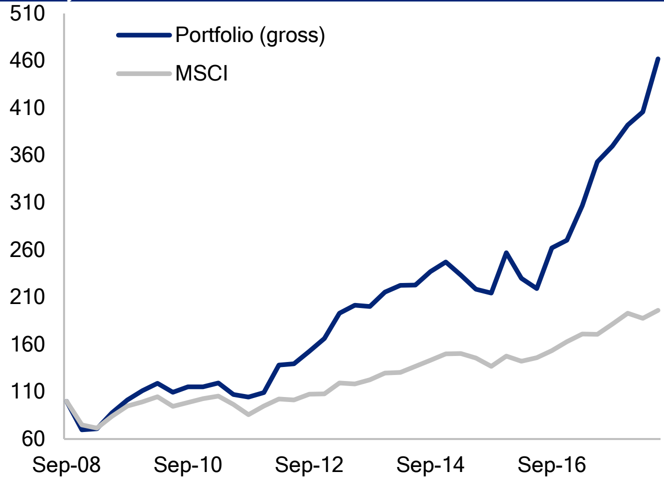
iolite

H1 2018

Investment strategy and rationale

The goal is to achieve sustainable, market-beating absolute returns by investing into a highly concentrated portfolio of global value stocks and bonds. Value investing is a low risk, high return strategy that has proven to work well over time if applied correctly and consistently. I believe iolite benefits from a stable and patient capital base, allowing me to swim against the tide. The small size of the managed fund gives me the liberty to fish in small ponds, where the big funds cannot go. Large funds have their own guidelines for investing in stocks, such as a threshold market capitalization and liquidity, among several other factors. As a result, large funds often miss out on attractive opportunities, such as in special situations and micro caps, where there are a lot of market inefficiencies. With growing assets, I will look to take full control of smaller businesses.

Summary



Management fee	0%
Performance fee	25% over a 4% annual hurdle
High watermark	yes
Initial investment	CHF 100,000
Front load	0% (a 1% stamp duty applies)
Back load	1%
Investment strategy	value / total return
Reference currency	Swiss franc (CHF)
NAV / share	CHF 1.11
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Performance

(%)	CHF (gross)				CHF			EUR			USD		
	Q1	Q2	Q3	Q4	Gross	Net	MSCI World	Gross	Net	MSCI World	Gross	Net	MSCI World
2008				(30.3)	(30.3)	(30.3)	(25.0)	(26.2)	(26.2)	(21.9)	(26.3)	(26.3)	(22.7)
2009	1.8	23.7	15.3	9.9	59.6	57.8	32.3	60.6	57.0	32.3	64.5	60.2	36.6
2010	6.9	(8.1)	5.3	0.1	3.6	3.6	3.5	22.9	18.2	22.5	14.7	12.1	14.5
2011	3.5	(10.4)	(2.6)	4.7	(5.4)	(5.4)	(7.7)	(2.7)	(2.7)	(4.9)	(5.8)	(5.8)	(8.0)
2012	26.6	1.1	9.4	8.8	52.3	42.3	13.5	53.4	42.1	14.6	56.3	45.5	16.4
2013	16.1	4.5	(0.7)	7.6	29.6	23.2	20.6	27.6	21.7	18.3	32.9	25.6	23.6
2014	3.2	0.2	6.3	4.3	14.7	12.0	15.6	17.0	13.8	18.2	3.0	3.0	3.8
2015	(5.5)	(6.5)	(1.8)	20.0	4.1	4.1	(1.4)	15.0	12.3	9.0	3.2	3.2	(2.2)
2016	(10.5)	(4.8)	19.6	3.1	5.1	4.8	10.2	6.7	6.0	11.6	3.4	3.4	8.4
2017	13.5	15.0	4.7	6.0	45.0	34.8	18.6	32.8	25.6	8.9	51.5	39.6	24.0
2018	3.5	13.8			17.9	14.4	1.5	19.1	15.3	2.7	16.0	13.0	(0.2)
Since inception (annualized)					**17.0**	**13.9**	**7.1**	**20.8**	**16.7**	**10.4**	**18.6**	**15.1**	**8.3**
Since inception (total)					**362.0**	**256.3**	**96.1**	**530.8**	**352.2**	**162.3**	**426.1**	**295.4**	**118.0**

Portfolio overview

1	**Jumbo Interactive** Australia public	% of portfolio EV Adj FCF	20% <$300m c.12x	A growing and cash-gushing niche company. Owner-run and no debt. A compounder with platform benefits and strategic value to larger industry players.
2	**Bakkafrost** Europe public	% of portfolio Market cap Adj FCF	18% <$3bn c.10x	A growing and vertically integrated company in an attractive sector that benefits from strong demand growth and supply constraints. Unique assets and best-in-class management with a long-term view.
3	**A coal company** USA public	% of portfolio Market cap EV/FCF Dividend yield	12% <$3bn c.5x >12%	One of the largest and lowest-cost miners in the U.S. Reserve life >50 years, underleveraged, run by a self-made billionaire who keeps re-investing his dividends. Recently completed a restructuring to facilitate buybacks and increase float. Improving momentum due to overseas demand growth.
4	**An advertising firm** China (HK) public	% of portfolio EV Adj EBITDA Adj capex	10% <$400m $120m $ 50m	A solid compounder with unusually good corporate governance (for China) given its controlling (but distressed) American shareholder. Over the last 10 years, the company has been growing earnings at 10% p.a. despite high cash dividends (no full reinvestment of capital). The company is sitting on hidden cash in the form of upfront payments/capex for future cash flows. An ideal target for any LBO fund.
5	**A legal services provider** Australia public	% of portfolio Market cap P/E P/BV	10% <$200m <7x <80%	A compounder that recently booked material impairments after an overly aggressive acquisition spree came to an end. Trading at low multiples and well below book (after impairments).

Robert Leitz

I am Robert Leitz, the sole investment professional at iolite. Before iolite, I held positions at various financial institutions, including TPG Credit (a hedge fund), Goldman Sachs' European Special Situations Group, and KPMG Corporate Restructuring. I graduated from the University of St. Gallen (HSG), Switzerland, with a Master of Science in Business Administration and Economics, and wrote my master's thesis under the guidance of Prof. Eli Noam at Columbia University, New York.

MSCI All Country (DM+EM) World Index All Cap (large + mid + small + micro caps), net dividends reinvested. MSCI estimates this index covers approximately 99% of the global equity investment opportunity set and I therefore consider it a very suitable measure of the market's overall performance. Please note that an index investor would probably have to bear costs not captured in this measure, such as account and product fees.

For the half-year ended June 30, 2018, the unleveraged portfolio returned +14.4% in CHF (+15.3% in EUR, +13.0% in USD) **net of all fees**. Since inception on October 1, 2008, the portfolio has generated net annual returns of 13.9% in CHF (+16.7% in EUR, +15.1% in USD). In other words, a Swiss franc invested at inception has turned into CHF 3.56 (a euro invested has turned into €4.52 and a dollar invested into $3.95).

The outstanding performance over the last few quarters has attracted attention, leading potential investors to ask me two questions: 1) what is your view on the market (it seems expensive), and 2) do you have dry powder left?

First, I generally do not have a view on the overall macro environment. I tend to invest bottom-up and worry top-down. This means I focus on picking assets at good prices and then consider macro risks that could impact my investments. That said, it seems most people I speak to are bearish – they point out that the last major correction was 10 years ago, and many fund managers complain about the lack of investment opportunities. In my experience, widespread caution and pessimism is not a sign of a market peaking. There may well be bubbles in select areas such as technology or high-yield bonds, and there is always the chance of a sharp market correction due to broader risks (e.g. wars, trade wars, large bankruptcies, etc.). However, I do not think the global stock market is necessarily overheating as a whole. As long as I can find stocks that offer attractive risk-reward profiles in a boom-and-bust scenario, I will continue to deploy capital. I do not fear volatility, but permanent loss of capital.

Second, a good portfolio manager should ask himself every day: if I were to build my portfolio from scratch, would it look like the one I currently own? I can say this is the case of the portfolio as it stands today. Even though some positions in the portfolio had a great run over the last few quarters, I still consider them undervalued given an improved outlook and improving market perception of these assets. Some portfolio companies have only recently started to show signs of a turnaround, and I expect their earnings to grow materially over the next few years. I have also started to build new positions, some of which are not yet disclosed in this report.

Thoughts on Value Investing: The Fallacies of Perception

In 2007, a man started to play the violin at a metro station in Washington DC on a cold January morning. He played six Bach pieces for about 45 minutes. During that time, since it was rush hour, thousands of people went through the station.

Three minutes went by until somebody noticed there was a musician playing. A middle-aged man slowed his pace and stopped for a few seconds – and then hurried up to meet his schedule. A minute later, the violinist received his first dollar tip: a woman threw money into the player's violin case and continued to *walk. A few minutes later, a man leaned against the wall to listen to him, but then looked at his watch and started to walk again. Clearly, he was late for work.*

The one who paid the most attention was a 3-year-old boy. His mother hurried him along, but the kid stopped to look at the violinist. Finally, the mother pushed hard and the child continued to walk, turning his head all the time. This action was repeated by several other children. All the parents, without exception, forced them to move on.

In the 45 minutes the musician played, only 6 people stopped and stayed for a while. About 20 gave him money but continued to walk their normal pace. He collected $32. When he finished playing and silence took over, no one noticed. No one applauded, nor did anyone recognize him.

The violinist was Joshua Bell, one of the best musicians in the world. He played one of the most intricate pieces ever written, with a violin worth $3.5 million. Two days before his playing in the subway, Joshua Bell sold out at a theater in Boston and the seats averaged $100. His performance in the metro was a social experiment by the Washington Post about the perception, taste and priorities of people.

If we do not notice one of the best musicians in the world playing the best music ever written, what else are we missing? The story tells us that we tend to see only what we expect, and that our perception is heavily driven by social conditioning.

In my mind, the Joshua Bell experiment also suggests why markets are inefficient, offering opportunities for independent thinkers: most market participants focus on the few companies and themes that dominate headlines, and so miss out on the many other opportunities readily available to them – but out of sight. The same goes for money managers: there are very few truly independent thinkers out there, and of those, very few can do as they like, as they are restrained by the customer base they serve. Many value investors I know have market-beating track records but are unable to attract funds because they are not skilled at marketing their product or because capital is not even trying to find them.

Thoughts on Life: How to Get Lucky

Over the last few years, I have become somewhat obsessed with studying highly accomplished people in business, technology, sports and philosophy. The idea is to learn from them, according to Warren Buffett's gospel: "Surround yourself with people better than you and you'll drift in that direction." One of my favorite "classes" is the U.S.-based National Public Radio (NPR) podcast "How I Built This" hosted by Guy Raz, where Guy allows successful entrepreneurs to tell their "rags to riches" story.

After having listened to several episodes, I would summarize the patterns I see as follows:

- Successful entrepreneurs pursue a practical approach to fulfil certain needs. Those could be entirely unfulfilled ones or improvements to existing products and services. According to most of the entrepreneurs interviewed, they were obsessed with developing a product or service, not making money (or so they say).
- All interviewees worked very hard in a very hands-on way. I am often surprised as to how simple their original setup was, and how much they did themselves to get the business off the ground. In most cases, it took years before they delegated key responsibilities, and they continued to be involved in many hands-on tasks as their businesses grew. It is astonishing what one can achieve by just picking up the phone.
- They approached everything as a learning opportunity, and failure never stopped them. Almost all of them faced severe resistance at multiple points in time, and it was their stubbornness and persistence that prevented them from giving up.
- Almost all interviewed entrepreneurs are good storytellers. I acknowledge that it is easy to tell your story once you are successful (and by the time you make it on national public radio, you are probably well trained in telling your story).

At the end of the interview, Guy's last question tends to be: "do you attribute your success to luck, hard work, a combination of both, or something else?" The answer tends to be: a combination of both. Most people credit a healthy portion of luck, but also their hard work, persistence, and the support from a few friends that helped along the way. An often-expressed view is that their approach and dedication made luck happen.

"Making luck happen" really struck my interest. It took me a while to realize the power and relevance of this skill and that the concept applies to all walks of life. In fact, I have come to the conclusion that success – and happiness – depend on the way people approach life.

Richard Wiseman, a British psychologist, researches the nature of luck and his studies have been published in the Skeptical Inquirer. According to him, people largely make their own good and bad fortune. He thinks it is possible to enhance the amount of luck that people encounter in their lives. In his conclusion, lucky people tend to create their own luck by four principles: 1) they are skilled at creating and noticing chance opportunities, 2) they make "lucky" decisions by listening to their intuition, 3) they create self-fulfilling prophecies via positive expectations, and 4) they adopt a resilient attitude that transforms bad luck into good.

Wiseman thinks unlucky people are generally much more anxious than lucky people, and research has shown that anxiety disrupts people's ability to notice the unexpected. The more they look, the less they see. Unlucky people miss chance opportunities because they are too focused on looking for something else. They go to parties intent to find the perfect partner and miss opportunities to make friends. They look through newspapers determined to find a certain job type in job advertisements and as a result miss other types of jobs. In contrast, lucky people are more relaxed and open, and as a result see what is there rather than just what they are looking for. Many lucky people go to considerable length to introduce chance and luck to their lives. Lucky people – who are optimistic, resilient, open to new ideas, and ready to take chances – are more likely to be successful entrepreneurs.

Most people interested in investing with me by and large fit the personality criteria Wiseman describes as lucky. These people are entrepreneurial personalities themselves: They are actively looking for opportunities to learn and invest, and they are not shy to take chances. When speaking to them, I am often surprised as to how many people they know and how savvy they are on a broad range of topics – a clear sign of curiosity and reflection, but also of their willingness to reach out and try new things. This stands in stark contrast to the common retail investors I speak to. Most retail investors tend to complain about their banks, yet they do little to actively improve their own situation. Few of them invest in equities, as they are pursuing the common path of perceived safety: they hold cash, pay into a life insurance policy, and buy a house. Unfortunately, this means they are missing the possibility to compound capital at high rates of return.

The cost of compounding at low rates of return can easily be worth a multiple of one's lifetime earnings. If somebody earns 100,000 a year and puts 20,000 aside each year, assuming no salary increase, she, over a 30-year timeframe, will have a lifetime income of 3 million, of which she can save 600,000. Compounded at 3%, the 600,000 becomes 1 million. However, at 10%, it turns into 3.6 million, and at 20%, it turns into 28 million. In the words of Einstein: "Compound interest is the eighth wonder of the world. He who understands it, earns it… he who doesn't… pays it."

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As iolite is approaching its 10th anniversary, I want to express my deepest gratitude to those who took a chance and entrusted me with their savings. I remain excited about the investment returns I think I can deliver over the next decades. Almost all my personal net worth remains invested in the portfolio, as I aim to compound my wealth alongside that of my co-investors.

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

Sincerely,

Robert Leitz

P.S.: Attached, for those of you who have not seen it already, an interview I gave in Forbes magazine earlier this year, on my latest investment in Faroese salmon company Bakkafrost. I believe it does a good job communicating my reasoning. With hindsight, I made one mistake: I mentioned the company's low P/E ratio as a reason to invest. It would have been better to say "normalized levels of free cash flow", as earnings are heavily impacted by price-related swings in inventory valuations, whereas cash flows are less so. With "normalized" I mean adjusted for ongoing capacity expansions (the company is expected to raise production capacity by more than 30% over the next couple of years).

Forbes: Why This Danish Salmon Company's Stock Price Could Double (February 14, 2018)

https://www.forbes.com/sites/lukeschiefelbein/2018/02/14/why-this-danish-salmon-companys-stock-price-could-double/

The Faroe Islands are a windswept archipelago between Denmark and Iceland. Their biggest employer is Bakkafrost, a farmed salmon producer. Bakkafrost is registered on the Oslo Stock exchange, and is one of the more prominent salmon producers in the Nordic region. We sat down with Robert to discuss his take on the stock and the future of salmon farming.

Luke Schiefelbein: *What about Bakkafrost initially caught your eye as a value investor? What catalyzed your entrance into the position?*

Robert Leitz: A few years ago, I went on a road trip through Western Norway and the number of fish farming sites caught my attention. I read up on the industry and the more I read, the more fascinated I became with the product and the value chain behind it.

The salmon industry is benefitting from very favorable tailwinds: growing demand and structurally restricted supply. Regarding demand, protein consumption is growing due to population growth, growing disposable incomes, and zeitgeist. Fish is perceived to be healthy and has a lower environmental footprint than beef, pork and poultry. Regarding supply, wild catch is at capacity and growth only comes through aquaculture. It is very difficult and costly to increase aquaculture production of salmon given the lack of suitable locations, license restrictions, diminishing natural feedstock supplies, and biological hazards that come with mass production such as diseases and parasites.

However, despite these industry tailwinds, I found it quite difficult to find a good company to invest in. Salmon farming is still a fairly young and fragmented industry with only a few larger, publicly listed players. Among these, some have overstretched themselves by investing outside their home market, some overleveraged themselves by pursuing aggressive acquisition strategies, and others just never managed to produce healthy margins.

I consider Bakkafrost the pearl of the industry. By buying shares of the company, an investor essentially purchases a stake of the Faroe Islands, an autonomous region within the Kingdom of Denmark located roughly halfway between Scotland and Iceland. The company operates permanent licenses in geographic conditions extraordinarily suitable for salmon farming, is fully vertically integrated, boasts state-of-the-art production facilities as well as decades of technical know-how, and is run by a shareholder-friendly owner-manager, Regin Jacobsen, who turned a small fishery into a global player.

As of February 2018, Bakkafrost is trading at a P/E ratio of around 11 times. This is extraordinarily low for an unleveraged, high-quality growth company. Bakkafrost is run prudently, has shown impressive organic growth with high return on invested capital, and is likely to grow production volumes by another 30% (+6% p.a.) until 2021, given current capex projects – all while also paying a healthy cash dividend.

Schiefelbein: *What is the market missing? How has the salmon market been disrupted by the recovered capacity in Norwegian and Chilean fisheries?*

Leitz: I believe the market has failed to catch up with Bakkafrost's growth and is overestimating the impact from short-term price swings. In 2016, global salmon supply declined by about 7% as Norwegian farmers suffered from the rise of sea lice (a parasite) and Chilean farmers suffered from a toxic algae bloom. Prices have recently come down as the situation in both countries is normalizing. I have no idea where salmon prices are heading in the short term, but I do believe they are likely to recover. Future demand is likely to grow exponentially, and supply must rise to meet it.

Schiefelbein: *What key metrics should investors be paying attention to as your thesis matures? What differentiates Bakkafrost's salmon farming from other salmon fisheries?*

Leitz: Investors should closely monitor production volumes, salmon prices and differentiate between growth and maintenance capex.

The total production cycle is about 3 years and smolt releases (i.e. the release of young fish from hatcheries into the open water) provide a good indication of future harvest volumes. Bakkafrost is operating permanent licenses without volume restrictions. Future growth is mostly driven by a new hatchery that allows the company to grow the smolt to a much larger size in a fully controlled environment on land, before releasing it into the open water. The shorter time in the open water increases production capacity by about 30% and also reduces biological risk.

Even if salmon prices decline by 20% to levels last seen in 2014 and 2015, Bakkafrost should do very well. As an unleveraged low-cost premium producer in a leveraged industry, it has the flexibility and capability to increase market share while other players are suffering.

Over the last few years, Bakkafrost's management has heavily invested to streamline the value chain, improve quality control and reduce the risk of biological hazards. Some of the benefits from these undertakings will only become visible in 2018.

Bakkafrost's investment in high-quality feed ingredients is not only to minimize the biological risk but also to provide a premium product. The natural diet of salmon is fish, and farmers used to feed fishmeal and fish oil extracted from wild catch. However, supply and price constraints led the industry to lower-quality substitutes over time, such as corn, vegetable oils, and wheat, even though keeping the feed closer to the natural diet of wild salmon provides measurable benefits: a healthier nutritional profile, a superior meat structure, and higher production efficiency due to improved animal welfare.

Bakkafrost is using a higher content of fish ingredients than its peers, and it has built its own environmental pollutant cleaning facility to improve the feedstock quality. This comes at a price. Feed cost make up about 40% of total cost for the industry versus about 60% at Bakkafrost.

Schiefelbein: *How vulnerable is Bakkafrost to a shift in the Faroe Island's regulatory regime? Do you see regulatory change controlling fish farming in reaction to the rise of sea lice and the propagation of escaped farmed fish in the wild?*

Leitz: Bakkafrost is the Faroe Islands' largest employer and probably accounts for more than 25% of the region's GDP. As such, the company has an extraordinary social responsibility and is subject to regulation and taxation risk.

Regarding farming licenses, the region's current regulatory framework is quite progressive. From 2001 to 2004, the Faroe Islands were severely struck by ISA (infectious salmon anemia) virus outbreaks. As a result, new legislation and regulation was introduced in 2003, which has resulted in one of the most predictable fish production environments in the world. In short, the new framework requires all farmers to keep production volumes at sustainable levels and to cooperate when planning production cycles and volumes.

Regin Jacobsen has invested heavily into quality and process control, and he has proven to be a very thoughtful, strategic thinker who carries his many responsibilities well. It is perhaps presumptuous to think that a regulator may try to threaten his company at the risk of endangering the fate of the Faroe Islands.

Schiefelbein: *Is the rise of seawater temperatures due to climate change a threat to salmon farming?*

Leitz: Salmon require water temperatures to be in a certain bandwidth, ideally 8-14˚C. The seawater temperature of the Faroe Islands provides ideal conditions, hovering around 6-11˚C. I am no marine expert, but a rise of 1-2˚C probably does not matter all that much to Bakkafrost, while players in warmer regions would feel such a change more severely. Higher water temperatures also increase biological risks such as toxic algae or amoebic gill disease. The recent algae bloom in Chile was blamed on unusually high seawater temperatures, the lack of hygienic conditions in the cages, and the so-called nutrients dumped into them.

Schiefelbein: *What are the biggest risks associated with your thesis? What could go the most wrong?*

Leitz: Bakkafrost is an operationally geared price taker and earnings are therefore subject to the volatility of salmon prices. As discussed, harvest volumes are subject to biological risk and the government might enforce volume restrictions or license removals if it feels current production levels are not sustainable. The ongoing growth projects are subject to execution risk and may fail to realize the desired outcome and become more expensive than originally planned.

Bakkafrost is also subject to foreign exchange risk and volatility: the company's workforce is paid in Danish krone (pegged to the euro) and is listed in Norway (with the listing currency being the Norwegian krone) while its sales are mainly based in US dollars and euros. Lastly, a profitable company is always at risk of higher taxation and labor cost inflation.

Schiefelbein: *Are there any risks associated with the growing preference for wild over farmed salmon? How much of a risk does PCB / dioxin exposure and concern over dye pose to Bakkafrost?*

Leitz: Wild catch has been stagnant for more than a decade as it is at capacity. A stronger consumer differentiation between wild and farmed salmon would probably lead to higher prices for wild catch given the supply restrictions. A higher reference price point for wild salmon may actually help support prices of farmed salmon as well.

There is a risk the industry may see demand shocks through events similar to what we have seen with mad cow disease, swine fever, or e-coli outbreaks. However, those setbacks have always only been temporary, as you cannot replace a key ingredient of the human diet such as pork and poultry. Of course, individual farmers may get hurt badly in a severe demand crisis, but demand usually comes back after a couple of years.

Unfortunately, the world's oceans are becoming increasingly polluted, and mass production requires disgusting industrial interventions to grow output levels. This has a severe impact on the quality of the food available to us. Pregnant women are told not to eat tuna due to the risk of mercury poisoning. In Vietnam, cheap aquaculture fish such as catfish are farmed in truly horrific conditions. Most meat products we purchase in supermarkets are subject to heavy use of hormones and antibiotics, exposure to feces, low-quality feed ingredients, and chemical interventions harmful to human health.

I honestly believe Bakkafrost is doing more to maintain a healthy, premium product than most of its peers. For example, current investment focused on keeping the smolt in fully controlled hatcheries for longer means the product is less exposed to pollutants and sea lice. We have already discussed the benefits of paying up for higher-quality feed ingredients.