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Interim Letter to BrightGate Focus co-investors
1st half of 2020

"I can calculate the motion of heavenly bodies, but not the madness of people"
Sir Isaac Newton

Dear co-investors,

First of all, we trust that both you and your families are well. BrightGate Capital sends a warm hug to all of you during these difficult times, and we hope that you and your family and friends have not been affected.

It is unusual to write the first letter to our investors in the midst of totally unprecedented events in the financial markets. Pandemics have been ancient travelling companions of the human race since at least the late Roman Empire, although their determining role in many of the greatest historical events has only recently begun to be appreciated. However, the combination of a global pandemic with the highest financial market valuations in the entire history of Western capitalism, makes this moment unheard of, and it will without doubt go down in the history books as yet another classic example of manic speculation.

This context of high valuations is not being framed in a robust economic environment, far from it, but in the worst economic crisis of the Western economies in the last century. On the one hand, the political response (especially that of the Central Banks, although many governments have also been quick to implement fiscal policies) has been much better than the response during the most comparable historical moment to the present one, the Great Depression of 1929, in which the stabilisation of the financial sector did not come until 1933 with the introduction of deposit insurance, following the bankruptcy of thousands of banks every year in the United States alone. On the other hand, although the political response has been good, the fall in global activity has had no historical precedent, and unlike what several analysts project, I believe that its effects will be far-reaching and lasting over time.

Although we will go into more detail later, the fund performed better than the indices during the first months of the year, as a result of the high liquidity with which we started, and performed worse afterwards for the same reason. The commission errors I made during the period, which are the ones I always consider first, were mainly due to the fact that I was slow to trim our energy positions at the end of February, when we already had evidence of the impact of Covid-19 on the mobility sector in China. While we at BrightGate were ahead of the market in anticipating the economic impact that the pandemic would eventually have, adjusting our positions accordingly, I should have been more aggressive in reducing our positions in two of our oil producers, Cenovus and Athabasca, as well as our position in Consol, and should also not have bought the bonds from a distressed oil producer in the United States that I ended up selling at a loss. On the other hand, I believe that the errors of omission, or lost buying opportunities during the downturn, have been substantially less, as we have taken advantage of this to strengthen some positions (we increased Athabasca, Check Point, the GSEs, and took up a position in Alliance Resource), although we should have had more conviction in some stocks with good businesses that we either sold prematurely after high returns in the space of a few days (Phillips 66, MHP) or bought a too-small position (Micron).

While it is impossible to say what the market will do tomorrow or in the next few months, trying to estimate what it will do over the next decade is somewhat more feasible (yet not easy). Stock market valuations are one of the few areas of human affairs where long-term predictions are easier than short-term ones. This is due to the simple mathematical fact that, in the long term, the major determinants of stock returns are the current dividend yield and the growth in earnings per share. In both cases it is not difficult to hazard a figure within reasonable ranges – the dividend yield, moreover, is a known variable at the time of the analysis. Although in the short term the change in valuation multiples can have a disproportionate influence on the returns obtained, in the long term their influence is much less, even in rising (or falling) markets where multiples structurally shift in a significant way.

From this point of view, most analysts using long-term models agree that the next 7-12 years will be very poor in terms of returns on equities. Credit Suisse, GMO, and JPM, to cite just a few examples, estimate that the annualised returns of the S&P500 in real terms will be in the range of -2% and 0.5%. John Hussman, extending the above analysis to more asset classes, concludes that essentially "investors are faced with the worst set of passive investment options in history." Our internally developed models suggest a similar conclusion.[1] That the above analysts reach such similar conclusions should be not interpreted as a result of group thinking or anything like that, but rather to the fact that *in the long run returns depend on a handful of very specific variables, which in turn take on relatively bounded values over the long term.*

But if the *a priori* analysis is not convincing, we can always resort to some of the episodes of history, which enlighten us with similar conclusions.

Lord Keynes and Mr. Munger: a tale of two investors in bear markets

I thought that to illustrate the dangers of investing in overvalued markets and the importance of market timing (in a broad sense, not understood as short-term trading), there is nothing better than going through history's archive and informing ourselves of the experience of two of the best investors of the 20th century, John Maynard Keynes and Charlie Munger. Given that both had to weather the worst stock markets of the century and were fundamental investors with highly concentrated portfolios, I believe the comparison can be very informative for the present time.

Keynes, besides being the most influential economist of the 20th century, was an extraordinary investor, a fact that is less well-known. He was one of the first contributors to the then uncreated school of behavioural finance, with concepts such as the beauty contest and reputational risk, as well as value investing (although the honour eventually went to Benjamin Graham for his more systematic exposure), having established the concepts of intrinsic value and the margin of safety, as well as the important distinction between speculation and investment. Keynes was also among the first to establish a fact that is now evident to us, which is the suitability of stocks as a long-term investment vehicle, and their

[1] See the letter sent to our investors in the BrightGate Global Income Fund at the end of 2019, where we also introduced a theoretical framework to understand the evolution of the earnings of the US economy in recent years.

importance in institutional investor portfolios, which at that time was almost exclusively comprised of government bonds and real estate.[2]

Unlike other investors with well-defined styles from the beginning, Keynes changed notably his investment style during his lifetime. Sometime in the 1920s, when he was investing with a top-down mentality and trying to anticipate the cycle with very poor results, Keynes moved to a fundamental bottom-up analysis philosophy, which he used to identify a handful of companies (his "pets", as he called them) with business models that he expected to do well in the long term. The low turnover of Keynes' portfolio in the last years of his life, as well as the small number of stocks he held, was not only the result of the fact that Keynes never became a full-time investor, but also because of his investment philosophy and his vision of the economy, in which excessive trading and speculation were almost considered to be morally deplorable and detrimental to the economic system as a whole.

One of the best sources available for understanding Keynes' performance is the Chest Fund at King's College Cambridge, which was established in 1920 and which Keynes managed until his death in 1946. From 1927 until 1945, Keynes' outperformance over the market was spectacular, with an annualised outperformance of 10%, a record that few investors can match. It is also worth remembering that these were particularly turbulent times, with the UK's exit from the gold exchange standard (and its subsequent dissolution internationally), the Great Depression, the crisis of the late 1930s and the Second World War.

However, that 10% excess return obviously hides how bad those eighteen years were for stock investors. This is the full performance of the Chest Fund against the general index:

Year	Chest Fund Return	UK Market	Excess performance	Treasury bill rate
1928	(3.4%)	7.9%	(11.3%)	4.2%
1929	0.8%	6.4%	(5.6%)	5.3%
1930	(32.4%)	(20.3%)	(12.1%)	2.5%
1931	(24.6%)	(25.0%)	0.4%	3.6%
1932	44.8%	(5.8%)	50.6%	1.5%
1933	35.1%	21.5%	13.6%	0.6%
1934	33.1%	(0.7%)	33.8%	0.7%
1935	44.3%	5.3%	39.0%	0.5%
1936	56.0%	10.2%	45.8%	0.6%
1937	8.5%	(0.5%)	9.0%	0.6%
1938	(40.1%)	(16.1%)	(24.0%)	0.6%
1939	12.9%	(7.2%)	20.1%	1.3%
1940	(15.6%)	(12.9%)	(2.7%)	1.0%
1941	33.5%	12.5%	21.0%	1.0%
1942	(0.9%)	0.8%	(1.7%)	1.0%
1943	53.9%	15.6%	38.3%	1.0%
1944	14.5%	5.4%	9.1%	1.0%
1945	14.6%	0.8%	13.8%	1.0%
Geometric mean	**9.1%**	**(0.9%)**		**1.5%**

Source: Benello et al. (2016), Concentrated Investing, Strategies of the World's Greatest Concentrated Value Investors, p.53.

Keynes achieved spectacular returns in a series of highly concentrated years, from 1932 to 1936, thanks to a series of expansive economic policy measures carried out by the United States (deposit insurance, further fiscal relaxation, exit from the gold standard, creation of the Reconstruction Finance Corporation) and the fact that at the beginning of 1932

[2] For a summary of Keynes' contributions as an investor as well as his returns, see Walsh (2008), *Keynes and the Market: How the World's Greatest Economist Overturned Conventional Wisdom and Made a Fortune on the Stock Market*, Wiley & Sons.

valuations were at very depressed levels. The latter years of the decade were bad, so much so that Roosevelt's "fiscal discipline" brought the United States into another recession at the start of the Second World War. Not only was the whole decade poor in terms of returns, but investors at that time would have had to have nerves of steel not to sell in 1932, and miss the mid-decade rally, and later in 1940 – and miss the bull market that started even before the end of the Second World War.

Munger is better known in the investment community and needs no introduction. Munger launched his investment vehicle in 1962 and lived through the entire bull market until the Nifty Fifty stock market crisis in the early 1970s, which also coincided with the breakdown of the Bretton Woods system and the OPEC embargo. An investor who had invested in the last decade up to the market recovery in 1975 would have earned returns of -2.5% in annual terms. In reality, these returns were much worse, as the calculation is based on nominal returns, obscuring the high inflation in the early 1970s and its enormous impact on real returns.

How did Munger fare during this decade? Although he widely beat the indices by 10% on an annualised basis, 1973 and 1974 were particularly bad for his vehicle, dropping more than 60% at the worst time in the market. The concentrated style, in which his two main stocks, Blue Chip Stamps and New America Fund, came to represent 80% of his portfolio, did not help, as did the fact that, unlike Buffett, Munger did use leverage in his fund. In any case, and as Munger later acknowledged, it would have been best to have been out of the market, as Buffett himself did in 1969 when he dissolved his investment vehicle:

Year	Wheeler, Munger	S&P500	Excess performance
1966	12.4%	(15.8%)	28.2%
1967	56.2%	19.0%	37.2%
1968	40.4%	7.7%	32.7%
1969	28.3%	(11.6%)	39.9%
1970	(0.1%)	8.7%	(8.8%)
1971	25.4%	9.8%	15.6%
1972	8.3%	18.2%	(9.9%)
1973	(31.9%)	(13.1%)	(18.8%)
1974	(31.5%)	(23.1%)	(8.4%)
1975	73.2%	44.4%	28.8%
Geometric mean	**7.6%**	**(2.5%)**	

Source: Benello et al. (2016), Concentrated Investing, Strategies of the World's Greatest Concentrated Value Investors, p.111.

What conclusions can be drawn from this? Although the choice of the vehicle is fundamental to be able to beat the indices in the long term, market valuations are no less so. Investors tend to forget that, while stocks perform positively over the very long term, over long periods of time their performance can be zero or negative, and even less so when the effect of inflation is taken into account (how many of us deflate the graphs of the S&P500's historical performance?). For individuals with 30-year savings horizons, a decade of lost returns should certainly have a major impact on their retirement expectations.

Finally, the above analysis did not take into account the impact of the vehicles' liquidity: Keynes' Chest Fund was an institutional investor, whereas Munger's partnership was a small vehicle with no daily liquidity needs. It is easy to imagine how poor the returns for investors (not necessarily for the vehicle) would have been, subject to the swings in market optimism, if the liquidity had been daily. And yet this is the reality of today's most vehicles.

Commentary on main positions

At the end of May, the portfolio had a return of -15.1%, in line with European and world indices, but behind the S&P 500 and other US indices. During the first days of June the fund's performance continued to rise in line with recent generalised increases.

Excluding our positions in government bonds, we are invested in 15 securities (14 issuers, 13 if we consider Fannie and Freddie as a single issuer), following the fund's concentration philosophy. The share of the fund invested is approximately 60%, with approximately 33% invested in high-yield bonds and convertibles, 20% in long-term equities (compounders) and 7% in special situations. The yield to worst of the bonds is 22.7%, with a duration of 2.7. Finally, our long-term equity portfolio is trading at levels (weighted by the weight of each position) of EV/NOA of 4.5x, EV/NOI of 10.9x, with a RNOA of 93.5%.[3]

Although I have great conviction in all the positions, there are two fundamental reasons why the percentage invested at present is not higher. The first is for reasons of sectoral diversification. Although there are sectors in which we find interesting investment opportunities, as may be the case with thermal coal, I believe that an over-exposure to a single sector may penalise long-term returns, especially in sectors that are not particularly attractive for the long haul. In general, there is a dichotomy in the management industry, with managers on the one hand investing only in good companies regardless of price, and on the other hand managers for whom price is the only investment variable, even if the business of the company in question is not good. My position is the middle ground: to focus on good businesses, but not at any price, which means lifting a lot of stones and letting many mediocre investment opportunities pass by until you find the right ones. This leads me to the second reason why the investment percentage is not higher: as I explained in the introduction, current valuations are unparalleled in the history of stock markets, so medium/long-term returns for investors buying at these levels will be mediocre; from this point of view, we believe that most investors will find it difficult to beat the performance of our apparently high level of cash.

Below, I detail the main positions in the portfolio, explaining the valuation and the main reasons for our investment in them:

- **Check Point Software:** Check Point is the main position in the fund, as it meets all the requirements I seek in long-term investments: it has a high level of cash on its balance sheet (which obscures the company's real profitability in "screenings"), it operates in a profitable and growing sector, the M&A record has been disciplined (unlike its competitors) and the management team has a long history, having founded the company (and created the first commercial firewalls) and still owning a significant percentage of it today. Finally, the company is trading at attractive multiples and is highly profitable. The market considers Check Point to be the boring company in the cybersecurity world, as its sales growth in recent years has been below the growth of the sector. The renewed emphasis on the distribution side over the past three years, especially in North America, as well as the movement towards a more recurrent

[3] EV/NOA: *Enterprise Value to Net Operating Assets*. EV/NOI: *Enterprise Value to Net Operating Income*. RNOA: *Return on Net Operating Assets*. I will explain in detail how we structure the accounting and present the multiples in our semi-annual letter that we will publish in July. At this point, I would just like to point out that the information provided by the EV/NOA, the EV/NOI and the RNOA if far superior to their "unlevered" counterparts (P/BV, P/E and ROE, respectively), which are usually presented simply because they are easy to import from databases.

subscription revenue model, will help improve the market's perception of the company's product quality. The company's Infinity solution, which provides comprehensive risk protection in the cloud, in the internal network, and in mobile devices, is proving popular with customers. The movement towards the cloud, as well as the increased importance of cybersecurity due to the teleworking trend, will further drive the measures taken by the company described above. I estimate that the target price could be around $140-160 per share, approximately 35% above current trading levels.

- **Thermal coal (Consol Energy/Alliance Resources):** our investments in thermal coal have been made through the two lowest cost producers in the United States, Consol Energy and Alliance Resources, and given the extreme pessimism towards the sector, we have done so through their bonds, which I believe pay sufficiently attractive returns for the generation of cash that can be expected from these companies throughout the cycle. Both Consol and Alliance operate mines that produce thermal coal with a higher calorific value than the average producer, and they also have logistics assets that allow them to export this coal outside the United States. Consol operates three longwall mines which are integrated into one complex in Pennsylvania, as well as a dry cargo terminal in Baltimore, whereas the Alliance mines have lower production volume and less mechanisation, but its management team has historically been able to operate them in a very flexible manner depending on market conditions, having made Alliance the most profitable listed operator in the United States over the last two decades. Alliance also has a significant oil royalty business which, although heavily penalised in recent months, is still a significant source of value. The cash generation of both companies with "average" coal prices is monstrous: Alliance has been generating average free cash flows of $300M (after investments in the royalty business) in recent years, against current net debt of $761M, while Consol has been generating average flows of $200M for a current debt of less than $750M. Rarely can one buy businesses at less than 3x the free cash flow that are profitable today and will not disappear tomorrow. The debts of both companies are also trading at significant discounts to par, "creating" a substantially lower enterprise value (EV) for those who buy debt at such discounts. In the coming months, as competitors continue to close mines and, above all, as the gas associated with oil production decreases, the price of thermal coal will rise, positioning both Alliance and Consol favourably for 2021 and 2022. The developing world will continue to need cheap energy to develop, and this will be even more true after the havoc that the economic crisis will unfortunately cause in these countries. The target price for both Alliance and Consol is par, representing a 50% appreciation and more than 100% from current levels, respectively. It is possible that over the next few months we will marginally lower our position in both, with the possibility of bringing in bonds from another thermal coal company with similar returns, in order to diversify the intrinsic risk that we have in Consol and in Alliance, while maintaining constant exposure to thermal coal. Growing interest in ESG investments practically guarantees that the stock of this companies is going to remain out of favour for some time and makes the investment through debt our preferred approach.
- **HC2 Holdings:** HC2 is a conglomerate led by Philip Falcone, a former US-recognised hedge fund manager who, following a SEC ban on managing hedge funds

for a period of time, began making his investments through HC2, a listed vehicle with stakes in businesses as diverse as construction, television stations, bioscience, natural gas refuelling stations and insurance. Our position in HC2 is structured through first-lien bonds and convertible bonds. The reason we have purchased HC2's debt rather than its shares is the group's high leverage: while we believe that Falcone will continue to sell businesses at attractive valuations to continue the deleveraging process that begun last year, I believe that the current uncertainties make the proposal to become shareholders highly risky. In any event, through our position in the convertibles we have an additional cushion of loss protection, as well as quite a bit of upside potential: at a 20% discount to the bonds' par, I estimate that convertibles could almost double in the base case scenario, and somewhat more if the group's divestments are made at high multiples. There is a published investment thesis on the group that I will happily provide to anyone interested in reading about the company in depth.

- **Berkshire Hathaway:** Berkshire Hathaway is a company that needs no introduction. Despite the excellent track record of what has been the best investor of all time, the market has been sceptical about Berkshire's chances of finding interesting investment opportunities in the current environment. On the one hand, it is argued that the worst is over and that Berkshire has not been fast enough and, on the other hand, that many of Berkshire's businesses will suffer during the crisis, statements that I disagree with. Most of Berkshire's subsidiaries are leaders in their areas of business and are better capitalised to both withstand the economic crisis and to make opportunistic investments when they present themselves. As I explained earlier, I believe the worst is yet to come in the economic arena, and Warren and his management team will be able to find a place for the $100bn. that they have in cash. I estimate a target value of about $220 per share (class B) and annual returns of 7% once that target price is reached.
- **Philip Morris CR:** is the Czech subsidiary of Philip Morris International, and its activity is focused on the production and distribution of Philip Morris products in the Czech Republic and Slovakia. Unlike the rest of the tobacco industry, Philip Morris CR has a very solid balance sheet with no debt (it has CZK6bn. compared to a market capitalisation of CZK38bn.), and a pricing power that I believe is still very much on the rise if we compare the prices of a pack of Marlboro in the Czech Republic and Slovakia compared to other places in the world. The tobacco business is also the cycle-resistant business for excellence. Philip Morris CR trades at very attractive multiples: we believe that the company in a base case scenario could generate around CZK3bn. per year in residual earnings with a growth of 2%, which would justify an EV of around CZK55bn., compared to the CZK32bn at which it currently trades. On the risk side, the biggest risk will be the movement of smokers from the traditional cigarette business to the heated-tobacco business, as the margins that Philip Morris CR obtains from being a mere distributor of the new products are notably lower.
- **Scully Royalty:** Scully Royalty is one of the few small companies in which I have had sufficient conviction to invest not an insignificant stake, as I believe that the potential for loss is limited and the discount at which the shares are trading is high, more so when one considers the potential for such a gap to close in the short term. Scully is a company with a complex history of asset divestments, and although it still

currently has a collection of assets that are in the divestment phase, the most valuable asset is the 7% royalty on the Wabush mine (Canada), which produces iron ore. The mine was closed for a few years due to technical problems (which have now been solved) that made it uncompetitive at the iron prices of a few years ago, but it reopened last year under the control of Cargill and an investment fund with a maximum production capacity of 6 million tons per year. If we assume production of 5 million tonnes per year and iron prices of $80 per tonne (Wabush iron ore, at a concentration of 65%, is sold at a premium to the indices), and we apply the current Canadian tax rate of 20%, the royalty would provide revenues of about $22M per year, which depends on the discount rate to be applied, and without wanting to be too precise, would imply a valuation of the royalty between $176M and $308M, compared to the company's market capitalisation at the end of May of about $100M, which at the end of 2019 had about $35M of net cash on the balance sheet and other assets that are in the process of being monetised – and that we estimate to be worth an additional $20M to $40M. Given that this will be the first half of the year in which the royalty will be fully operational and therefore reported in the accounts at the end of June, we believe that the market (and some algorithms) will recognise the value of this asset throughout the year. The shareholder structure, in which three investors hold the majority of the shares, will help to realise this value. To my surprise, iron ore prices have remained robust to date, at around $90, helped mainly by Vale's problems at several of its mines. The investment has two fundamental long-term risks: first, risks of overexposure to a single asset, arising from the operational risks of the mine itself (flooding, worse than estimated reserves, destruction of the asset from any cause) and, secondly, that the management team makes poor capital allocation decisions with the dividends from the royalty. While iron ore prices may be volatile in the short term, it will be difficult for them to fall permanently below $70 in the long term, because of the increasing challenges of finding deposits of a certain size that are profitable at these prices.

During the summer I will continue to closely monitor the evolution of the pandemic in the southern hemisphere countries and in the United States, where I believe that the pandemic is still not under control and have a high probability of a new outbreak as we approach the winter. I continue to believe that as the economic crisis becomes increasingly evident, investment opportunities will emerge.

In August I will send you another letter updating the end of June and the most significant news about our positions.

Yours sincerely,

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