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Dear investor,

Azvalor Managers FI was successfully launched last November and we sincerely appreciate your interest in the fund. The **main concept** behind it is to hire external Managers that we consider of the highest quality, in order to access interesting markets and sectors beyond our traditional reach, thus expanding our investment capabilities. The Managers that make up the fund are Donald Smith & Co, Mittleman Brothers, Moerus Capital and Goehring & Rozencwajg Associates.

Azvalor Managers FI is **not a fund of funds**, that is, it does not invest in other vehicles, but directly in the companies that each Manager selects for our portfolio. The main advantage of this format is that it allows us to pick any Manager in the world, without restriction, and we also avoid a double layer of management fees.

A difficulty that may arise as we widen our horizon is how to filter the vast universe of Managers that we have available. The good news is that we know exactly the kind of people we are looking for, which helps us narrow down this universe significantly. In short, the **requirements** that we seek coincide with Azvalor's self-imposed guidelines:

- **Independent boutique owned by employees.** In the investment industry it is very common to see a Manager move from one firm to another. If the firm is owned by its employees, stability is usually much greater as the incentive to switch companies is significantly smaller. Moreover, the motivation and determination to do things well is much stronger. For example, in the case of Donald Smith & Co, it would be highly unlikely that two Managers like Donald, and his right-hand man Richard Greenberg would have stayed together applying a consistent and successful investment process for almost 40 years if they had been working for someone else. The study "[The Boutique Premium](#)", published by the US firm AMG, analyzes how this and other advantages of the boutique structure result in greater long-term added value for investors.
- **"Skin in the game":** significant investment of the Manager's personal wealth in the strategy he manages, a concept that we will develop later in this letter.
- **Stable, committed and hard-working investment team.** As the great investor Peter Lynch once said: "In investing, the person that turns over the most rocks wins the game". Turning rocks over,

that is, discovering and analyzing in-depth a large number of companies, is a demanding task for a Manager. It requires a high level of commitment and long working hours, something which is very complicated to do without strong vocation and passion.

- **Specialized in a specific strategy.** If you are looking for the best shoemaker in Spain, you will probably not find him in that huge mall that sells all types of consumer goods. It will more likely be that small shoe store which has been manufacturing shoes for 30 years, and does nothing else, nor does it try. Perhaps this shoemaker could also make belts or bags, and perhaps, given her talent, she would not be too bad at it, but one cannot be the best at everything and we prefer to focus on Managers who do one thing and do it very well. For instance, Leigh Goehring has done nothing else since 1991 but to invest in the natural resource space, which has certainly helped him become, in our opinion, the best Manager in this space. The fact that both his parents worked for Exxon, and met at a refinery, probably contributed to his passion for this sector.
- **Strong stewardship mentality towards investors' interests.** We look for Managers who do not have a salesmanship attitude with clients, but who actually treat fund-holders as co-investors. In the case of Mittleman Brothers, it is interesting to see how, for nearly a decade since its foundation, the firm refused to hire a marketing related person. Focused on investing, they will never sell their products aggressively. In fact, they select the clients they want to work with very carefully, as they chose us, by testing us when we first approached them. This explains why their client retention rate is 96% since 2002, meaning, hardly anyone who invests with them leaves out the door.
- **Reasonable volume of assets under management and limited capacity.** Related to the previous point, we look for Managers who do not want to significantly grow their assets. Their objective is to obtain outstanding returns, and they all know, just like we do, that "size can kill", quoting the legendary investor, the recently deceased Jack Bogle. The point is that it is more difficult to buy and sell, particularly smaller companies, if you have significant stakes in them because market liquidity is limited (liquidity is the number of sales transactions for each security in a certain period of time). This has been demonstrated by numerous research papers, such the one published in the American Economic Review by Chen, Hong, Huan and Kubik, in 2002: "[Does Fund Size Erode Performance?](#)". Consider this, if a school has to buy fruit daily for 1,500 children, it will not be able to go the local fruit store and buy organic products because it will not find enough stock; instead, it will have to turn to large wholesalers that produce in bulk, which is where most big schools buy their fruit, so it is unlikely that this school will stand out from its competitors for the quality of its food.
- **Extensive experience and excellent track record in the very long-term.** Not only past performance is no guarantee of future returns, but in our view, it is not even predictive of future results. Therefore, our selection process is focused on qualitative aspects. That said, we analyze

the track record of a Manager to understand if an investment process has been applied consistently over time. For instance, it is interesting to see how Amit Wadhwaney, founder and Manager of the firm Moerus, kept his investment process intact at Third Avenue after 1998 and 1999, when his performance significantly lagged the benchmark and his competitors because he did not jump on the bandwagon of the dotcom bubble (it went up 38% less than the index during this period). From 2000 to 2002, when the bubble burst and the market fell by more than 40%, the conviction behind his process made his fund return around 35%, obtaining positive figures in each of those calendar years. The temperament of a Manager and his conviction on an investment process are tested in times like these, that all Managers go through sooner or later, so we want to invest with those who have successfully weathered different market environments.

- **Investment process focused on stock selection.** We invest in shares with our minds set on buying a small part of a business, and in this sense we look for Managers with a deep knowledge of all the companies in their portfolio, something which is very difficult to achieve with overly diversified portfolios. On the other hand, the market does not always recognize the fair value of a company in the short- or mid-term, so it's critical to have a long-term investment horizon and allow the price and the value of companies to converge, which, on occasions, may take years to occur. Moreover, we want them to be able to invest in their best ideas, regardless of whether these are in the indices or not. In this sense, we want truly active management and, indeed, the overlap of the fund's portfolio with the benchmark is close to zero (Azvalor Managers' active share is 99.17% relative to MSCI AC World NR index, as at 31st December 2018).

How do we find and select them?

An essentially qualitative selection process requires a lot of time and resources, but we believe it is the best (and probably the only) way to find Managers that will deliver excellent returns. Our idea generation process avoids quantitative filters using databases; we look for Managers that are off the conventional radar, where very few people look, contacting many who do not necessarily do active marketing. Evidence of this is that, for all four Managers, we are the first mandate they receive in Europe, and we believe they agreed to work with us on the basis of mutual respect, arising from a similar philosophy in the approach to the investment world.

After our first contact with Managers who fulfil, on paper, what we are looking for, we dedicate dozens of hours doing research, evaluating all aspects of the investment team, management firm and investment process that we consider relevant in a Manager. For example, in terms of the investment team, we assess the following aspects:

- **Team structure:** analysis of how the investment team is built. Who is in the team? What responsibility does each team member have? What previous experience do they have? How do

they divide the work? What internal dynamics do they follow? What communication channels do they use? Does the team have the necessary resources and do the professionals have complementary skills? Does the team know its strengths and weaknesses? How are underperforming professionals managed?

- **Team stability:** analysis of the team's evolution over time. Have many relevant professionals left? If so, why? Do they have the appropriate long-term retention measures? Is the firm able to attract external talent? How are the selection processes carried out? Is there a long-term succession plan?
- **Decision-making process:** analysis of efficiency and effectiveness in the decision-making process. Who makes decisions and how? Are these adopted by consensus or is there one or more people driving all the decisions? Does this structure lead to slow and bureaucratic decision-making or to dilution of responsibilities? Are decisions made at the point of maximum analytical insight?
- **Workload:** analysis of Managers' dedication to analytical and portfolio management tasks. How much time do Managers dedicate to marketing? Are they responsible for resource and team management? Are they assisted in administrative and operational tasks? Do they manage several investment strategies?
- **Incentive structure:** analysis of whether economic incentives are aimed at generating good returns for investors. Does variable remuneration depend on fund returns or on asset growth? If performance is taken into account, what's the measurement period and against what benchmark? Is part of the remuneration paid in fund's shares? Are employees obliged to invest in the firm's funds? If not, do they do it voluntarily?
- **Intangible aspects:** Do Managers have the right temperament? Do they come across as motivated and passionate about their work? Are they too arrogant in their convictions?

To evaluate all these elements, as well as aspects related to the management firm and the investment process, which we will address in future letters, we rely on numerous **tools**, such as due diligence questionnaires with dozens of pages of information on the Manager. We also look at institutional presentations; all quarterly letters sent to investors since inception; publicly available information; published interviews and recorded conferences of the Manager throughout his or her career; analytical tools to evaluate the investment portfolio and its evolution over time; numerous direct contacts with the Manager by phone; face-to-face meetings in both their and our offices; and conversations with other institutional investors that have been investing with the Manager for years, as a reference check. In addition, the role of **Álvaro Guzmán de Lázaro and Fernando Bernad**, who do

the “last mile” work to analyze the depth and robustness of the Manager’s analytical processes and investment theses, is key to this process.

“Skin in the game”

One of the requirements aforementioned, which I would like to draw attention to in this first letter, is the concept of “Skin in the game”. We look for Managers who “eat their own cooking”, that is, managers who invest their own wealth in the strategies they run. In other words, they buy for our fund the same stocks they buy for their own money and that of their families. This concept of alignment of interests seems intuitive enough, but there are also studies that support it. As you may know, in the USA, Managers must report to the regulator on the money they invest in the funds they manage, and a few years ago Morningstar conducted a small study that proved that, in fact, there is a positive correlation between co-investment, stability of the Manager leading the fund and long-term returns.

Table 1: Amount invested by the Manager (range), Return percentile over 5 years and Number of funds analysed

Amount invested by the Manager (range)	Return percentile over 5 years	No. of funds analysed
More than \$1,000,000	39	391
Between \$500,001 and \$999,999	42	194
Between \$101,001 and \$500,000	45	656
Between \$50,001 and \$100,000	48	273
Between \$10,001 and \$50,000	52	367
Between \$1 and \$10,000	53	144
\$0	53	1,860

Table 2: Relationship between star rating, average tenure of the Manager leading the fund and average amount invested.

Star rating Morningstar	Average Manager tenure (years)	Average Manager Investment
5	6.2	\$300,061
4	6.3	\$250,890
3	5.4	\$161,602
2	4.6	\$124,810
1	3.8	\$110,991

Source: Morningstar, “Reflections on Fund Management: Five Lessons from 25 Years”, Don Phillips, 2010.

It is striking how, in almost half of the funds, the Manager does not invest a single dollar in his fund (table 1). On the other hand, it is not surprising to see that, on average, the greater the Manager investment, the longer the Manager stays running the fund, and the better the long-term performance (table 2). As Don Phillips, Morningstar's Director of Research, said: **"In short, nobody washes a rental car"**.

We firmly believe that a talented Manager who put his money where his mouth is will achieve better results, and in this sense, we are convinced that we have selected for our fund a small group of Managers that will significantly outperform the market in the long run.

Thank you.