Investor Letter

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POLLEIT & RIECHERT
Investment Management

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Dear Investors,

2017 was another good year for all of us. The value of your investment in the P&R REAL VALUE has increased by +18.4% after fees. Please take some time to read this letter. As we celebrate our 5-year anniversary, I have devoted a good chunk of the letter to the key lessons learned based on my reflections on the past.

Annual changes in euro in percent[1]

Year	P&R REAL VALUE	World Index	Gold Index
2013	6.8%	21.8%	-30.5%
2014	13.9%	20.2%	12.8%
2015	13.2%	10.7%	-2.1%
2016	18.5%	10.4%	12.2%
2017	18.4%	7.5%	-1.4%
Annualised return since inception	14.0%	13.8%	-3.3%
Total return	93.2%	91.1%	-15.4%

Compared to the World Index (+7.5%), we achieved an outperformance of 10.9 percentage points last year. We also performed better than the DAX index (+12.5%) and gold (-1.4%), measured in euros.

Let me remind you that we spend almost no time on thinking about stock market indices. Our goal is maximising the long-term performance of our fund. The best measurement for this is the compound annual growth rate (CAGR). Since inception, five years ago, that yardstick has been +14.0% after fees. We have done (slightly) better than the World Index (+13.8%), markedly better than the DAX index (+11.0%), and trounced gold (-3.3%). In any case,

[1] The performance is calculated based on the BVI method and considers annual distributions. Fund inception was on 12/27/2012. The LYXOR ETF MSCI WORLD D-EUR is used as basis for the World Index, including all dividends. The Gold Index is based on the ZKB Gold ETF in EUR.

I am happy to say that we have been able to significantly increase your investment after inflation.

The fund holds 11 positions as of the end of the year. The top 5 positions are unchanged and represent 67.3% of the fund:

- Credit Acceptance
- Cimpress
- World Acceptance
- Metro Bank
- Constellation Software

We hold 1.3% in cash, and are therefore almost fully invested. 66.5% of the portfolio is invested in shares listed in US dollar, 22.9% in pound sterling, and 9.3% in Canadian dollar. In dollar terms, our performance would have been considerably better as the euro won 13.8% against the dollar. The size of the fund is 30 million euros.

Don't let the foreign currency fluctuations intimidate you. Constellation Software, for example, is attributed to Canadian Dollars simply because we purchased the shares in Toronto. However, the company's revenues originate in the US, Europe, the UK, Canada, and Switzerland. Our other firms have similar diverse revenue sources, and, therefore, our currency risk is much lower than the numbers suggest.

In the last six months, we left the portfolio by and large untouched. We were not lazy but we simply didn't find anything that was worth swapping against one of our existing investments. We do not like to disrupt the magic of compounding unless we find an investment with a much more favourable price-versus-value relationship. With that, let's move on to the more important long-term considerations.

The Past

I remember paging through old, dusty books on hyperinflation to study the signs of a *crack-up boom* when we launched our fund five years ago. At the time, we thought it was possible that the public would lose confidence in the stability of our fiat currencies. The scale of what was to happen just looked too gigantic. Central banks have since printed roughly one third of the money supply in dollars, euros, pound sterling and yen and artificially suppressed interest rates across the whole term structure.

Our portfolio reflected our concerns. In the early days, we were only gradually building our positions as we were hoping for lower entry prices. We kept a sizeable portion of the fund in cash and gold. However, the reality turned out differently: Confidence in government-supported markets grew; stock markets rose (and the price of gold fell). Furthermore, I picked a few stocks that would no longer meet my investment criteria today. The result was a below-average performance in the first eighteen months. Thanks to our investors' patience and long-term orientation, that allowed us to learn from our mistakes.

We did that by working like a sculptor. We removed everything that fell outside of our investment framework and instead focused on great businesses that traded at a significant discount to our estimate of intrinsic value. Our investments in Cimpress and Credit Acceptance serve as very good examples. The stock prices of the two companies have followed the business performance (albeit sometimes erratically), resulting in a handsome gain since our first purchases about five years ago. They are up 4.2x and 3.4x respectively. This is good news for all our investors but even more so for investors who invested with us after the first eighteen months. Since mid-2014 our CAGR has been 20.1%.

In recent years, our investment approach has evolved. Most importantly, we have learned that business analysis and stock selection must be at the core of what we do. To convince you that you are still in good hands with us, I could now try to impress you by outlining our next great investment idea (we do have a few names short-listed), or by analysing the stock market and predicting next year's index level (ignore any market forecast, especially those of experts). But rather than telling you *what* I do, I believe it is much more valuable for you to understand *why* I do what I do. Knowing the "*why"* allows you to assess whether we are aligned with your values and long-term goals.

Finding my purpose

It was a day in spring, about ten years ago, when my boss handed me the much-coveted bonus envelope in his office. I worked for a large, international investment bank and was responsible for selling investment certificates. My team and I had a successful year, and the bonus figure in the letter was very pleasing. Yet, I did not feel happy. I had realised that our business partners and their end customers were dissatisfied because several of our investment products did not perform well. From our point of view, the responsibility of the investment decision was with the buyer, so, like a merchant, we offered what was in demand. After all we were dealmakers and were rewarded for generating transactions. Investors, however, relied on us to help them navigate through financial markets. They saw us as financial experts who know how to make money. Back then, I may not have had a well-conceived investment philosophy, but I knew that investing in hot trends wasn't a formula for success and that I would invest my own money differently. I was part of a system where my interests and my colleagues' interest were not aligned with the best interests of our business partners and end customers. That made me feel dissatisfied and unfulfilled.

At the time, I became aware of what Randy Komisar calls the most dangerous risk of all – to spend your life not doing what you want in the hope that you can buy the freedom to do the right thing later. That is why I eventually decided to end my career at the bank. I wanted to embark upon a journey to learn from the world's best investors and then, eventually start my own investment fund. Five years and thousands of hours of reading, learning, studying, and practicing later, I launched the P&R REAL VALUE fund together with Thorsten Polleit. I now eat my own cooking, and I get excited when investors with the right long-term owner mentality join us.

Now you know what motivates me: It is the idea of meeting you twenty years down the road and hearing you say that I made a positive difference in your financial life by increasing your or your customers' wealth. I will make mistakes, learn, change, and evolve, but my mission will not change – which is to *find out how the world really works so that I can create value and share it with others.* Therefore, at Polleit & Riechert, maximising the value of your investment over the long run will always be paramount. The following principles explain *how* we work to achieve that.

Our principles

Always stick to the principle of price versus value

There is only one relevant principle in investing: Price versus value. The value is the present value of all future cash flows of an asset. Every asset is attractive at one price, and unattractive at another. Intelligent investing requires assessing the value and, therefore, it is our job to estimate all future cash flows of a company. This principle serves as an anchor for navigating through volatile markets and allows us to take advantage of the mood swings of Mr. Market.

Within the spectrum of value investing, we prefer investing in great businesses because here, we see the best chance for us finding significant undervaluation. Managers of outstanding companies can reinvest profits over many years at attractive rates, which, in the long run, leads to an exponential growth in profits. Many investors underestimate the long-term potential of truly great firms. Additionally, sell-side analysts only focus on the next few quarters. In contrast, we pay little attention to quarterly forecasts. We hold our magnifying glass over the more distant future and look especially for qualitative evidence of a great management, a shared purpose (their "why"), a strong culture and a growing moat. However, you will argue, isn't it extremely difficult to look far into the future? It absolutely is, and that is why we only dare to do it for a select few companies, usually only after very intensive research (skimming over a sell-side report and holding the finger in the air is not enough) and sometimes only after several years of building trust with the company's management team.

Think independently

Every transaction is preceded by the question: Why am I right while the opposite side – the market – isn't? We can only achieve consistently high success rates by developing our own independent assessment based on sound evidence and facts, and not on other people's opinion.

Keep it simple

We believe in keeping things simple. In investing, there are no extra points awarded for complexity. We therefore, prefer simple business models or situations that lead to straightforward decision-making. I have recently googled for mental models around that topic and found an interesting heuristic from the 14^{th} century called Ockham's razor. A slightly modified version would simply say: "*Of several possible paths with a similar probability of the same outcome, choose the simplest*."

Take our foreign currency risk. We could reduce it but would need to spend a lot of time on determining the appropriate size of hedges. We would have to quantify the change of future cash flows caused by changes in foreign currencies for each individual company (considering revenues sources, cost effects, internal hedging strategies etc.). Or, we could just simply accept currency fluctuations in the reasonable hope, that over the long run the movements in major currencies will even out. Applying Ockham's razor principle cuts away extra time spent, trading costs, risk of errors and allows us to focus on the things that really matter.

Always ask: "Will it make our boat faster?"

Ben Hunt-Davis, a gold medal winner in the men's eight rowing crew in the 2000 Olympic Games, put it in a nutshell. In the two years of preparation leading up to the final race, before each activity, he asked the same question: "*Will it make our boat faster?*" It is amazing how many activities can suddenly be filtered out and replaced with meaningful goal-oriented work by asking the right question.

As an example, people often ask us why we offer our funds as an Alternative Investment Fund (AIF) and not in the widely accepted UCITS format. Since our AIF structure is more restrictive for investors, we could attract significantly more assets by converting to UCITSs. But here is the trade-off: To comply with UCITS rules, we would have to reduce our concentration. Whenever excellent ideas are replaced by less favourable ideas, the long-term value will not be maximized for our investors. Our boat would in fact be slowing down. It is hard to resist the sirens of asset growth, and that is why many money managers compromise and morph into business managers over time (maximizing their business returns, not yours).

On the other hand, I hope that all those investors who are suitable and would like to invest can find access to our fund. Some banks and fund platforms are unfortunately reluctant to offer access to non-UCITs Funds. That's why each investor who musters the necessary persistence to go through the checks and paperwork deserves a reward. (Ms. Feistel will be happy to put your name down for our next Christmas book gift – of course in compliance with Mifid II's inducement policy).

Create many "win-wins"

I recently met the former boss of a publicly traded company. He spoke openly about his everyday life back as a public company CEO. It was revealing for me to hear how he experienced constant pressure from different groups of investors, analysts and the media. Short-term traders criticized him for the depressed share price, long-term investors saw a need for better capital allocation, while analysts kept asking for a dividend. Everyone had a different agenda and kept distracting him from running the business. It does not strike me as an isolated case, and for the most part, executives and members of supervisory boards opt for striking a balance between what is good for the stock price and what is considered good corporate governance. Trying to conform to the accepted norm, however, is a recipe for mediocrity.

We are, in contrast, looking for outliers, for companies that are extraordinary and fanatic about long-term success, measured by growth in intrinsic value per share over many years. If we find a promising company with a leadership team whose priorities are aligned with ours, we can provide shelter from the storm with our capital. We can support the managers and convey that it is okay to be guided by long-term goals even if it induces short-term pain; that it is okay to ignore other, non-economic and unreasonable demands and focus on the business instead. By doing so, we can create long-term value, which we ultimately share with you and with the other shareholders of that company.

This is one reason why I network and share ideas with other like-minded investors. Together we are able to own a bigger piece of a company to support managers with a more meaningful and stable capital base. As our fund size (and my experience) continues to grow, I am excited by the prospect of having more firepower to provide patient capital and support great managers.

Looking ahead

But what about the raging stock market, inflation and a possible *crack-up boom*? It is indeed likely that the massive government interventions in our global financial markets will lead to unintended side effects. When central banks start unwinding their balance sheets (if they ever will) it will create all kinds of deflationary risks. Furthermore, the current 9-year bull market has pushed earnings multiples to a level that can only be justified if interest rates stay low for very long. For all those reasons, it is easy to foresee a crisis at some point. In fact, we saw the glass half empty during most of the last five years. And while we have been wrong so far, I'm sure, if we keep on predicting disaster, we will eventually be right.

Investing by predicting market movements is the wrong way. A much wiser strategy uses a different insight. Over time, I have learned to appreciate the many ways we humans progress in spite of suboptimal circumstances. During my visits to our portfolio companies, I see smart people intelligently adapting to change and developing new products and services, to continue to widen the moat of the business. Their actions and efforts will not show up as increased profits in the next quarter or two but a few years down the line. I am convinced that profits at our portfolio companies will continue to rise in the long run, even against the backdrop of higher inflation or a recession. That makes me feel very comfortable and has convinced me that long-term investing in great businesses is the best alternative to grow your wealth over time. (For an upbeat take on the world, I recommend the book "The Rational Optimist" by Matt Ridley).

I once asked Tim Martin, the founder of the British pub chain Wetherspoon, why his company has grown successfully for almost 40 years, while about 80% of all restaurants and bars fail within five years. His answer (I paraphrase): "*We try to avoid great plans. We dig around in the details and focus on process. Not on outcome*." To me, that seems to be good advice from someone who can handle crises.

You can help us by adopting the same owner-oriented mentality and by staying invested during the next inevitable market correction. If we remain focused on our process – as Tim Martin did – we will find great businesses trading at wonderful discounts for you. Long-term this could result in even higher returns for your investment.

In closing, I stay rationally optimistic, mentally prepared for the worst and really look forward to the next five years. Thorsten Polleit and I remain at your disposal and will be happy to answer any questions.

Sincerely,

Matthias Riechert

PS: Speaking of win-win – in recent years, our assistant Susanne Feistel and three young stars of value investing have been supporting us. Thank you very much!

From left to right: Susanne Feistel (Assistant), Jimish Gandhi (Research Analyst in the US), Amita Agarwal, and Dhiren Joshi (Student Research Projects, London Business School).

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