January 20th, 2023

QUERCUS
Fund

2023 First Letter to Shareholders

Dear partners,

What an eventful year 2022 was... stock markets had the biggest decline since the 2008 crisis. In addition, the increase in interest rates made for a negative year for bonds as well. Such a simultaneous downward trajectory for both asset classes represents, in fact, one of the worst years on record for the so-called balanced approach of asset allocation (i.e. a portfolio divided between bonds and stocks).

	Annual	**SPY**
2020 (Dec)	3.7%	3.3%
2021	23.2%	27.0%
2022	-17.1%	-19.5%
Accumulated	6.0%	5.6%
Annualized	2.8%	2.7%

The Fund hit a low point of -31.3% at the end of October, which by then represented an underperformance of 12.6p.p. (percentage points) against SPY, to close the year at -17.1%, an outperformance of 2.4p.p. against SPY.

Now, imagine if some automatic risk management rule constrained the Fund's positions due to volatility. In order to reduce market risk, our positions may have been compulsorily sold at the worst moment (when volatility increased), the significant recovery that happened in the following couple of months would be missed, and the Fund's annual performance would be even worse. Instead, it was as good a time as any to remember that, as embedded in the strategy of the Fund, the utmost measure of risk is the probability of permanent loss of capital - emphasis on permanent.

There is a famous saying in financial markets: "past performance is not indicative of future results". Why would past price action be, then?

In any case, this illustrates that anything can happen to stock prices in the short term, both in absolute and in relative terms. This is especially true to a portfolio as concentrated and as distinct from any stock index such as ours.

Do not be mistaken: as much as I try to relativize the (hopefully temporary) loss that occurred in 2022, these are unsatisfactory results. One may feel a little less sad because the Fund slightly outperformed the overall market, but it remains lower in price than at the beginning of the year. That is the opposite of what is expected by any investor. And yet the Fund had no redemptions in 2022. I am honored by your trust.

The Fund is committed to provide satisfactory *absolute* returns, *in the long run*. Your investment manager could just as well have sold short the market, or bought oil future contracts, or in a number of winning strategies throughout the year. I have not.

Truth be told, I was not actively searching for such alternative strategies. My focus continues to be to find extremely undervalued companies, so that in most, if not all, macro environments we will have a wide enough margin of safety to prevent permanent losses of capital. Only on rare occasions the Fund will be positioned to take advantage of a strong insight regarding a mispriced macro environment.

In that sense, the Fund is bound to have periods of bad results from time to time; nothing precludes an extremely undervalued company from becoming more undervalued.

Most importantly, the Fund's *value* is above what it was at the beginning of the year – a caveat: that is in my own assessment, which may be conservatively appraised, but is definitely subjective. Even as the price (the Fund's NAV) decreased from 127.8 to 106.0, my estimate is that its value increased from 420 to 460. I hope to convince you of this in the next chapter.

In other words, the process stands uncorrupted – to provide the greatest value at a given price –, even if it did not produce good results in this particular year.

As mentioned in previous letters, my preferred performance indicator is the annualized rate of return, especially over long periods of time. It will comprise boom years such as 2021 and bust years such as 2022. So far, our actual results of 2.8% per annum is much lower than my expectations, and it should be much lower than what you expect to receive. However, a period of 25 months is far too brief to reach any conclusions as to the success of the Fund's strategy. We will get there. I am as confident as ever.

You heard about the macro events, but what about the micro?

With different degrees of anxiety, you probably read about the most impactful macro events of 2022: war and its consequences, global inflation, higher interest rates, inflated energy prices, probable recession in some parts of the world, deglobalization, sharp deceleration of economic activity in China… These were all over the news. And for sure their aggregate impact was negative to the value of our Fund's portfolio.

However, from a bottom-up perspective, some positive events took place as well. My intention is not to provide every technical detail about them, but instead to highlight their relevance. Here are some of them:

Tianjin Development Holdings (~20% of the Fund): it sold a loss-making division for the equivalent of a third of what the market values the whole company. Net cash now represents 2.5x the whole market cap (yes, you read it correctly).

China Sanjiang Fine Chemicals (~20% of the Fund): it finished the construction of a new plant, which took more than three years to build, at a total cost of 5x its market cap. It is highly likely that from 2022 year-end onwards, its high financial leverage will begin to decrease and, even considering the petrochemical downcycle, subsequent results will be much better than the last two years'. More on that in the next chapter.

Sonagi (~15% of the Fund): although at a discounted price, it agreed to sell an indirect stake of a non-core asset to its controlling shareholder, for 2x its market cap.

Compagnie de l'Odet (~15% of the Fund): it sold less than half of its second largest subsidiary for the equivalent of 100% of its market cap.

These are some of the reasons why I believe that, netting all out, the value of the Fund is larger now than at 2021 year-end. As mentioned earlier, value cannot be precisely pinpointed – remember, it is a function of assumptions regarding the future, which is uncertain by definition. Nevertheless, it is an important metric to track, maybe the most important of all. Stock prices are far more volatile and far less controllable – in fact, not controllable at all – than the intrinsic value of their underlying companies.

Sometimes the gap between the process (growth in the Fund's value) and the results (growth in the Fund's NAV, computed via stock prices) will increase, no matter how large it was to begin with. I believe 2022 was such a year.

Sanjiang Fine Chemicals

You may remember that in the 2022 Second Letter to Shareholders I mentioned an investment in a new position that was about to become relevant to the Fund. It is time to reveal it, and explain its rationale.

Sanjiang Fine Chemicals is a petrochemical company based in China. There are plenty of negatives about the petrochemical industry, and even more about Sanjiang Chemical current positioning:

- It is a commodity business. Your product is just as good as your neighbor's, and you can only compete in price;
- Although there are regional price differences, it is a global market. Demand usually grows a bit faster than global GDP; as for supply, a new plant may take 5 to 7 years to be built, from planning to commissioning. Therefore, investment cycles are fairly predictable. We have been in a downcycle over the last couple of years, and it should last at least another year;
- Petrochemicals can be made by processing three different feedstocks. From the cheapest to the most expensive: ethane (extracted from natural gas), naphtha (refined from oil), and methanol (produced from coal or gas). Sanjiang Chemical's current plants only produce them from methanol, the least competitive of them.

So, why are we invested in a marginal cost producer in a commodity industry during a downcycle? Because the company is just about to substantially 1) increase its production capacity, and 2) improve its competitive positioning. Let me elaborate.

The magnitude of the capacity increase: after three years of construction, the new plant has just been completed; it is expected to add at least 50% to the company's revenue, starting from 1Q23. It may not run at 100% capacity at the beginning, an issue which may take a few quarters to adjust. In any case, the expensive, capex-heavy, balance-sheet leveraging phase of the project is over. The yet to be announced 2022 results should show its maximum financial leverage.

The nature of the capacity increase: the new facilities will be fed by a mix of naphtha and ethane, which through the cycle are going to be far cheaper than methanol. Therefore, the company should significantly improve its cost competitiveness.

So now we have a sense of what the company will look like in a few months, compared to its history. It seems that it is on the verge of a huge increase in earnings. But what about the price? How much of this is priced in?

Its business is so cyclical that to estimate how much the company will earn once the new plant is up and running would be a fool's errand. But some large numbers can give us a hint of the potential.

At the end of 2020, the company expected the new plant to generate 20% return on assets on a yearly basis. At RMB 6.5bn of capex, that equates to RMB1.3bn. To keep things in perspective: the whole company's market cap at the end of 2022 was about RMB 1.5bn. Although no detailed explanation was provided, that expected return is most likely before interest costs, and considering a very different environment than today (in 2020 the company had record results on its methanol plant). In reality I think the new plant will not be able to generate such high returns so soon; in mid cycle years though, those potential profits are feasible.

From 2017 to 2021, net earnings from their current facilities fluctuated between RMB 0.4bn and RMB 1.1bn – 2022 results, yet to be announced, should be far worse –, for an average of RMB 0.75bn. Given the size and the feedstock advantage of the new facilities, it seems reasonable to assume that it can double its earnings, which means that it may earn its whole market cap in a single year. Since historically it pays more than 30% of its profit as dividend, arithmetically the future seems bright.

However, to assume that the next five years will be similar to the last five may be unreasonable. They may be far worse, for the whole industry – remember, we are in the midst of a downcycle. On the other hand, the cycle can improve faster than expected, which would not be the first nor the last time it happens. Most of the time, I shy away from such predictions. Regardless, given that the construction has finished, I am confident that the company can survive this downcycle, and that it shall pass. It always does. Suffice to say that once it becomes clear that the situation is improving, the stock price will probably be much higher (a stock trading at a crystal clear P/E of 1 is very rare).

It is certainly not as safe a proposition as buying Tianjin Development Holdings at less than half the cash in hand (while having high-quality profitable subsidiaries), or as bullet-proof as, through Compagnie de l'Odet, earning indirect royalties on 30% of all music listened to globally (while in the hands of one the ablest asset allocators in Europe). But the price at which it is available now, together with the myopic backward-looking view of the market, seems too good an opportunity to miss.

Every beginning of a calendar year, we are drowned in forecasts by economists, stock market strategists, research analysts, political consultants, sports commentators, astrologers, haruspices (as were called the diviners who inspected livers of sacrificed goats in Ancient Rome) and the like. At the end of 2020, the consensus indicated that the S&P 500 would reach 3,800 points at the end of 2021; it ended that year at 4,766, an error of 25%. Similarly, a year later the projected figure was 4,825, compared to the actual figure of 3,840 at the end of 2022. Those numbers speak for themselves.

The foolishness of forecasting is not confined to the investment world. About 2,500 years ago, Laozi had already reached the conclusion that "Those who have knowledge don't predict. Those who predict don't have knowledge."

Just as it happens every single year, 2023 is destined to bring surprises. No one knows their characteristics, their magnitude, or if they are going to be positive or negative. The Fund will continue to position itself by trying to pay a price low enough to withstand such inherent uncertainty of the future – preferably in resilient, or even better, compounder businesses such as elevators, music royalties and noodles.

Or, in the words of Joel Greenblatt: "The secret to investing is to figure out the value of something – and then pay a lot less."

Best regards,

Diego B. Milano