April 17th, 2021

2021 Second Letter to Shareholders

Dear partners,

If you read the 2021 first letter to shareholders a few months ago, you may remember with some curiosity that I mentioned that there are a couple of companies in which almost 50% of our money is invested. This letter reveals their identity, and explains a little about them.

Since the launch of the fund until the end of March 2021, the net asset value per share increased by 15.8%. Part of this result was due to the positive movement of the market itself; after all, a high tide lifts all boats.

	Annual	**SPY**
2020 (Dec)	3.7%	3.3%
2021 (Jan-Mar)	11.6%	6.0%
Accumulated	15.8%	9.5%

In the table above, “the market” performance is measured by SPY. SPY is an exchange-traded fund that tracks the main index of the largest 500 US companies (the S&P 500 index). You can buy it using your home broker, just like any stock. It is an easy to invest, well diversified, comprehensive alternative with very low fees. However, it is not our benchmark, and definitely not a tracking device. In fact, at the moment we have in our portfolio companies from five different countries, but no companies incorporated in the US. This was not by design; it just happened that, at the moment, better opportunities were found in other places.

The current price to value ratio, as described at our First Letter, stands at less than 0.30x.

While I do expect significant appreciation of the fund’s value through the years, over a few months the results are anyone’s guess. So I urge you to react to such good results with what the ancient Greeks called *ataraxia*, which is generally translated as “unperturbedness”, “imperturbability”, “equanimity” (according to Wikipedia). Please do not consider these results as steady or recurring. Double-digit returns for a quarter are most certainly not the norm - neither for the market nor for the fund. It would be a recipe for disappointment to expect otherwise.

Management fees, performance fees and incentives

So far, the results are being presented net of all fees and expenses, but still gross of performance fees. Those shall be accounted for from April onwards, when the administrator's statement may contain an item called "provision for performance fees" or something similar. This provision will be updated on a quarterly basis (at the NAV statements of the months of April, July, October and January), and become due after a year is completed, if justified by the annual performance. As stated at our presentation letter and the fund's documents, these fees are the result of 25% of the gains above a 6% annualized threshold.

The usual fee schedule of comparable funds in the market is what is known as "2+20": 2% of all assets under management as management fees + 20% of net gains as performance fees. Sometimes the investment manager agrees to charge the performance fees for the gains above a benchmark, which is far more equitable for the shareholders.

However, it is much rarer to find a fund that charges zero management fees. I believe this is a key differential point of the Quercus Fund: if fees were charged on top of the total assets under management, a particular alignment of interests would automatically vanish: the more money shareholders invest in the fund, the more money I would make. And yet at the same time, the less money you would make, because it would be harder to perform.

An honest money manager would agree that a good performance over one million dollars is significantly easier to be achieved than over one billion dollars. But almost all of them reach for the billion-dollar fund, because it makes sense… to the money manager. A typical conversation between recently introduced asset managers starts with "how much money you manage" instead of "how has your fund performed". This is a not-so-hidden secret of the industry: the business is built for asset gathering. Performance is just one way to get there.

Doesn't the lack of management fees make the fund riskier? After all, if the only way the investment manager makes money is if the fund performs well, there might be an incentive to make high-risk, high-reward bets. That would be true, if not for the fact that all my investments are in the fund, at the same circumstances as yours. If the fund loses money, I will be the most harmed. Therefore, when analyzing a potential investment, my primary thinking is on how much there is to lose (not an original thought: https://www.youtube.com/watch?v=gVouCLdfbjc).

After the annual 6% threshold is reached, your net gains are charged at a proportionally higher than average rate (25% instead of the typical 20%). So how does our own "0+25" compare to the typical "2+20"? Let's look at some sensitivity analyses:

	TYPICAL HEDGE FUND		FUND W/ THRESHOLD		QUERCUS FUND	
	(2%+20%)		(2%+20% over 6%)		(0%+25% over 6%)	
return before fees	**fees**	**return after fees**	**fees**	**return after fees**	**fees**	**return after fees**
6%	3.2%	2.8%	2.0%	4.0%	0.0%	6.0%
10%	4.0%	6.0%	2.8%	7.2%	1.0%	9.0%
20%	6.0%	14.0%	4.8%	15.2%	3.5%	16.5%
46%	11.2%	34.8%	10.0%	36.0%	10.0%	36.0%
60%	14.0%	46.0%	12.8%	47.2%	13.5%	46.5%
70%	16.0%	54.0%	14.8%	55.2%	16.0%	54.0%

Compared to the typical hedge fund, which charges management fees off the top and its performance fees are calculated over all gains, a shareholder of the Quercus Fund is disadvantaged after a 70% return before fees. That would be fantastic, but is highly unlikely.

Compared to a less abusive fund, which charges management fees off the top and performance fees only above a threshold, you become disadvantaged after a 46% return before fees. In your pocket that would mean 36% return, before I start charging more than the average.

Enough of boring calculations. Let's talk of something much more amusing: music.

Financière de l'Odet

A complex conglomerate, small cap in France, with low liquidity, low free float, and a controversial controlling shareholder. It has its issues, for sure. And yet that is one of our largest positions.

A year after Napoleon died, Bolloré Groupe was established in 1822, at a time when Brazil was about to become independent. The group had its ups and downs through decades, and was badly struggling in the 1980's. That was when Vincent Bolloré took over the family business, and managed a complete transformation from its nimble origins as a producer of paper for cigarettes and bibles to a behemoth that controls a global logistics company bearing his name, a myriad of ports and railroads in Africa, a solid-cell battery start-up… and on and on. Its main asset, however, is a controlling stake in

Vivendi, a € 30bn media conglomerate which owns companies like Universal Music Group ("UMG"), Canal+ (a major pay-TV company in France and Africa), Havas (publicity) and Editis (publishing). Nowadays, Vincent Bolloré is one of the richest people in France.

Through an arcane, spider-web-like corporate structure (if you feel like getting dizzy, take a look at the detailed organizational chart at page 300 of Bolloré's annual report, at https://www.bollore.com/bollo-content/uploads/2020/05/boll_2002375_urd-2019_gb_mel.pdf), he has effective control of all these assets with far less than 50% economic interest. Our investee Financière de l'Odet ("Odet", soon to be named Compagnie de l'Odet) is one of these holding companies. It directly owns more than 50% of Bolloré's shares. After adjusting for cross-shareholdings, the *minorities* of Odet have an indirect economic interest of ~12.5% on Bolloré Group. A couple of steps down the corporate ladder and we get to the crown jewel: a ~3.0% stake in UMG, the undisputed leader in the music industry (which is controlled by Vivendi).

Ever since the music business was structured closely to as we know it today, it has been dependent on new releases. Most of its revenues came from physical sales: once you bought a record, you could listen to it over and over. We all lived in this environment up to the 2000's. Piracy has been present and evolving for a long time, with the development of blank cassette tapes, CD burners and, of course, MP3 downloads. Total sales in the industry decreased by a lot since the beginning of 2000's up to 2015. Even today, recorded music revenue is at ~60% what it was in 1999.

As we speak, Spotify, Apple Music, Amazon Music and Youtube are changing our relationship with music. Pay a few dollars a month, or listen to some ads in between songs, and you can listen to pretty much anything you want, for as long as you want. Piracy has become much more irrelevant.

A game changer yet to be recognized is the stickiness of the revenue for the labels in this new environment, given the increased importance of catalog vs new releases. Labels are paid as a function of their share of streamings. So every time you listen to, let's say, "Comfortably Numb" on Spotify, the former members of Pink Floyd all get a little richer… while in the old days that only happened once, at the moment a "The Wall" CD or LP was bought. Back then, you truly were only as good as your last success.

That is a huge difference between video and music content. Think on how many times you have repeatedly watched your favorite movie or series, and how many times you have listened to your favorite song or album. I would guess a handful at most for video (unless you are a five year old kid), compared to dozens… maybe countless for music. The need for new video content is relentless, incurring in new production costs, while every time a song is streamed, music labels receive their royalties... with barely any marginal cost at all. In fact, since its nadir in 2015, operating income for UMG has been increasing at more than 20% per year.

"The best business is a royalty on the growth of others, requiring little capital itself." – Warren Buffett

All major streaming programs are meant to be comprehensive, one-stop-shop where you can listen to anything you want. I suppose they are able to do that and yet not offer any Bing Crosby (who still holds the all-time record of best-selling single) or Glenn Miller (who in just four years scored more top ten hits than either Elvis Presley or The Beatles throughout their careers) songs. Good luck trying to do it without The Beatles, Rolling Stones, Elton John and Queen in your library. I suppose someday their

importance to popular music business will fade, too. But what about Rihanna, Taylor Swift, Lady Gaga, Billie Eilish? Some of them will probably remain relevant for decades.

What I mean is that the importance of catalog may not be perennial, but certainly has decades of visibility.

When it comes to the current status of the industry, the music industry is in effect a global oligopoly. The three main labels (Universal Music, Sony Music and Warner Music), represent ~80% of streamings. All artists mentioned here, with the exception of Bing Crosby, Glenn Miller and Elvis are part of UMG's catalog. That is how irreplaceable it is. Of the top 5 artists in Spotify in 2020, UMG had 4. It is not all roses though; the balance of power seems to be shifting away from labels to artists, who depend much less on the former to become famous, compared to the situation before the Internet. Someday the labels' dominance over the music industry will shrink.

UMG is expected to be IPO'ed up until the end of 2021. A Tencent (the largest company in China) -led consortium recently bought 20% of UMG at a € 30bn valuation, which if it does not give it a floor, it is at least an indication of value. That is the equivalent to € 1,500/share of Odet.

Odet current share price is ~ € 1,000/share, which is close to the net value of all its other assets, excluding UMG. That means you essentially get the crown jewel for free.

I understand that Financière de l´Odet stock is a complicated security to pinpoint its value - even its effective number of shares is difficult to be determined. Our other heavyweight position, on the other hand, exposes the absurdity of the efficient markets theory (a theory which states that shares prices reflects all information).

Tianjin Development Holdings

Tianjin Development Holdings (Tianjin Dev) is an investment holding company majority owned by the municipality of Tianjin, a city of 16 million people in the metropolitan area of Beijing. Only four cities in China are directly-administered (i.e., with a political status of a province): Beijing, Shanghai, Tianjin and Chongqing. It is a large, important city.

Its current market capitalisation is HKD 1,700mm, which is something like $ 220mm. By any classification it is a small cap. *I believe it is worth multiples of this price.*

Tianjin Dev has stakes in various independent and unrelated businesses in the city. The main ones are the Otis subsidiary in China, a listed pharmaceutical company called Tianjin Lisheng and the also listed port of Tianjin. Additionally, it owns smaller businesses such as utilities which serve Tianjin's Economic Development Area, a money-losing and up for sale electromechanical subsidiary and a Marriott hotel in Hong Kong.

Let's start with the most important part, and main reason why we are invested: its 16.5% stake in Otis China. It was the first joint venture established by Otis in China, in 1984, and after decades of consolidation, it currently controls all operations of Otis in China. Its plant in Tianjin is also one of the main Otis R&D centers globally.

The elevator and escalator industry is a top quality business: a sale of a new equipment (at a profit) assures you a decade of recurrent maintenance revenues at high margins and low additional

investments, with exceptional visibility of results. Service (i.e. maintenance) procedures are highly regulated, and due to life safety concerns, quality is far more important than price. Top 5 participants represent 70% of the industry globally. However, in China the elevator business is not as high quality as in the US and Europe. Service market is still very fragmented and the conversion ratio (maintenance contracts as a % of new equipment installed) is much lower: ~30% instead of 90%+ in developed markets. According to Otis management, this is a key point they intend to focus on, and improvement should be around the corner. Up until last year, Otis itself was part of a huge conglomerate (United Technologies), which kind of exploited it as a cash cow to finance other ventures. As an independent company, possibilities for growth investment that were neglected by its parent company will be pursuited.

As expected, the market in China is huge: more than 6mm units in operation (out of 16mm globally), of which Otis serves only 210k units. More than 500k units are added each year, accounting for half of the global growth. Opportunities abound.

Otis is a $ 30bn market cap company. China operations represents more than 15% of its profit, and its main growth driver. If it were to represent 15% of its market value, that would mean $ 740mm of value for Tianjin Dev… or three times as much as its whole market value. And all other subsidiaries would come for free.

The port is one of the ten largest containerports in the world (fun fact: of the ten largest in the world, ten are in Asia; seven in China). At probably undervalued market prices, (something like 6x earnings, and 50% discount to its own subsidiary listed in Shanghai), its stake is worth more than 40% of Tianjin Dev total market cap.

I do not have any major insight on its pharmaceutical business, except that its stake is worth more than 80% of Tianjin Dev's whole market cap, by current market prices.

And did I mention that net cash is more than twice the size of its market cap? Not much credit risk here.

The comparison of the value of the sum of its parts to its market value is just stunning. Sure, it is an obscure little state owned company in China, with less than optimal capital allocation, not much appreciation for minority shareholders, intricate accounting numbers… Its stock price can fluctuate at any range and the market can take a very long time ignoring it; but looking at the underlying value, management would have to destroy a criminal amount of shareholder value for us to permanently lose a significant amount of money.

The detailed description above of our two main positions is an anomaly; the only reason they were so described is because, if I were in your position, I would like to know better where half my money is concentrated. I will usually shy away from describing in detail our investments before selling them.

The reason may seem abstract and even quaint, but is significant. It is much harder to change your mind after a public declaration, worse of all, in writing. Humans strive to be trustworthy. Therefore, whenever you disclose your conclusions in the open, you become heavily biased to keep these

conclusions, even in the face of disconfirming evidence. If you have ever got entangled in an endless argument on Twitter or Facebook, you know what I mean. Consistency and commitment tendency is what Charlie Munger called it in his 1994 Psychology of Human Misjudgement speech, ten years before Facebook was founded. If this subject interests you, google it. It is worthwhile.

Situations may change, and I must be able to change my mind and sell these positions, if that turns out to be the rational thing to do. Let's hope the change happens because of an increase in the price, not because the value is lower than I thought.

DIEGO B. MILANO