Investor letter for Kapitalforeningen Blue Strait Capital

Year 2018

Dear fellow investor,

The net asset value per unit **declined** by 17.83% after costs in the 2018 financial year. The MSCI World Index which represents a wide segment of equities across the world, had a return of -3.89%. The accumulated return since the inception of Blue Strait is at -14.0% against the MSCI World Index at -1.3%. Blue Strait has a very-long term investment horizon. Blue Strait was established as late as in October 2017 and is consequently very young, which means that it makes little sense to measure the compounded average annual rate of return in a historic perspective. But believe me, this important key figure will not be forgotten in the long run.

While the purpose of Blue Strait is long-term capital appreciation, the net asset value development in the first financial year, in absolute as well as relative terms, is quite a tall order that can shake even the most trusting fellow investor. This is particularly so when considering the studies of Kahneman and Tversky, who exposed man's loss aversion, showing that the human brain perceives losing as twice as painful as it perceives the pleasure of gaining! A portfolio with only a few companies is susceptible to high fluctuations in returns in individual years. These fluctuations do not always represent the development in the intrinsic business value. My focus in each individual investment is on whether the market developments reflect the development in the intrinsic business value and whether there is an increased risk of permanent loss of capital. In 2018, the market developments did not reflect the increase in intrinsic business value of the individual companies in the portfolio.

This means that despite the unfavourable development in terms of prices, only a single investor with a minor investment has left Blue Strait since the inception. On the other hand, I have welcomed new investors, and existing investors have increased their investments in Blue Strait. I thank you all for the confidence you show in me. It is reassuring that you keep your calm during this turmoil. Together, my wife and I are the largest investor in Blue Strait. We have collectively invested more than 90% of our liquid assets in either Blue Strait or in the same assets as in Blue Strait. We have increased our investment in Blue Strait, both in 2018 and in early 2019.

At the end of 2018, the investments in Blue Strait were divided across seven companies of which the largest position made up 18.6% and the smallest position was 7.4%. At the end of 2017, there were five companies. I divested one company from the portfolio and invested in three new companies.

I sold our investment in the US insurance company AIG. AIG is an ordinary company in which I have previously invested, and I believed that it would also fit Blue Strait at a discount to book value. The company originally aspired to achieve a return on equity of 10-15% which would be possible when the company had adjusted its cost base and introduced a more disciplined claims assessment regimen. After the third CEO had been appointed and the provisions trend continued to disappoint, I lost faith in their ability to reach their goal. The provisions in an insurance company is an area that may be particularly prone to constant miscalculations and develop catastrophically in the absence of the required discipline. At the same time, I had identified some highly interesting investments that I knew would absorb a great deal of liquidity during the year. The AIG investment provided a loss for Blue Strait throughout the period with a loss of almost 10% in USD and almost 14% in DKK, and it amounted to -0.6% of the return in 2018.

Declining share prices, particularly in Q4, due to an escalated trade war between the USA and China, higher US interest rates, fears of a slowdown in the USA and a real, commencing slowdown in China afforded me the opportunity to further add to the three latest company investments at very low prices; Danske Bank, JD.com and Zooplus. However, the initial investments in these companies were comparatively large. The low prices of Danske Bank and JD.com were based on short-term company-specific issues that I do not believe will affect their long-term values. During the period from our initial investment until the end of 2018, JD.com declined by 53.7% and made up -10.3% of Blue Strait's return for the year. But it was an optimal opportunity for further exposure. At the turn of the year, Blue Strait was consequently almost fully invested with liquidity of just 5.7%, down from 40.0% at the end of 2017.

I expect that our current investments will remain in the portfolio for many years to come and we will see the companies' underlying return on capital expressed in their market values and thus in our compounded annual return. With time, the undervaluation of these companies should also be able to generate additional returns from the market's positive re-assessment of their cash flows.

In life, the journey matters more than the destination, but things are different with investing. Here, the destination matters more than the journey. So while the annual returns will fluctuate quite a bit, I remain highly confident that we will all be enriched with a future, long-term per annum return that is very satisfactory – including the 2018 result. My personal goal is to make a meaningful contribution and build a track record that makes me proud and benefits you. Despite last year's headwinds, my outlook for our companies' future ability to generate value is very optimistic. (This is one of those sections you might be reminded of in 2–3 years' time and may wish that you had deleted!!!)

As mentioned in my investor letter from last year, most of which you will find appended, I prefer companies with a high return on capital. And even more so if they can reinvest the majority of their cash flows at a very high return on capital, also known as compounding.

"If the business earns 6% on capital over 40 years, you're not going to make much different than a 6% return – even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result."

- Charlie Munger

The seven companies comprise three extraordinary companies with a high return on capital; Admiral Group, Fairfax Financial Hld. and Ringkjøbing Landbobank, (45.7% of the portfolio), two compounders with a latently very high return on capital; JD.com and Zooplus, (24.6% of the portfolio) and a more ordinary company; Danske Bank, (13.2% of the portfolio). In addition, there is a company that I describe as a special situation with political risk, Fannie Mae, (7.4% of the portfolio) – all markedly undervalued in the stock market when I made the initial investment and even more today.

JD.com and Zooplus are companies that reinvest the entire profit they would otherwise have generated if they did not support growth rates in excess of 20% per annum. Their business models mean that they are not capital-intensive at all and, due to current accounting policies, their reinvestments are recognised directly in the income statement and not, as in more traditional companies, in the balance sheet. That may seem like boring accounting mumbo-jumbo to some of you but in short, they exploit and expand their competitive advantage by consuming profit today to get a larger profit later. As they scale up their business and are able to grow their turnover more than their capital investments, a future positive operating margin will gradually result in an ever-higher return on invested capital. They are in the category "two birds in the bush are worth one in the hand"! However, as we know, the value of companies depends on discounted future cash flows - positive cash flows, that is - which is why the risk, just like for other companies, also in this case is related to the analysis of the management's abilities, the company itself, its business model and its future sustainability.

The keyword for JD.com, Zooplus, Admiral Group, Fairfax and Ringkjøbing Landbobank is the business performance of the companies. As mentioned, I expect these "Blue Strait subsidiaries" to remain in the portfolio for 5-10 years, possibly longer. This is why it is critical for them to retain or increase their return on invested capital in the years to come. They will only be divested if my analysis is incorrect or if I find companies that are even better at the right price.

Despite a portfolio concentration across just seven companies, their activities and business models vary greatly, as can be seen, for instance, looking at the companies Zooplus and Danske Bank.

Zooplus is Europe's largest online pet food retailer, typically dog and cat food and other pet accessories, with a market share of 50% of the online market and 6-7% of the total market. The total food and accessories market for pets is worth EUR 23 billion and grows relatively independently from the economic cycles, at 2-3% a year. Zooplus has over 18 years of experience in the online market with more than 8,000 articles and has been growing turnover by 28.7% p.a. since 2010. Zooplus spends its positive operating margin from retaining customers on reinvestments in new customers, thus exploiting the increased migration from offline to online retail trade. This means that the market share is being expanded in keeping with a migration that has grown from 1-2% in 2010 to more than 10% today. Originally guard animals, dogs now are now given human names and are a real part of the family. Pet owners are more likely to think of themselves as parents of pets, rather than owners. In a world where pets are becoming increasingly integrated in the family, this is an industry in growth. With more than 6 million active purchasing accounts, Zooplus has the undisputed largest customer base of dedicated pet owners in Europe.

To most people, Danske Bank represents typical value investing. The bank has a low market price in relation to its current equity and earnings, and its intrinsic business value is undervalued due to extraordinary events that has put pressure on the current market value. No-one has been able to overlook the massive media frenzy that exposed a previous management that failed to live up to its responsibilities. A management that has now been replaced. Danske Bank is an ordinary company due to its long-term average return on equity. The bank does not have a unique competitive edge and I consequently expect the average return on equity to be around 10% over time, through booms and recessions. For this reason, I do not characterise the bank as being extraordinary in nature. The keyword for this investment is multiple expansion. We therefore need the stock market to reassess the company's earnings and equity - the sooner, the better. I expect to hold this investment for a much shorter period than the other companies in the portfolio; around 3-4 years. During this time, the wait will be rewarded with a high annual dividend yield.

As illustrated by the above description, I take different approaches to the life of the individual investments in the portfolio. Many studies have shown that the market participants' average holding time of portfolio companies has decreased considerably in the past 50 years. This means that the portfolio turnover has increased considerably. Against this background, external factors will decide the price trends in the short term. The market participants appear to care little about the individual company's long-term economic development. They focus more on whether a given quarter meets the analysts' expectations or not. I think it gives us an advantage on our journey towards actually being long-term oriented that we think as company owners and are thus able to arbitrage in time. And it evidently gives me a clear advantage to have fellow investors with a similar mind-set – more than you would perhaps think.

My 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. I pursue this objective by primarily investing in quality companies, but also in ordinary companies when both types are estimated to be significantly undervalued. I am not concerned about the quarterly or annual price trends but will rather focus on the actions taken today that will maximise the long-term value for Blue Strait. If I succeed in implementing this strategy, remain disciplined and focus on the long haul, it is highly probable that I will achieve our objective.

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 favourable 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.

If you have any questions, you are always welcome to contact me.

Best regards

Ole Nielsen
February 2019

APPENDIX

I deploy capital in Blue Strait 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 stock 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 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 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 Blue Strait.

But it will be even better to invest in small and medium-sized companies with a high return on the invested capital which are able to reinvest much of their profits in the company 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 the 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. Blue Strait 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-based 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 Blue Strait 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.

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

* Due to extraordinary circumstances in late 2018 and early 2019, the investor letter for 2018 is published in February 2019.