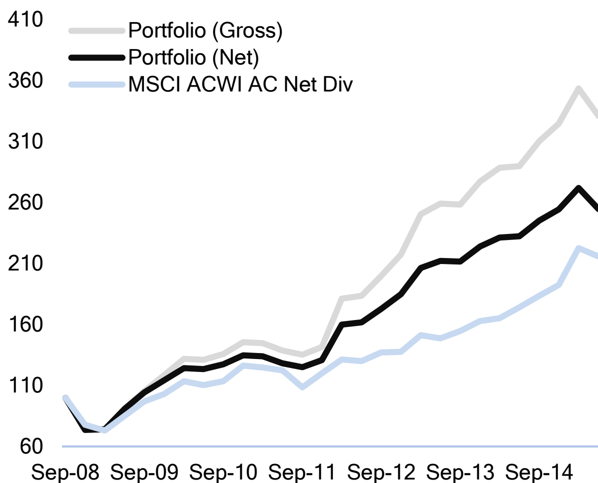
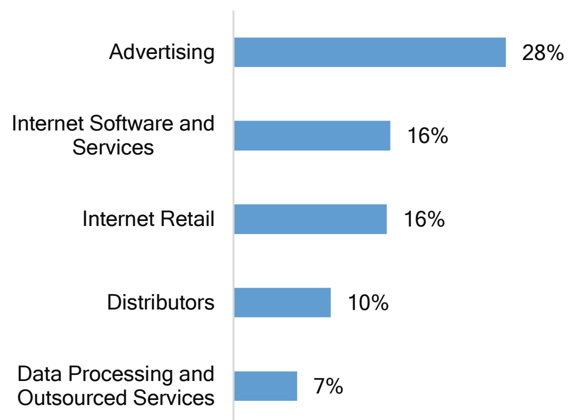
iolite CORE PORTFOLIO Q2 2015

		Performance (net of fees)	EUR[1]	Index[2]
Inception Date:	01 October 2008	**Quarter**	-6.3%	-3.0%
Portfolio Style:	Value / Total Return	**Year-to-Date**	0.2%	12.1%
Manager:	Robert Leitz	**Last Twelve Months**	9.6%	23.9%
		Since inception (annualized)	14.9%	12.1%
		Since inception (cumulative)	155.0%	116.0%

Performance in EUR



Top 5 Positions



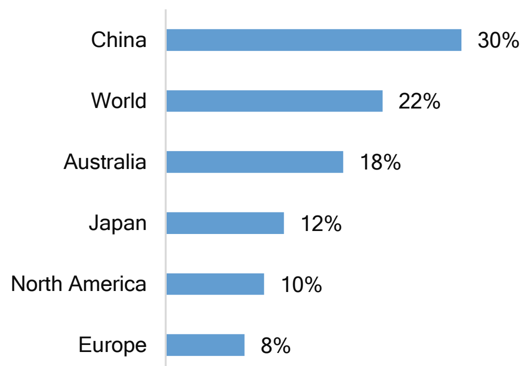
Market Review

Equities had a mixed quarter despite continued loose monetary policies around the globe. European markets suffered from an escalating fiscal crisis in Greece, and Chinese markets experienced a sharp correction of almost 30% in June. Nevertheless, thanks to strong gains earlier in the year, Chinese equities still ended H1 well above year-end 2014 levels. The US dollar remained strong against most other currencies as investors hoped for a rate hike (that didn't materialize). Commodity prices remained generally weak, but the debt and shares of oil companies saw a liquidity-driven rebound.

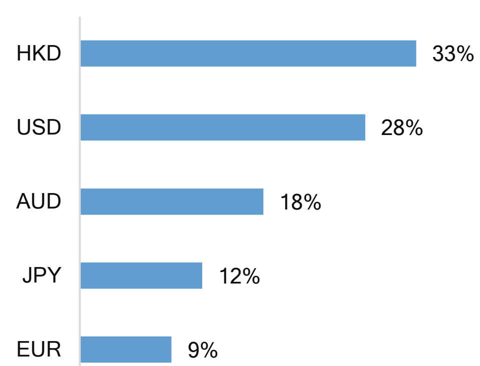
Portfolio Review

The portfolio had one of its weakest quarters as measured by market prices, as two of the largest holdings declined substantially (I kept adding to these positions as cash became available). Rather than focusing on this decline, it is important to note that my core investment theses haven't changed. It is also important to note that the portfolio's Australian positions (18% of assets) might have suffered from tax selling (in Australia, the tax year ends in June). During the quarter, I exited one position (Sichuan Expressway) at a healthy profit and entered into one new position.

Geographic Breakdown by Revenue Market



Geographic Breakdown by Listing Currency



[1]Net returns: no leverage, after all costs (no management fee, 25% performance fee for returns greater than 4% p.a., high watermark)
[2]MSCI All Country (DM+EM) World Index All Cap (large+mid+small+micro caps), net dividends reinvested

Since inception on October 1, 2008, the core portfolio has generated unleveraged net cumulative returns of +155.0% in EUR (+113.1% in USD) and annualized net returns of 14.9% in EUR (+11.9% in USD). In other words, €1.00 invested at inception has turned into €2.55 ($1.00 invested at inception has turned into $2.13).

THOUGHTS ON INVESTING IN A NEGATIVE YIELD ENVIRONMENT

Earlier this year, Finland floated a €1 billion five-year note at a negative interest rate of -0.017%. The demand for this note showed that savers were willing to pay Finland for the privilege to keep and spend their money. This is not an aberration. Countries like Germany, France, Sweden, Netherland, Belgium and Austria have seen their two-year sovereign debt trade at negative yields.

The extended run of loose monetary policy by several major central banks has led to an overabundance of extremely cheap credit, which skews everything: demand, supply, profits and the price of all asset classes from bonds to equities to real estate.

The amount of money being pumped into the system is staggering and surpasses common human comprehension. Let's try to put things into perspective. Over the last three years, the National Bank of Switzerland (a tiny country with only 8 million people) inflated its balance sheet by USD 300 billion to prevent a strengthening of the Swiss franc against a weakening euro. According to public estimates, this is enough to fund visionary projects such as DESERTEC (an enormous solar power plant in the Sahara desert capable of supplying most of Europe with energy) or a manned landing on Mars. Either project would employ thousands of highly skilled engineers (with the expected trickle-down effect to other sectors of the real economy) and lead to enormous technological breakthroughs.

If this sounds too much like science fiction, here is another example. The Gotthard Base Tunnel, a major high-speed railway link through the Alps and the world's longest and deepest traffic tunnel when it will be finished next year, cost CHF 14 billion to build. This is only half the amount the Swiss National Bank printed in the three months to April 2015 – *after* officially ending its peg of the Swiss franc to the euro.

Given the unprecedented size of global monetary easing combined with record-low yields, I believe government and corporate bonds are in obvious bubble territory and cash yields no longer compensate savers for the significant risks they are taking, be it permanent loss of capital through defaults or loss of purchasing power through inflation. While I am aware that markets can stay irrational for a very long time, it should be a certainty that, at some point, they will revert to the mean.

Fixed income instruments were long known to deliver safe and stable nominal cash yields. For the last thirty years, they also delivered quotational gains (as yields were coming down and the bubble was building up, similar to multiple expansion in equity investments) that could be realized either through trading or refinancing. In today's world, however, a fixed income investor takes significant downside risk while the upside is severely limited: cash returns are zero and quotational gains are

dependent on a scenario of yields dropping further from today's record lows. In addition, a quick look at the junk bond market reveals that underwriting standards have dropped severely given the market's excessive liquidity, while inflation (i.e. the loss of purchasing power) is likely to pick up given global monetary easing at an unprecedented scale.

If anything, this might be the time to borrow, not to lend, at least for those who know how to value and structure an investment. However, while leverage can enhance returns, especially in an inflationary environment, prudent investors will still prepare for the possibility of the market softening and, consequently, refinancing risk further down the road.

Income-generating assets able to maintain their pricing power (i.e. equity in businesses and real estate), if bought and sold at the right price, might provide a better way to protect and increase purchasing power over time, especially for those willing to bear temporary illiquidity and market price volatility. The beauty of owning cash-generating assets is that the upside is potentially infinite (with returns driven by normal cash generation, real growth, inflation and multiple expansion) while the downside is dependent on the margin of safety as determined by the price paid relative to a business' intrinsic value. Of course, the difficulty of fundamental (value) investing lies in properly assessing the value of a business and maintaining buying and selling discipline.

In many cases, however, given the lack of cheap opportunities, investors continue to justify paying higher prices for equities based on perceived and promoted qualities. This might look smart as long as markets are going up, but it is destined to disappoint once markets correct. By overpaying for an asset, investors become dependent on other market participants' willingness to pay a similar or higher price, i.e. they become speculators in what is ultimately a "Greater Fool's Game".

I am aware that higher inflation might make the case for bullish and/or leveraged investors seem stronger, as well as diminish the purchasing power of cash reserves of cautious investors. Some people argue that governments can't afford a rise in interest rates, as they are dependent on inflation to help them deleverage. For my part, I wouldn't want to position my portfolio such that its success is dependent on low interest rates, earnings growth or multiple expansion. Instead, I believe an investment should generate sufficient cash returns to pay for itself over a short period of time – either in a going concern or liquidation scenario.

I recently read up on the Nifty Fifty bubble and see many parallels to today's markets. The Nifty Fifty refers to popular large-cap stocks on the New York Stock Exchange in the 1960s and 1970s that were widely regarded as solid buy-and-hold growth stocks. Among the Nifty Fifty were McDonald's, IBM, Texas Instruments, Digital Equipment, Coca-Cola and Wal-Mart. Deemed "one-decision" stocks, the Nifty Fifty were meant to be bought and not sold, and at the time, investors were willing to pay unbounded prices for a piece of the Nifty Fifty pie. However, when the market finally did correct in 1973-1974, many of the Nifty Fifty stocks dropped by more than 70%. While many of the original Nifty

Fifty stocks are still around, it could have taken two decades for investors to recover their original investment!

THOUGHTS ON NEGATIVE WORKING CAPITAL

A favorite topic among value investors is insurance “float” – seen as an amazing tool to multiply returns. I’d like to present my own thoughts on float and negative working capital, and how they factor into the investment process.

Working capital is a financial metric that represents operating liquidity:

- Working capital = trade receivables + inventory - trade payables
- Net positive working capital = trade receivables + inventory > trade payables
- Net negative working capital = trade receivables + inventory < trade payables

In most cases, a business with positive working capital funds its production cycle with structural debt and equity, whereas businesses with negative working capital generally use their suppliers (trade payables), customers (prepayments) or banks (trade financing) to fund production or trading activities. Whether a business operates on negative or positive working capital depends to a large extent not only on the business model, but also on management’s skill and ability to manage a company’s balance sheet.

Generally speaking, lower working capital levels increase the return on equity (i.e. lower equity required to run the company/less capital tied up in the production cycle). Negative working capital can be a very cheap and (almost) perpetual source of funding. However, it can also indicate operating inefficiencies, accounting weaknesses or low earnings quality. Despite its importance, common valuation metrics such as EV/EBITDA, net debt or P/E all fail to properly take working capital into account.

Insurance and Banking

Both insurance and banking are built on negative working capital. In insurance, clients pay upfront for a potential claim further down the road. In banking, clients provide capital in the hope to get it back at a later point in time and earn interest in between.

While both business models are similar, I would argue that insurance is slightly more attractive than banking, as banks tend to only live off the spread between borrowing and lending rates whereas insurance companies live off the underwriting margin plus the investment gains from what Warren Buffett calls “float” (i.e. negative working capital).

In Warren Buffett's 2010 letter to shareholders he elaborates on float:

> *"Insurance float – money we temporarily hold in our insurance operations that does not belong to us – funds $66 billion of our investments. This float is "free" as long as insurance underwriting breaks even, meaning that the premiums we receive equal the losses and expenses we incur. Of course, underwriting results are volatile, swinging erratically between profits and losses. Over our entire history, though, we've been significantly profitable, and I also expect us to average breakeven results or better in the future. If we do that, all of our investments – those funded both by float and by retained earnings – can be viewed as an element of value for Berkshire shareholders."*

In other words: if underwriting results break even, the insurance company has been given money to invest for free and the gains on those investments are its to keep. Note, however, that it is not the float that belongs to the insurance company but the earnings generated by the float.

The right time to grow float (i.e. write insurance premiums) is when volatility is high, as the market is willing to pay more for protection. Insurance float is a great way to raise capital when market participants are distressed, angst-ridden or tight on cash.

Ever wondered why hedge funds like to set up reinsurance companies? It's because it allows them to raise capital quickly (big tickets), this capital is theirs to keep for a long time, and the 100% levered equity returns make the classic 2-20 hedge fund compensation structure look dirt cheap. Float is an extremely elegant way to leverage equity returns on investment portfolios, especially if the investment manager is shielded from underwriting losses. This is why insurance specialist Joe Taussig calls float "structural alpha" [3].

Even though an investor can greatly benefit from structural alpha, he should be aware of the pitfalls that may come with it. The difficulty in valuing financial businesses is the opaque nature of their financial statements. In contrast to other businesses, assessing the financial statements of banks and insurance companies is, at best, an educated guess. It is very easy to grow total assets, book equity and earnings by increasing underwriting volumes or deposits, as the true cost of doing so will only show over time.

Financial institutions can easily manipulate profits and balance sheet strength by:

- Delaying write-offs for a long time
- Marking investments to (unrealistic) model values
- Hiding and/or out-running underwriting losses by growing float or deposits

[3] https://www.youtube.com/watch?v=cNQ4UBhj5X4

Many investors cite growth in book value per share as a measure of value creation. With financial institutions, however, the quality of growth in book value per share and the sustainable level of income earned on float is more important. Germany's Commerzbank is a great case study of a bank that, for at least a decade up to 2008, grew its balance sheet in the face of deteriorating earnings quality. Most market participants hailed Commerzbank's growth and increasing cash dividends up until 2008 – and suffered severely when the true quality of the bank's book was ultimately revealed. Commerzbank's shares dropped 90% during the financial crisis of 2008.

These dynamics also apply to many non-financial businesses — such as automakers, supermarkets and retailers — with financial operations (e.g. leasing, consumer credit) to help boost sales and margins. In the hands of a good manager, the added structural alpha can lead to outstanding long-term equity returns. In the wrong hands, however, the added leverage can quickly lead to catastrophic losses. I remember a supermarket chain that started issuing credit cards to drive sales. This went well for a few years until default rates increased, the company was forced to tighten lending standards, and sales subsequently collapsed.

On another note, negative working capital in the financial sector also allows for a few interesting asymmetric investment opportunities, where the upside is a multiple of the downside. For example, it will be interesting to watch the space of bond insurers. During the financial crisis, this was one of the hardest hit sectors. These days, in the aftermath of the financial crisis, the sector is benefiting from favorable market dynamics (high demand and low supply) while market valuations of bond insurers are (arguably) low, based on P/E or P/BV ratios. However, note that interest rates – and defaults – are at historical lows thanks to quantitative easing. While aggressive underwriters will most likely be able to grow their book values at high rates, the key question is when and how badly these companies will suffer once interest rates and defaults revert to the mean.

PORTFOLIO OUTLOOK

The current bull market is entering its eighth year and I am seeing far fewer opportunities than at any time since 2011. That said, I am finding enough to keep the portfolio fully invested. In fact, I consider the portfolio very undervalued as some of my biggest ideas haven't played out yet. Most of my personal wealth remains invested in the portfolio and I keep adding funds as they become available.

A friend told me a few years ago, "Robert, I'd like to invest with you but I am waiting for a time when the portfolio is down. I don't want to get in after your ideas have played out. I want to get in when you have new ideas and they haven't played out yet." I am very thankful to have investors that share the mindset of patient, value-oriented investors and aren't driven by short-term market swings. If you are such an investor – now's the time to invest!

When looking at Q2 returns, please note that about a fifth of the portfolio is currently invested in Australian companies. In Australia, the tax year ends in June, which leads to a heavy bout of so-called "tax selling" in May and June, where investors intentionally sell underperforming assets to incur a capital loss to offset capital gains by other investments.

As a general rule, I don't like to talk about positions in order to avoid ownership bias. That said, here is a bit more color on the portfolio's key positions (in order of magnitude), as I want to make this part of my letters more tangible. Overall, I consider my current ideas undervalued for various reasons and believe their mid-term stock performance should be fairly uncorrelated from the overall market's development.

1. A great compounder at a fair price. Unfortunately, the stock's market valuation rose faster than I was able to scale up the position as new funds became available.
2. An unloved, misunderstood and profitable company. It's going through a turnaround and trading below what I consider its liquidation value. I bought into it too early, as I overestimated profitability going forward, but I believe my core thesis still holds water – especially at the current, lower valuation and noting management's latest guidance. The company's use of cash will be crucial (more than 50% of market cap).
3. A small company investing all the cash it generated from a great business into a new – and thus far unprofitable – geography. The market seems to only value the company based on the depressed profitability of the combined (old + new) business without giving any credit to the cash-gushing established business or the growth opportunity of the new business.
4. A basket of profitable Japanese stocks trading below net cash.
5. A small, profitable distribution business trading below net working capital and an obvious takeover target in a consolidating industry trading well below historic M&A valuations. I expect the business to benefit from lower fuel prices. Unfortunately, the significant upside is mitigated by dilutive management compensation (the chairman/CEO is also a material shareholder).
6. A holding company with a good but unexciting portfolio of attractive niche businesses controlled by a decent capital allocator – currently trading slightly below my fair value estimates.
7. A company operating in a cyclical industry but with a flexible cost structure and low capital requirements. The near-term market outlook is much more challenging than I originally assumed (I underestimated the size and severity of industry overcapacities). However, I believe the share price now reflects most of the downside (market sentiment is as bearish as it gets) without giving credit for any potential upside given the order book, the flexible cost structure and imminent industry bankruptcies that will take out capacity.

As always, I am happy to receive feedback and answer your questions.

Please spread the word!

Robert

CLOSED POSITIONS (H1 2015)

Position	Sector/Industry	Listing Currency	Absolute Return (in local currency)	IRR
Ebix	Application Software	USD	71%	61%
EBIX is a provider of software and e-commerce solutions to the insurance industry. The company operates data exchanges that connect various entities within the insurance markets and enable the participants to carry and process data. At time of purchase, EBIX had come under immense pressure from short sellers with 50% of its publicly owned market cap sold short. Allegedly, the company was involved in accounting fraud and there were issues with the business model. I took a contrarian position as I considered the fraud thesis inflated, the company was still generating high cash flow, and because management had started to aggressively buy back shares (funded from cash and higher leverage). Indeed, operating results came in better than expected and a short squeeze led the stock to rise 400% within a year from its trough. The short squeeze pushed the stock's valuation far higher than my fair value estimate, and I sold based on valuation, not momentum.				
Sichuan Expressway	Highways and Railtracks	HKD	144%	28%
Sichuan Expressway engages in the investment, construction, operation and management of road infrastructure projects in Sichuan Providence, China. When the Chinese stock market declined about three years ago amid fears of a deep recession in China, I screened the market for big and growing companies with decent corporate governance and a large foreign investor base. Sichuan Expressway ticked more boxes in my checklist than most other Chinese companies (including many of its expressway peers) and I picked it up when it was trading at a low multiple to normalized (i.e. post growth capex) free cash flow. In addition, the H shares were trading at a discount to the A shares, despite the same ownership rights. I sold once the shares hit my fair value estimate.				

PERFORMANCE & BENCHMARKING

%	in EUR							in USD		
	Q1 Net	Q2 Net	Q3 Net	Q4 Net	Portfolio Gross	Portfolio Net	MSCI ACWI AC Net Div[2]	Portfolio Gross	Portfolio Net	MSCI ACWI AC Net Div[2]
2008	-	-	-	-26.2	-26.2	-26.2	-21.9	-26.3	-26.3	-22.7
2009	0.7	22.6	14.7	9.5	60.6	55.0	32.3	64.5	58.0	36.6
2010	8.8	-0.7	3.2	5.7	22.9	17.8	22.5	14.7	11.8	14.5
2011	-0.5	-4.3	-2.3	4.6	-2.7	-2.7	-4.9	-5.8	-6.7	-8.0
2012	22.1	1.2	6.8	6.9	53.4	41.1	14.6	56.3	45.9	16.4
2013	11.7	2.8	-0.3	5.8	27.6	21.2	18.3	32.9	25.2	23.6
2014	3.3	0.5	5.5	3.7	17.0	13.6	18.2	3.0	2.3	3.8
2015	6.9	-6.3			2.0	0.2	12.1	-6.1	-6.1	3.2
Annualized					19.4	14.9	12.1	15.4	11.9	8.3
Total Since Inception					231.3	155.0	116.0	163.3	113.1	71.4

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Net returns: no leverage, after all costs (no management fee, 25% performance fee for returns greater than 4% p.a., high watermark)
Index: MSCI All Country World Index All Capitalizations with net dividends reinvested

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