2017 Investor Letter

Kapitalforeningen Blue Strait Capital

Dear fellow investor,

The net asset value per unit increased by 1.07% after costs in the period from inception on 4 October 2017 to 31 December 2017.

Thank you very much for your trust in investing in Kapitalforeningen Blue Strait Capital (KBSC). Basically, all investors in KBSC have invested with me historically in one form or the other. My wife and I are the second-largest individual investors in KBSC and at the same time, we have invested more than 90% of our liquid assets in KBSC or in the same assets as in KBSC.

As you know, I have been portfolio manager of a number of mutual funds, starting as long ago as on 1 January 1987 (see appendix 1). At that time, I took an intuitive approach to investing, based on refusing to pay too much for an asset. Back then, I was not very consistent in my investment approach, but I could see the advantage of investing without too much risk and still be able to generate relatively good returns. Notably that these two issues go hand in hand and are not each other's opposites.

A few years later, I read Warren Buffett's famous 1984 address on Graham and Doddsville in which he describes a specific investment method called value investing and a number of investors in the US, besides himself, who had practised this form of investing. What I had worked on intuitively and inconsistently, these investors had performed consistently with above-average returns for many, many years. And from that moment, I was "hooked for life."

Back then, my investments were characterised by the more quantitative approach to value investing as described in Benjamin Graham's book Security Analysis from 1934 and later editions and in his subsequently published book The Intelligent Investor. It was not until later that I started focusing on better companies as mentioned in Warren Buffett's letters for Berkshire Hathaway.

In 2002, I initiated Investeringsforeningen Nielsen Global Value (INGV) which has held a mix of ordinary and high-quality companies for a long period of time. The quality companies made up the largest individual positions. But as they increased in value, particularly since the financial crisis in 2008, I have had to reduce these positions in accordance with the statutory diversification rules for mutual funds. As a result, these companies were unable to contribute fully to the return for INGV (see appendix 2). In 2007, I formed a private limited company with contributions from a couple of my major investors in which I wanted to make concentrated investments in such high-quality companies. By "concentrated", I mean literally, as the assets were to be divided among a maximum of 10 companies, but preferably fewer. The average annual returns for this private limited company was 14.45% p.a. (before fees) in the period from 2007 to the end of 2017 as compared to the MSCI World Index at 5.92%, see appendix 3.

Other investors who regularly expressed a desire to invest with me with a similar concentration found it cumbersome to have to invest through a private limited company. For this reason, I initiated KBSC in 2017. It has the same infrastructure as ordinary mutual funds, but without being subject to the same diversification rules.

I would like to give an account of the main philosophical considerations underlying my decisions for the deployment of capital in KBSC.

I deploy capital in KBSC based on the value investing philosophy. The objective is to maximise the investor's long-term average annual net asset value per unit while minimising the risk of permanent loss of capital.
This objective has been a unifying principle throughout all the years I have invested in securities, which is also apparent in my previous statements.

In the very long term, the market value of a company follows the development in the company's intrinsic business value. But in the short term, and sometimes even in the slightly longer term, the market value may be lower or higher than the intrinsic business value. As Benjamin Graham mentioned in his metaphor on the equity market, Mr Manic-Depressive will sometimes set a high market value on businesses and Mr Manic-Depressive will sometimes set a low market value on businesses. In other words, the stock market fluctuates over time between optimism and pessimism. I attempt to exploit Mr Manic-Depressive's mood swings by investing assets when the market value of a company is below the intrinsic business value I have calculated.

I believe that the concept of preserving capital is just as important as increasing capital. It is important to avoid the risk of permanent loss of capital as additional returns often occur by being able to obtain returns on capital from higher and higher levels. The core of value investing is to only deploy capital when the difference between market value and intrinsic business value, i.e. the safety margin of the investment, is sufficiently large.

I therefore define risk as the risk of permanent loss of capital and not as price volatility or "tracking error". When a company is priced low according to my calculation of the intrinsic business value, the risk is lower. When a company is priced high according to my calculation of the intrinsic business value, the risk is higher. It is irrelevant to me, how much a company's market value fluctuates in relation to the general stock market. I attempt to find investments where the risk/reward ratio is so skewed that the risk of permanently losing capital is limited. However, for a very limited part of the assets, it is possible to make investments where the risk is expressed in terms other than a pricing difference, as described further below.

This also involves a willingness to hold cash for some periods of time rather than always being fully invested. When I am unable to find investments that meet my criteria and that is within my circle of competence, a cash position is a risk-free investment. A cash position may not generate a return right now, but it is an exceptionally good asset to have in hand when the market presents us with exquisite investment opportunities.

Accordingly, I am willing to wait for a very long time for the right opportunity rather than exposing the capital to precipitate action provoked by cash "burning a hole in my pocket". Discipline is an important concept for the investment process, both in terms of holding cash when I am unable to identify interesting investments with the right characteristics and in terms of investing in the right companies at the right prices whenever possible.

One of my many idols, investment icon Lou Simpson, was investment manager at Berkshire Hathaway that owns GEICO, an automotive insurance provider. In GEICO's 1988 annual report, Lou Simpson stated the following:

"In equity investing, when you don't have any really good ideas (i.e. excellent companies at very attractive prices), doing nothing – or selling – is the best course of action."

My most lucrative long-term investments over the years have been when some companies have exhibited characteristics resulting in high growth in their intrinsic business value combined with a market value that was significantly lower than the intrinsic business value.

I mentally focus on equity investments as being part ownerships of companies. As an investor, I believe that the best way to optimise long-term assets is to have an owner-oriented and value-based investment framework that focuses on companies with a high return on invested capital due to a stable or expanding competitive advantage.

I want to be a form of 'silent partner' in quality companies, preferably with owner-managers with a history of financial success and a track record of high morale and high integrity. For instance, when skilled owner-managers combined with a company with certain characteristics are available at the right price, this will be so much more favourable for long-term investment returns. These characteristics include:

- A high return on invested capital
- The possibility of reinvesting with a high return on invested capital
- High net free cash flow
- A strong and durable business model
- Specific competitive advantages
- A competent and shareholder-oriented management

Financial value is created when a company's return on invested capital exceeds the cost of capital. A company with a high return on invested capital can grow its intrinsic business value when the company has a durable business model that can suppress the competition on an ongoing basis. If the company fails to preserve its competitive advantage, the return on invested capital will be eroded. A company may exhibit earnings growth without the company growing its intrinsic business value in real terms – even though the return on invested capital is relatively high. It will erode the company's financial value if the growth of invested capital is higher than the earnings growth.

Many of the large, successful companies in the world that generate high returns on invested capital have historically also seen very handsome earnings growth. But some companies that still achieve high returns on invested capital do not possess the same potential for earnings growth going forward. This does not mean that these companies are not interesting. At the right price, they may be excellent investments as well as a potential investment for KBSC.

But it will be even better to invest in small and medium-sized companies with a high return on invested capital which are able to re-invest much of their profits at a high or exceptionally high return on their capital. They will still be able to achieve handsome earnings growth by exploiting their business model and thus by developing towards market dominance, or at least towards increasingly larger shares of their market. The internal compound interest effect of such investments is preferable compared to companies that do not have the same possibilities and must consequently pay out a large share of the profit for the year in the form of dividends. Dividends are subject to tax and leave the investor/me with the challenge of having to once again allocate this at a high rate of return.

If I fail to identify quality companies that are valued at the right prices, ordinary companies may also be of interest to me, but only in the presence of a potential and probable event of a narrowing of the difference between the company's market value and the intrinsic business value over a short span of years. The danger here is that this event may be protracted. This means that you run a risk of holding a company for a number of years that generates average or low returns on invested capital. And in the long term, you consequently end up with a return reflecting the company's lower return on capital.

There may be special situations in which I assess that there is a particularly high difference between the intrinsic business value and the market value but where the equity is subject to a risk that is not just financial, such as an event risk or a political risk. Such an investment will still be within the value philosophy as the company is significantly undervalued, also when considering the identified risk. Investments in such companies may not exceed 10% of the assets, measured in terms of cost.

I am a proponent of concentrated investment in a portfolio when the ratio between the expected rate of return and the risk is sufficiently favourable. My decisions are completely independent of how many companies are included in the MSCI World Index, our benchmark, or the distribution among sectors or countries in this benchmark. KBSC will consequently contain 5–10 companies. Many market participants or investors will dislike this concentration of investments, but it is my opinion that by combining value investing with concentrated investing, the results may be extraordinarily positive, provided that this strategy is pursued with a clearly defined investment philosophy and a disciplined investment process. However, one should not fail to acknowledge the inherent concentration risk.

As the investments in KBSC will be few and of a very long-term nature, ordinary reporting will only be made once a year in the form of this investor letter. However, individual occasions may require a statement from me during the course of the year. In the report, I will touch on some of the subjects that have had a bearing on the performance in the year concerned. But there will be years in which it will seem as if I fell asleep at the office and years where I appear to have been very active. Both assumptions are incorrect. They are just indications that the earth's orbit around the sun does not match the measurement duration of investment success.

At the end of 2017, the investments in KBSC were divided across five companies of which the largest position made up 16.4% and the smallest position was 7.0%. All companies are financial sector entities. 60.0% of the assets had been invested and KBSC thus held 40.0% as a cash position.

Again, thank you very much for trusting me with your investments. I will do my best to live up to this confidence. With respect to your investments as well as mine, I will live by the words of Colin Powell:

" There are no secrets to success. It is the result of preparation, hard work and learning from failure."

Believe me, I have had my share of failure. Mostly those you cannot see, as I have rejected many good companies at favorable prices and only later discovered that I should have invested in them. The art is to learn from your mistakes, maintain your passion and continuously attempt to get better at your work.

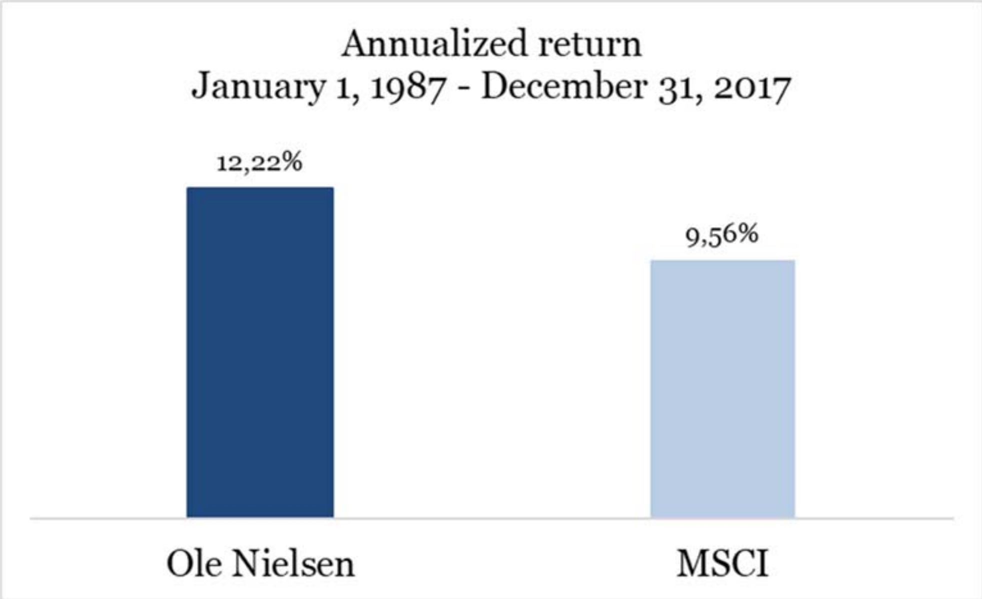
I will e-mail the investor letter to all investors in January. The investor letter will also be uploaded to my website.

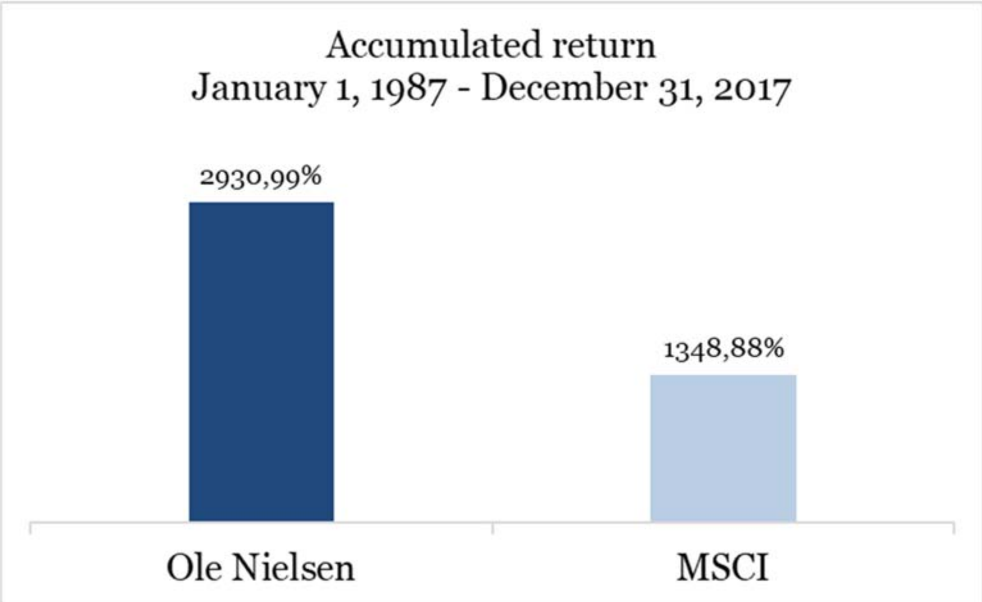
If you have any questions whatsoever, please feel free to contact me, as always.

Best regards

Ole Nielsen
January 2018

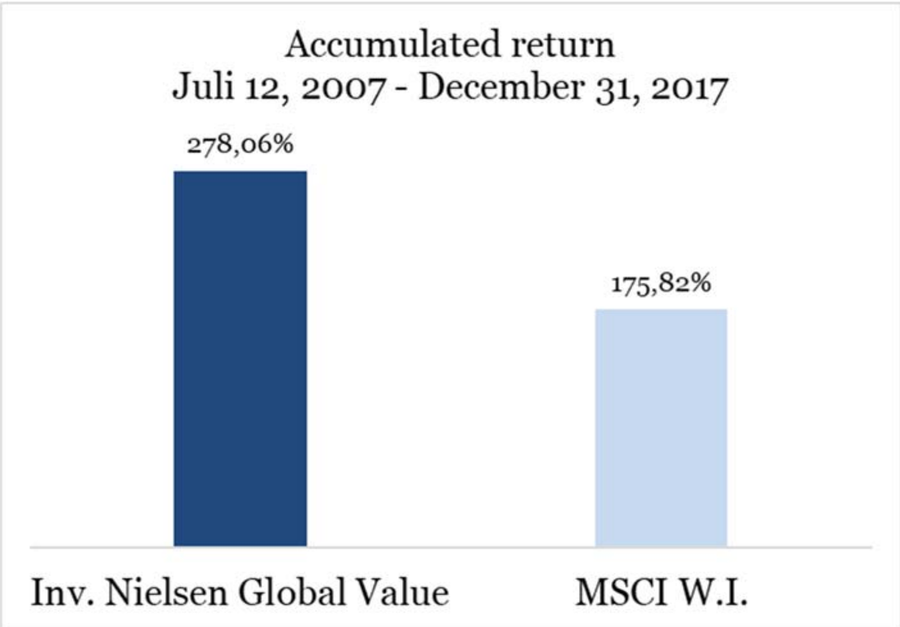
Appendix 1.


Annualized return
January 1, 1987 - December 31, 2017
12,22%
9,56%
Ole Nielsen
MSCI

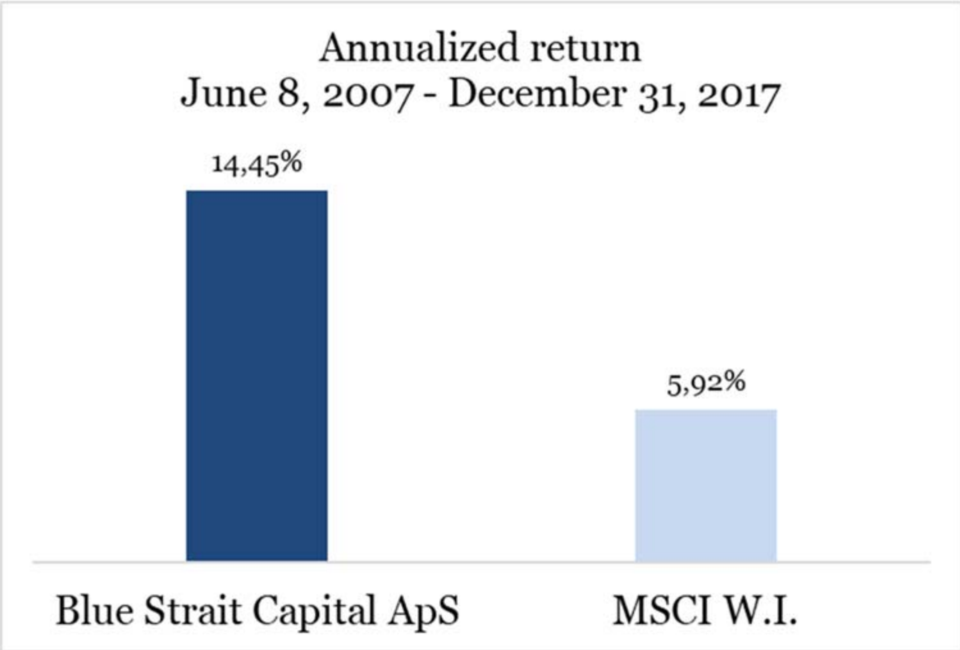

Accumulated return
January 1, 1987 - December 31, 2017
2930,99%
1348,88%
Ole Nielsen
MSCI

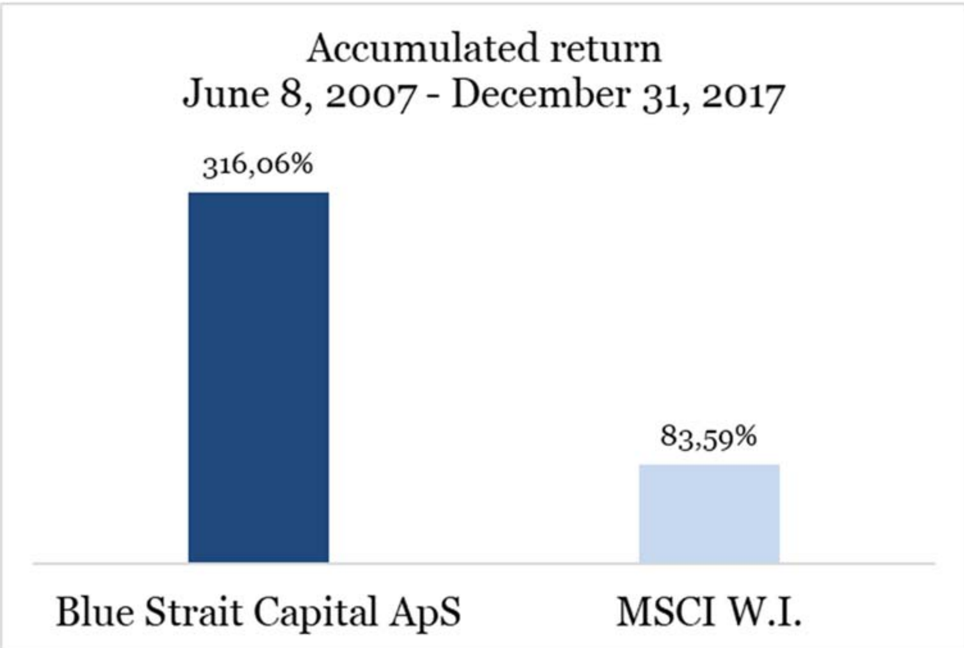
Appendix 2.


Annualized return
July 12, 2002 - December 31, 2017
8,97%
6,77%
Inv. Nielsen Global Value
MSCI W.I.


Accumulated return
Juli 12, 2007 - December 31, 2017
278,06%
175,82%
Inv. Nielsen Global Value
MSCI W.I.

Appendix 3.


Annualized return
June 8, 2007 - December 31, 2017
14,45%
5,92%
Blue Strait Capital ApS
MSCI W.I.


Accumulated return
June 8, 2007 - December 31, 2017
316,06%
83,59%
Blue Strait Capital ApS
MSCI W.I.