MILKWOOD CAPITAL

13 July 2015

To our partners in the Milkwood Fund

The Milkwood Fund is up 15.5% for the first half of 30 June 2015[1].

	YTD 2015	Since Inception[2]
The Milkwood Fund	15.5%	19.4%
MSCI World (MXWD)	1.5%	4.6%
Peer Group Funds (avg)	1.6%	5.4%
SP500	1.8%	14.7%

The purpose of our letters is to communicate, as honestly as possible, thoughts on our investment approach and process. Not performance. Performance is a product of our investment process. Returns can be fleeting if we alter what we do, what we know works. At times we will be lucky, and at times unlucky, especially when measured over the short term. The longer you are invested in the fund, the lower the influence of luck will be, and the greater the influence of the manager's (my) skill will be. To decide if the role of luck will diminish, analyze our investment process.

In this letter I will take you through two examples of our investment process. Firstly, an investment that has so far turned out to be successful (lucky?), and secondly, an investment which has cost us 1% of our fund. Painful!

Before that, a warning.

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

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A few thoughts on what won't work…

The majority of fund managers today are espousing the formula for investment success to equal;

"Good quality companies"
+
"Great / trustworthy management teams"
+
"Fair value".

Notice how all three are subjective.

Barrons recently asked a fund manager, "What kind of companies do you look for?"

His reply, "I want to find some of the world's best businesses (hardly unique!) that can compound at high rates over long periods of time, identify them when they're trading at a reasonable valuation, and then just marry them. Our goal is to find businesses we can own for five to ten years".[3]

I have nothing against the fund manager, but if we break this down a little, you will soon realize that it cannot possibly live up to the bill of being the answer to investment success.

3 See Barrons 11 July 2015 entitled "Applying Old Lessons to New Money"

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The attributes such as good/great quality is something that doesn't spring up overnight. It takes years or decades of performance to decide if a company is "good quality". What about "trustworthy management"? Does a company create trust overnight? Like "quality", it takes years to create trust.

The point is – companies that possess these attractive attributes were around last year, or the year before, or the decade before that. There is very little "new" out there that hasn't been uncovered in the quality basket – especially with so many are chasing after so few.

If markets are to move higher, and if the "good quality gang" is to be the driving force behind these markets, two things need to happen. Both hold out danger signs.

1. Clustering– the same stocks that have the "right attributes" get driven to outstandingly high valuations
2. Investor perception becomes cloudy making an increasing number of companies appear sexy, when in fact they are pretty ordinary.

Today, we see signs of both 1 and 2 occurring. In the case of 1, it takes just one large activist fund manager to publicize his bullish views to have more than 12 apostles chasing after his latest investment idea. Unfortunately, the higher these stocks rise in price, the lower the future returns will be.

What about 2? A former "not-so-hunky" male acquaintance (let's call him Shrek) used to have a tried-and-tested method to increase his "strike rate" with the ladies at nightclubs. Instead of arriving at 11pm when the senses of his would-be admirers are at their peak, he made of a point of arriving well after 2am. By then, the Vodka, G&T etc. had done the trick. Now appearing fresh-faced and alert, Shrek turned himself into Brad Pitt - at least to the women still dancing in the club.

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In investing terms, what happened to Shrek is pretty similar to the pursuit of the current buzzwords for investment success - “quality”, “trustworthy management”, “fair valuation”. When everyone is chasing after the same thing, the longer the party continues the duller the senses become.

Many fund managers today are chasing opportunities that do not justify the valuations they are paying. The 2am Brad Pitts will turn out to be 9am Shreks.

Our approach is a little different and more flexible. Obviously, if we can find truly great companies at fair prices we will take the opportunity to invest. But our examples below illustrate the different sources of our ideas and different reasons for making the investment. To generate attractive long-term returns, and for our fund to continue to outperform, 6 factors are important to maintain:

1. Milkwood is small which provides us with *more* opportunities to invest in compared to larger funds.
2. Our fees are low (very!). You receive the benefit.
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, sectors that offer interesting ideas
5. We have a concentrated portfolio – Menzies, our largest position - is 15% of the fund
6. Luck

Below, follows two examples of what we do all day.

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United Insurance Holdings (UIHC)

We were lucky enough to meet the head underwriter at Lloyds last year, and he was clearly despondent about the prospects for reinsurance. This got us thinking about the repercussions of cheap capital and "alternative reinsurance" on the insurance sector. [4] It seemed to us that the *winners in this sad tale of capital misallocation are likely to be direct insurers* who can maintain pricing power through great client relationships or other means, but who also reinsure heavily and are active where reinsurance competition is strongest.

Nothing jumped out at us from the initial screens we did.

On a recent trip to the US, we noticed a large-scale direct advertising effort from an insurer called UIHC. A few weeks later while attending the Berkshire Hathaway AGM, co-incidentally Warren Buffett spoke about the risks of Re-insurers when he said "Reinsurers have taken a turn for the worse". This piqued our interest, so we set about doing more work on the topic and looking again at beneficiaries of this – the direct writers – one of those being UIHC.

That's how ideas come to us. By having inquisitive minds, we are constantly trying to find investments that are attractive. We don't have one model that fits all.

4 "Alternative Reinsurance" instruments like Catastrophe (CAT) Bonds competing head-to-head with traditional reinsurers. If you're not familiar with CAT Bonds, a typical arrangement is one where an insurer issues a bond that offers a juicy yield for its credit rating, but with a catch. The catch is that the principal is no longer repayable should a defined event occur (such as three major hurricanes in one year). The insurer is therefore effectively reinsured, as it can use this capital to pay claims instead of paying its (ex-) creditor.

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In the case of UIHC, an added attraction is that we have found a seemingly Peter Lynch-style investment with a favourable capital cycle in the current reinsurance market. What do we mean?

UIHC's main niche is Homeowner's insurance in windstorm and hurricane-prone areas of the US, with 75% of their current exposure in Florida but with diversification underway. This is a large and commoditised market for *reinsurers*, but pricing power lies with the *direct writers* who have good distribution. UIHC have been able to lock in very cheap reinsurance for multiple years, insulating them from even a 2004-5 hurricane scenario (the worst on record).

The Peter Lynch part comes in by replicating the success they have had in Florida to the rest of their footprint. UIHC is currently active in 9 states, and plan to replicate their success in an additional 9 over the next few years (they already have licenses). They do this mostly by recruiting some of the most established broker salespeople in the industry - this effectively gives them instant scale in a new town or territory.

We bought UIHC on 7x earnings. What's more, those earnings are growing at about 15% annually. Direct competitors of similar size, with similar growth, trade at an average of 2.6x Price-to-Book, while we were able to invest in UIHC at 1.4x. For a business delivering over 20% ROAE (increasing), we think UIHC is incredibly attractive in the long term. In addition, we have seen similar cases were these faster-growing niche insurers become take-over targets…a longer-term possibility for UIHC.

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Tungsten

At the end of 2014, I had the idea of reviewing all IPO's in the UK and Europe from the beginning of 2013 onwards. I got the idea after re-reading Marathon Asset Management's excellent book called "Capital Account"[5]. Something they did in September 2000 was review all recent IPOs which preceded the dotcom bubble. This group inevitably has many losers and a few winners. We were searching amongst the ruins to find opportunities.

Unfortunately we found one.

Tungsten is a UK-based e-invoicing business with a twist. It provides financing at the click of a mouse to suppliers of large corporations. This financing was made available through the combination of acquiring a banking license and a funding facility from a US lender. It was set up to help small businesses alleviate the financing strain from working capital drain. This was brought about by the delaying tactics of large corporations. The business idea was initially supported by the UK government.

We conducted further analysis and had discussions with the company. I felt comfortable that we had found a winner. Tungsten had already signed up 25% of the Fortune 500 companies and was adding suppliers rapidly. We analysed a similar company that was acquired by SAP for US$4.3bn (vs. Tungsten's market cap of US$200m) in 2010 called Ariba, but at a later stage of development. This gave me confidence that the business model was as attractive as I thought.

What could go wrong?

5 Capital Account – A Money Manager's Report on a Turbulent Decade 1993-2002 containing a selection of contemporary reports written by Marathon's Jeremy Hosking, Neil Ostrer, Charles Carter, Nicholas Sleep and Qais Zakaria, published by Texere.

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The key mistake I made was expecting the market to continue financing the expansion of the business with equity. As Tungsten grows, it requires funding for expansion and global growth. Instead of receiving support from the equity market, (although its largest shareholders did support it), with short-sellers circling, (and they have every right to do that), the share price fell 60% - costing us 1% of the fund's value.

We haven't given up hope. We still believe that the future of Tungsten will be successful. Rest assured, we will keep you posted on how this develops.

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Current Holdings

Below are a list of our major current holdings by sector. We have omitted positions that we are currently active in.

Sector	**2nd Quarter 2015**
Financials	Barclays Sberbank Citi
Insurance	UIHC Metlife
Logistics	Locamerica Santova Menzies
Retail	Sainsbury Tesco
Media	Mail.ru Neopost
Food	Marfrig

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Conclusion

In my year-end letter I wrote the following:

> "The most encouraging achievement of running the fund for over a year has been building a base on similarly-minded investors into the fund. This is partly by design – we don't actively market the fund, our focus is on finding great investments. And most importantly, we have not had one redemption from the fund. We think this speaks volumes regarding the quality of the investors we have in Milkwood, and tangibly contributes to future returns. (In our case, there are no prizes for being first – rather our wooden spoon is gold plated)."

Of course, all of this is still valid. We still have not had one redemption but have had existing partners increase their investment into the fund (On that note, we still have capacity in the fund – please contact Andre regarding share classes available). I appreciate your continued trust and support and hope we have rewarded you with the fund's performance.

Our search for attractive investments continues. Our pipeline of ideas is strong and our process is working and disciplined.

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

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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