

February 24th, 2024

2024 First Letter to Shareholders



Dear partners,

We are currently in one of those underperformance periods mentioned in the introduction of our [last letter](#) (which also described a couple of unforced errors on my part that were responsible for more than 6 percentage points of last year's underperformance. Rub your nose in your mistakes, as Charlie Munger would say). While annoying, they are necessary for subsequent outperformance, and not unusual at all. Nothing precludes this one from either lasting longer or, alternatively, ending suddenly. What I can tell you is that the conviction that the names we own are worth multiples their current prices is as high as ever. We should be excited about it, instead of depressed.

	Annual	ACWI	SPY
2020 (Dec)	3.7%	3.4%	3.3%
2021	23.2%	16.6%	27.0%
2022	-17.1%	-19.8%	-19.5%
2023	8.6%	19.9%	24.3%
Accumulated	15.0%	16.5%	31.5%
Annualized	4.6%	5.1%	9.2%

ACWI and SPY are ETFs that track the performance of the MSCI All-Country World and the S&P 500 indexes, respectively.

Wonderful companies at wonderful prices

Shitcos (as in sh*t companies). Cigar butts. Small caps. Value traps. Private-equity behavior in public markets. At various times, our investments were described among these labels - or worse.

While the utmost characteristic of any position in the Fund is an extreme gap between its price and its value - although it sounds like a broken record, I cannot emphasize enough the *extreme* adjective -, it is time to call attention to a different feature.

A lot has been said about the shift in Warren Buffet's mentality from cigar butts to high quality businesses. That shift arguably started with the acquisition of See's Candies in 1972, and by influence of his recently passed partner and friend Charlie Munger. The famous quote "it is far better to buy wonderful companies at a fair price than fair companies at a wonderful price" comes to mind. Needless to say, Li Lu's* approach is the Holy Grail: why not search for both characteristics? Wonderful companies at wonderful prices?

Such opportunities do not come very often, to put it mildly.

We are fortunate to have about two thirds of the Fund invested in these conditions. Fantastic returns on equity, strong pricing power, leading competitive positions, long growth runways. Namely, Otis China (via Tianjin Development Holdings), Indomie (via First Pacific) and Universal Music Group (via Compagnie de l'Odet) - *wonderful companies*.

These are not small, emerging, unproved enterprises; they are rather dominant in their fields, selling multi billion dollars in products and services every year.

They may be concealed within intricate corporate structures, low liquidity issuers, equity-accounted participations, and surrounded by hairy issues. After all, the wonderful prices may be unjustified, but usually do not come unexplained.

Nevertheless, the fantastic businesses are there; that's what we own through these bouncing pieces of paper. And regardless of the performance of the stock prices - and some of them are as flat as the price of a Costco hot-dog, which is notoriously the same since 1984 -, those businesses keep humming along, year after year.

The best part: they come for free. The remaining, not-so-great assets of these companies are worth, in all three cases, significantly more than their market cap. Instead of paying, we are effectively getting paid for owning a stake in Otis China, Indomie and UMG - *wonderful prices*.

* Li Lu is the only external fund manager Charlie Munger ever invested with. His fund, Himalaya Capital, has achieved a compounded annual return of 30% since its inception in 1998.

Annual review? Not exactly

Beginning of a year is a time when the financial industry gets drowned under a pile of fund letters and year-end reviews.

I deliberately tried to not write a letter to shareholders in January in order to zoom out at least a bit. As mentioned in the [2022 First Letter](#), an arbitrary calendar year change does not mean a thing to the portfolio. Likewise, our thought process should be unaffected by it.

In fact, the second letter of any year should be far more interesting. Most of our core positions report on a semi-annual basis, with annual results being disclosed in March. So why hurry an update in January, given that after two months we would be much better informed?

Typically, these annual reviews offer an update of the companies' operations and/or stock prices. The lack of even a mention of how much they are worth compared to their price is what catches my eye. How undervalued are they, on a conservative basis, even by an imprecise and broad analysis? Without a bridge between price and value, we are talking about momentum, either in price or in the companies' operations.

We are not in the game of following momentum. Our game is buying securities at prices extremely below their intrinsic values (I know, broken record). And in our case, those keep getting more and more extreme.

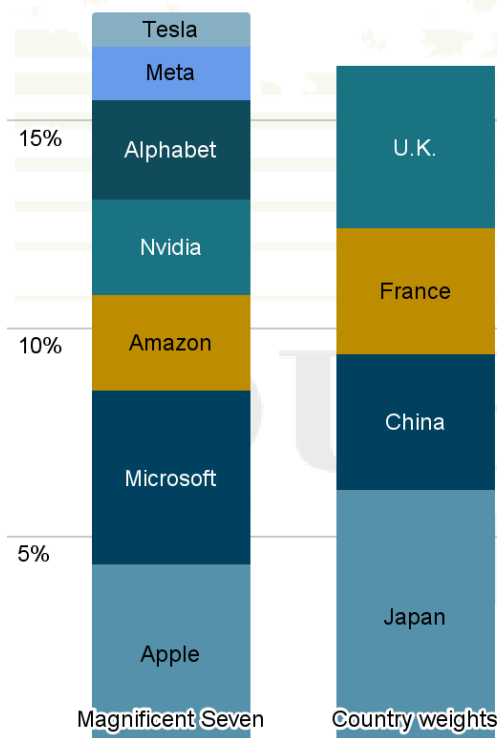
A case in point of the benefits of waiting for a worthy update comes from one of our largest holdings, Compagnie de l'Odet. This letter was essentially complete a couple of weeks ago, but I held its release until the end of February. One of the most significant corporate events of the past twelve months for our portfolio was the sale of its logistics arm to CMA CGM for € 4.65 bn. That's the equivalent of 70% of year-end market cap for Bolloré - add to that another 25% or so of discount for Odet.

In the last couple of years all of Bolloré logistics operations were sold, for a total of € 10.35 bn. That is 55% above what I originally considered as a fair value (although intentionally conservative) in 2021 - see [page 36 of the 2022 Annual Meeting's Presentation](#).

I could have issued this letter with the caveat that this deal was expected to close by the end of February, since a few regulatory clearances were still pending - a global logistics deal of this magnitude must be approved throughout the world. It seemed much better to wait a couple of weeks and confirm that the deal is cleared as of yesterday, and as a result the company is bound to be awash in cash. What will Vincent Bolloré do with all this liquidity? I don't know, but I am comfortable with his investment abilities, and thrilled with the possibilities.

Another mainstay of year-end reviews are performance comparisons between indexes. S&P went up x%, small caps y%, Mag7 z% (as in "Magnificent Seven", a group of

Weighting in the MSCI All Country World Index



7 huge trillion, or close to trillion dollar companies which were responsible for more than 70% of the absolute gains of the Nasdaq in 2023 - the exhibit below indicate how significant they had become), and so on.

I do not intend to repeat them, but a particular one is worth a mention:

The P/E multiple of the main HK index is now lower than the P/B of the Nasdaq index.

I don't think I ever saw such disparity. "E" stands for earnings, a ["flow"](#) figure, which is a result of the operations of each and every single year. "B" stands for book value, or shareholder's equity, and is a ["stock"](#) figure, cumulative and with no time dimension attached to it. It is like comparing income to total wealth, or annual rent to the value of a house (in \$ / square meters).

I am not a particular fan of using P/B ratios (or unexamined, unadjusted P/E ratios for that matter). Additionally, we can fill pages rationalizing that Nasdaq returns on capital are higher, companies' governance are better, runway for growth is longer, China's (and Hong Kong's) commies are evil, and so on. Nevertheless, such concepts should not even be comparable. Apples and oranges. Better still, apples and apple trees.

As you know, a large portion of our portfolio is listed in HK, and the reason for that is the same as for the remaining portion, not listed in HK: an extreme difference between price and value (yes, again). At the moment, my highly flawed estimate is that our portfolio is worth 4.5 times what it is trading at, and their total worth increased by more than 10% last year. Both figures are going to be updated after the release of their 2023 results.

Earnings mirage on a faulty ratio

I have seen too many analyses in the line of: it is better to buy stock A trading at 20x P/E with 2% dividend yield and growing earnings at 10% a year than stock B trading at 5x P/E with 5% dividend yield with no growth in earnings.

The reasoning behind it is that, if the end multiple is the same (and that is a big if: among other assumptions, it presumes that the expected growth rate will be maintained in the future... even though trees don't grow to the sky. Not even AI trees), stock A is expected to give you 12% return a year, while stock B should give you 5% a year. The higher growth more than compensates for the lower current yield.

Multibillion dollar fund managers have argued in that line.

That is, euphemistically, misleading accounting.

We have three pieces of data here: earnings (by way of P/E), dividend yield and earnings growth. Earnings are an accounting term: IFRS, GAAP or a similar entity dictates how to calculate them. Dividend is the cash distributed by the company; as precise as it gets. Earnings growth, on the other hand, is a projection, imprecise by nature, dependent on the future.

By inverting a P/E multiple, you get the earnings yield. So, a 20x P/E stock is equivalent to a 5% earnings yield stock. If 2% is paid out as dividends, that means that the remaining 3% yield is being reinvested - i.e., 60% of its earnings are being retained by the company. *The underlying assumption behind the growth rate is the rate of return of the*

earnings being reinvested. In stock A's case, 10% expected growth = 60% retention rate x 16.7% return. Such return on investment sounds reasonable, and may even be sustainable.

Let's do the same for stock B. A 5x P/E stock is equivalent to a 20% earnings yield stock. If 5% is paid out as dividends, that means 75% of its earnings are being retained. If they result in no growth, that means the rate of return of these reinvested earnings is zero.

But no one invests money with the expectation to get a zero return. They may at the end of the day get zero return, or even (wildly) negative returns. But it is considered irrational to expect no return (this is an academic, purely conjectural exercise. Let's not digress into zero or negative interest rates). So either the earnings are wrong (explanation 1) or earnings growth rate is wrong (explanation 2).

In explanation 1, 75% of its earnings are being reinvested to keep the business at the same level. Dicta from IFRS or GAAP may account for this sterile portion as net income, but an important link to reality is missing, given that it looks, swims and quacks like ~~a duck~~ an expense. An adjustment is needed to get to what Warren Buffett calls "owner earnings" (i.e. net income available for distribution after retaining the amount necessary to keep the business at the same level), which in this case is only 25% of the one assumed by the unadjusted P/E multiple. In effect, stock B trades at a 20x P/E on owner earnings, and distributes 100% of it as dividends.

The preference for stock A in lieu of B gets much clearer now. Both stocks at 20x P/E. Stock A gives us 2% as dividends and 10% growth; stock B, 5% as dividend and 0% growth. Easy pick.

In explanation 2, we should take into consideration *some* earnings growth. If we take a 10% rate of return on the already calculated 75% retained earnings, that should give us 7.5% earnings growth.

It becomes a choice between stock A at 2% dividend yield and 10% growth, and stock B at 5% dividend yield and 7.5% growth. Not so easy to choose, is it?

Now imagine that company B, after a while, reaches the conclusion that its reinvesting opportunities are just not worthy of pursuing, for whatever reason. It could then distribute 100% of its earnings and renounce any growth - to become a 20% dividend yield stock. At that point stock B would be far more compelling than A.

In the real world, a decision would take into consideration a myriad of factors that add uncertainty to the assumptions: the odds that these earnings will actually be achieved,

how long these reinvestment rates of return can be maintained, how they might develop over time, the likelihood of a higher payout of earnings as dividends, and so on.

The point is, retained earnings have value. Imprecise, but real.

Some even more stretched choices consider stock B as a 5x P/E stock which pays no dividends (and no buybacks) and has no growth. I am sorry to say, but a business with no expected growth in the foreseeable future, and no dividends, has zero owner earnings, and is probably worthless.

Remember in past letters and presentations how it is mentioned that the normalized, sustainable, look-through P/E on owner earnings of the Fund's portfolio is lower than 2.5x? That would give us a 40% earnings yield. The average dividend yield of the portfolio is something between 6% and 8%. It means that more than 80% of these non-auditable earnings are being retained, on a portfolio basis.

A chunk of it may be missing by faulty normalization or unsound analysis of its sustainability on my part. I am confident that the portions to be invested at Indomie brand, or by the hands of Vincent Bolloré will add significant value. Other fractions are going to be invested at riskier projects and may be lost. And others will be conservatively stashed as cash by the companies earning pitiful returns, to be invested who knows when at who knows what rates - or finally decided to be distributed as dividends (remember [Sonagi's](#) dividend?) or buybacks.

But they are not an accounting mirage.

(Note: after all caveats, the portfolio's P/E still is below 2.5x)

Best regards,

Diego B. Milano

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