The first quarter of 2016 has been a testing time and you have come through with flying colours. We have had some inflows into the fund and importantly, no outflows. "*Longue peut durer*" as the French say.

	Jan	Feb	Mar	1Q16
Class A	-7.9	2.9	6.2	0.8
Class B	-7.9	2.9	6.2	0.8
Class D	-7.9	2.9	6.2	0.6
MSCI World	-6.1	-1.0	6.6	-0.3

Note: Class D monthly differences are lost in the rounding

The Dangerous Virtuous Circle

In the table you can see our monthly performance was volatile to say the least but it doesn't matter one bit. True long term valuation-based investors needn't worry about stock prices falling *when they are confident in their investments*. In addition, volatility creates opportunities to buy into companies at more

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attractive prices. However, this creates a virtuous circle a dangerous virtuous circle.

John Templeton said "investing is nothing more than looking for a bargain". Naturally, being wired to take advantage of Mr Market's moodswings practically implies the investment manager has to be attuned to market movements in times of high volatility. And that is mostly volatility on the way down, not up. How else can you buy into your favourite companies when they are cheap? It is easy for this to translate into screen watching, a habit that takes less than 21 days to foster and is a challenge to shake.

Screen watching can also result in pain to the fund manager. As discussed, it is impossible to escape this at moments of extreme volatility if you want to buy cheaply. So that pain is hard to escape for the fund manager, but doesn't need to be passed on to our partners in the fund you. (Hence our view that monthly commentary should be discontinued, although you will of course continue to get monthly statements from our administrator and you are welcome to call us any time to discuss the fund.)

Checking how investments are doing is something Daniel Kahneman wrote about in his book "Thinking Fast and Slow", a great read.

> *"Individual investors can avoid the curse…by reducing the frequency with which they check how well their investments are doing. Closely following daily fluctuations is a losing proposition, because the pain of the frequent small losses exceeds the pleasure of the equally frequent small gains. Once a quarter is enough, and may be more than enough for individual investors.*
>
> *In addition to improving the emotional quality of life, the deliberate avoidance of exposure to short-term, outcomes improves the quality of both decision and outcomes. The typical short term reaction to bad news is increased loss aversion. Investors who get aggregated feedback receive such news much less often and are likely to be less risk averse."*

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Studies have shown losing money is twice as painful as making money on your investments. When we checked the data for our fund, we found our investments go up in value 51% of the days markets are open and decline in value 49%, according to Bloomberg (don't worry, we don't check prices everyday). If we were worried about short-term performance we would be depressed (suicidal even), experiencing double as much pain as pleasure even though the fund would have gained in value overall. Being depressed does not translate into a positive environment for decision-making and it's a tendency that should be avoided at all costs.

Portfolio Update

John Menzies PLC

John Menzies PLC produced a "boring, but stable", as the CFO put it, set of results. Being our largest holding, we were comforted by improved management (the CEO resigned) and a focus on contract profitability. The problems encountered with the Gatwick contract have being partially resolved and that should no longer be a drag on earnings.

We are excited by the opportunity to work with other activist managers to unlock value in Menzies. Our estimates of the "real" value justify Menzies being our largest investment. It has already generated returns of 55% for us, and we think it has more to offer. Over the next 18 months we would expect a conclusion to the activism (aka Boardroom Fireworks).

Emerging Markets

Marfrig and Locamerica (Brazil) continue to recover due to a mix of good operating results and the reappearance of the occasional optimistic EM investor. For EM businesses, access to debt is a key barrier to entry – if you already have it you are in a far stronger position than an existing player or new entrant trying to raise money. This is particularly true in times of EM

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market stress and capital outflows. In other words, capital intensive businesses with dominant market shares sometimes do very well in times of increasing interest rates when capital is scarce. In the case of Santova and Locamerica, both are benefiting by having growing market shares in tough operating conditions.

Financials and Banks Biggest Losers

Offsetting our winners were the banks. Barclays stock price declined 32%, Citigroup 19% and Metlife 9%, reducing our performance by over 7%.

We bought more of each in Q1.

Irrespective of share price volatility, *in each case these companies are doing exactly the right things operationally*.

- Barclays, our second largest investment, exemplified this by deciding to dispose of Barclays Africa, cutting the dividend and scaling back on global ambitions.
- Metlife successfully fought back against the US government and won. They are also taking concrete steps to unlock value through restructuring.
- Citigroup showed some cost discipline, but can do so much more.

All are super-attractive investments trading below book value, with single-digit P/Es pricing in all the negative news flow (of which there is no shortage).

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Conclusion

Once again, I thank you for your patience and trust you have placed in us to manage your money. The portfolio remains undervalued and we see upside of at least 80% to fair value.

We remain open to new investments.

Should you wish to discuss anything about your fund please give me a call.

Kind regards

Rhys

Terms of Business

- Treat investors as partners
- Your returns are my returns
- Maintain a lean cost structure
- Highlight and honestly analyse mistakes
- Conduct ourselves with integrity and fairness in all our dealings
- Follow our ideas and convictions even at the expense of short term pain

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