ESTRATEGIAS de INVERSION

Azvalor.

“ESTRATEGIAS DE INVERSIÓN” INTERVIEW

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What’s your view on the current market situation, especially regarding value investing?

Your question reminds me of 2009 when huge doubts loomed after some of the biggest market falls in decades. That was a period of despair— even depression — and most investors saw no reason for optimism. At that time discussions suggested nothing positive for the future landscape for investors. Everything was negative even though the fundamentals of many companies were fantastic. However, the investment environment was seemingly not attractive. Yet, we saw great opportunities in those company prices which had been affected by the depression. It was precisely from this situation which led to the following years becoming the best years of returns for value investors in many decades.

Generally speaking, "buying" when most investors are pessimistic tends to be a good investment.

Value investing combines business reality with investor perception. The best times arise when general investor perception is very pessimistic, yet businesses are in good shape. It’s especially true when companies’ fortunes have reversed and they have come through, to emerge successfully, from tough times.

That is the same picture that I see now.

I see many similarities when it comes to how we manage money. Today, as then, few management companies remained faithful to their value investing philosophy. Today we can see the same kind of fatigue, even abandonment of their principles. For me, that’s another sign - a great opportunity. So now is the time to judge who are the true believers - those who faithfully stick to this way of investing or those who are just passing by.

Are you confident that value investing will achieve again the returns it did after the 2008 crisis? How can value investing adapt to the post-COVID-19 World?

Buying good businesses that haven’t done well on the stock market, that haven’t attracted new investors, but are actually very good, provides us with a great investment opportunity. Just as in 2009, neither the perception nor the expectations are good today, but many businesses have been doing their homework for years, quietly, with great effort, so that today they are in very good shape - their fundamentals are good, their earnings are growing (some are growing a lot), but they are still trading as if they were depressed or even as if they were about to disappear.

I am confident that investors who do their homework will do very well and that their results will be as strong as ever. It's a formula that has always worked in the past. It is a timeless philosophy, yet it is one which will always go through moments of doubt. Even Buffett has been questioned and scrutinized many times over the decades.

In our case, we deeply trust in the companies in which we are shareholders. Numbers are extraordinary and historically attractive even compared to those of 2009, which is an example of a past opportunity we have already come through. In Azvalor International's portfolio, the companies are offering average returns over 15%, and therefore we believe the fund will tend to converge to those returns from the present moment (as it happened in 2009 and during the following 5 years).

Next December you're celebrating your fifth year as a company and all your funds have been losing money since their inception, how do you evaluate both the returns and the assets under management?

Five years have passed yet it feels like we started yesterday. When you do something you are passionate about - a vocational activity - time stands still. Yet clearly you need to assess how you've done when it comes to such a significant anniversary. But when you make that assessment you must do so by putting the last 5 years into context, which in our case is a 25 year career as investment managers.

The most important change we had to make? We were not just managing investments but also managing a company (and everything else that implies). Fortunately, that transition has gone well, thanks to the great work of the team that takes care of all the non-related investment and client centric tasks which are managed by our partner Sergio Fernández-Pacheco. We owe Sergio and his team a great deal for the smooth transition that we have experienced over the last years.

As for the funds' results, of course we are not satisfied with the returns, yet at the same time, we continue to be totally convinced that the value of each and every one of the businesses in which we are investing is worth far above their current price. And that sooner or later, value will emerge, and the market will rationally value the businesses currently being punished. In fact, the gap between value and price is one of the greatest we have ever seen - not in Azvalor, but in all our 25-year career history. Besides, the risk we assume in these companies is small thanks in part to the soundness of their businesses, their strong balance sheets, and the prices at which they are trading today. We believe these factors offer us an enormous margin of safety. For while nothing is impossible, we feel that the price of many companies cannot fall much further. Even if it does, it would not do so permanently. And in case it falls further it would provide us with an even better opportunity.

A fund's price provides important information, but it is not the only information nor is it necessarily the most relevant. Similarly, the net asset value reflects different circumstances that must be put into context, but not mixed up. Within the data underlying our performance you have:

- Some successful investments have already been "harvested" and so will not affect the future value of the fund because its gains have already been "collected" and reinvested in another company. So, it will be that new company, and not the past one, which determines the future of that money.
- Then there are investments that are mistakes, from which we will no longer be able to regain the money, and so we consider them "lost". We have had some of those in this period but

at a similar rate to those experienced over the last 25 years. Thank God the failures are few, though the lessons learned are worth a lot if only to avoid repeating them in the future, while their impact, although painful, has been limited.

- Investments that have endured falls in price when, in our view, they are worth more than what we paid. Here we disagree with the price the market is assigning to them because we have complete certainty that their "reasonable" or “intrinsic” value is WAY above their current price.
- This point explains the bulk of the difference between what the fund is "worth" (€230) and its trading price today (NAV as of November 13th: €93). This is where we find most of the expected returns that have not surfaced yet and where we focus our efforts on reviewing the reality of the businesses, to make sure this reality is still there after the investment has been made.
- Investments which have increased their price relative to the average purchase cost, but whose value is, in our opinion, still much higher than their current price. In these circumstances we continue to keep the position though progressively reducing their weight, as the price increases, the future expected returns get lower and the risks we assume get higher. These investments, like those of the first group, have given us good returns, but they are hidden because they are overshadowed by the losses of the previous group.

Understanding investment in this way reinforces our willingness to stick with the same companies and encourages us to continue being shareholders regardless of current circumstance and prices. And even considering the negative past returns, future returns will no longer depend on them but on the behavior of the companies from now on. In this sense, our – cautious - optimism about the fund's performance remains high.

We have already been through many situations when the market tests us and then changes its mind - sometimes quickly – and a bed of thorns suddenly becomes a bed of roses. This has happened in the case of many companies - some of them still in the portfolio. We have had in the portfolio stocks which have doubled in price since we invested even though they initially halved. Such shares have been a four bagger from their minimums since we became shareholders.

Finally, although a period of five years may seem enough to make an evaluation, the facts show us that this is not always the case.

The returns that we obtain in the next five years are in no way linked to the returns obtained in the last five. Rather, returns are down to both the evolution of the businesses (regardless of whether they are priced correctly or not) and to the valuation that the market assigns them. So, the starting point is today's price - and not previous ones.

How is Azvalor holding up in this unusual year of pandemic and economic crisis?

We are holding up well. We are seeing signs of confidence and strength from our co-investors, who are showing great patience and conviction. The results have not yet been reflected in the net asset value, but their trust remains, and this allows us to manage the funds based on management decisions instead of having to sell against our criteria in order to return money to our clients (in any case the liquidity of our companies is very high today). So, from the point of view of investors we are in a "sweet" moment for this environment unlocks new and good opportunities and it allows us to invest at extraordinarily attractive prices, in companies with good businesses trading at bargain prices. This type of situation has always generated good results for us. You sow the returns when you buy well, but you can only reap them when the market recognizes it, and pays for it, and that has not yet happened in the portfolio's global valuation. To be more exact, it has happened in some parts of the portfolio, but we have reinvested those results in the companies which today offer the best opportunities for reinvestment (the ones that have behaved the worst on the stock market, but whose businesses remain solid and are therefore damming a lot of value yet to emerge). It can be frustrating not to harvest the fruits over a period of more than four years, but they are embedded in the portfolio and the time will come when we can reap them.

How much importance do you give to teamwork in a company like yours?

As we understand it, investing in a responsible way requires many hours of study and work to get to know well what you are buying. It is a very demanding job. And businesses - companies - are complex entities, multifaceted (history, team, regulation, competition, incentive systems, fashions, disruptions, etc.). Understanding what you are buying and the reasons to invest requires a lot of experience and knowledge. To do this, you must rely on a good and well managed team to unlock their full potential. The final decision is made by the manager, but the work of the analyst helps him to be more effective and have full confidence that decisions are made on well-crafted information.

We have lived through many times like these when the market tests you - sometimes over a long period of time. The test requires us to have serenity and confidence to make the best decisions. And that serenity and confidence lies in the certainty of a well-done job.

Teams do not necessarily need to be large, but they do need to be well geared and really focused on where we believe the value —the opportunity— lies. That requires being able to humbly discard many options in which we either do not contribute much or we do not see value, and to focus only on where we think the opportunities are. In short, it is about understanding what's essential and not getting diverted by peripheral matters.

With that goal we have built a well-coordinated senior team, with a lot of experience. Thanks to that, we have a high performing team which is ready to navigate these complexities and to take advantage of the many opportunities that confront us.

You are one of the great defenders, among the Spanish asset management industry, of the opportunities in commodity related companies. Why this overweighting of companies linked to gold, uranium, copper, or oil?

We are defenders of opportunities - pure and simple – as long as we find them in companies that we can understand, and which meet the conditions we require to become investors. Briefly, we ask of a company:

- To have a competitive and hard to replicate business.
- To have capable and honest teams.
- To have healthy balance sheets.
- Where price does not reflect - by a wide margin - the true value of the company.

Today, in a world where almost only the fastest growing businesses are being valued (even though many of them are not generating profits) or where many investors are seduced by their popularity (it is not the same being a client or a user than being a shareholder), there are companies that are less visible, shine less and are forgotten, yet are excellent investments. Our goal is not only to buy good companies but to make good investments and this requires "something else", such as buying them at good prices. That forgetfulness of the market to which I refer to is shown in the depressed prices at which we can buy them and is where we clearly see the opportunity to make good investments.

Opportunities appear when reality and perception diverge from each other; and this is exactly what we see and experience in the companies in which we invest, many of which happen to be in the energy or commodities sector, although not exclusively.

Now that all the management companies are turning to investments with ESG standards, and in megatrends such as renewable energies and the electric car, how do you explain your bets on fossil fuels or on polluting considered energy sources?

Yes, these megatrends seem unstoppable today. But I tend to think it is better to be cautious with "fashions", and above all with the results that can be obtained, as an investor, from situations of massive consensus regarding certain commodities.

Although we flee from fashions, we are in companies that today partly benefit from them - by not being a part of the fad, it is not the ultimate reason for our investments, but the concrete situation that the company is going through. For example, the decarbonization of society implies a strong increase in copper consumption; as an example, an electric car requires 4 times more copper than a combustion car and an offshore windmill requires 15 tons of copper. We are investing in Freeport McMoran, one of the largest copper producers in the World, not really because of our ability to predict the evolution of copper price but for the huge improvements that have been made and continue to take place in the company, and because its quoting price (despite having risen a lot) is still far from demonstrating that situation. Thanks to all the adjustments and good work of its management team, its profits are growing faster than its competitors. This is happening against a background of rising copper prices which benefits all companies in the sector, but even more those companies that have done their homework better. As for today, these are growth companies sold at value prices. And this is not only happening with copper companies; the energy transition needs a lot of materials which today are trading as if they were somehow not needed. Yet the more the society invests in renewable energy, the bigger the need for these materials. At the same time, the price of the companies that are devoted to producing these materials are trading at depressed prices, despite years of improving competitiveness and business betterment. In our view, it cannot be right for society to support the need for renewables while at the same time not believing in the companies that make sustainable energy possible. From an investment perspective, not believing in the most competitive companies when they are trading at bargain prices defies logic, given they produce the materials that are central to this form of energy.

As for fossil fuels, we all know that these will progressively weigh less (as a percentage) in the world energy mix, but we have many years before that happens, as much of the world continues to need them, with some countries depending on them. And this is happening against a background of increasing demand in the world's energy requirements so any drop in the use of fossil fuels is partly compensated by the total increase in energy demand. This is especially true in those parts of the World where populations and per capita income are growing the most, where the energy demand is increasing the fastest, and where fossil fuels are the only affordable source of energy due to their low purchasing power.

In those parts of the world fortunate enough to have the economic resources, countries are fighting to reduce emissions, either by applying new technologies to make fossil energies less polluting (efficiency improvements or new techniques to capture CO2), or by replacing them with cleaner technologies. In this case, we also benefit from this evolution because we have invested in nuclear energy – the true zero CO2 emissions technology, fossil free – which keeps growing in the World energy mix (although many people still consider the opposite).

In general, you don't have a big approach to the technology sector, however, Warren Buffett himself admitted to having been mistaken in not seeing the potential of this sector and currently his main position is Apple. Are you not considering investing in FAANG in the short term?

We try to avoid investing where we are not completely sure (it's better not to act, than to act without conviction). Knowing how to say "no" to what we don't understand, to what does not feel comfortable, or does not let us sleep peacefully - even if it is something popular and everybody is doing it - is part of our discipline. We do look at what other investors, like Buffett who we respect and admire, are doing. But to invest in a company we must be convinced and make our own reasoning for that decision. We are aware of our limitations when it comes to investing, and I believe that knowing these limitations - and accepting them - is good for us and therefore good for our co-investors.

We admire Buffett as an investor; he has many capacities which no one else has and which make him different and the number one. And sometimes we agree with him, as in Barrick Gold, one of our main investments for a couple of years now, in which Buffett has just entered, and sometimes we do not agree with him.

Everyone must follow their "book" and their convictions, enhancing their own capacities and managing their limitations.

COVID-19 was a shock to the markets in March. Was it a month of big purchases to take advantage of the drop in prices? In which companies did you invest?

COVID-19 has made living hard, if not sad, for everyone. But from an investment perspective some opportunities have also appeared. First, as a team we have been more united than ever and very focused on what we believe is important and essential in our everyday work. The new working circumstances force us all to be even more focused, better coordinated and to give a little more of ourselves. And second, when markets act irrationally, opportunities abound. In our case, we have delved into many new companies seeking opportunities brought by those depressed prices, which are a product of COVID-19's effect on the markets. But to invest in one company we have to disinvest in another, and the companies we now own are very competitive, we have great conviction in them, and their prices have also fallen, so in the first half of the year we have not seen much rotation. More recently, and following the great performance of some companies after the summer, such as Barrick Gold, Southern Copper or Hyundai, we have partially sold those as they have performed best. In the Hyundai case, we have completely sold the position and have bought new companies like SQM – a World leader in lithium production - or Suncor – a Canadian oil producer that had fallen excessively and which has a very competitive business in its sector–.

You have a fund that invests in the Spanish and Portuguese stock market — Azvalor Iberia. Is it easy for you to find value in Spain after the corrections of the Ibex 35?

We have only invested in three Ibex 35 companies: Acerinox, Mapfre and Repsol. We have an "active ratio" (% of investments which do not overlap with the Ibex 35) of more than 98%.

The indexes, like the averages, hide the specifics of the companies. We invest based on the fundamentals of each company, not on the fact of being part or not of an index. Each company is a world, and whatever is important is found in its specific circumstances.

This does not mean that we do not see value in many Ibex 35 companies. But this is a "competitive" process, and today we see more value in companies which are not in the Ibex 35, with the already mentioned exceptions.