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First Half 2017 Investor Letter

31 July 2017

To our partners in the Milkwood Fund,

Cumulative gross returns in USD since inception. MSCI includes dividends.

To 30 June 2017:	Milkwood Fund	MSCI World
Trailing	%	%
Six months	9.6	11.5
One year	31.1	18.8
Two years	29.7	14.4
Three years	35.3	15.2
Since inception (1/1/2014)	56.6	22.3
Compound annualised returns since inception (1/1/2014)		
Gross	13.7	5.8
Net (A)	12.5	5.8

Net Performance in USD after fees (Class A):	Milkwood Fund	MSCI World
	%	%
2017 (YTD to 30 June)	8.8	11.5
2016	31.0	7.9
2015	2.8	-2.4
2014	3.4	4.2

In this letter, I will provide a brief summary of our investments. But first, it makes sense to answer the question that investors would want to know – why do we not own FAANG[1] stocks? I'll address this under the topic of Mistakes of Omission.

Mistakes of Omission (or why we don't own FAANG)

In most of my letters I have written about the mistakes I have made by selecting the wrong investments. This is easy to do when performance is good. It is harder to do when winners do not compensate for losers. And it is something almost forgotten in *times like now*.

Analysing mistakes should not detract from the satisfactory performance of the fund. But our performance could have been better (Which golfer doesn't want to birdie every hole?) How?

[1] FAANG is an acronym for the five most popular and best performing tech stocks, namely Facebook, Apple, Amazon, Netflix, and Alphabet (Google).

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Mistakes of omission, I have felt, are generally an easy way out. It's not that hard to admit missing out on investment ideas, as long as you find better ones. It's far harder to write about missing obvious clues resulting in a loss of dollars.

Earlier, I said that mistakes are often forgotten in *times like now*. Let's define "times like now".

Volatility is at an extreme low. Just think, a fund like Milkwood with 10 core investments, highly concentrated, and not managed with short-term volatility in mind at all, has increased its value for 12 consecutive months. It shouldn't happen. On a larger scale, the S&P500 has been up for 9 straight months. The measure of realised volatility has fallen to levels last seen in 1997.

Low volatility masks mistakes. In more volatile times, market values would appear lower (or higher), than they are today. And so, mistakes are hidden… for now. This applies as much to the Milkwood portfolio as it does to the market overall. Complacency is high. We wait for the tide to go out to see who really is swimming clothed.

Mistakes of omission are exaggerated. For example, I considered an investment in RACE US, the listed company that owns Ferrari. After it was unbundled from FCA, it had a market value of US$9bn, a level I thought was, at best, fair value. A year later, now valued at US$21bn, this mistake of omission has been exaggerated. Incidentally, I don't see any reason why its market cap should not be US$9bn again, sometime in the future.

There are many others similar to RACE.

Market performance is being driven by tech companies. Without FAANG, the S&P500 would be up 6.6%, not 11.6% this year. Our performance delivered since inception avoided investing in FAANG stocks, (with the brief exception of Amazon – which I mistakenly sold 100% ago).

As an investor in the fund, I would want to know why the fund manager (me) has decided to avoid them. So here goes…

To answer, consider that valuation is the most important variable in our decision-making. Like true value investors, (defined as valuation driving the decision, or as Seth Klarman put it, "value investing is at its core the marriage of a contrarian streak and a calculator."), we are an inherently cynical bunch. Value investors, like ourselves, get excited about seeing temporary bad things happening to over-valued, good companies. Sometimes, value investors have been proved right. An expensive company suffers a misstep, growth disappoints or management's hubris gets in the way of making sensible decisions. All resulting in the poor performance of the overvalued company. Today, FAANG stocks have not disappointed their holders, but the future might be different.

The cynical value investor pounces, and makes an investment when temporary trouble (sometimes anticipated, sometimes not) results in a bargain valuation. Typically the "see, I told you he was going to waste the money" or "see, I told you that product wouldn't grow at 25% a year" scenario. The value investor gets excited when these mistakes are evident in the valuation. At that point, an investment is made without having to be overly optimistic on the

future of the company. It's when the margin of safety is large enough to sleep at night, knowing that the most important concept in investing is not losing money.

Now, to be a successful Tech investor, you have to turn all of that on its head. You have to believe that the most implausible ideas will one day make a fortune of money. E.g. Ocado will reduce the cost to deliver a basket to your door to less than £15, or Tesla will sell more cars (at a higher price) than VW, Ford and Toyota combined, or that 90% of advertising will go to Google and Facebook into perpetuity (and advertising will grow!). Or, you need to believe that each of these businesses will pivot to new business models and technologies and make even larger sums of money in those new fields (moonshots have to work). While all things are possible, the point is, investing in them doesn't suit our investment style. Think Rafal Nadal on grass courts.

Granted, some great investors who we admire have bought into these stocks. Interestingly, these are "underweight" positions, relative to the size they represent in the index. This suggests to me, that it's a case of damage-limitation, rather than strong conviction. A sign to be cautious.

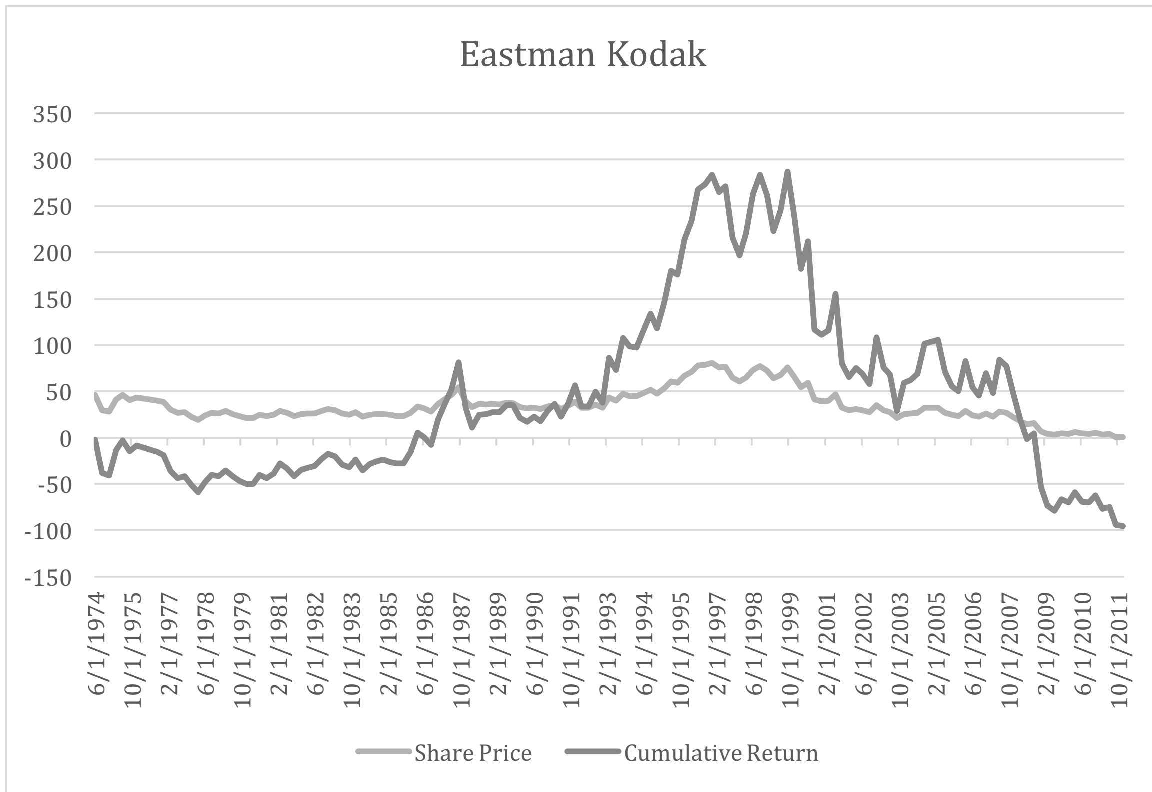
What happens if something goes wrong?

At this year's Berkshire Hathaway Annual Meeting, Warren Buffett mentioned that the largest 5 companies in the US were tech companies that required no capital to grow. That's wonderful for valuations in the good times (now). But what happens in the bad times (future)?

Unlike businesses that invest in tangible assets – such as a railroad, or, interestingly, a bank – tech companies mostly reinvest into intangible assets. They may acquire smaller businesses with a niche bit of kit which they can bake into their existing product. When it works, it has amazing returns. E.g. Facebook buying Instagram for an earthshattering (at the time) US$1bn in 2012. But what happens when it goes wrong?

The lifespans of big companies are getting shorter. In a recent study by Innosight (found here), the turnover of companies entering and exiting the S&P500 is the fastest ever. Granted, some are due to M&A activity, but here are some well-known companies whose business models have been disrupted enough for them to exit the S&P500 (or worse) in the past 10 years.

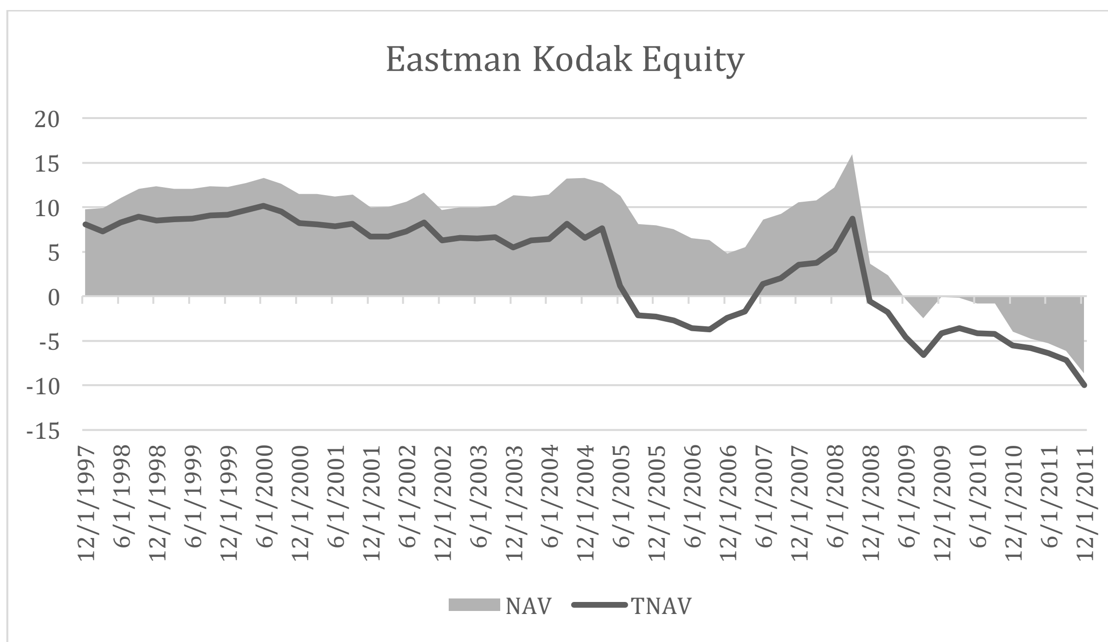
- Eastman Kodak
- Abercrombie and Fitch
- International Game Tech
- JC Penny
- National Semiconductor
- US Steel
- Radio Shack
- Avon
- The New York Times



At the top of the list is Kodak. Back in the 1980's, Eastman Kodak looked as good as any FAANG stock today. A dominant market position. Revenue growth of above 20%. EBITDA margins in the mid-20's, and low debt. And, owning it from 1974 until 1999 would have produced good returns. If you include dividends, you would have made nearly 300% owning it in the 1990s. The rising tide did indeed lift all ships.

But the collapse from its peak in 1999 to bankruptcy took 13 years. This would have resulted in investors who bought Kodak in 1974 losing 92% of their investment, including dividends.

Typical of tech, reinvestment dollars went on intangibles. This left investors with nothing as revenues collapsed and the business failed.



There are many other companies that can be used as warning examples. RIM, Nokia, and Yahoo are forgotten tech companies that caused pain to long-term investors. Also, there are some outstanding examples of companies that have built durable business models, and given outstanding returns to investors. However, I am not sure too many exist in tech land. If they do, I am unlikely to be the fund manager who will find them. The Milkwood Fund will stick to having a valuation underpin to all our investments, and perpetuate the mistakes of omission I have made to date.

And now, to our investments.

In a recent Capital Allocators podcast, Ted Seides interviewed Tom Russo, the great long-term, global consumer investor. Ted Seides asks him about periods his investment activity I transcribe below:. The full audio is here: www.capitalallocatorspodcast.com/tomrusso.

> Ted: Alongside of what you've said about…not selling, the capacity to reinvest, the capacity to suffer, there is an implication that you never sell.
> Tom: Right
> Ted: What has your portfolio turnover been?
> Tom: It's low, obviously it's quite low. And it's low even while, when people ask me, what's new in the portfolio, I often say, most of what's in the portfolio is new, because most of what's in the portfolio is vastly different than it was five years ago, or will be five years from now, because the companies are buying and selling all the time, and so, we feel like we are less needful of doing that, because the companies are doing that all the time.

In the first half of 2017, I feel similarly about our portfolio. Not much has changed to the underlying holdings, but much has changed when we consider actions our investment companies have made.

Menzies PLC

Menzies, (the aviation and distribution business), remains our largest investment in the fund. In March, Menzies announced their intention to have two separate listings, using DX PLC as a potential vehicle to achieve this. Whether DX PLC is eventually used or not, (a police investigation and resignation of CEO and CFO poses some concern to the tie up!), our expectation is that Menzies will be separated into two entities during 2017.

And then?

The real attraction of Menzies remains the aviation businesses. At the beginning of 2017, Menzies acquired ASIG, the airline refueling business, bulking up and providing a runway for future growth through efficiency gains and cross-selling, (selling more services to UK and US airlines with existing relationships).

Amounts in GBPm	Current	Post DX merger
Market Cap	570.0	570.0
Menzies Distribution	140.0	213.8
Implied Menzies Aviation	430.0	356.2
Net Debt	140.0	140.0
Implied EV	570.0	496.2
FY18 Operating Profit	67.0	67.0
Net Profit	39.5	41.2
P/E (x)	10.9	8.6
Pre-tax P/E	7.9	6.6
EV/EBITDA	8.5	7.4

The attraction of course remains the valuation, (see table above). Depending on the eventual structure of the separating transaction, Menzies Aviation will be valued at between 8.6-10.9x earnings. A valuation 60-80% higher could easily be justified.

Barclays PLC

Barclays disposed of 42% of Barclays Africa, resulting in its adjusted capital ratio improving to 13.5%, the highest of the major UK banks. In addition, the company announced that it would

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end its "bad bank" run off from July 2017. This means that for the first time since the financial crisis, Barclays will be focused on its core bank.

So why do we continue to like Barclays?

With the legacy issues mostly out the way, (some legal issues remain unresolved, such as its settlement of US and Qatar investigations), Barclays management have given a return on tangible equity target of 10%. This is may even prove conservative, as after all the disappointments from 2008 – 2017, management surely would have learnt to under-promise and over-deliver. Tangible Net Asset Value per share is 284p – a 10% return will place Barclays on a P/E of 7x, at today's price of 207p. With the sector at 11.5x, and with tangible equity of 284p, 50% upside in Barclays is possible. And that value should grow at 10% annually thereafter.

Greencore

Greencore made two acquisitions recently, one in the UK, (near Heathrow airport and small), and one in the US, (adding Peacock Foods), taking its annual sandwich production up to 1.5bn, and prepared meals to 140m per annum. Peacock Foods adds 40% to group revenue in 2017, and 30% to EBITDA – so we are following the integration of this business into the group very closely. So far it is going well, and we look forward to 2018 results when the benefits of this acquisition are likely to be felt. To put numbers to it, EBITDA in 2016 was GBP134m. In 2018, Greencore should be generating GBP260m.

Sports Direct

In our 2016 letter, we wrote about Sports Direct. Subsequently, the UK press has gone to great lengths to report on the raucous drinking and behaviour of Mike Ashley, Sports Direct's CEO. However, this only served to aid holders of Sports Direct. In 2017, Sports Direct has bought back 41m shares, (from 570m to 529m in issue), at prices which were lower thanks to the bad press Mike Ashley received, (personal thanks to the FT and Daily Mail). Mike Ashley did not sell any of his 330m shares he owns.

Recently, Sports Direct reported better results, with revenue growth of 12%, proving once again that "every saint has a past and every sinner has a future".

Other changes in portfolio include the following:

- Increased our investment in Sainsbury and Tesco on the weakness created during the Amazon/Wholefoods tie up.
- Pershing Square created a secondary listing on the FTSE and was included into the FTSE250 Index. Our holding in Pershing Square, (now at a 22.5% discount to NAV), is indirectly hedged, (there is a limit to belief that every sinner indeed does have a future!).
- Subsequent to the end of June, the fund has started building an investment in a UK company, in an industry we know well. More on this at year end.

As always, I thank you for allowing me to manage your money, alongside mine. We own investments which have the potential to perform very well, but with valuations that are highly

<u>attractive</u>. Finding suitable investments does, at times, mean we have to embrace the CEO who pukes into fire places at the Horse and Groom, or buy into companies that require some work to extract the true value of the underlying attractive businesses. All investments are constantly thought through and re-evaluated, ensuring we have a margin of safety, at all times.

Should you wish to discuss any aspect of the fund, please give us a call, or, pop in to visit us in Windsor.

Cordially,

Rhys Summerton

PS. For those looking for a few good summer book ideas, here are some:

- "The lives, loves and deaths of splendidly unreasonable inventors" by James Coller, (if you want to surprise dinner guests with your knowledge of the origins of popular products like the Gillette razor, or Tippex, this is the book for you).
- "Am I Being too Subtle?" by Sam Zell (A great read about property and business in America, as conducted by the forthright Mr Zell).
- "University of Berkshire Hathaway" (This book will resonate with those who have been to the Berkshire Hathaway Annual Meeting, and covers the meetings from 1986 to 2015).

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