



### Q3 2021 Portfolio Review

Partners in WMKI's Strategic Opportunities portfolio own a piece of 18 high quality enterprises. While you will see 20 "tickers" on your brokerage statement, there are some duplicative exposures. Activity during the quarter was minimal.

Q3 performance did not deliver the wealth creating result we aspire to achieve. However, short-term results – whether good or bad – are a poor barometer for the performance of our "conglomerate" of businesses. Over a long period, the economics of our business holdings and total portfolio returns will align. As a reminder, returns should be judged on a minimum of a 3-year time horizon, though 5+ years is a much more reasonable measurement period for long-term investors.

Total Returns to September 30, 2021	WMKI Strategic Opportunities Gross Returns	WMKI Strategic Opportunities Net Returns	MSCI All Country World Index
3 months	-2.4%	-2.5%	-1.1%
Year-to-Date	21.4%	21.1%	11.1%
Since Inception	29.9%	29.6%	24.3%

### Business Updates

**Aon:** Our top contributor to Q3 performance was Aon (ticker: AON), a large, global insurance brokerage firm that added over 1% to the portfolio return. Aon is widely trusted by businesses across the globe to provide strategic advice and risk mitigation across any number of hazards, from hurricanes to cybersecurity.

While our business holdings have a large collective exposure to the (re)insurance space, I try to avoid direct, outsized exposure to catastrophe risk such as hurricanes. This is due to my view that the severity of catastrophe risks continues to accelerate, making many (re)insurance companies underprepared for future claims. Our businesses are more specialized in nature, such as Arch Capital Group (discussed in my [Q2 Portfolio Update](#)) or Fidelity National Financial, which is a title insurance business.

As an insurance broker, Aon sits in an interesting piece of the insurance value chain. The brokerage industry exhibits oligopolistic qualities, with increasing returns to scale from negotiating leverage and shared costs. In fact, while (re)insurance businesses could suffer from increasing severity of catastrophe losses, Aon should benefit from these secular trends as businesses need to protect themselves against an ever-increasing stream of risks. Aon's expertise is needed now more than ever.

Aon's management is intensely focused on Returns on Invested Capital (ROIC) and free-cash-flow (FCF) growth, the two metrics I love the most! Businesses create value by generating cash (FCF) and then reinvesting that cash in high returning projects (ROIC). The longer this reinvestment can occur, the more valuable the enterprise. Over the last decade, Aon has turned top line growth of ~4% per annum into a 14% FCF CAGR while more than doubling their ROIC. I purchased Aon near the initiation of the portfolio for ~16x FCF, which is currently difficult to find for such an attractive business. I suspect Aon will be a part of our "team" for quite some time.

**Canadian Pacific:** While Canadian Pacific (ticker: CP) provided a 0.64% drag on performance in the quarter, the company was nonetheless able to get a strategic acquisition of Kansas City Southern (ticker: KSU) approved by shareholders. It is important to note that regulatory approval by the governing body, the Surface Transportation

Board, has not yet been granted. However, an encouraging interim step known as a Voting Trust has been approved, which improves the odds of success.

In my view, CP is the best operated railroad in North America, led by Keith Creel who learned from his predecessor – and most famous rail executive of all time – Hunter Harrison. Since Keith assumed responsibilities as COO of CP in 2013 (he assumed the CEO title in 2017), the railroad's operating ratio (a measure of total operating expenses to sales – lower is better!) improved from 83.3% to 57.1% last year. If you ever doubted the impact of management on a railroad's performance, this should change your mind!

KSU is a railroad that goes deep into Mexico and whose rail lines link up perfectly with CP in Kansas City. KSU has long been a sought-after asset in the rail industry and CP's primary Canadian competitor, Canadian National Railway unsuccessfully attempted to purchase KSU at a higher price. I view the asset as extremely strategic to CP for two reasons:

- 1) I believe that in the long-run, CP's network is materially enhanced by KSU's assets. By providing a seamless experience for shippers from Mexico all the way to Canada, CP could be the beneficiary of any move towards insourcing production to North America to combat the global supply chain issues that have been exposed during the pandemic.

If there is any doubt as to the strategic nature of KSU and CP merging (the companies point to \$1B+ in EBITDA synergies), I would point to an excerpt from a recent Financial Times article where the CEO of competitor Union Pacific was quoted saying, "The UP enjoys over two-thirds of all rail traffic to and from Mexico...If that gets jeopardized because a new acquirer uses market power to move that business in their favor, that's not good for our customer base..."<sup>1</sup>

- 2) As owners of CP today, we are no longer betting on a turnaround of performance. Investors enjoyed those improvements over the last several years. Rather, we are betting on continued excellence by Keith and his team at CP. My biggest fear in owning CP has been Keith getting "poached" by a larger competitor. While the combined CP/KSU will remain one of the smallest Class I rails, Keith is putting a material amount of his reputation at risk in the transaction. I believe this provides more stickiness to Keith's tenure at CP, which should in turn provide greater comfort to us as long-term investors.

**Alibaba:** My biggest mistake in the quarter was the purchase – and subsequent quick sale – of Alibaba (ticker: BABA). My position in Alibaba cost us ~1% in performance for the quarter. I have long respected the Chinese e-commerce giant and felt the valuation did not align with the true economics of the enterprise. However, I wanted to wait for clarity from a government antitrust investigation prior to purchasing the business. After a relatively minor fine was levied, I felt it was safe to purchase Alibaba.

I did not foresee the onslaught of regulation the Chinese government would put on countless non-Alibaba businesses. While the long-term effects of regulation on Alibaba's economics are unknown, investors are rightly petrified of an unfriendly business environment in China. I quickly recognized my mistake and sold the position very soon after our purchase, which did save quite a bit more pain.

While I don't believe my evaluation of the business was wrong – and I expect Alibaba to ultimately be much more valuable than it is today – I am not comfortable with the government risk I cannot effectively understand or underwrite. It is a valuable lesson in the nuance of risk management as well as the importance of situational analysis in conjunction with business and valuation work.

1) Chavez, Steff, "Wildfires and violent weather leave railroad giant facing \$100m bill." <https://www.ft.com/content/8f5c8360-19eb-437a-b55c-4c393ffa0ba5>. September 16, 2021

## Goals

*"It's a constant quest to try to be better today than you were yesterday  
and better tomorrow than you were the day before."*

*– Kobe Bryant*

While I have been clear on my intention to be a long-term investor of your collective capital, it occurred to me that I have not laid out a concrete goal for you, my Partners.

My primary goal is simple: Deliver excellent long-term returns with the highest levels of transparency and integrity possible.

Excellence is defined as at least top quartile performance vs. other investors over a 10, 15, and 20-year period.

The natural question you ought to ask yourself is why not shoot for top decile performance every year (or quarter!). While that would be a phenomenal outcome, I am not aware of any investor who has accomplished this feat over an extended period. Only 1/5<sup>th</sup> (yes, 20%) of top-quartile US funds over 2010-2014 stayed in the top quartile for 2015-2019.<sup>2</sup> Simple mathematics tells us that only ~5% of equity managers would be a top quartile performer for 10 years ( $25\% * 20\% = 5\%$ ).

Academic literature – and the media! – likes to slam active investment management as something of a lost cause. I read the data differently. I believe investors underperform the market for two basic reasons:

- 1) Situational: Investors who are not sufficiently concentrated and long-term oriented to add real value. They become “closet indexers” (investors who closely replicate their chosen benchmark, which makes them less likely to materially underperform – and conversely – less likely to outperform as well) and focus on gathering assets rather than delivering returns.
- 2) Inflexible: Investors who have a particular style that is setup to perform well in only some environments. Think high growth investors over the last several years of perpetually shrinking interest rates!

Neither of the two factors listed above are a knock on the intelligence of the investor community, which is filled with some of the most brilliant individuals in the world. However, the factors listed above are an indication of the incentives and structure of the professional investment industry.

Why be a closet indexer? Because clipping an asset management fee on average performance is a great business! Why have a style that only sometimes adds value? Because it's easier to sell a “fancy sounding” strategy than an “own good businesses and be patient” strategy! The investment industry enjoys making things (things that sometimes resemble investing) sound hard to justify their fee stream.

If we desire strong long-term results, then I should also set my intentions on a long-term, sustainable process that includes consistent discipline, continuous learning, and strong conviction in our businesses.

So how will we invest to achieve my simple (but not easy!) goal? While I will keep process discussions for future writings, I intend to hold a low turnover, concentrated portfolio of businesses, which has been shown to add outperformance of ~2% per annum.<sup>3</sup> The enterprises we own are likely to share the following traits:

- 1) Economically defensive moats.
- 2) Management teams with high integrity and strong alignment.

In summary, my focus is on delivering consistent excellence rather than episodic brilliance.

2) Berling Liu, “How Long Do Top-Quartile Funds Stay There.” <https://www.evidenceinvestor.com/how-long-do-top-quartile-funds-stay-there/> July 5, 2020

3) Martijn Cremers and Ankur Pareek, “Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently.” <file:///C:/Users/william.knowles/Downloads/SSRN-id2498743.pdf> Working Paper, December 2015

## CFC Required Reserves

*Note: Feel free to ignore this section if you do not own a Controlled Foreign Corporation as many of my investors – and myself – do. These entities are essentially setup as captive reinsurance businesses for operating assets and are required to hold a very conservative portfolio of at least 85% investment grade fixed income and a maximum of 10% exposure to US common equities.*

In my [Q2 Portfolio Update](#) I discussed several adjustments to the required reserves portfolio to reduce both our interest rate exposure and our fees on investment products. To summarize the moves:

- 1) I shifted ~35% of our broad investment grade ETF (AGG) allocation to an interest rate hedged investment grade corporate bond ETF (IGBH). In addition to reducing duration risk (interest rate risk), IGBH helped pickup incremental yield.
- 2) I shifted from a broad preferred equities ETF (PFF) into two preferred securities, Qurate Retail and Liberty Broadband. This both reduced expenses and enhanced our yield materially on the 5% allocated to preferred equities.

While early in Q3 interest rates fell even further, they started trending up towards the end of the quarter (and have continued to do so in Q4). The upward drift in interest rates – which seems like a long-term inevitability – supports the reduction in interest rate exposure made to the portfolio. I continue to be comfortable with our relative positioning and am happy to deliver results far superior to our collective cash alternative (though certainly not good enough!).

You will note that I have begun to include a Fed Funds alternative to the performance reporting. While our custom benchmark describes “what is possible” if we could directly invest in the market from our CFCs, it is not possible to deliver these returns without bearing expense. The Fed Funds provides the true alternative to my investing efforts as it is what your CFC required reserves would otherwise be invested in.

<b>Total Returns to September 30, 2021</b>	<b>WMKI CFC Required Reserves Gross Return</b>	<b>WMKI CFC Required Reserves Net Return</b>	<b>Required Reserves Fed Funds Alternative*</b>	<b>Required Reserves Custom Benchmark**</b>
3 months	-0.1%	-0.3%	0.0%	0.1%
Year-to-Date	0.1%	-0.6%	0.0%	0.0%
Since Inception	1.2%	0.5%	0.1%	1.2%

\*Represents the alternative yield on required reserves if left in the default cash alternative option.

\*\*90% AGG (iShares Barclays Aggregate Bond ETF)/10% S&P 500 Total Return

**Disclosures:**

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