



MILKWOOD CAPITAL

November 2014

To my partners in the Milkwood Fund,

Our first nine months performance generated returns of 6.8% *after* fees in Class A (gross 8.4%), the largest share class. Please refer to your statement already sent for your relevant share class returns.

9 months is too short to make any meaningful conclusion regarding the fund's performance. We need to be judged as we judge - over the long term. In other words, we don't manage money on a short-term basis, and you shouldn't benchmark us on that basis either. In addition to this usual disclaimer (which our keener investors may have picked up has been repeated in every letter I have written), I would add that recent volatility is a healthy reminder to take outperformance with the same pinch of salt as underperformance. It's the intrinsic value of the companies we invest in which matters, not the short-term - random - movements of share prices.

Our letters are to update our partners of the actions we have taken, and the reasons. At the same time, we are cautious to publish our opinions of some investments. The reason for this is simple. When something is published publically, it makes it more difficult for the publisher to change his mind, if indeed the facts do, as Keynes suggested. So when we delay an update, please bear with us. These letters are meant to update investors regarding our thinking of what is meaningful to us in the fund. Timing is less important.

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

Being Contrarian...comes with a cost.

The term “value investors” has become overused. While we are extremely valuation-driven, in markets such as the current one (5 year bull market, S&P at all- time highs), opportunities to find great value require a more contrarian mindset. In contrast, in 2009 investors did not have to be contrarian. You “simply” had to make the decision to invest to do well.

Being contrarian however comes at a cost – emotionally. And this is probably why so few fund managers are good at it.

In the book “The Small Big” (partly written by Robert Cialdini) they quote studies in conformity – or following the crowd - which explains why it is so tough to go against the grain. It’s quoted below:

“In a modern- day replication of Solomon Asch’s classic conformity studies from the 1950s, a team led by neuroscientist Gregory Berns told a group of people that, as part of a study on perception, they would be shown a series of 3-D objects and would later be asked to identify which objects were the same in terms of size and shape and which were different.

The researchers also pointed out that while everyone would be involved in the study, only one member of the group would be hooked up to the functional magnetic resonance imaging (fMRI) brain scanner in the next room and that everyone should remain in the waiting room while they set up the machine. However, all this was just an elaborate ploy, because everyone in the group was part of the study and in on the act. Everyone, that is, except for the person hooked up to the MRI – the genuine study participant – who was about to

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

become the subject of a fascinating experiment designed to identify what happens in our brains when we go against the group consensus.

Having been “selected,” the study participant was then connected to the scanner, shown a series of pairs of 3-D images, and asked which were the same and which were different. However, before answering, the participant was first informed that the “volunteers” in the other room had also been shown the images and for each pair of images had made a decision about what the correct answer was. Sometimes the group gave a deliberately wrong answer in order to see whether the person would cave to the social pressure.

Despite the fact that most “selected” participants knew the group’s wrong answers didn’t seem right, *they still conformed to them about 40 percent of the time.* Perhaps more interesting, though, was the finding that *when the study participant made an independent judgment that went against the consensus of the group, the areas of the brain associated with emotion were activated, suggesting that there is a real emotional cost to going against the group and the price we pay is a painful one.*

It can be especially hard to go against those groups that we consider to be particularly important to our own social identity – in other words, groups that help us define who we are and how we see ourselves.” - The Small Big, small changes that spark big influence by Martin, Goldstein and Cialdini.

Which brings us to Tesco...

At the end of 2Q14, we had a 2% investment in Tesco. We were attracted to the brand, the store locations, its 33% market share (now 28%), its international

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

footprint and valuation¹.

Subsequently, Tesco has halved in value.

We have taken this decline to increase our investment in Tesco to 8% of the portfolio. Mostly this was done below 200p, which has cushioned the portfolio from mark to market losses in 3Q and beyond.

Before we get to our view of the investment attractiveness of Tesco, it's worth thinking about why a company would go from being worth £30bn to £14bn in 6 months. Surely technology doesn't change that quickly? Surely shoppers haven't migrated to discounters so quickly? As the CEO of Sainsbury, Mike Coupe, recently said, "The demise of the UK retailer is greatly exaggerated".

HP, a similar story?

Before we started managing partners' money, I invested in HP, the "Dog of the Dow" in 2012. Just as some are describing Tesco today – a "melting Ice Cube" according to one hedge fund manager who is short the stock – HP was in 2012.

Here are examples of the headlines we have randomly chosen from back then. After reading them, tell me if you feel like buying it.

➤ HP – Cut to Underperform from Hold

¹ Why, you may ask wasn't it a larger holding than just 2%? When faced with a sector we find attractive, we always attempt to acquire the most attractive investment in the sector. In our opinion, we ended up liking Sainsbury more than Tesco and positioned the portfolio accordingly.



MILKWOOD CAPITAL

- HP Losing market share to competitors
- Ahead of the Bell HP downgraded
- Pain at HP may worsen
- Goldman cuts PC forecasts as demand fades
- JP Morgan Survey points to tough times for PC demand
- HP Analyst Day No short term fix
- HP falls 5.5% to lowest point since 2002
- HP 4Q Pricing trends worsen
- HP's cup of woes are brimming over
- Things get trickier for HP
- Moody's lowers HP's Snr Debt Rating to junk
- HP sued over accounting fraud
- Infighting is wrecking HP
- HP needs a new strategy and board

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

- FBI is probing HP's purchase of Autonomy after US\$8.8bn write-off
- HP falls as much as 15% on accounting crisis
- HP takes an \$8.8bn hit on accounting improprieties
- More disappointment ahead for HP says top competitor

And my favourite:

- HP the Story only gets worse

Back in December 2012, analysts had 3 buy ratings, and 33 holds/sells recommendations.

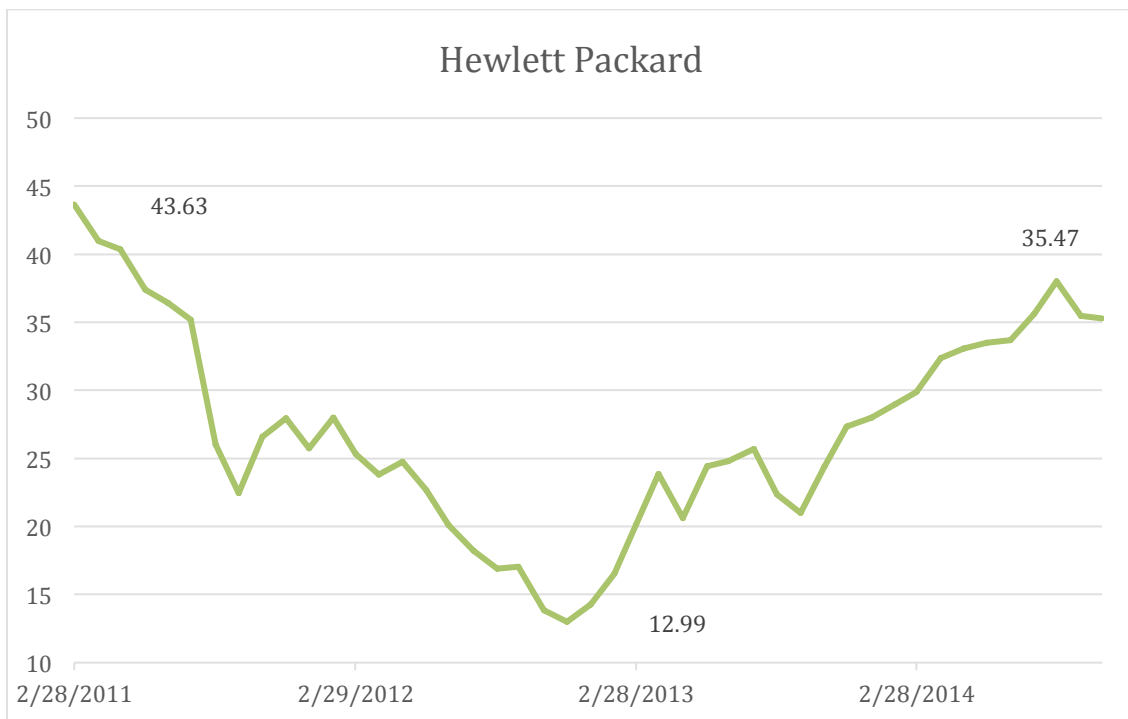
Today, with the stock up 3x its December 2012 low, there are 18 buys, but only 2 sells.

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL



The example of HP shows how markets tend to overreact to newsflow. When things are going badly, Mr Market tends to put the boot in, to really make sure the victim receives a good kicking.

The headlines we have used for HP could easily be substituted for Tesco. Think about the accounting scandals where an overstatement of £263m wiped off about £2.8bn of Tesco's market value. Think about the change of management and lack of trust. Think of the market share decline. Think of the

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

rating agency downgrades. You get the picture.

But our conviction in increasing our stake in Tesco – now to 8% - is driven by valuation. The value we see in Tesco is simply too compelling, at least by our analysis, to not take advantage of.

What is that value?

Let's add it up.

Value of operations outside of the UK and Ireland = £14bn, roughly the market cap of Tesco today. This includes South Korea, Thailand and smaller Eastern European operations.

In addition, Tesco owns businesses which are only vaguely aligned to its core business of UK retailing. Dunhumby, Giraffe and Tesco Bank all fall into this mix. We think they are worth £4-6bn. Which implies the value of the UK and Ireland retail business is between zero and £2bn. This business should generate between £1.2bn - £2bn of FCF when the market normalizes - making it an incredibly attractive proposition.

In other words, the largest grocery retailer in the UK is trading at less than one year's FCF. In addition, the property portfolio of Tesco as a group is valued at north of £30bn. To lose money on the Tesco investment would require some serious value destruction from these levels.

Where we could be wrong is if Tesco does not realize the value of its non-core assets, or if a new management team decides it's better to raise fresh capital

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

rather than sell or rationalize the asset base. So, like all great investment opportunities, it is not without risk. And remember *the definition of risk is that more things can happen than will happen*. In this case, we feel comfortable that the margin of safety is sufficient to prevent permanent loss of our capital

Portfolio changes

We have been fairly active in the portfolio. We have reduced our investment in Citi, the closer it gets to fair value, the less margin of safety it has. In addition, we exited our investment in UTIW (and closed our corresponding short position on Expeditors) at a net gain of over 25% (which makes up for some of the mistakes we have made!).

Below we disclose our holdings which are above 5% of the portfolio:

Banks

- Barclays
- Sberbank

Logistics

- Locamerica
- Santova

Retail

- Amazon
- Sainsbury
- Tesco

Media

- Mail.ru

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

Conclusion

As always, we thank you for the support in investing with us. The portfolio is undervalued and I am optimistic the future performance of the companies will be rewarded.

Finally, if you are looking for something to read, why not visit the [milkwoodcap.com](http://www.milkwoodcap.com) website and follow the link to the reading room (<http://www.milkwoodcap.com/index.php/reading-room>). Here you will find recent reads and links to Amazon. By using the link, we generate a few pennies for charity - these go to Julian Baring's Scholarship Fund (which last quarter amounted to £22.15).

Our best recent read is Guy Spier's "The Education of a Value Investor". It's a brilliant book on the softer issues with regard to running a fund and gives us enormous confidence that we are on the right track (or perhaps that Guy Spier is on the right track).

I welcome any feedback from our partners. Please feel free to call or visit us in Windsor.

Cordially,

Rhys Summerton

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com



MILKWOOD CAPITAL

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

70-72 Alma Road
Windsor
Berkshire
United Kingdom
SL4 3EZ

Email: rhys@milkwoodcap.com
Tel: +44 1753 844 599
www.milkwoodcap.com