Quarterly report Q4 2023

Charlie Munger

28 November 2023 was a sad day for anyone who calls themselves a Value investor. Charlie Munger died at the age of 99 in his home town of Omaha. Munger rose to fame as the business partner of another local, the six-year younger Warren Buffett with whom he made Berkshire Hathaway the success that it is today. The two met back in 1959. Munger was 35 at the time and Buffett still in his late twenties. They hit it off straight away and decided to join forces.

Munger was a vocal investor who didn't shy away from giving his opinion of the world and investments. He told us what he thought of cryptocurrencies on several occasions. And it wasn't exactly complimentary. He once also stated that there are three ways of going broke: "Liquor, ladies and leverage". Munger was the man who taught Buffett to accept that genuinely sound companies are almost never dirt cheap. And that sometimes, obviously within limits, it's worth paying slightly more for companies with a clear competitive moat. Buffett remains exceedingly grateful to him for his advice to pay the asking price for See's Candies, one of Berkshire Hathaway's most successful investments ever. Ms Florence See was rather fond of round figures and wanted to receive precisely USD25 million for the family business in 1972. That meant USD25 million and not a cent less. Buffett thought that was too high and the deal was in danger of falling through. Munger persisted and Berkshire ultimately bought the company for USD25 million. Since the acquisition, the company has contributed more than USD2 billion in retained earnings to Berkshire. Buffett has repeatedly praised the tenacity of his partner Charlie Munger. Although this certainly doesn't constitute evidence that Value investors are big spenders when it comes to the prices they're willing to pay for specific investments, it was an important moment in Berkshire's business operations. As the years went by, Berkshire grew in size and it became increasingly difficult to identify investments that matched Buffett's game of buying "cigar butts with one puff left". As an apprentice to the equally-legendary Value investor Benjamin Graham, Buffett learned that it can be extremely profitable to invest in companies that can be bought for such a low price that the investor in fact gets a free puff of profit. Although this is a strategy that continues to be extremely profitable, it also has its drawbacks. Firstly, there's generally not much left after that one puff and this restricts the upward potential. Secondly, such situations are often concentrated in companies with small market values. As Berkshire grew larger, it found it harder to identify such situations as the tradability of this type of equity is often too low.

Berkshire was increasingly forced to look at bigger companies, often with higher valuations.

This is a disadvantage. Buffett has often said he would love to exchange places with investors who manage only a fraction of his assets so he could examine a much broader spectrum of companies.

Yet it makes sense for small investors as well to bear in mind that some companies simply deserve a specific valuation and will never be dirt cheap. This isn't entirely at odds with a Value strategy: even Value investors are prepared to pay for quality. What they refuse to do is pay for a glorious future that may or may not materialise. And this is where Value investors differ from growth investors, for whom the most important factor is high growth.

Review of 2023 and outlook for 2024

As we wrote in the last quarterly report, 2023 wasn't a great year for the Value investment style. The common thread here was persistently rising inflation and central banks raising interest rates to curb it and the economy slowly heading for a recession. Mid and small-cap companies were hit especially hard as the market views them as sensitive to interest rates and economic cycles. Higher interest rates are supposed to have a proportionally bigger impact on these companies' earnings than on those of large-cap companies, as well as making the debts of smaller businesses much more expensive. This was also clearly visible in the annual performance of the various main global indices. Whereas the UK's FTSE 100 noted an annual performance of 2.5% for example, the small-cap segment was down by 8% versus 1 January 2023. We saw the same thing closer to home: the Dutch AEX posted a gain of 14.5%, while the mid-cap index's performance was almost flat.

Many Hong Kong equities likewise experienced difficulties, as can be seen from the 15% or so that the leading Hang Seng index lost in 2023. Elsewhere, the enormous returns in the US naturally stood out. The S&P 500 was up by 25% and technology index Nasdaq even gained as much as 55% after falling by 34% in 2022. We're now seeing even more outrageous equity valuations in the US than before and the price gains on the markets are being carried by a handful of names such as Amazon, Meta, Alphabet and Tesla.

These well-known companies are currently trading at valuations of 30 to 60 times their earnings and we don't believe this is tenable. Overall the US S&P 500 stands at a multiple of 21x and the FTSE 100 at below 10x. Hong Kong equities are trading at a multiple of 6x. This means it will take an average of 21 years, 10 years and 6 years respectively to recoup what you pay for these companies.

The tail end of the year did bring some relief for a variety of equity prices after the rate of inflation was more or less halted, at least according to the market's interpretation, which generates expectations of lower market interest rates in the coming year. We immediately saw several reports and recommendations declaring small and mid-cap equities to be the asset class for 2024.

Dutch national newspaper het Financieel Dagblad recently also published an analysis showing that European mid and small-cap equities are again trading at a discount versus big companies for the first time since 2004.

We've seen severe downward pressure on prices in the UK for some time. Prestigious publications The Economist and Financial Times nevertheless claim that the clearance sale of British equities is now over. In 1997, UK pension funds held in excess of 45% of all equity interests in the UK. Interest in British businesses has plummeted in recent years to a paltry 4%, almost to the point where it cannot drop any lower. The AIM index has fallen by 30 percent in the last three years and bottomed out last October. The realisation is gradually dawning that things have gone too far.

Too cheap means a high premium on delisting

It's no wonder, and it's not the first time we've said this, that many equities have recently turned out to be exceedingly cheap and this is reflected in the acquisition premiums that are being paid. The most recent and tangible examples from the portfolio are **Hotel Chocolat** (on which more later in this report), **Impellam** and **Wentworth**, for which the acquisition premiums exceed even our wildest dreams. A further three names from the portfolio will therefore be withdrawn from the stock exchange, while the merger and acquisition market has shrunk considerably around the globe. In Europe, the value of all acquisitions declined by nearly 20% in 2023 and the number of deals likewise fell sharply.

The biggest news of the final month of 2023 was that after months of negotiations the Impellam Group is to be taken over by Dutch company Headfirst. This acquisition premium isn't to be sniffed at either at no less than 154% (!) of the price when initial acquisition talks leaked to the media and 66.7% of the price on 12 December, just before the takeover was announced on 13 December. We're very pleased with this news and via the issue of convertible and short-term bonds will continue to have a stake in this new combination.

Of course not everything worked out well in 2023. The Hong Kong fund was affected by the poor sentiment surrounding China and the Special Bond Fund likewise had a tough time for a variety of reasons. The **Genel Energy** and **Gulf Keystone** stocks in the individual portfolio bore the brunt of it. We've already written about this in previous reports. Oil exports to Turkey have been at a standstill since March 2023 and there's political stalemate between Baghdad, Erbil and Turkey. Although everything looks to be heading in the right direction, no solution has been found yet and companies are having to make do with domestic sales that only just cover their costs. This also takes us right to the heart of one of the big themes for 2024. When exports (which account for 0.5% of global demand) are resumed, these companies are again poised to generate enormous cashflows, just as they did up to March 2023. Until that time, however, we have cashflow-neutral operations and (luckily) balance sheets bulging with cash.

We'd also like to mention **Begbies Traynor**. This listed family business has been a successful part of our portfolio for many years. Its stocks lost 20% of their value in 2023, yet the company's performance is perfectly sound and it's making periodic acquisitions to boost scale.

We're as enthusiastic as ever about Begbies thanks to the high degree of anti-cyclical business. Moreover, it looks as if a third activity of tax consultancy may be added. We view this as an excellent addition to the company's insolvency and accountancy activities.

We've recently added a few names to the portfolio too and will examine new stocks **Cab Payments, Marlowe PLC** and **SigmaRoc** in more detail in coming quarterly reports. They certainly got off to a good start in December with gains of between 15% and 40%.

OVMK Special Bond Fund

With bond yields continuing to climb and a few situations specific to individual companies, it was a tough year for the bond portfolio in 2023. There are a couple of themes that could change this in 2024 and beyond and we review these in brief below.

First of all there's the inverse yield curve. For professionals this is an everyday term but it's worth explaining what we mean by this. The simplest way is to illustrate it using an example.

In a normal world, if you lend money for an easily manageable period of two years, you can demand a lower rate of interest than if you lend the money for longer. An awful lot can happen but if you want to lend money for 20 years then you receive a higher rate of interest than if you lend it for a short time. After all, you're exposed to default risk for longer.

Yet something peculiar has been happening on the financial markets for some time now. Short-term interest rates are higher (!) than their long-term counterparts and we call this phenomenon an inverse yield curve. The reason behind this is clear. As central banks have set themselves the goal of curbing inflation, they've raised short-term interest rates several times. However, inflation is expected to fall again to around 2%, the long-term target rate of many central banks.

The inverse yield curve is historically also often a sign of economic tension (recession), but this is generally only temporary. The impact on the Special Bond fund was considerable but in turn also of a temporary nature.

First of all we hold a large number of bonds with a short remaining duration in the fund. This means that a sizeable portion of the portfolio will be redeemed within 3-5 years and the parties that lent the money will receive 100% of the principal.

Due to the high short-term interest rates, many bonds of this type are trading at below 100% of their nominal value, but this is purely the effect of high market rates and has nothing to do with the final amount you receive. Moreover, we often receive double-digit coupons (interest income) and, all things considered, investors in this type of bond cannot fail to be anything other than enthusiastic. It's simply a matter of time before this money is paid to investors. As an example, the HKN 11% bond will be redeemed in March 2024 and this is the first in a long list of bonds that will mature but currently contain only 'hidden' value.

Other consequences of the inverse yield curve are low bond prices and the absence of coupon payments on steepeners. Steepeners are financial instruments issued by financial institutions. We acquired these steepeners several years ago to take advantage of the upturn in interest rates when the negative rates we were experiencing at the time inevitably returned to being positive. Steepeners generate interest based on the difference (spread) between 30-year bond yields and 2-year yields, so long minus short. If this spread is large enough, investors receive substantial payments. When yields were negative and there was too little difference between short and long-term yields, we bought these bonds issued by prestigious financial institutions such as Morgan Stanley, Jefferies, Bank of America and Goldman Sachs at low prices.

Some of what we predicted came true. Yields reverted to normal levels and the steepeners started generating payments again. However, in 2022-2023 the steepeners were once more all trading far below their nominal values. We've already explained the reason for this and again it's temporary in nature. Short-term interest rates have been higher than long-term rates for some time now but will undoubtedly start to normalise in future. Reason enough to be enthusiastic about this part of the portfolio in coming months.

And lastly, we'd like to mention **Dignity Plc**. We told you about this UK firm of funeral directors in 2021. The idea was straightforward. Having outstanding bonds poses an obstacle to the company splitting off the valuable crematoria. This was the reason why Phoenix Asset Management withdrew the company from the stock exchange and shortly afterwards hinted at hiving off these crematoria and in doing so creating value. The plan failed, at least for now. Interest rates climbed and the whole plan needed rewriting. It became significantly more expensive to finance the costly plan and the price at which the bonds would be redeemed declined as well. Losers all round, unfortunately. An offer was recently made to redeem the bonds at 84.25% of their original value. This translates into a substantial upturn versus the value of the bond, which had fallen to about 60%. Good news you might say, but we don't agree that these bonds can simply be redeemed at below their nominal value. We were therefore one of the few parties to vote against this plan, for which a comfortable majority existed among other investors.

Despite the plan having been approved, the company hasn't yet succeeded in arranging financing for it. This keeps the door open to further price gains and the bond isn't trading at anywhere near the value that Phoenix and Dignity are now offering (74% versus 84.25%). To be continued, without doubt. The scenarios are clear. Either the bond will be redeemed at 84.25% in 2024 or the plan will misfire, which may result in the bond temporarily trading at a lower value but at the same time regaining its full potential. We're in fact hoping for the latter, but in the short term the first option (redemption in 2024) is driving up the price.

Hotel Chocolat

Some sectors seem to have a structural tendency to perform poorly on the market. The construction sector, for instance, where there always appears to be some temporary new circumstance that stops businesses earning a return on invested capital that generates a reasonable return for investors. Aviation is another sector that almost always faces economic conditions that stand in the way of decent margins. If it's not COVID then it's a recession, pilot strike or sudden increase in fuel prices. This explains why Buffett once said that if investors had known then what they know now, they'd have shot down the Wright brothers. In contrast, there are sectors that generate remarkably good returns. We once read an article on the exceptional returns earned by investors in the chocolate sector over the years and never forgot this extraordinary fact. Analysis of the returns yielded by listed chocolate manufacturers points to substantial excess returns. This is understandable. Chocolate is the eternal friend, in economically good times and bad. Furthermore, brand loyalty is common among consumers when it comes to products of this type and the outlay is relatively small, which restricts price elasticity. As an investor it's definitely worth keeping an eye on this sector. As a Value investor, it's a question of waiting for a time when one of the listed chocolate manufacturers can suddenly be acquired at a price that represents an undervaluation. And such a time did indeed arrive. We've monitored Hotel Chocolat, a luxury niche player with a UK listing, for some time now. For many years the company was a crowd pleaser on the market with a valuation that can only be described as generous, to say the least. The company was founded in 2003 by Angus Thirwell and Peter Harris and floated on the stock exchange in 2016. Its shares, which in 2021 had climbed to over GBP5, suddenly plummeted in 2022. After highly successful growth in the UK, Hotel Chocolat wanted to expand internationally and set its sights on the US and Japan. In practice this turned out to be more difficult and more expensive than expected, causing Hotel Chocolat to change its growth strategy in mid-2022. The focus was placed entirely on further growth in the UK, where there were still plenty of opportunities to be found. Investors were disappointed at this news. The equity collapsed completely and dropped from GBP5 to slightly over GBP1. And we thought this an excellent reason to take a closer look.

We decided to acquire an interest in the company at the end of 2022. We expanded the position in the first half of 2023 to a (in retrospect far too low) weight of 0.5%. The reason for our enthusiasm: although two major growth markets had been removed from the strategy, the company still had the extremely interesting UK home market with its array of growth opportunities. Punishing the equity price by more than 80% was a severe overreaction in our view. As we've already noted, in some cases the UK market seems totally incapable of allocating a rational price to companies in the mid and small-cap segment. And this makes it highly fertile ground for acquisitions. An offer on Hotel Chocolat duly materialised: US multinational Mars had been eyeing the company keenly for some time. The enormous downturn in Hotel Chocolat's equity price provided the ideal opportunity to buy and the company sprang into action.

Mars is offering shareholders a price of GBP3.75 and this is a premium of no less than 170% on the price on the day of the announcement when its stocks could still be bought for GBP1.37. This makes it the highest premium paid for a listed company in the UK in the past 25 years. Another indication of the excessive pessimism in the UK mid and small-cap market, where it's possible to find extreme bargains.

This means we're again 'losing' a model name. Yet we certainly won't shed any tears over this one either. At the right price everything in the portfolio is for sale. Incidentally, we think Mars has got itself an excellent deal here too. Hotel Chocolat's focus on luxury and ethical business practices make it the ideal poster boy for the group and under the wing of Mars the company can be rolled out worldwide after all. A win-win situation for everyone involved.

All that remains is for us to wish you all a happy and healthy 2024.

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