SIA

Strategic Investment Advisors Group

Long Term Investment Fund

Newsletter

of March 2019

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«…tout le malheur des hommes vient d'une seule chose, qui est de ne savoir plus demeurer en repos dans une chambre…».
("All of humanity's problems stem from man's inability to sit quietly in a room alone.")

Blaise Pascal, Discours sur les passions de l'amour

Overview of our funds

Table 1 and figures 1 through 4 show the evolution of our funds' Net Asset Value over the last few quarters.

Table 1: **Net Asset Value - Net assets under management of our funds**

March 31, 2019	NAV	Δ 3m	Δ 12m	Annualized return (s.i.)	AUM *(in mio)*
LTIF Classic [EUR]	416.24	19.5%	9.1%	8.7%	129
LTIF SRI (EUR)	95.80	15.7%			12
LTIF Natural Resources [EUR]	113.71	21.5%	11.6%	0.9%	19
LTIF Stability A Cap [EUR]	181.76	16.0%	6.5%	4.5%	8

Source: SIA Group

Figure 1: **LTIF Classic EUR**
vs. MSCI Daily TR Net World Index EUR

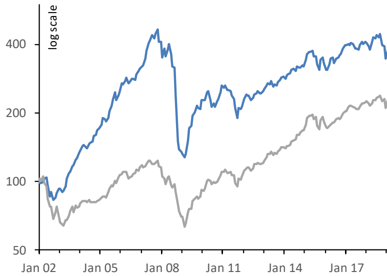


Figure 2: **LTIF Stability A Cap EUR**
vs. HFRX Global Hedge Fund Index EUR

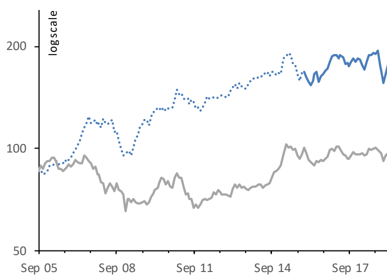
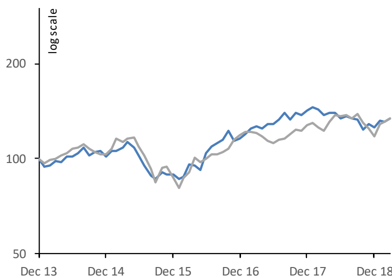


Figure 3: **LTIF Natural Resources EUR**
vs. S&P Global Nat. Res. Net TR Index EUR



Long-term investors in our Classic fund, who check their holdings once a year, should see an increase of 8.8% over the last 12 months, which is close to our long-term average goal of 10%. In this sense, the last 12 months could be considered "standard" or "unexciting". But this is not how it felt for an investor who followed the fund's NAV every day during those 12 months:

Figure 4: **line chart of all our funds in the last 12 months**

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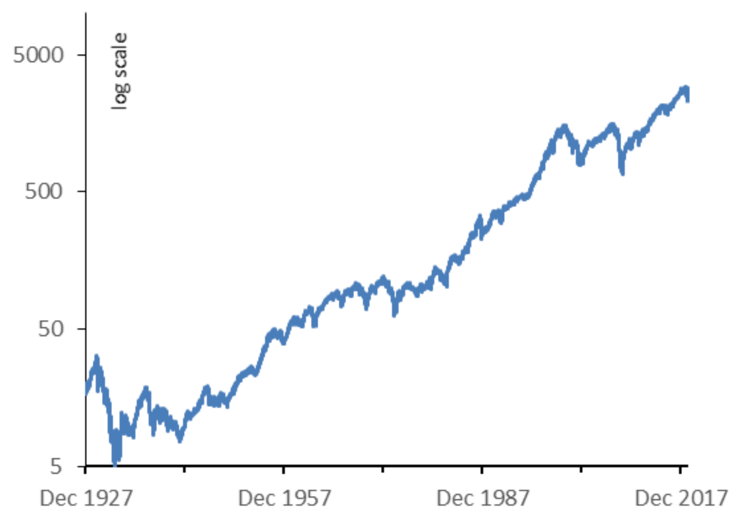
Something similar can be said of an investment in our Natural Resources fund - it went up by 10.61% over the last 12 months, but with rather more volatility.

Why is it so difficult to make money on the stock market when "everybody knows" that it goes up over the long term?

Figure 5: **S&P 500 since 1927**



Over the last decade of low interest rates, we have seen investors looking desperately for yield in ever-increasing esoteric investments. These investments range from the now normalized private equity funds, where investors freeze their money for 10 years without knowing what it will be invested in, to high-yield (read: low-quality) corporate debt or even direct loans, to "real assets" schemes where the investor becomes the proud owner of a 7%-paying bond backed by an Argentinian solar energy start-up. Many of these investments have indeed given an interesting yield, although we submit that, from a business point of view, they had a higher risk than a wide portfolio of good quality stocks. The latter, as we see in the previous chart, tend to return an annualized 8-9% per year (12% over the very long term, 6% if we take the last 20 years, which were the worst in 100 years). Right now, we estimate that the "expected return" – i.e., that which a long-term investor will earn with some of the highest quality, lowest-risk shares available – will be around 8%. This refers, we repeat, to purchasing a basket of shares that will only lose money if a cataclysmic geo-political development occurs (which won't deal kindly with the other investments either). Why is this?

We suggest that the reason is two-fold: First, the illusion that movements in quoted shares equal profits and losses for the investor. Second, the illusion that the price of an asset's lack of movement (because there is no liquid market for it) equals low risk. Let's take a look at these delusions in turn.

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Investors and the huge industry around them of analysts, brokers, advisors, fund managers, etc. tend to make statements such as, “last year went well, but we lost a lot of money in the last quarter”, or “I’ve made a lot of money with my Apple shares”. These seem like fairly straightforward statements, but apart from being wrong, they also betray an approach to equity investing that makes it almost impossible to earn money over time.

In his latest letter to shareholders, Warren Buffett explains that Berkshire Hathaway earned USD 4 bn in the last quarter according to the new accounting rules, which is a very low number for such a huge enterprise. He subsequently provides a few details: The companies that Berkshire runs directly made USD 24.8 billion in profits (i.e., real profits; that is, more money in the bank). But the shares Berkshire owns in other companies (Apple, Wells Fargo Bank, American Express, etc.) went down by USD 20 billion. The new accounting rule mashes them together to produce Berkshire’s profits. Clearly, these “profits” – that is, the operating profits made by the operating companies that Berkshire owns and the mark-to-market changes in the valuation of the unsold shares in the market – are very different. The first ones are stable, and “real” in that they generate cash that can be distributed or re-invested. The second ones are arbitrary numbers that change all the time with no relation to the underlying business. Buffett writes:

> “…neither Berkshire’s Vice Chairman, Charlie Munger, nor I believe that rule to be sensible. Rather, both of us have consistently thought that at Berkshire this mark-to-market change would produce what I described as ‘wild and capricious swings in our bottom line.’
> The accuracy of that prediction can be suggested by our quarterly results during 2018. In the first and fourth quarters, we reported GAAP losses of $1.1 billion and $25.4 billion respectively. In the second and third quarters, we reported profits of $12 billion and $18.5 billion. In complete contrast to these gyrations, the many businesses that Berkshire owns delivered consistent and satisfactory operating earnings in all quarters. For the year, those earnings exceeded their 2016 high of $17.6 billion by 41%.
> Wide swings in our quarterly GAAP earnings will inevitably continue. That’s because our huge equity portfolio – valued at nearly $173 billion at the end of 2018 – will often experience one-day price fluctuations of $2 billion or more, all of which the new rule says must be dropped immediately to our bottom line. Indeed, in the fourth quarter, a period of high volatility in stock prices, we experienced several days with a “profit” or “loss” of more than $4 billion.
> Our advice? Focus on operating earnings, paying little attention to gains or losses of any variety. My saying that in no way diminishes the importance of our investments to Berkshire. Over time, Charlie and I expect them to deliver substantial gains, albeit with highly irregular timing.”

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In previous newsletters, we discussed the difference between noise and signal. For a long-term investor, the noise is the market movements and the signal is the real profits that companies make. We will never stop reminding our investors of this difference – a company that loses money draws on its banks reserves, has to take up some debt or issue capital, all of which make its owners worse off. Conversely, a company that earns a profit has more money in the bank, which it can use to pay dividends, with which its investors can pay their living expenses, or re-invest them in the business, thus ensuring even greater profits in the future.

But none of this (bad or good) happens when share prices go down or up. As long as the investor is there for the long run, the movements are pure noise. There is, however, one big exception: When shares prices go "on sale", investors have a chance to make even more than the long-term 8% annualized average, while decreasing their risk. The chances of an investment being profitable, all other things being equal, increase inversely to the price paid.

As long as investors think that they "lost" 15% of their savings last year by being invested with us, they will find it insufferable, and rightly so. People should not invest their wealth in anything that can lose more than 15% in just three months and about which nothing can be done. But this is most definitely not what happened during the last quarter. Shares went down, profits went up. Our investors did make money last year, about €27.5 per share in the Classic fund, which is a 8% over the average price last year, and 27.5% over the initial investment in the fund 17 years ago. Not a bad return, going up every year.

The second reason why profiting from the stock exchange is difficult is closely tied to the above – volatility is perceived as a risk. An investment in something whose price moves a lot is perceived as riskier than an investment in something apparently stable. But this is very simplistic. Share prices not only move a lot in the short term, but also fairly randomly, which makes investing in shares in the short term a very risky exercise. However, long-term share prices are not random, as we saw in figure 5. They go up with the overall level of the economy in general and with companies' profits in particular.

On the other hand, some investments may exhibit stable prices simply because there is no market for them, which doesn't, of course, make them less risky. For a long-term investor, risk is a business consideration (will the company make the money we expect?), not a financial one.

Understanding these two points is essential for making money with stocks, because attractive long-term results always include very negative periods. If investors believe they are losing money instead of realizing that they are experiencing noise, they will probably sell at the most inopportune moment, therefore foregoing the great returns that come to those who understand the real nature of investing and waiting. The following are two vivid examples of the latter.

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It is well known that Warren Buffett is a great investor who has amassed one of the world's largest fortunes by simply investing a very small initial amount of money well. The fortunate few who invested in his company early on have all become millionaires. An investment made in Berkshire shares in 1987 has multiplied more than 100 times, yielding an annualized return of more than 16% – twice as much as most indices. But that 16% is an average, of course. Not all years were like that. For example, from 30 June 1998 to 29 February 2000, Berkshire lost 44% of its market value, while the overall stock market gained 32%. We believe that not many fund managers would have survived that. Reality pushes them to "go with the crowd" and then they miss the very strong rebound. Making money on the stock markets demands that investors accept a lot of noise. They can only do this if they realize that behind the noise there are signals and if they know how to read and trust these. During that period of huge "underperformance", Berkshire kept publishing its real profits, which were actually growing far stronger than those of the "dot-com" companies whose shares' appreciation was fueling the rise in the indices – until the bubble burst. Then, in Buffett's words, the low tide showed who was swimming naked, i.e., who was making real profits (signal) regardless of the share price movements (noise).

But an even "higher authority" than Buffett serves as the second example. In his paper, "Even God Would Get Fired as an Active Investor", Wesley Gray describes a very interesting experiment: Determining the results that an investor, who knew beforehand which stocks would be the best performing ones over the coming 5-year period, would gain. Starting in 1927, the author constructed a rolling portfolio, using currently available information and only "investing" in the best stocks over the next five years. The results would be excellent: 29% per year for almost 100 years. This would be so good that the investor would end up owning everything. But now comes the amazing thing: At some point, that impossibly good portfolio would be down by 75%! Remember, the portfolio invests in only the best stocks, but at some point even the best stocks go sharply down – as in 2008. Again, how many investors would have stuck with that portfolio? The study goes a bit further: What if, on top of knowing which would be the best-performing stocks beforehand, the fund manager also knew which would be the worst-performing ones? That would create a wonderful long-short portfolio.

Again, as expected, the results would be excellent. Over time, that "fund" would return an average of 46% per annum, which is absurdly high. But here is the interesting point: That long-short portfolio, which is typically sold as "market neutral" and is presumed to be very stable because the short position compensates for the market vagaries, would have had periods of negative performance to the tune of -47%. Again, not something many investors would accept in a "hedged fund" (or almost any fund for that matter). The author's conclusion is clear – not even God could meet many investors' requirements. It's therefore not surprising that most people don't make much money on the stock market in spite of it being the market with the highest liquidity and expected return.

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Comments on our portfolios

As mentioned in our December newsletter, we took advantage of the market drop at the end of the year to go fishing – in the stock market.

After the strong market correction during the last quarter of 2018, and given the interesting valuations of many sectors and stocks, we decided to go to the Goldman Sachs Industrial Conference in London in early December.

We took our fishing rod along, as all the industrial companies' shares had collapsed, because, in average terms, these have a beta much higher than the market, i.e., they had dropped even more than the overall indices. At the conference, we saw about 30 companies, most of which had a good price, although many experience cyclical risks and some structural risks.

It was amazing to see the global industrial sector fall from 260-point levels built over 3 years (see the relevant MSCI Industrial Index chart in Figure 6) to 210 levels in a few weeks due to fear of an impending recession.

Passive/algorithm/quantitative strategies that are very pro-cyclical – i.e., they exacerbate movements by selling what drops and buying what rises– caused an accelerating effect, although the speed and depth of the correction surprised us this time. At SIA, we remain convinced that we are experiencing a "mid-cycle slowdown". In our opinion, this correction was a good opportunity to buy cheap even for the short term.

Figure 6: **World Industrial Index**

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More importantly, if we are wrong and the world economy is on the verge of a recession, nothing would truly change for a long-term investor. Given that our Classic portfolio has a very low real/industrial risk (not to be confused with volatility), a recession is always temporary. After the usual sharp correction, "normal" valuations recover quite quickly − in many cases within a 1-2-year period.

Again we repeat our mantra: We must stick with our long-term investments in times of recession, as these will pass and a well-built portfolio will return to its previous price levels relatively fast. We regard ourselves as businessmen, and businessmen do not sell in downturns, they run their business for the long term.

And we brought two good companies at a great price: Prysmian and Metso.

These two companies are not new to us. Prysmian is a world leader in electrical and telecommunications installations in the industrial cable sector, while Metso is a leading company for mining, energy, and construction materials in the equipment and services sector.

Both companies are on our watch list and we have been following them closely for about a decade. A few years ago, we were invested in Nexans, Prysmian's competitor in the cable sector, and we have known Metso for a long time due to our proximity to the mining sector, where we expect an upward investment cycle in the short and medium term.

Metso, the Finnish leader in equipment and services to the mining and materials sector

We will start with Metso, an investment case with considerable visibility and thus “easier”, because the Finnish mining equipment & services group has a massive backlog (new orders growing at 30% in Q418) and the outlook is for double-digit growth in the coming years. The times ahead look very good for Metso.

In our opinion, the mining investment cycle started in 2018 and, given the need for investment in most commodities to meet the projected demand, will remain strong in the medium term. In this context, we expect Metso to organically show close to double-digit growth in the next few years and to benefit from the business’s operating leverage as it expands.

The relevant graph (see Figure 7) shows how the mining sector's spending in 2018 was half of the total invested in 2012, and 30% below the average of the previous up-cycle. By definition, this trend has to be reversed, since − with or without an economic crisis − the demand for commodities is growing at a very stable rate (c. 2-3%) annually and most mineral grades are in decline. We therefore expect very good years of investment in both brownfields and greenfields, with a very positive impact on Metso.

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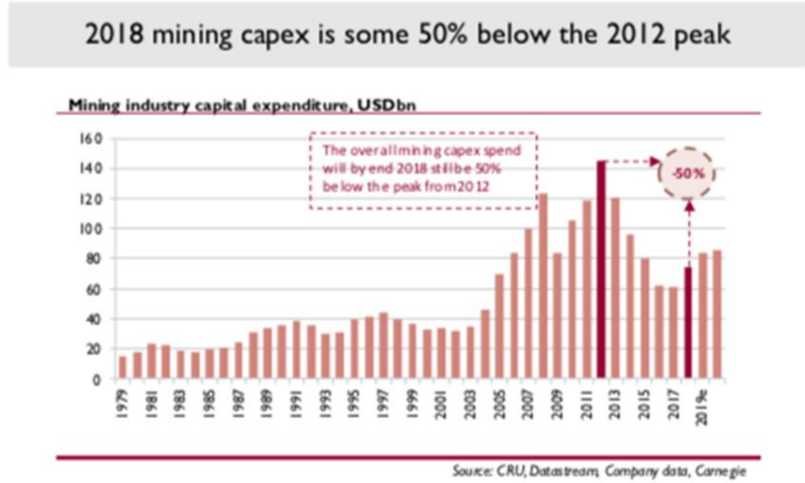
Figure 7: **mining capex**



We bought Metso at an average price of 24 euros per share, which increased to 31/32 euros in a couple of months (see Figure 8). We expected this rise, but not so fast and we are not far from the company's intrinsic value. There is no hurry, because it is a good business in a cycle that is expected to be long. There are years of growth ahead and potential in the operating margins. Currently the stock trades at a PER19 of around 16x and we foresee upgrades.

Figure 8: **Metso share price, 2016-2019**

Prysmian, leader in the industrial cable sector

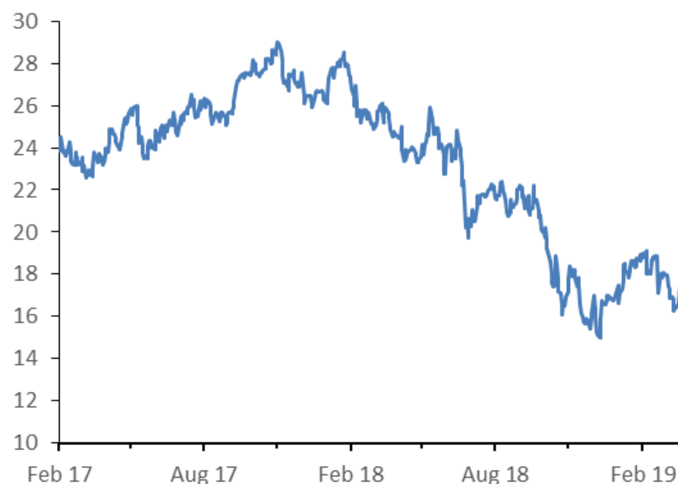
Prysmian is a more complicated investment case, because the company had a series of problems during the last two years, leading the stock to fall from EUR 30 to EUR 20 levels before the correction at the end of 2018. After the correction, it dropped to EUR 15 per share, where we decided to buy.

The 2017 and 2018 problems were more cyclical than structural in our view. We summarize these as 3 main issues: 1) the project execution hiccups due to the novel technology used during the installation of an electricity cable in Scotland (WesternLink Project); 2) the delay in the new submarine cable installation projects in Europe; 3) the purchase of General Cable, which was partly financed with a capital increase.

After this uneasiness and the corresponding strong correction, Prysmian's business remains very much unchanged, if not reinforced with General Cable (one competitor less, economy of scales). The WesternLink issue is behind them, and the submarine projects are expected to be tendered as early as this year.

Unlike Metso, Prysmian's share has not bounced much. It remains at very depressed levels of 16/17 euros per share, which is the level at which we bought it in December (see Figure 9). We took the following into account: the Metso's decision was obvious, given that everything was going well for them, but Prysmian has more upside, although this will possibly take more time. Our intrinsic valuation of Prysmian is above 30 euros, but the market remains very concerned about the negative 2017/18 issues and the inevitable recession risk.

Figure 9: **Prysmian share price, 2017-2019**



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The salmon industry

In early March, we went to Bergen in Norway to the year's largest meeting of the salmon industry. It gave us a chance to meet all the producers, some suppliers, and analysts. We came away convinced that this is an excellent investment, with the global demand growing faster than the supply, which is constrained by the natural limit in good farming sites. We have slightly increased our position in the industry again by taking advantage of the shares' ups and downs. Although the industry is very stable, the shares fluctuate a lot.

Some words on our Long Term Investment Fund Natural Resources

The salmon industry is also represented in our Natural Resources fund. Most of this fund's shares are sharply up, correcting for the unwarranted drop of 2018's last quarter. The production of many metals, especially copper, is very constrained by geological and environmental reasons, and the market is in deficit, which has already started to push prices up. We have increased slightly our position in copper producers. Conversely, we have started to reduce our position in palm oil producers. It's a sector with a strong headwind from public opinion and future profitability is less clear than we thought. Like last year, we are planning a Natural Resources seminar in Zurich in September, where those investors who can attend will be updated on our views on the sector.

Other than this change, we have not made many changes to our portfolios. We have seen sharp rises in many of our shares in this first quarter, but these are mostly simply a recovery of the previous quarter's unjustified drop. We expect good results from most of our companies, and don't foresee many changes. As mentioned above, the possibility (which we think is remote) of a recession will not dictate what we do. We never make long-term investment decisions based on short-term fears. Despite its fluctuations, we do expect our current portfolio to return a better percentage than the average 10% over the next few years.

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