

Investor Letter

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POLLEIT & RIECHERT
Investment Management

July 26, 2017

Dear Investors,

We are pleased to report a further increase in value of your investment in our fund. Within the first half-year, the NAV of the P&R REAL VALUE fund increased by +4.2%. In comparison, the World Index rose by +2.4% (in euro), and the Gold Index lost -0.7% (in euro)¹. The Dax Index climbed by +7.4% in the same period.

Since inception four and a half years ago, the average annualised return of the P&R REAL VALUE fund has been at +12.5% after fees and is thus better than the World Index (+12.2%), the Dax Index (+10.7%), and gold (-3.5%). If you invested three years ago, it is +18.6% (World Index + 9.6%).

Our fund consists of almost two-thirds of securities denominated in US dollars. Therefore, the decline of the US dollar against the euro of -8.2% negatively impacted our performance. We regard this as a short-term fluctuation, and do not attempt to forecast these in the future.

As at the reporting date, the fund holds 13 positions in equities and call options, representing 96.6% of the fund's assets. Top 5 positions include:

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

¹ The performance is calculated based on the BVI method and considers annual dividend payments of 0.20 euro per fund unit. Fund inception was on 12/27/2012. The business year starts and ends on 30 December. The World Index is based on the LYXOR ETF MSCI WORLD D-EUR. The Gold Index is based on the ZKB Gold ETF in EUR.

As a reserve, we are holding 0.5% in cash as well as 2.9% in a certificate with gold underlying. 65.6% of the portfolio is invested in US dollar equities, 22.9% in pound sterling, and 8.2% in Canadian dollar. The fund volume is 24.3 million euro.

How are our companies doing?

Metro Bank

Metro Bank is growing at a phenomenal rate. Last year, the number of customers rose from 655,000 to 915,000, the balance sheet total grew by 65%, and more than 300 new employees were hired. In our last semi-annual letter, we had told you of our mystery shopping, the results of which we sent to the bank's management. Companies that grow very strongly make mistakes. Therefore, recognising problems is less important than analysing how these mistakes are dealt with.

In our case, the company responded quickly and transparently and they were very interested in our customer feedback. We believe that Metro Bank has a culture that can deal with challenges and will, therefore, create a great deal of growth and value for us shareholders. The stock price has gone up significantly but does not nearly reflect the full long-term potential. If you want to get a visual impression of the new bank branches ("stores"), please click here: ▶ [Metro Bank Branches](#)

Credit Acceptance

Credit Acceptance is an outstanding example of a company with good corporate culture. An indication of this is the repeated nomination of the firm as one of America's Fortune 100-Best Companies-to-Work-For. According to Fortune's survey, 95% of all employees are proud to tell others where they are working. This is remarkable for a company that offers auto loans to sub-prime customers.

The explanation lies in an extremely positive, stimulating work environment. It includes, for example, meticulously prepared and (afterwards) evaluated town hall meetings, during which employees are given direct access to CEO Brett Roberts and can make suggestions for improvements. The inner workings of this organisation explain why earnings per share have risen by 27% (CAGR) over the last 10 years and why we believe it is likely that the next decade will result in still more value for us shareholders. Since our purchase, the stock price has more than doubled. If you would like to know more about this company, we recommend Brett Roberts' exceptional shareholder letter: ▶ [Shareholder Letter Credit Acceptance](#)

World Acceptance

Many small improvements often remain undetected until *Mr. Market* suddenly wakes up. This is exactly what happened with World Acceptance in early May. As a one-two punch, the company reported significantly improved quarterly results and the renewed possibility of share buybacks. Since about one third of the free float was sold short, this good news led to a short squeeze. Within two days, the share price shot up from \$56 to \$88 US dollars. Our investment thesis, which we have explained to you in detail in our Q4 2015 letter, seems to have proven right so far, even if the management is still facing many challenges. The stock price is still cheap relative to our estimate of value (P/E ratio of 8).

Changes within the portfolio

A new investment – The Gym

The Gym Group plc is pursuing a discount strategy with fitness studios in the UK. Like Ryanair and Easyjet in the aviation industry, *The Gym* offers lower prices than many established companies in the fitness industry through a cheap no-frills offer. In Germany, this trend is already advanced. About 45% of all fitness studios are discounters with a handful of large chains and McFit as the market leader. The UK is far behind and will likely catch up. Here, only 23% of all gyms are discounters. The Gym's offer is straightforward and compelling, so new studios quickly attract customers. About 70% of the members come from competitors in the medium price segment. However, 30% of the customers are first-time members – an indication of increasing demand.

The management of The Gym regards surpassing a return-on-capital hurdle as top priority and not, for example, revenue growth or market leadership. Only the second goal is to reinvest the greatest possible portion of the free cash flow into new gyms. If CEO John Treharne succeeds in keeping the quality of the gyms high and the price low, the company will continue to grow with high incremental returns for several years. We monitor the new openings and the price behaviour of the individual studios to assess whether the company is going to take a route similar to that of Starbucks (with high returns on capital despite ever more coffee shops) or whether increasing competition within the discounters will lead to eroding yields. We have built a relatively small position at prices that are about 11x our estimate of owner's earnings. For more details please click here: [▶ Presentation The Gym](#)

Aggreko Sale

In turn, we sold Aggreko, realising a considerable loss. Up to our purchase, the company had achieved exceptionally high returns on capital over a period of about eight years, followed by a correction that we attributed to a mix

of external reasons. We assumed that durable market entry barriers, along with growing global demand for electricity, would lead to renewed profitable growth.

We were wrong. We have underestimated three things: (1) The learning curve of customers who increasingly put Aggreko in competition with other players by using tenders. (2) The technological development of alternative sources of energy. (3) The risk of change of management. We will make further mistakes in the future, but we prefer to learn from other people's mistakes.

We are lowering our fees

With immediate effect, we are reducing our fixed advisory fee from 1.5% to 1.0%, and from October, we are implementing a hurdle for our performance fee which requires an amendment of the fund prospectus. We will then receive a 15% performance fee only for the portion that exceeds 5% on an annual basis.

We believe it is fair that you receive a higher share of the performance. Thereby, we are also improving your investment fund, as lower costs will increase the chance of a long-term outperformance.

To explain let's look at an example. Assume that we achieve a return of 10% before all costs and fees. The following items will be deducted:

- Our fixed investment advisory fee (1%)
- Our performance fee (15% over 5%)
- Trading fees (approximately 0,02%)
- Administrative costs of the investment manager IPConcept and the custodian bank DZ Privatbank (approximately 0,35%)

Subtracting all the above results in a net return of about 8.1%. Our benchmark index, the World Index, is an index fund (ETF) with running costs of 0.35%. The difference in cost is 1.56 percentage points, which means that we must first achieve an outperformance to this extent to provide you with the same after-cost result.

This cost disadvantage affects all actively managed funds and is one of the reasons why more and more capital has flown from actively managed to low-cost, passive index funds in recent years.

However, if you compare the P&R REAL VALUE with other funds, you should also consider those costs that are not disclosed but nevertheless are just as real for investors:

- **No Trading.** We are making long-term investments with a *targeted portfolio turnover rate of less than 20%* (corresponding to a minimum five-year holding period). We estimate that the average turnover rate of an active mutual fund is at least 100%. We trade with a much lower frequency and thus produce only one-fifth of the trading costs. We are also excited about the fact that IPConcept has reduced the commission rates for our fund by one third.
- **No size issue.** With our small fund size, we can take positions in less liquid stocks. Large funds, particularly those that rebalance frequently produce market impact costs, which lead to a considerable performance disadvantage. These costs can amount to 1% per turnover rate of 100% according to an estimate.
- **No costs for external research.** We conduct our own independent research and do not charge the fund with costs for external research. It is, however, industry practice to obtain external research from brokers (reports, meetings, events and infotainment). The costs for this service are not paid by the asset manager but typically bundled together with (inflated) execution costs which are paid by the fund. The new MiFID2 regulation will target this practice.
- **No kickback payments.** We do not pay kickbacks for fund adviser or distribution networks because these indirect payments make it deliberately difficult for investors to understand the sources of costs. We'd love nothing better but customers who find their way to us directly or through recommendations. This saves costs and promotes a personal long-term relationship. *If you are happy with us, please feel free to recommend us.*

Our competitive advantages over passive index funds

Despite the cost disadvantage, there are good reasons why our active entrepreneurial investment management can produce better long-term results *and* promotes better capital allocation in our society. We observed the following by visiting annual general shareholder meetings.

At the shareholder meeting of Judges Scientific, Matthias Riechert was the only shareholder to attend – an excellent opportunity to meet the people who safeguard our capital. On all other shareholder meetings PR consultants, analysts and corporate adviser outnumbered shareholders to a large extend which highlights a growing principal agent risk.

On the same meeting, a board member received more than 30% no votes for his re-election. The no votes came from investors who outsourced their

voting to proxy voting services. These agencies decide on thousands of voting proposals by assessing whether the proposal complies with corporate governance guidelines using a time-efficient standardised method. In this case, the board member exceeded the maximum recommended tenure. *But not everything that can be counted counts.* The fact that the person provides valuable contributions to the management of the company cannot be assessed based on an algorithm. We give credit to Judges' supervisory board precisely *because* they did not follow the guidelines in this case.

On another meeting, we asked the chairman of the remuneration committee about his thinking behind the firm's compensation structure. He answered proudly: "We have appointed an external consultant who has aligned our remuneration to that of similar companies." Warren Buffett on this topic: *„If the board hires a compensation consultant after I go, I will come back – mad."* The practice promotes average performance. In fact, we are finding more and more similar compensation plans, which are tied to the same bundle of adjustable numbers. Only few companies have simple targets that consider cost of capital and thus only reward economic value creation.

Bottom line

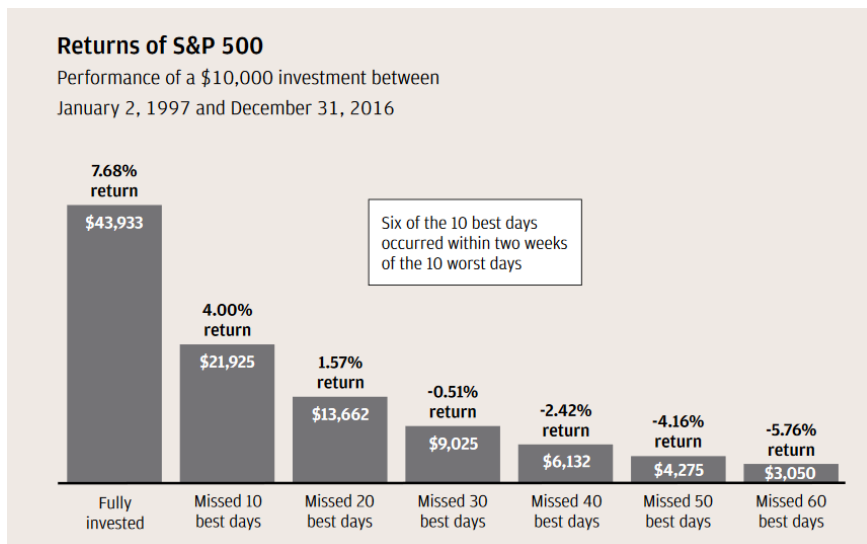
If more and more money flows into passive investments, the connection between the company and its owners ceases to exist. The use of agents promotes mediocrity and herd behaviour in company management.

It will become easier for us to find outliers who are guided by a think-for-yourself principle and who nurture a culture of ownership, responsibility and alignment of interests. As an active long-term investor with a concentrated portfolio, we can invest enough time to get to know a company and assess its culture. A passive, quantitative fund cannot do this because culture cannot be "quantified".

In his book "The Outsiders", William Thorndike coined the concept of the *iconoclasts*. A term that is applied to any person who challenges long-cherished beliefs or institutions because they are false or harmful. We count ourselves among these challengers and look for entrepreneurs who think and act independently as well. These rare candidates often produce extraordinary long-term results for their shareholders and can only be discovered early on with the antenna of an active manager.

How to improve *your* performance

Over the past 20 years you could have earned an average annualised return of 7.7% with the S&P index. However, if you missed only the 30 best days, your annualised return would have been reduced to -0.5%.



Source: Annual Report of JP Morgan, page 64.

If you (just like us) don't know on which days Mr. Market will make the biggest jumps either up or down, the smartest recommendation is to stay invested – either in index funds or with good active managers.

We wish you an enjoyable summer and look forward to the second half of the year. Please feel free to contact us if you have any questions.

Kindest regards,

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