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8 August 2016

To our partners in the Milkwood Fund

The Milkwood Fund had a strong first half to 30 June 2016.

	YTD 2016[1]	**Since Inception**[2]
The Milkwood Fund (net - A)	8.7%	15.6%
MSCI World (MXWD)	1.6%	2.6%
Peer Group Funds (avg)	-1.2%	3.4%

Phew. Let's take a deep breath and talk about 1H2016, a period of shocks, disappointments and surprisingly good equity market returns (e.g. the MSCI World actually generated a positive return including dividends). So what is going on?

Recently, we read an interesting piece which answers the question. The "Three Most Important Words" in investing – *I don't know*. You can find it here.

To quote the introduction,

1 Please refer to your relevant statements for performances by share class
2 Inception was 14/01/2014

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> *"These three words, almost never uttered in this business, are far and away the most critical to long-term investment success.*
>
> *Why?*
>
> *Because the future and markets are unpredictable, and having the humility to admit that is very hard for us to do. We're simply not wired that way and instead suffer from the behavioral bias of overconfidence. Which is to say we overestimate our own abilities when it comes to sports, trading, driving or anything else."*

Therefore, in an attempt to explain what is going on in the world (Brexit, Trump, Florida shootings, ISIS, France, negative interest rates, refugees, Hillary) many are distracted from the key consideration to investing - finding investments that will grow our wealth, by taking the lowest possible risk. Anything else, we simply *do not know*.

"Tell me where I'm going to die, so I don't go there"

In some ways, knowing what to avoid is as important as knowing what to embrace. Charlie Munger said "Tell me where I'm going to die, so I don't go there" which we apply to investing (rather than longevity). Being contrarian, means we are continuously avoiding the popular and embracing the hated.

What to Avoid

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You may remember (and many even claim to have identified) the bubble-like conditions of tech valuations in 2000.

In 2003, Scott McNealy, the founder of Sun Microsystems reflected on investor behaviour. Here is what he had to say about that crazy time:

> *"We were selling at 10x revenues when we were at $64. At 10 times revenues, to get you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64 (or $150bn?). Do you realise how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*[3]

Imagine paying 10x revenue! Well don't imagine too hard. You might be doing something even more ridiculous right now (as we will show below).

In our 2015 interim letter we wrote that the recipe for success that many fund managers talk about is investing in "high-quality" companies at "good/fair/attractive/addyourownadjectivehere" valuations. Next time you read

[3] The company was sold in 2009 for US$5.4bn, 3% of its 2000 peak. Even so, it was actually one of the more successful companies of the 2000 tech bubble

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a fund's marketing document, count the number of times "quality" comes up. And then if you really want to chuckle, go back 7 years and find out how many times "value" came up. And then ask yourself, how many quality companies are still to be discovered 7 years into a bull market? And how many "value" ideas are around today? I'm willing to bet the numbers broadly invert.

But, what is making matters very tricky for investors true to the art of value investing is the struggle to perform, while they look enviously at their "quality" investing neighbours flashing their Marquis Jet Card and buying large houses from oversized management and performance fees.

To explain our thinking, we go back to the great investor Howard Marks who published his investment letters in a book called "The Most Important Thing". He described the issue that contrarian, value investors face today by comparing first level (face value) and second level thinkers.

> *"First level thinking says. "It's a good company; let's buy the stock." Second-level thinking says, "It's a good company, but everyone thinks it's a great company, and it's not. So the stock's overrated and overpriced; let's sell."*
>
> *First level thinking is simplistic and superficial, and just about everyone can do it (a bad sign for anything involving an attempt at superiority). All the first level thinker needs is an opinion about the future, as in, "The outlook for the company is favourable, meaning the stock will go up."*

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> *For example, when I lived in Los Angeles, a stockbroker often spoke on the radio station I listened to while driving to work. His advice was simple: "If there's a company whose product you like, buy the stock." That's first-level thinking. How seductively easy. But also how error-prone, in that it ignores the possibility that a company with a good product can have a bad business; the good product can become obsolete; or the stock can be priced too high to be a good investment.*

I'd like to explore final two points a bit further.

Point 1 - A Good Product can become obsolete

The world we are living in is showing a change in tastes and priorities at an alarming rate – *probably the fastest rate of change seen by anyone alive today*. Alarming because this makes investing tougher than usual. And even more alarming in that investors are willing to overpay for "certainty" when very little exists. A good example of this in equity markets is a company like Richemont. This is a hard luxury player selling great brands such as Cartier, Panerai, Vacheron Constantin, and which was rated very highly by the market in 2013. It ticked all the boxes. A great company (tick), demonstrated by high ROEs (tick), a great management team (tick), great (can we say "timeless"?) brands… tick, tick. Great, great, great. Or so the investors said.

But two things happened. Firstly, the market realized that these businesses are much more cyclical than they expected. And secondly, they underestimated the slowdown in sales, this time from China. And today, the group faces pressures from a change in consumer behavior as smartwatches exert pressure on 50% of operating profits it receives from watches.

Investors buying Richemont in 2013 were ignoring any requirement for a margin of safety. A quality company Richemont may *have been*, but the world changes quickly. As an example of that, below is a list of the top 10 S&P companies (by market cap) in 1986, and the same list today. Only 2.5 (Exxon is the 0.5) companies remain on the list 30 years later.

1986	**2016**
IBM	Apple
Exxon	Alphabet
Royal Dutch	Microsoft
AT&T	Exxon Mobil
General Motors	Amazon
DuPont	Berkshire Hathaway
BellSouth	Johnson & Johnson
Phillip Morris	Facebook
Merck	General Electric
General Electric	AT&T

Point 2 - The stock can be priced too high to be a good investment

What really concerns us is valuation paid for very poor growth.

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Earlier in this letter we quoted the absurd behavior going on during the tech bubble using the example of Sun Microsystems. Well here is a modern day example.

Johnson & Johnson had a market capitalization of US$170bn at the start of 2012. Today, its market cap is US$340bn. Over this time it added just US$5bn - or 8% - of cumulative revenue. This *growth* in revenue did not come cheap. It cost US$12bn of net acquisitions and a further US$17bn of capex, a total of US$29bn of investment. So the market is rewarding 8% cumulative revenue growth with 100% increase in market value, despite that growth "costing" US$29bn in acquisitions and capex.

Let that sink in.

Remember, in the Sun Microsystems example cited earlier, 10x revenue made no sense. But in Johnson & Johnson, investors are willing to pay 28x for new revenues added since 2012.

So who are buying these overvalued "quality" companies?

If you do not have the stomach for occasional (and possibly prolonged) relative underperformance, then passive investing is a great option for your money. More and more investors are making this choice and it's these flows into ETFs that are partly responsible for the re-rating in stocks like J&J and many others.[4]

[4] Of course, active managers who have been overcharging their investors for far too long are partly to blame for sending people to the "holy grail" of ETFs.

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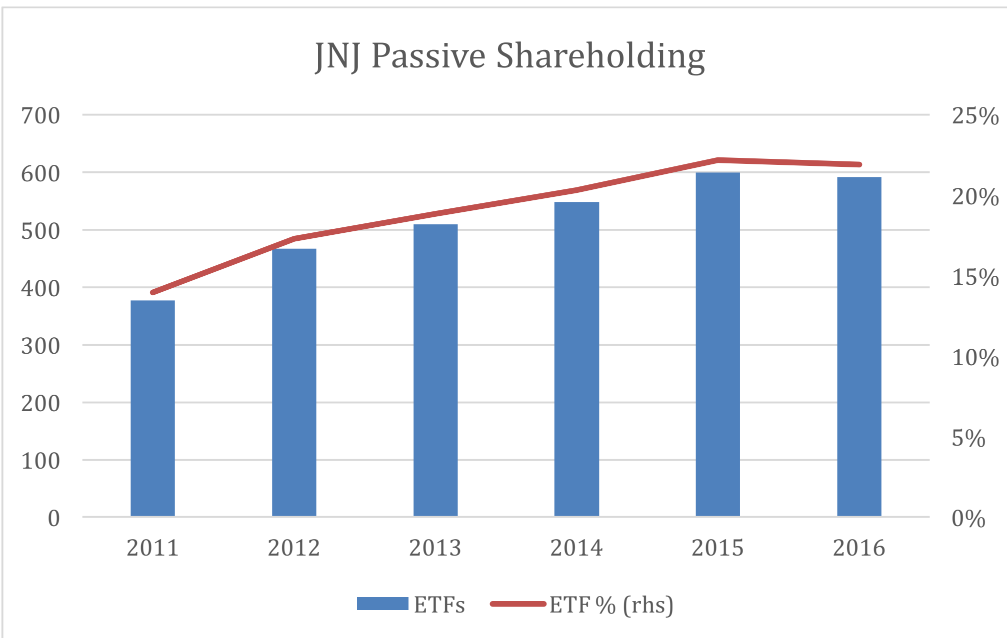
The graph below shows passive inflows have risen from 13% to 20% of JNJ's overall shareholding since 2011. This continuous flow of marginal buyers is helping to drive valuations beyond reasonable valuations.



Add to this all-time-low bond yields and a very blatant stretch for yield elsewhere in the markets. All this leads us as thinking investors to come up with a list of avoids:

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Avoid bonds
Avoid bond-like equity proxies
Avoid investing in companies with high ETF or passive shareholders
Avoid high valuations
Avoid what other fund managers term "a quality company". (Because if it was cheap, fund managers would highlight that characteristic, not the quality).

Subsequent to the end of the 2nd quarter, we have partially hedged our portfolio by increasing our short exposure in similar situations to that which we have described above.

Our Portfolio

Below are our major holdings above 7% of the portfolio.

Sector	**2nd Quarter 2016**
Financials	Barclays Citi
Insurance	Metlife
Logistics	Locamerica Menzies
Retail	Sainsbury Tesco
Media	Neopost

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Menzies
It was an eventful 6 months for Menzies. It saw a change in Chairman, a change in CEO and a change in CFO. It won contracts in the US, Middle East and Europe.

The group returned to revenue growth, defended the UK distribution business well and increased its dividend more than profits. The result was a re-rating in the share price by 20% for the half-year.

The way forward remains positive. Here's why.

Since day 1 of our investment, we have been pushing for the break-up of the group. As a reminder, Menzies is made up of two divisions which have nothing in common, and no synergies – an aviation business and a distribution business. Having them as one combined entity results in the true value of each business being under-appreciated by the market.

After our investment was made, we reached out to other "like-minded" investors who kept up the pressure. Lakestreet has proven to be a fantastic fellow shareholder and have been meticulous in their approach to unlocking value. While a victory lap is premature, we are confident that the group is on a path to unlocking value in the near future. With a proactive Chairman now in place, we expect that the group will be separated into its two parts by mid-2017, possibly before. Our combined valuation of the two businesses is GBP8.50-9.00, which is 40% upside from here.

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We have been criticized for our concentrated investment in Menzies which at one point reached well over 20% of the fund (largely through price appreciation). Our investment in Menzies has returned 66% in USD terms since our first purchase in November 2014, despite a much weaker GBP. *Concentrated investing is more important now than ever before, because attractive opportunities are hard to find 7 years into a bull market*. Our view is: if you find a gem, buy as much of it as you can, or else settle for below-market returns.

Barclays

Our second-largest investment is Barclays. Its share price (in USD terms) fell 42% in 1H2016. So we bought more. Our view on Barclays is more bullish than ever before. Here's why.

At the end of 2015 we wrote:

> *"We are not buying Barclays because it's a perfect asset. We own Barclays as we wait for the value – already on the balance sheet – to be reflected by the market. I don't know when this will happen. But while we wait, value should build up in the bank to the tune of 33p per share annually"*

What's happened?

The value on the balance sheet, measured in Tangible Net Asset Value terms has risen from 273p to 289p per share. It's share price has moved in the other direction.

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In addition, we set out what we would like to see from Barclays management. Jes Staley, the CEO, had recently been appointed. Our wish-list was:

1. Sell off its African operations
2. Reduce its "bad bank" assets to more accurately reflect the returns on capital it generates from the core bank
3. See regulation easing

What's happened?
On all 3 counts, we have seen progress being made in the right direction. This has given us more confidence that the management team is on the right track both operationally and structurally.

But, what has changed is the commonly-held view on interest rates. We *do not know* where interest rates are headed. But we do know that the following two things make banks hugely attractive investments, irrespective of what happens to rates:

1. Banks are highly inefficient and can cut costs in excess of what the analysts currently anticipate. This will offset the temporary pressures from lower rates.
2. The lower rates go, the lower the cost of equity falls for banks. The analyst community is way, way behind on this. As an example of this, I have requested the cost of equity calculations from the banking analysts at two of the largest equity investment banks no less than 7 times. It is a simple request, and even a vaguely literate junior analyst should be able

to send it through. I'm yet to receive any calculation that makes sense. Despite this glaring "oversight" (on their part), they continue to use cost of equity numbers in their research reports which have absolutely no basis in the current reality.

All this is great news for us. We have taken the opportunity to increase our investments in Barclays and other banks which will pay off in the end. Paying 150p for 298p of bone fide value has never made anyone poor.

Conclusion

Our fund has continued to perform well throughout 2016, and our returns are compounding well ahead of the market over the duration of the fund. Even so, it is the long term that we are focused on, so any short term outperformance (or underperformance) is unimportant.

We would also like to welcome the new investors who entered the fund at the end of June 2016. Your timing was impeccable.

As a reminder, I repeat reasons below why I believe Milkwood should provide a good home for long term thinkers and their money.

1. Milkwood is small, which provides us with *more* opportunities to invest in compared to larger funds. Large funds are generally motivated by asset gathering rather than asset management.
2. Our fees are low (very!). You receive the benefit.

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3. We are passionate about investing. If I had a choice of what to do during the day, finding a great investment idea surpasses everything else I'd rather be doing (note – I said "during the day"!).
4. Milkwood has a global remit. There should always be countries, regions and sectors that offer interesting ideas
5. We have a concentrated portfolio, ensuring investments are only made when conviction is strong.

Luck will, of course, play its part.

Our search for attractive investments continues. Our pipeline of ideas is strong (thanks in part to Brexit), and our process is working and disciplined.

As always, please feel free to contact me should you wish to discuss our fund and its prospects.

Cordially,

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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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