Investor letter for Kapitalforeningen Blue Strait Capital

Year 2019

Dear Fellow Investor,

The net asset value per unit increased by 26.78% after fees in the 2019 financial year. The MSCI World Index, which represents a wide segment of companies across the world, show a return of 30.19%, spearheaded by the US equity market. The accumulated return since the inception of Blue Strait is at 5.27% against the MSCI World Index at 28.14%. Blue Strait's investment horizon and targets are very long-term. As Blue Strait is a quite young capital association, established in October 2017, it is too soon 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 term. I welcomed new investors in 2019 and would like to thank all of you for the confidence you show in me – including those of you who increased your investments. Together, my wife and I constitute the largest investor in Blue Strait, having 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 during 2019.

In addition to the ambition of generating a satisfactory long-term actual return, it is also my ambition to generate a long-term return above that of the MSCI World Index. It may seem like an uphill struggle to trail by 22.87 percentage points after a little more than two years, but that is not necessarily the case. 2018 and 2019 clearly reflect how widely a concentrated portfolio can fluctuate in absolute terms, but also in relation to the MSCI World Index. This could also occur, but with positive results, in the future.

However, at this moment, I take comfort in the words of Henry Ford:

"*When everything seems to be going against you, remember that the airplane takes off against the wind, not with it.*"

Charlie Munger, Warren Buffett's partner in the holding company Berkshire Hathaway, once said that the perfect diversification of a portfolio is two companies. We're not quite there, but almost! At the end of 2019, Blue Strait contained seven companies, the two largest of which, JD.com and Fannie Mae, together made up 46.3% and the smallest position, Fairfax Financial Hld., was 4.8%. See below.

Fannie Mae Ord. + Pref.	23.2%
JD.com	23.1%
Ringkjoebing Landbobank	14.2%
Admiral Group	13.6%
Danske Bank	11.0%
Zooplus AG	9.2%
Fairfax Financial Holdings	4.8%
Liquidity	0.8%
Total	100.0%

But concentrating the portfolio like this involves real risks. As a long-term investor of non-geared assets, I do not consider price fluctuations to express the real risk. How we get from A today to B later on does not matter, as long as we get to B. Rather, the risks are related to three issues:

1. whether I correctly analyse a company's long-term competitive advantage and its ability to expand it, return on capital and free cash flows;
2. whether I erroneously pay too much for the individual company; and
3. whether I misjudge the time it takes for ordinary companies to narrow the difference between market value and intrinsic business value.

These three parameters must be measured over a number of years and are not suitable for short-term investors.

As stated, the return amounted to 26.78%, more than recovering the negative return of 17.83% in 2018. The share prices of two companies in the portfolio, Zooplus and Danske Bank, declined by 28.1% and 10.8% respectively in 2019, thus substantially dragging down both the overall return and in terms of the MSCI World Index. These two positions were among the three I took in the 2018 financial year which continued to decline throughout 2019. Two companies, Admiral Group and Fairfax Financial Hld., generated a positive return incl. dividends of 27.3% and 11.3%, respectively, but still lowered the overall return in relation to the MSCI World Index. The remaining companies, JD.com, Ringkjoebing Landbobank and Fannie Mae preferred stock and common stock exhibited significant positive returns of 71.7%, 54.9% and 75.3% and 200.2%, respectively, thus enhancing the overall return in relation to the MSCI World Index. The returns of the individual portfolio companies exhibited a very large spread.

One of the largest positions in the portfolio, JD.com, was established in 2004 and is China's equivalent of Amazon. JD.com benefits from the migration from physical retail trading to online trading in China and its active customer base has grown 30% a year over the past five years. Turnover increased by 38% p.a. over the past five years. Their business model involves low prices, respect for brand copyrights (no copies), short lead times through its own logistics system, excellent customer service, high efficiency and motivated staff. In addition, they have continuously worked to widen their logistics systems to reach customers throughout China. As the scaling increased, margin trends and cash flows accelerated in 2019. For a company with a relatively small capital base, this generates higher returns on invested capital, and is a significant driver of long-term value creation.

JD.com's increase may seem steep, but the company's shares declined by 53.7% in 2018, meaning that the price has yet to return to the entry point of our initial investment in March 2018. Online companies such as JD.com and Zooplus notably belong to a group of businesses with particularly wide annual price fluctuations. All comparisons aside, the Amazon share has increased by more than 100,000% since its IPO in 1997. Despite this success, however, the average price decline from high to low in the individual years was 35%, with the three largest slumps being 83%, 73% and 64%.

It is not the lower price in itself that warrants investment, but rather the future level of return on invested capital and free cash flows compared with the intrinsic business value versus the market value. This ratio was highly favourable for JD.com in March 2018, but the underestimation gradually increased for the rest of 2018. In the period from March 2018 to H1 2019, I increased the position at lower prices in JD.com, and the position made up a share of 23.1% going out of 2019.

One could frown and say that the initial investment was too large, as it would otherwise have opened up for building up an even larger position based on lower prices, thus further reducing the average acquisition price. But when there is a sufficient difference between the market value and the intrinsic business value of a company with formidable financial characteristics, execution must be resolute in terms of both investment and the position size. Attempting to get the timing of a purchase right or believing in better prices can turn out to be financially expensive errors in the long run.

Fannie Mae is the largest mortgage lender in the US and currently has the highest profit per employee. Like other financial companies, this company faced critical challenges at the onset of the financial crisis in 2008. A number of financial companies were placed under conservatorship during the financial crisis to stabilise their finances and relaunch them as well-consolidated undertakings. The AIG insurance company was one of them, and Fannie Mae was also placed under conservatorship. Under the scheme, Fannie Mae was granted an overdraft facility with the US Department of the Treasury against annual instalments of 10% until the loan was repaid.

When Fannie Mae had written off all bad debts in the summer of 2012 and faced years of high profitability, President Obama's then administration changed the law to enable the government to appropriate the company's entire annual profits in the future rather than 10% a year. 11,000 documents on this subject remain classified and under seal. A number of plaintiffs have succeeded in bringing a few documents to light, exposing that the Obama administration was aware that Fannie Mae would be profitable once again and directly stating that the legislative change would enable the government to take shareholders' profit in the future. In God's own country and the cradle of capitalism, this amounted to highway robbery. Government expropriation of private property without compensation!

The shareholders' litigations are currently working their way through the court system and reaching their conclusion. Fannie Mae continues to be trapped in conservatorship, but the current administration under President Trump is working to change the situation. In March 2019, Trump issued a formal memo about ending the conservatorship of Fannie Mae which was officially articulated and planned throughout the year. A number of court orders have found in favour of the plaintiffs, which is positive. And there are formal and clear indications that the Trump administration is working to release Fannie Mae from its conservatorship. Both the price increase and positioning have brought the share of this position up to 23.2%. I want to make it perfectly clear, though, that these matters and the final realisation of the administration's plans will be crucial to the final success of this investment!

I have been an investor in Ringkjoebing Landbobank for many years. My first investment in the bank was back in 1992, then in 2000 and again during the financial crisis in 2008. Ringkjoebing Landbobank was also included in the portfolio when Blue Strait was established. The entire team, headed by CEO John Fisker, have demonstrated extraordinary bank management skills for many years. Discipline, efficiency and business acumen have enriched the bank's shareholders over the past three decades, accelerating after John Fisker's arrival in 1995. In 2018, the bank merged with Nordjyske Bank which had a higher cost ratio and lower return on equity. The two banks' integration is going according to plan and Ringkjoebing Landbobank is climbing back to its historically high return on capital. Unsurpassed management and operational performance, a chronic underestimation of the bank's market value for many years and an ongoing stock buyback programme are the ingredients for an economic cocktail of an extraordinary long-term return.

Danske Bank is a league below in terms of efficiency and return on capital. And the high-profile money-laundering case in the media affected the market price to an extent that the bank is currently worth more dead than alive. And that is despite the fact that the bank's management has now commendably acted proactively. Once the bank has paid its fines, rationalised its cost structure and adapted to the new economic environment, I expect a new normal to settle in. A normal situation also leads to a more normal pricing of the bank's business in the equity market. The share price has steadily declined ever since my initial investment in the autumn of 2018, and I have increased the position several times since then. One might say that we are arbitraging in time by disregarding short-term reward to optimise long-term returns. However, a long-term average return on equity of approximately 10% p.a. will still leave the bank in the realm of the ordinary, and "the sooner, the better" will therefore impact the compounded average annual rate of return of this investment.

Admiral Group is primarily a British motor insurance company, established in 1993. Its business model builds on a high level of service, direct sales and low costs so that its customers' prices generally match the lowest in the industry. The management gives high priority to staff motivation. As they adhere to the notion that people who like what they do, do it better, they aggressively prioritise staff motivation. For several years, they have been ranked among the best companies to work for in the UK. Both management and all employees are shareholders in the company. Admiral's customer base has grown well since the establishment and the company has copied its business model in Spain, Italy, France and six US states, which supports a long-term growth potential. With low capital invested, Admiral has an average return on equity of 50% a year, distributing 95% of net profits as dividends.

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 20 years of experience in the online market with more than 8,000 SKUs and has grown its turnover by 27% p.a. since 2010. Zooplus spends its positive operating margin from retained customers on customer acquisition costs, 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. With more than 6 million active purchasing accounts, Zooplus has the undisputed largest customer base of dedicated pet owners in Europe.

I have been a Fairfax investor since 2000, and Fairfax also found a place in the portfolio in October 2017. I have great respect for CEO Prem Watsa, Canada's counterpart to Warren Buffet, and his colleagues in Fairfax, and as an investor in the company, I see a great long-term potential for growth in book value per share. Like Berkshire Hathaway, Fairfax utilises the insurance company's "float" to invest in equities and interest-bearing debt. Together with the return on float and a positive operating profit from the insurance business, Fairfax has increased its equity per share by more than 18% p.a. since 1985. Nevertheless, I have reduced the position somewhat to free up liquidity for increasing holdings in some of the other portfolio companies where I see a larger potential.

My objective is to maximise the investor's long-term average annual net asset value per unit and to outperform the MSCI World Index 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 these companies are estimated to be significantly undervalued. I am not concerned about the quarterly or annual price fluctuations but will rather focus on the actions taken today that will maximise the long-term value. 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."

The art is to learn from your mistakes, maintain your passion and continuously attempt to get better at what you do.

Best regards

Ole Nielsen
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