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2016 Annual Letter

6 February 2017

To our partners in the Milkwood Fund,

Cumulative gross returns in USD since inception

To 31 December 2016:	**Milkwood Fund**	**MSCI World**
Trailing	%	%
One year	33.4	8.8
Two years	37.1	9.8
Three years	41.8	11.9
Compound annualised returns since launch (1/1/2014)		
Gross	12.3	3.6
Net	11.6	

Net Annual Performance in USD after fees (Class A):	**Milkwood Fund**	**MSCI World**
	%	%
2016	31.0	8.8
2015	2.8	1.1
2014	3.4	2.3

On 27 January 2017, Theresa May and Donald Trump stood in the Oval Office, brought together by a bust of Winston Churchill[1]. Few would have guessed such an event with these three players would have been possible a year before – me included. It teaches us a good lesson on expectations.

After reviewing the performance above, it is perhaps fitting that we start this letter with another lesson on expectations, from Winston Churchill (perhaps fake - who says we don't keep up with the times?).

"In the 1930's, Churchill taught a lecture course at Cambridge on human sociology. One afternoon standing at the lectern and, always prone to the dramatic, he turned to the large class and demanded: "What part of the human body expands to 12 times its normal size when subjected to external stimulation?"

1 Itself a topic of the fake news here

The class gasped. Churchill, obviously relishing the moment, pointed at a young woman in the tenth row. "What's the answer?" he demanded. The woman flushed and replied, "Well, obviously it's the male sexual organ."

"Wrong!" said Churchill. "Who knows the correct answer?"

Another woman raised her hand. "The right answer is that it's the pupil of the human eye, which expands to 12 times its normal size when exposed to darkness."

"Of course!" exclaimed Churchill, and he turned back to the unfortunate first woman who answered incorrectly. "Young lady, I have three things to say to you. First, you didn't do the homework. Second, you have a dirty mind. And third, you are doomed to a life of excessive expectations!"" [2]

The lesson for our investors is not to expect a repeat of 2016. Rather, spread the excess returns over the duration of your investment in the fund – hopefully a lifetime. I don't see our performance being as good in future years for at least two reasons:

1. I have little control over the discovery of undervalued situations in the portfolio. Value was discovered quickly in 2016, but who knows what happens in 2017 and beyond.
2. I will make mistakes in the future, as I have in the past. These mistakes may end up being far more costly. So far, our sins haven't required a full confession session.

When I started Milkwood, I would have expected delivering better returns than what we have generated. Yet, a comparison to other funds and the overall market puts our performance in a clearer context. I urge you to carry out the exercise.

The Letter

The idea of writing an investment letter is far more difficult than it seems. The original intention of investment letters was to (firstly) update investors on the fund's performance, (secondly) its investments and (thirdly) the fund manager's thoughts on the future – more about this below.

Firstly, as a fund manager if your performance is poor, you need to justify it. If your performance is good, the numbers speak for themselves. Therein lies a lesson. Recently, I have read other investment letters which have included quotes from Socrates, King David, Voltaire…I could go on…we may be at peak investment letter quotes.

Secondly, I don't want to write too much about what we own. The more we write convincingly about our investments, the more we feel married to them and the harder it becomes to recognize a mistake. [3]

Thirdly, I have no idea about the future, and even if I did, it would be wrong. We had many good examples of this in 2016. I would never had expected "Brexit" to carry the vote. I would never have expected Trump to win the US election. I would never have expected the pound

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2 From Barton Bigg's brilliant book Hedge Hogging
3 Guy Spier wrote about this in his excellent book Education of a Value Investor

to devalue by 8% to the USD. I could go on and on. The point is – *it's futile to write about what I think, and an even bigger waste of time for you to read it.*

My view is that investment letters should help current and potential investors, (more about that later), understand how ideas are generated. This is not to second-guess what the fund manager does. When poking your head into the cockpit at 33k feet, you don't ask the pilot, "Shouldn't we be at 35k?"

Which leaves me to write this letter as an answer to the most common questions that I receive from investors already in the fund and those who want to become investors – "What is our process?" I hope this letter explains it better, and, importantly, reminds you of what the Milkwood Fund is all about.

Milkwood was set up because I'm passionate about investing. As I've said in prior letters, I would rather run Milkwood than doing virtually anything else. Sad.

I wrote in my initial Milkwood letter in 2013 (available here) that as an ex- sell-side analyst, I came into contact with over 300 hedge fund managers and buy-side analysts. And I would not want any of them to invest my own money (with two exceptions). I stick to that. Recent negative publicity for hedge funds is justified, in my view. 99% of them should not exist. Think about that. There are currently about 11000 hedge funds globally. If only 1% existed, that would still leave 110 hedge funds to invest in. I think that's about the right number of managers who actually have their clients' interests at heart. (Here's a challenge – make a list of good hedge fund managers whom you believe to be genuinely good at what they do, have delivered market-beating returns and are investor-centric. I doubt the number will be over 30!)

There are two reasons for the poor performance of hedge funds. Most importantly, hedge funds originally were set up as independent, non-institutional businesses, mostly because of the poor performance of big, institutionalised long-only funds. As funds became successful, more money was attracted to the hedge funds. With more money came more regulation, and with more regulation, hedge funds became institutionalised all over again. Generally, they have become exactly what they were set up not to be.

The second reason is greed.

Here is a working example. It is not in any way intended to place a negative spotlight on the fund we will discuss (don't sue us). It is purely to illustrate how our motivation at Milkwood is different. And why our investment process is perhaps different. I'll explain if this sounds a bit cloudy.

"Bear with", as Tilly said to Miranda.

Some fund managers are fighting against maths

In a recent edition of an investment journal, I came across an advert from a very successful (and good!) UK and Global fund manager. It got me thinking why anyone with US$2.5bn of assets under management earning a management fee would advertise? I estimate the overall

management fees earned by the fund manager are north of US$25m annually. After all, fund size is the biggest headwind to long-term performance.

In the advert it states, "You should never forget that another way of characterizing "value" and "quality" is to use the simpler definitions: bad companies and good companies." Ha!

The advert continues to list the top quality companies the fund manager is buying - a brewer, a consumer goods company and an alcohol company. I would bet that everyone reading the advert would know and probably use what these "quality" companies produce. And so, as readers identify with these companies, they tend to feel their investment is "safe" with funds that invest in them. But safe they are not.

Howard Marks says it best. *"It shouldn't take you too long to figure out that success in investing is not a function of what you buy. It's a function of what you pay". "An asset of high quality can be overpriced and be a bad investment, an asset of low quality can be bought cheaply and be a good investment".*

The fact that these quality companies are expensive, generally delivering disappointing growth and are over-owned (which I discussed in our previous letter here) will result in poor returns for investors. Novo Nordisk is a recent example of this. In 2015, Novo Nordisk trading on a P/E of 34x expected earnings, based on growth of 15%. Subsequently Novo Nordisk reduced its growth rate from 15% to 5%. You can imagine what happened - the valuation gets hammered as expectations come back to reality.

So why do successful fund managers advertise?

In reality, there is only one reason for a fund manager to advertise, isn't there?

Instead of the above described advert, imagine this. Imagine an advert by a fund manager saying that instead of owning "quality" companies (ones that all the readers know, and consume products of), they were rather buying into companies that were hitting the headlines regularly for the wrong reasons. Companies which have apparent problems, be that corporate governance, or operational. Companies issuing profit warnings or admitting to misdeeds. They would be wasting their time advertising!

Which brings me to:

Our process

The intention of my letters is to describe, using examples, how we invest. I've clearly done a bad job at this because the most popular question we get from potential investors is – "What is your process", followed up with, "How do you find your ideas?" followed by, "Don't you need

a big team to search for ideas?" I'll address these below. Hopefully, future meetings will be shorter.

"What is your process?"

When asked, my normal reply is "our process is we have no process". Serious face. While some may think that sounds glib I honestly mean it.

It's also not the answer people want to hear. It would be far easier for me to say "we run screens looking at quality companies that demonstrate a long-term ROE above 25% with expanding margins and showing uninterrupted revenue growth through a recession, trading below 8x earnings that don't require high capex". (Tick in the box). But it wouldn't be true.

In thinking about it a bit more it came to me that <u>we do have a process</u>. It's just not easy to place in a box. So, let me try and explain it.

Firstly, we read everything. Everything we can get our hands on. That includes annual reports, conference call transcripts, magazines, fund manager letters, 10K's, books and various magazines.

"But surely being global you can't possibly cover that many companies?"

That's true. But we cover what is interesting (or fascinating).

I'll define interesting as:

- industries performing very well or very poorly. In other words, these companies must be doing something right or something wrong which makes them interesting.
- The great companies of the world like Amazon, Starbucks, John Deere, Google etc that demonstrate above average long-returns. Generally, these are companies we would love to own, but are too expensive.
- Peers to companies we already own or have owned in the past that we know well.

Here is an example. Brambles is listed in Australia and owns a phenomenal business called Chep which leases pallets to everyone - literally everyone. We haven't owned Brambles due to its excessive valuation. But, following the company's results and conference calls provides us with valuable clues to the puzzle of current global trade. Why more people don't do this is beyond me. Insights provided by companies like Brambles are valuable in how we might find and think about other opportunities or which regions to invest in.

In thinking about the most common source of ideas that are currently in the portfolio, most have come from a combination of following other companies and looking up and down the supply chain.

Here is how we came up with some companies in the current portfolio, and what triggered our interest.

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Menzies	US Airline companies
Barclays	US Bank comparisons
Greencore	Starbucks and U.K. retail
Sports Direct	Performance Sports Group

Don't you need a bigger team to be global?

No.

In the foreword to the great autobiography of Ed Thorp[4], Nassim Taleb says. *"Many successful speculators after their first break in life, get involved in large-scale structures, with multiple offices, morning meetings, coffee, corporate intrigues, building more wealth while losing control of their lives."* Taleb continues *"It is vastly less stressful to be independent – and one is never independent when involved in a large structure with powerful clients".*

And here is the point *"It is hard enough to deal with the intricacies of probabilities, you need to avoid the vagaries of exposure to human moods".*

Keeping things simple and small worked for Ed Thorp. As the Financial Times put it in a recent interview with Ed Thorp, the 86 year-old could pass for someone 30 years younger! Warren and Charlie haven't done too badly either

Ultimately, all we are trying to find is 10 of the best ideas which offer the most upside with the least risk of losing money. To do this we need *the flexibility* to invest globally. I make no claim that I'll find the best performing ideas globally. Only hindsight can do that.

And this is where the element of *relative performance* comes in. Over time, whether we are successful or not will depend on our selection of 10 ideas vs. our peers and / or a benchmark. Our success will not be measured against the 10 best performing ideas every year. That's the hindsight fund. If we miss out on an investment that does incredibly well for a period of time, we do nothing more than look at the historic share price graph of Valeant.

Flexibility

But here is where it gets complicated. Markets change. And to continuously outperform, funds need to have *flexibility* with their "process", but never their *discipline*. That is a very under-appreciated factor in successful fund management. Some allocators might think this is "style drift". Normally a red flag. Rather, being *flexible* to us means that we are open-minded regarding where ideas originate. At different points in the market cycle, our investment process will change *as far as the origin of investment ideas is concerned*. For example, in 2009, running screens on Price to Book valuations threw out enough ideas, which on further investigation, would generate outstanding returns. Today, that screen would yield mostly fundamentally flawed companies and flawed returns.

[4] Ed Thorp – A Man for All Markets, published 2017

The one thing that will remain constant in our investment process is thorough analysis of the company, combined with extreme discipline in adhering to a valuation philosophy.

And when it comes to valuation, as investors in listed equities, we don't have to come up with a market value – Mr Market does that for us. We also don't need to be precise about fair value. Our job is *to make sure that our probability-weighted range of outcomes indicate sufficient upside to offset the risk* – a margin of safety. Margin of safety can be measured in various ways. Valuation is the most common, and the one that we are comfortable with, for now. Other investors base their margin of safety on the quality of the company, or even company management's ability to replicate results continuously. All have their place and have been proven to be successful. For now, we will stick to valuation as the bedrock of our investment decision.

And that brings me to one of our latest investments.

Sports Direct

Sports Direct is a UK and European sporting goods retailer. It has over 740 stores split between the UK (500 stores) and Europe (240 stores). It is hitting the headlines for many of the wrong reasons. Here are some of them (with links):

- Sports Direct risks fresh shareholder anger with review appointment
- Shareholder group hits out at Sports Direct's "disappointing" failure
- Slave labour at Sports Direct
- Sports Direct auditor under investigation over company's family deal
- Mike Ashley running Sports Direct like 'Victorian workhouse'

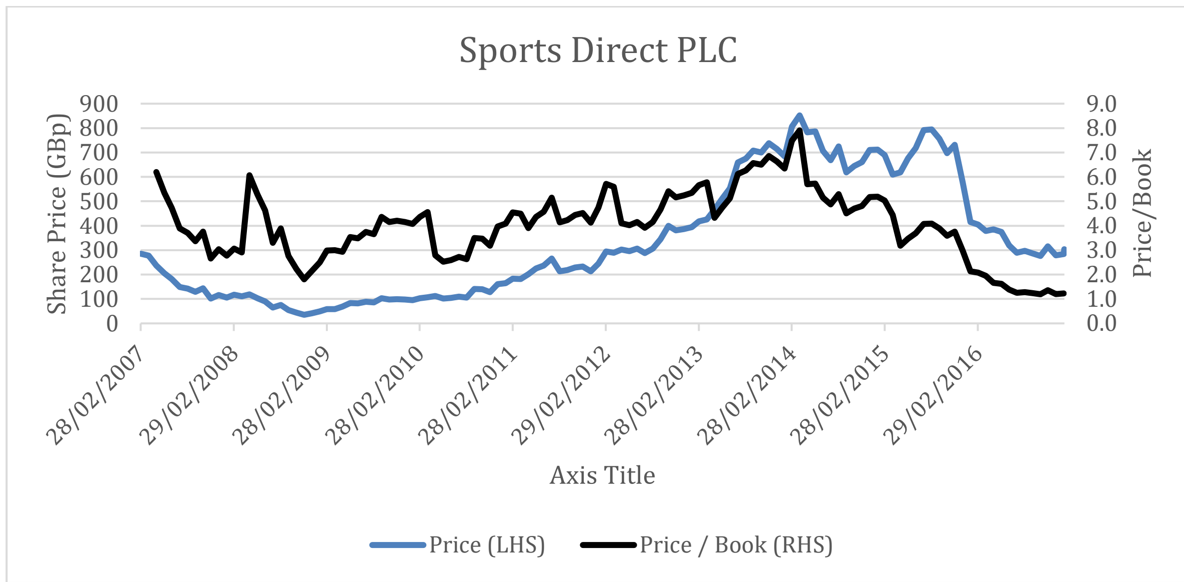
What's not to like!

Sports Direct was built up from founder Mike Ashley's first store in 1982 with a loan of GBP10k from his parents. It was listed in 2007, at a price GBp285 – the same price as today - but 10 years and GBP1.1bn of FCF generation later. Over that time, the value created has been applied in 3 ways –

1) increasing the store base,
2) acquiring brands such as Dunlop, Slazenger, and Karrimor and
3) acquiring real estate to house the stores.

Where it hasn't gone is into the founders' pocket. Mike Ashley does not take a salary or bonus or receive any share options, even though he is entitled to do this. We estimate this saved the company GBP70-GBP100m since listing.

Today, Sports Direct PLC has de-rated to be valued at near its book value. We show book value as it illustrates the extent of the de-rating of valuation, and not as being indicative of what I think Sports Direct is actually worth.



Reasons for the de-rating

Our work on Sports Direct started by looking at Nike. In 2012, Nike started a campaign called DTC (direct to consumer). The idea was to cut out retailers from the distribution channel, and boost its own margins. For players like Sports Direct, this spelt trouble. Rightly or wrongly, we felt that this change of approach by Nike would result in Sports Direct and others receiving second-rate product (or no product) vs. what would be available at a Nike store, or online.

This, coupled with a host of other governance issues, resulted in Sports Direct producing 3 profit warnings. Add to that "Victorian" labour practices, a grilling in front of MP's and high profile bankruptcies in sport retail and you have quite possibly the most hated company in the UK.

Have these problems gone away? In some cases, we think so. Nike, for example, has a dedicated team of over 20 staff (vs. zero in 2014), who are focused on ensuring the Nike product is correctly presented in Sports Direct stores. Our recent visits to 14 Sports Direct stores have shown us that Sports Direct does have access to the latest and best Nike stock – should they choose to stock such models. Not only that, but Sports Direct has the best prices we could find for almost every style we sampled.

Regarding corporate governance issues, when buying something controlled by an entrepreneur, we accept things may never be perfect. And let's put things into perspective. I would rather back someone who has made a billion pounds like Mike Ashley has, than a pimply analyst armed with a shiny Moss Bros suit and excel spreadsheet, providing their thoughts on who should be chairman. After all, it's likely that the pimply analyst's predecessor (and / or current boss) was happy to encourage investment in Sports Direct at double the current price. Beware the swings of sentiment.

Does Sports Direct do anything well? One of the amazing strengths of Sports Direct is its ability to generate business utilizing limited retail space. For example, Dicks Sporting Goods requires 4.5x as much space to generate a $ of sales vs Sports Direct. This leads to higher margins and lower inventories. Sports Direct's model is built for churning inventory even if the experience isn't quite as good as a trip to a Nike store (installing an aircon in the Westfield store would be an easy win!).

In addition, our own store visits provided a different picture to what appears in the news. Our store visits indicated that staff seemed rather content and motivated, even those whom we believe did not suspect us of being undercover head-office staff. Technical product knowledge was lacking, but we were interested to learn from staff that a new staff training system has recently started rolling out. Baby steps.

Valuation

Sports Direct has a market value of GBP1.7bn. For that, we get GBP700-GBP800m of real estate, investments and brands (Sports Direct recently sold its stake in Dunlop for US$114m, and it has other brands of similar quality and value). Sports Direct carries very little net debt, so the implied value of the remainder of the business is c. GBP1bn.

On a normalized basis, Sports Direct will generate between GBP200-GBP285m of FCF (after adjusting for rental expenses). This results in an "at worst" valuation of 5x FCF, which drops down to 3x if things go well. I would guess with a high degree of certainty that the true valuation of Sports Direct is double this range.

In addition, Sports Direct has launched a share buy back. By our calculations, the company has bought back around 1.7% of the shares in issue in 2017 so far. At this rate, the free float will disappear by mid-2018 as Mike Ashley owns 56%, leaving only 44% free float available. In other words, the 1.7% bought back recently equates to 3.5% of the available listed shares.

While we like share buy backs, one key risk for our investment in Sports Direct is that the company is taken private without the value being fully appreciated. (Mike Ashley has stated that he sees a benefit in Sports Direct being listed, but people do change their minds).

Our investments in retail have so far not been all that successful. For example, Tesco has only recently made us a profit and Sainsbury is just above breakeven. How is Sports Direct different? Most importantly, Sports Direct carries no debt, which allows it to move quickly to react to changes in the market. Of course, I could be wrong. But as the examples of Tesco and Sainsbury show, when your margin of safety is wide, you usually at least don't lose money.

Mistakes – A "Premortem"

Historically, I've always confessed to mistakes made. We can all learn from them. In this letter, I'll confess to the costliest one which impacted our fund in 2016. Unfortunately, I have not learnt anything from it. The mistake was to not fully hedge the GBP/USD exchange rate for

our UK investments. It cost the fund 730bps of performance. I'm happy to have this off my chest.

Perhaps more useful to our investors is exploring what my future mistakes could be. Or what could go wrong with your investment (we could be here all day, so I'll focus on one). I thought about this after attending a course at Harvard on Behavioural Finance where the brilliant Michael Mauboussin discussed the idea of doing "pre-mortems" (read more about it here – I believe it adds a new process to portfolio management).

Put differently, if I had to be writing this letter in a year or two and had to report that our investments had not performed well, what could the reasons be?

Most of our largest investments are labour-intensive. Menzies employs over 31,000 people. Greencore 12,000 employees. Sports Direct 29,000. And, wait for it - Barclays 129,000. Bankers! Currently, inflation expectations are heading higher, whether these expectations turn out to be sustainable or not is anyone's guess. But higher inflation and politically populist governments could lead to higher wages – even for bankers. Already, Sports Direct has announced that they will spend an additional GBP10.7m on wages next year, albeit from a low base.

How did we end up with labour-intensive businesses? When searching for investments we steer clear of those industries that are negatively exposed to disruption (at least in the short term). And in doing so, we have ended up with investments that are labour-intensive. This means headcount reduction is unlikely to be a saviour of increased labour costs. The key will be if, and how quickly, these increased costs can be passed on to the customers. We may end up with a mismatch between increased revenue and higher wage costs. I hope all our investments have a margin of safety sufficient to mitigate this risk.

Conclusion

Besides our performance, I'm most proud of, and grateful to, our 58 investors, ranging in size from our current minimum of US$100k up to the multi-millions, who have entrusted me with managing their money. What's more, we have a 99.5% retention rate of investors - I see room for improvement.

When I launched the fund in 2014, I gave the undertaking to keep the fund below US$100m for the first three years. This was for two reasons.

1) Size is the enemy of investment performance. Smaller funds outperform larger ones, all else being equal. Having said that, US$100m is really insignificant and our investment returns would actually have been aided in 2015/16 if we were somewhat larger. This does not mean that we aspire to ever be a large fund. Milkwood will always be small enough to benefit from mispricing across market capitalisations.

2) I have tried to replicate the way I invested in my private capacity prior to Milkwood taking outside investor money. Limiting the fund size allowed me to get used to managing other people's money alongside my own. It was fortunate that I did. I have learnt that managing <u>your</u>

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money weighs heavily on my shoulders – the responsibility I feel is enormous and far higher than I expected. This adds caution to pulling the trigger on new investments.

Now, with 3 years of performance completed, we may look to increase the fund's size. To do this, we will only allow investors into the fund as opportunities are identified. It makes no sense to accept new investors when the opportunities are limited.

As I do like to meet all our investors from time to time, I invite you to visit us in Windsor. It is only by visiting HQ that you can fully appreciate the simplicity of the operation, and understand how "our process is no process" is truly practiced. But besides that, a trip to Windsor is worthwhile to experience the Two Brewers pub at the end of our street, established in 1792, (or for those like me with African origins, Nando's is equally good), and Windsor Castle with an amazing artillery room and unmatched art collection.

As always, should you wish to discuss any aspect of the fund, please give either Andre or myself a call.

Cordially,

Rhys Summerton

PS – for those looking for a few good book ideas, here are some:

- A Man for All Markets by Ed Thorp
- Tools of Titans by Tim Ferris (minus the LSD)
- Einstein: His Life and Universe by Walter Isaacson.

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