MILKWOOD
CAPITAL

First Half 2018 Investor Letter

18 August 2018

To our partners in the Milkwood Fund,

Cumulative net (A) returns in USD since inception. MSCI includes dividends.

To June 2018:	Milkwood Fund	MSCI World
Trailing	%	%
6 months	-6.0	-0.1
18 months	0.7	24.5
Two years	21.0	32.9
Three years	17.0	28.7
Compound annualised returns since launch (1/1/2014)		
Gross	8.6	7.8
Net (A)	7.7	7.8

Net Annual Performance in USD after fees (Class A):	Milkwood Fund	MSCI World
	%	%
2017	7.1	24.0
2016	31.0	8.8
2015	2.8	1.1
2014	3.4	2.3

As usual, this letter is divided into two parts:

- Part 1 - Overall investment thoughts – the pond
- Part 2 – Discussing Menzies and UK banks, our two largest investments - the fish

Part 1

We argue for sticking to our valuation-based investing style at a time when it's tacitly encouraged to veer from valuation-based investing. "Anything but value" is Mr/Mrs/Ms Market's cry. But remember, he/she/it is prone to mood-swings.

Why do we stick to valuation, when it no longer seems to matter? Granted, there are examples of companies that have been astonishingly successful… situations where bothering about valuation would have led to the wrong investment conclusion. For example, I owned up to selling our Amazon investment far too early, based on valuation. However, in the stock market, short-term success is a function of human nature, Mr/Mrs/Ms Market's wild moods swing between euphoria, (with momentum), and depression. When the music stops - and depression sets in – look out! That's when valuation becomes the only bedrock to rely on. A portfolio of "stories" will not make enjoyable reading, while a portfolio of well-priced companies with substantial assets supporting them, will withstand this.

Let me elaborate on how we try to execute on this framework.

Investment Framework

Today, the investment world is divided into three broad groups of companies:

Category 1 - Beneficiaries of disruption – e.g. tech – expensive
Category 2 - The soon-to-be disrupted – e.g. consumer staples - expensive
Category 3 - The already disrupted -e.g. newspapers - cheap

Being a valuation-based investor, we steer clear of Category 1 and 2, (both are expensive). However, Category 1 is where the majority of investors have placed their bets recently, (wittingly through active investments or unwittingly by buying market cap weighted ETFs).

Our issue is that today's beneficiaries of disruption are generally 1) well-known, 2) expensive, and 3) tomorrow's soon-to-be-disrupted (Cat 2) and eventually Cat 3 companies. When investors change their interpretation between categories, violent changes in valuations occur – to the downside, moving from Cat 1 to 3, and enormous upside from Cat 3 to 1. Therefore, as valuation-based investors, our

needle-in-the-haystack goal is to find companies that are mispriced, yet with business models deserving far higher valuations, in line with category 1. In other words, we want *beneficiaries of disruption, priced as the disrupted*.
In 2004, Michael Mauboussin wrote one of the great articles of investment literature, in my opinion - **Decision-Making for Investors** (link here). If you haven't read it, take some time out and read it for yourself. It has relevance now, even though it was written 14 years ago. Below I will quote some points from this piece, and apply it to the Milkwood Fund.

Mauboussin describes 3 factors which determine success across probabilistic fields - investing being one of them:

1. The focus on process versus outcome
2. The constant search for favourable odds
3. Understanding the role of time.

Running a portfolio tests our resolve on all three factors.

For example, in the short term, some bad decisions could result in a good outcome. A recent case is Mattress Firm. It was acquired by Steinhoff in August 2016. At the time of the announcement, it was the most heavily shorted stock on the NYSE. It was running leverage of 5x EBITDA. The market environment was highly competitive and it had taken on far too much retail space. It was a near sure bet that Mattress Firm would be a winner…if you were short. However, along came serial acquirer and fraudster Steinhoff, which paid 2x the market value. Those who were short, suffered. The *process the shorts used may have been exactly right, but the outcome was painfully wrong*.

Robert Rubin, who held many roles in Banking and was former US Treasury Secretary, (and holds an unflattering place in Nassim Taleb's book "Skin in the Game" on how to play the compensation game in banking, without taking risk), describes the situation like this:

> "Any individual decision can be badly thought through, and yet successful, or exceedingly well thought out, but be unsuccessful."

How does this apply to our framework? Today, paying up for companies which are expensive and demonstrate no long-term sustainable advantage, or at least questionable sustainability, may appear successful. Share prices may continue to rally. But a company can only be worth as much as its discounted cash flow, *ultimately deployed at its investors discretion,* (this last point is important and largely ignored by the market – for example, does anyone question if Facebook will ever return meaningful cash to its shareholders, or will it continue to reinvest the proceeds into something new to stay ahead of technology disruption? I'd bet shareholders don't see much of the cash).

Which brings us to the second factor: Maintain favourable odds.

Mauboussin says:

> "Perhaps the single greatest error in the investment business is a *failure to distinguish* between knowledge of a company's fundamentals and the expectation implied by the stock price. *When a company possesses strong fundamentals, investors tend to buy irrespective of expectations.* Similarly, weak fundamentals cause investors to avoid a stock. These tendencies lead to an inability to properly calibrate odds, producing suboptimal performance." (emphasis added)

Today's focus for most investors is finding operational winners, (i.e. companies that are currently executing on disrupting other businesses). Investment strategies and terms such as "scale economics shared" are being used to justify virtually any valuation, simply because one smart fund manager successfully invested in Amazon in 2005. While a powerful strategy, making the assumption that this isn't reflected in today's valuations is like betting on the favourite horse in every race, ignoring the odds being offered.

So where does that leave us in following a valuation-driven approach in the Milkwood Fund?

Our focus is investing in companies that might be valued as disrupted, but are beneficiaries of disruption. Our two largest investments fit into this category. Menzies was considered a disrupted newspaper distributor when we bought into it, but underneath the skin is a highly attractive aviation services business requiring limited capital to continue growing. Interestingly, Menzies exhibits a prime example of the "scale economics shared" business model that so many today are using to justify overvaluation. Banks too, (discussed below), fit into this framework.

However, money is made by moving *between* categories. Perhaps Bruce Berkowitz says it best: "We buy on assets (cat 3) and sell on earnings (cat 1)".

To execute on this, Mauboussin says the third factor is "Understanding the role of time".

> "Dealing with probabilities requires *persistence and staying power*. In the short term, results may be very unsatisfactory. Long term an appropriate

> process delivers good results. You cannot judge performance in a probabilistic field over the short term."
>
> "In recent decades the investment community focused more and more on outcomes – and increasingly on short-term outcomes."

How do we apply this to Milkwood?

Our investments are valuation driven. This means that the probability of gain x the amount of gain is far higher than the probability of loss x the amount of loss. We estimate the gap between these numbers for our portfolio is over 35%[1]. Downside is limited and measurable, while the upside will look after itself - over time.

Part 2

Menzies

The Menzies story is well-known to our investors, as it has been our largest investment for over 2 years. It is also the chief reason for our recent underperformance. So why do we still like this investment?

A category 1 idea in category 3 clothing.

When we bought into Menzies in 2015, we were attracted to the aviation services business. Aviation services businesses have tremendous economics – they require very little capital to grow, and they help airlines operate more efficiently, by sharing the benefits of scale. They operate in a growth sector, where growth is driven by:
1) more people are flying than ever before (Boeing suggests a forecast of 4.5% growth for the next 20 years), and
2) airlines increasingly outsourcing. The ability to consolidate the market is a real one, particularly if you are listed. None of Menzies' competitors are.

The other part of the business, newspaper delivery, was the reason the valuation was held down. Clearly, the view that the business could be split from Aviation Services was not widely believed, otherwise why would it have been trading at such a low valuation?

In July 2018, Menzies announced the sale of the newspaper distribution division. This leaves Menzies as a standalone aviation services business (caveat: shareholders will vote on this sale later this month, but we don't expect this to be a problem).

[1] This is not to be confused with the upside we estimate in the portfolio, which I think is far higher.

Tick.

With the split of the business in the bag, why hasn't the share price re-rated? We should add a "yet".

Menzies has much in its favour *operationally*. However, being listed in the UK and based in Scotland, it is not uppermost in the minds of the investment community. In addition, MIFIDII has had some unintended consequences, (most regulation has unintended negative consequences, but MIFID II is in a special category all its own). Brokers seeking to satisfy their business models, (and vastly overpaid analysts), have taken the view to focus coverage on the big companies, ("our competitors cover it, so we have to"), and cut coverage of smaller companies. This has left a hiatus in coverage of companies below US$4bn in the UK. MIFID II is a real problem for investor relations teams who attempt to drum up support of their companies… but it's an opportunity for investors like us who are prepared to take a long-term view, with time on our side. It will take time for Menzies to re-rate, but value always wins, MIFID or not. [2]

What happens if the market never appreciates the value?

Currently, too much money is chasing too few opportunities in private equity. Preqin believes the PE industry raised $453bn in 2017, and David Rubenstein said in May this year that private equity is able to raise more money now than ever before in his (long) career… It's safe to say there is some dry powder around.

The situation in the Aviation Services industry is a good example of the arbitrage available between private (high) and public (low in the UK) valuations. In June 2018 (i.e. very recently), a competitor to Menzies called Worldwide Flight Services (WFS) was sold to Cerberus, a private equity fund. Cerberus paid a reported EUR1.175bn equity value and assumed debts of EUR200m. Incidentally, WFS is run by the previous CEO of Menzies Aviation.

The valuation paid by the private equity fund works out to be about 1.1x revenue and about 10-12x adjusted EBITDA.

If we applied the same multiples to Menzies we get a valuation of between GBP10 to GBP13 per share vs. today's GBP6.40, (assume Menzies generates GBP95m EBITDA in 2019 based on GBP/USD 1.28).

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[2] Here are some numbers from Hardman & Co on the impact of MIFIDII: Liquidity for LSE midcap companies has fallen 9.8% on a rolling 12-month basis. The number of analysts has fallen 4.7%. "It is widely reported that attendance at brokers' conferences has collapsed. Institutions are concerned that they might inadvertently transgress the new rules." "Some brokers are reporting a 50% fall in number of analyst meetings".

I concede that we don't own Menzies for the sake of a private equity bid. I'd assign a low, (say 10%), probability to it being bought in the next 12 months. Yet, having such a close peer being bought in a private equity transaction does flag the attractive upside of Menzies private market value. We could make the story even more attractive. Consider that WFS is exposed to freight, while Menzies has a less cyclical business model. Menzies could justify a higher valuation than WFS.

We hope that Menzies remains a listed Aviation Services business for the long term. Being listed, if it achieved the right earnings rating, it could consolidate the market by using stock, (something unavailable to its competitors). Once again, this all takes time. Having competitors owned by private equity is also a plus, as pricing should remain rational.

UK Banks

The Milkwood portfolio has always had exposure to banks and insurers. There are two reasons for this:
1. Post 2009, there are fewer investors interested in financials, making them misunderstood.
2. Valuations are attractive, absolutely and relatively.

I have had reasonable success in investing in financials as they make attractive valuation-based investments. Recently, my decision to invest in Barclays has been "unrewarded" (a mistake).

The most common pushback we hear about banks is, "How do you know what's in the balance sheet?", or, "What will cause banks to re-rate?". Most objections come from the rear-view mirror rather than the windshield view, as Peter Lynch might say. The fact is that the rear-view mirror view is now 10 years old. Instead of me justifying our bank investments, I thought a quote from The Bank Investors Handbook would suffice:

> "Are investments in bank stocks risky? One of the authors had a very lively conversation recently with someone who claimed that banks are completely un-investable. This fellow's arguments were the same as most coming out of the financial crisis: banks are over-levered, their balance sheets are black boxes, they're loaded with derivatives, they would have gone under in the crisis if not for accounting gimmicks keeping them alive, and so on and so forth. Had he ever actually looked at a bank's financial statements? He hadn't, but that didn't get in the way of him having an opinion. He's not alone. We've heard the same arguments in many different forms as justification for avoiding bank investments. The issue to be explored is whether banks actually are risky investments. And, if so, are they any riskier than any other

> business investment? Are cars risky? Is a lawnmower risky? *…[The authors then go into extensive detail about the risks of cars and lawnmowers]…* The common theme is that many things in life have risk when one doesn't know what they're doing, but risks can be managed with knowledge and experience. The same applies to investing in securities of banks. Out of the laundry list of risks related to bank investments the two that seem to get people the most hot and bothered are (1) the leverage of banks and (2) the balance sheet as a black box. This chapter will discuss those risks. This isn't to give short shrift to the various other risks inherent in bank investing, but they are of somewhat secondary importance.

I'll skip the discussion regarding point 1 – Leverage. Leverage is less of an issue now, in my view. Banks have raised sufficient equity, since 2009. In practical terms, instead of being 30x geared, (rearview mirror), UK, (and US), banks are 7-9x geared, and now need to return excess equity to shareholders (windshield).

Regarding point 2 – the balance sheet black box – the authors state the following:

> "After leverage the second most popular reason for not investing in banks is because their "balance sheets are black boxes." Here's a question: do you REALLY understand what's on any company's balance sheet? Is it possible that General Electric inadvertently overvalued some of their inventory amongst the $17b held on their balance sheet? Is it possible that the array of t-shirts and jeans at The Gap aren't the "true" valuation? How many companies out there are furnishing financials with wildly inflated property or asset values that managers with rose-colored glasses think might be obtainable someday, sometime? We're not even talking about fraud or misdirection. It's not always possible to firm up a perfect valuation.
>
> Let's shrink the argument and consider a small industrial company like George Risk Industries, a family controlled yet traded company that makes specialized sensors and circuits, for a second. They hold on a relative basis a lot of securities, a few million in cash and some fixed assets. They breakdown the securities holdings in their annual report into very broad categories such as equities, municipal bonds and mutual funds. However, we don't know what funds they own or why they've lagged the market with their asset mix. We also don't know if their $4m in fixed assets are old machines held together with a bit of duct tape, prayer and a "git-r-done" attitude, or if their factory is full of top of the line equipment. We just don't know."

In favour of banks is the enormous data available to analyse the balance sheets. In addition, the oversight of banks today, (stress tests, regulatory and capital restrictions forcing more responsible lending e.g. mortgages over credit cards), is superior to anything ever before. Contrast that with, say, Facebook, which has virtually zero oversight, as no one knows how to regulate it, (is it a media company or a technology company?), has zero certainty regarding capital returns, and operates across over 100 countries, (here is the example of Myanmar https://www.reuters.com/investigates/special-report/myanmar-facebook-hate/). Imagine the complexity in deciding what makes a monthly user, (something Facebook has proved to be thoroughly unreliable at doing), vs. lending someone 60% of the value of the home where they will live for the next 5 to 30 years, charging a small premium to your average funding rate? Which is a more sustainable business?

But there is also another benefit to banks, seldom mentioned. Technology.

As mentioned earlier, it's rare to find companies that are priced as disrupted companies, but are *beneficiaries of disruption* or technology. I think banks are such an example.

As Rory Sutherland, (Vice President of Ogilvy), says: "In business, what you need is not a universal rule, but a lucrative anomaly". Banks could be just that anomaly.

Let me explain.

In February 2018, RBS launched its digital assistant, called Cora. Cora conducts the basics, answering over 2000 questions, and providing mundane information. The human bank teller, taking annual and sick and maternity, (or paternity), leave and requiring training for AML and compliance etc. and taking lunch when the bank is busiest, (during lunch time), and arriving late after a night out, might struggle to improve her knowledge year after year. Since launch, (6 months ago), Cora, on the other hand, has not taken a day's leave, is available over lunch and, importantly, has improved her knowledge by 100%. Cora can detect emotions of the customer, and doesn't have emotions, (unlike the human bank teller). Also, customers who are reticent to use technology are more likely to use Cora.

The result? RBS hasn't released data. But Lloyds recently indicated that its AI investment had saved 115 000 hours human hours this year, which conservatively works out to a cost saving of GBP8m annually. The expensed investment/cost, (taken through the income statement), is around GBP20m – a payback of 2.5 years. Over time, these numbers will result in better cost/income ratios and improved profitability.

UK banks have large branch networks, but these can be reduced thanks to technology. In 1997, Barclays had 2597 branches in the UK. All UK bank branches totalled 12 000. Today, Barclays has 1246 branches. Total UK branches today is 6

000. Barclays disclosure indicates that only 3.5% of its customer base doesn't use digital banking in some form. Hence, we expect more cost savings and improved profitability.

Where has all the money gone?

It is quite easy to work out the mistake that I have made investing in Barclays. The simple question is: if these trends are so positive, why hasn't it created any value?

And that's a valid question. Here are some numbers which sheds more light on to it.

In 2011, Barclays had a tangible book value of GBP47bn. Today, Barclays tangible value is GBP45bn. This means that over 6 years, Barclays has destroyed GBP2bn of value, rather than creating value.

What has happened?

Barclays has a current market cap of GBP31bn. Looking at Barclays through the rear-view mirror shows GBP35.6bn was paid out in items we view as non-recurring, and a further GBP5bn in dividends. Looking through the windshield suggests that if Barclays can repeat this performance of the prior 6 years, it will be able to return more than its entire market cap back to shareholders, or a 21% return.

Litigation and conduct charges	GBP15.1bn
Bank Levies	GBP2.4bn
Historic losses from Non-Core banking	GBP10.1bn
Loss on sale of Barclays Africa	GBP2.5bn
Excess taxes	GBP7.1bn
Dividends	GBP5.1bn
Total	GBP40.7bn

Consider, too, that Barclays and other banks are likely to be in a stronger position in the next 6 years vs the past. Interest rates will likely be higher. Barclays is a more focused bank with fewer issues for management to deal with. Legal costs will decline. Returns will be higher.

My mistake has been underestimating the time it has taken to rectify the legacy issues facing the bank. While not all issues have been dealt with, the most recent results required no further provisions for payment protection claims or other litigation.

Instead, Barclays reiterated its intention to buy shares back and pay a dividend of 6.5p per share – a 3.6% yield, higher than any other major bank in the UK or the US.

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Conclusion

Our investments have not moved much in 12 months, but our fund continues to slowly tick upward in size. We have attracted new investors, while maintaining our historic ones because we share a common view that valuation-based investing – an unpopular investment style – will result in great future returns. Value works because it occasionally goes through times when it doesn't – like now. This time is not different, and I look forward to reporting on how the portfolio develops in future periods. If we protect the downside, and avoid permanent losses, the upside will take care of brief periods of underperformance.

As always, I wish to thank you for the trust and faith you have in me managing your money.

Cordially,

Rhys

PS – here are book and podcast recommendations, perhaps a little late for the summer holidays.

Books:

Total Rethink by David McCourt – an autobiography of a serial disruptor.

Valley of Genius – Adam Fisher, (an astounding amount of work went in to this detailing the history of Silicon Valley. Find out how Steve Jobs really did end it all)

Bad Blood by John Carreyrou, (it's the story of Theranos, but I bet it's also about what is happening right now in hundreds of overvalued start-ups throughout Silicon Valley).

Everybody Lies by Seth Stephens-Davidowitz, (ex-Google programmer tells us what our search history really reveals about us and why we ask Google the things we do).

The Bank that Lived a Little, (Philip Augar wrote a highly readable "The end of gentlemanly capitalism in the 1990's. This book on the history of Barclays is highly readable, especially when it's our second largest holding!)

The Sports Gene by David Epstein, (can practice make perfect?)

The Happy Brain by Dean Burnett, (highly recommended read as the author touches on ideas that make us happy that perhaps we have never thought of e.g. why are we happy in our childhood home?)

Podcasts:

"Masters in Business" interview with Fund Manager Leon Cooperman is a great podcast about his time managing money, (just before he turns his fund into a family office). If you're wondering how good he was as a fund manager, wonder no more. He tells you a few times! Nevertheless, there are some good lessons).

"What It Takes" conducts a series of interviews with outstanding business brains. Chip Wilson (founder of Lululemon), Steve Madden and John Mackey (Whole Foods) are business masterclasses.

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