Investor Letter for the calendar year: 2020

Author: Timo Buss

Re: Why experiencing volatility is the price to pay for attractive long-term returns

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Dear fellow investors,

Thank you for taking the time to read my first investor letter. Since January 1st, 2020, I've been advising my own fund for Hamburg-based fund boutique Covesto Asset Management, according to my own investment philosophy and with a high concentration in the best investment ideas.

Due to cost advantages, I did not set up the fund completely from scratch but instead took over a fund shell (DE000A2JF8K9, S tranche) that had already been listed since 2018. **The development of the fund price during the years 2018/19, which you can see on many financial platforms, therefore has to be assigned to the former advisors.**

Since taking over the fund at the beginning of the year, I reassembled 100% of the portfolio and changed the fund's legal structure from AIF to UCITS. Additionally, I launched a second tranche in mid-February (DE000A2PR0E7, I tranche). Starting with this letter I would like to report to you annually the considerations which were important in advising the fund during the calendar year, whether new significant investments were made, how the portfolio structure and performance at year-end turned out and, at the end, devote myself to one topic in detail.

This year's topic in detail is **why volatility – in the form of experiencing significant temporary ups and downs in the stock market – is the price for attractive long-term returns.**

The investor letter begins with a table showing the portfolio structure and a performance overview.

<u>Portfolio structure</u>

| NAV* as of 31.12.2020 | 10.47€ |
|---|---:|
| Weight of the largest investment | 9.3% |
| Weight of the five largest investments | 38.3% |
| Weight of the seventeen largest investments | 84.0% |
| Weight of cash | 2.7% |

*The NAV refers to the S tranche, the I tranche was launched on 11.02.2020

As you can see, the weighting of the most important investments is relatively high. This stems from my conviction that fund managers who want to beat the market must necessarily do something *differently* than the market.

The three most obvious ways to achieve a *different* performance than a broadly diversified stock market index are:

1.) Market timing (building up the investment quota prior to rising market phases and reducing the investment quota prior to falling market phases)
2.) High trading activity (constant title and sector rotation) or
3.) Low trading activity with a very high concentration in the best investment ideas

The theoretical excess return potential is declining from 1.) to 3.), but the possibility of repeating very good results in practice increases from 1.) to 3.). My investment strategy for the Patient Capital Fund focuses on point 3.) and ignores points 1.) and 2.).

**For this reason, the focus of my work is meticulous research, the highest possible concentration in the best investment ideas and continuously striving to avoid behavioral errors.** The largest positions in the fund are regularly weighted near the maximum regulatory limit of 10% of the fund volume, the top 5 positions often make up ~40% of the fund volume (2020: 38.3%) and the top 17 positions represent >80% of total assets (2020: 84.0%).

Below I would like to inform you about the ten largest holdings of the fund.

Alphabetical listing of the ten largest holdings of Covesto Patient Capital

Alphabet → *current publication (Link): BIG TECH ANTITRUST UND DER FALL GOOGLE*
CCL Industries
Fomento Económico Mexicano
Marel
Microsoft → *current publication (Link): MSFT:US | MICROSOFT*
Prosus
S&P Global
Spotify
TomTom
VISA

With this list I would like to inform you annually regarding changes in the most important investments. In case you would like to check upon the holdings more frequently, you can access the portfolio structure which is daily updated here including a breakdown by country, sector and currency.

Performance overview

| Period | Covesto Patient Capital* (1) | DAX** (2) | Delta (1)-(2) |
|---|---|---|---|
| 2020 | 10.2% | 3.6% | +6.7% |

*The performance relates to the S tranche, the I tranche was launched on 11.02.2020

**The fund is not limited to German companies. I am therefore of the opinion that a tabular comparison with the domestic DAX index is only partially meaningful. A comparison with so-called world indices (in EUR), for which the renowned index providers regularly charge high fees, would be more substantiated in terms of informative value

The table shows the performance of the fund since I started advising it. As long as a track record for a new fund has only been available for a few years, such a table provides little information about the skills of a fund advisor. Only in the long run will it become clear whether a fund advisor creates repeatable value-add for his investors with a previously defined strategy.

The reason for this is that during short periods of time strong movements on the capital market are often primarily driven by collective emotions such as fear or euphoria (hardly predictable) and only in the long term do hard criteria such as profit growth of listed companies (more predictable) explain sustainable price appreciation. Due to this fact I will show the fund performance in the table above each year but don't intend to address it too much during the first couple of years. Instead my plan is to draw a more detailed conclusion at the interim results in January 2025 (after five full calendar years of performance). For the next four years I have high expectations for the sales and profit development of the largest investments in the Patient Capital Fund. If these expectations are met or exceeded over time, the market valuations of these companies are likely to be significantly higher in the future for good reasons and you as a fund investor will enjoy capital gains.

The table above shows the fund's performance in relation to the development of the German stock index DAX. **However, since the fund, in contrast to the DAX, can invest internationally – and makes extensive use of it – a comparison with the development of so-called world indices (in EUR) would be more substantiated in terms of informative value after said five full years of performance.** My goal in advising the fund includes outperforming both the national as well as a global index in the long run.

My specific expectation is that the majority of the portfolio companies can increase earnings per share in the lower double-digit percentage range in most years, although the valuation does not fully reflect this. Since there is a fundamental relationship between the long-term profit development of the companies contained in a mutual fund and the development of its fund price, **I aim to achieve a performance of >10% p.a. on average for your as well as my investment in the fund over the long run.**

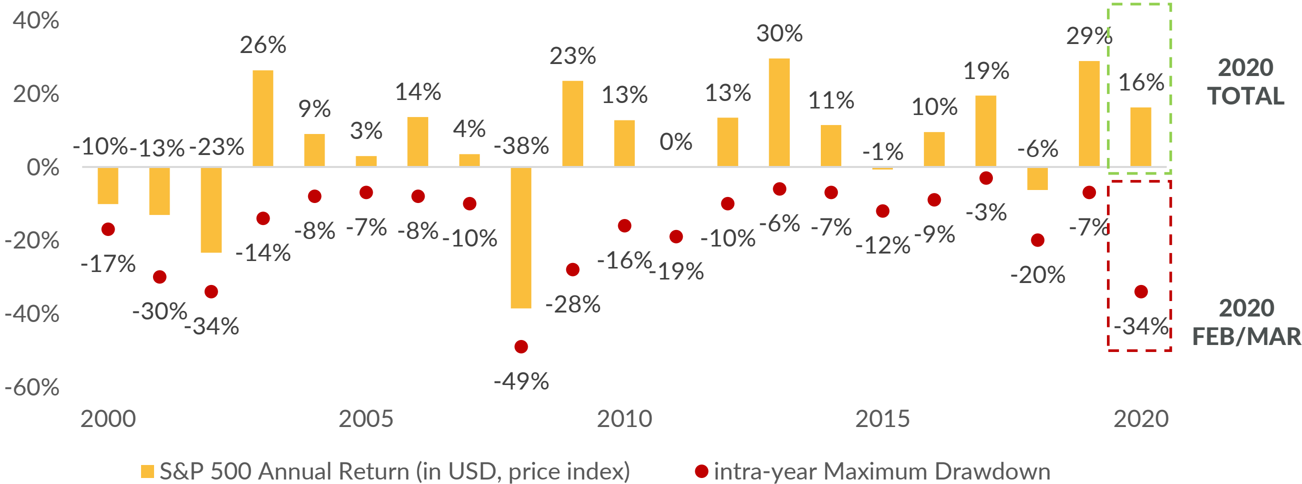
Why experiencing volatility is the price to pay for attractive long-term returns

The path to achieving this targeted return of >10% will not be linear, however. The stock market development during the calendar year 2020 serves as a good example. While in previous years investors were often able to enjoy high annual returns from investing in the stock market with only low volatility, in 2020 collective emotions such as fear in February/March (partly justified) and a later return to euphoria (partly unjustified) led to strong capital market fluctuations, downwards as well as upwards.

In industry parlance, the decline from a previous high to the next low is known as the maximum drawdown (MDD for short). In 2019 many stock indices achieved an annual performance of >20% with an MDD of only -7% (for the S&P 500 for example), which for investors was hardly a cause for concern. **Historically, however, the stock market has regularly seen significantly worse declines, namely by more than 10% on average every two years and by more than 25% every seven years.** From a capital market historian's point of view, the sharp swings during Q1/2020 are therefore *not* an anomaly, even though declines of more than 25% had not occurred for over ten years until March 2020.

In March 2020 the "once-in-a-century" event COVID-19 led to the shutdown of significant parts of the global economy and, in consequence, the stock market as well as the price of the Covesto Patient Capital Fund fell by more than 25% from a previous high (to be precise the fund had a maximum drawdown in 2020 of -33% vs. -39% for the DAX and -34% for the S&P 500, see exhibit below).

***Exhibit: Despite an intra-year drawdown of -17% on average in the stock market between 2000-2020 and -34% in the reporting year, the annual return for the S&P 500 was positive in 14 out of the past 21 years***




A negative event like COVID-19 can occur at any time without prior notice. For this reason, I advise the fund based on my philosophy that it should be invested in outstanding companies from different industries which have the necessary balance sheet and earnings strength to survive a crisis preferably without any government, capital market or bank support.

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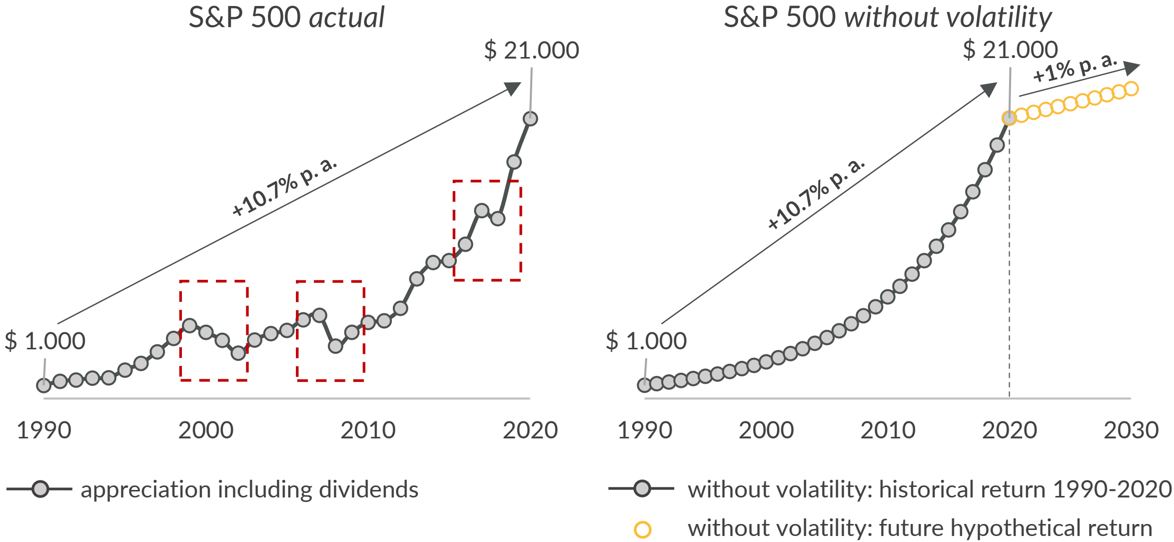
Illustrative of such resilience is the **mantra of Microsoft's founder Bill Gates, according to which the software company should always be managed in a way that if no sales were recorded for a full year, the cash reserves were sufficient to pay all employees' salaries and other operating costs for an entire year.**

With a 9.3% weight in the fund, Microsoft is currently our largest holding and generated sales of around $ 143 billion in fiscal 2020 and an operating profit of $ 53 billion (37% margin). Of the costs in between, $ 16 billion is fully variable and $ 74 billion is semi-variable or non-variable. At year-end, according to the founder's mantra, the company had cash reserves of US $ 137 billion, offset by financial debt of $ 63 billion. So the net cash balance was $ 74 billion, the exact amount of all semi-variable or non-variable employees' salaries and other operating expenses for one year. Even if Microsoft had not emerged as a COVID-19 crisis winner in an alternative crisis scenario (e.g. a digital instead of a stationary shutdown), the odds would have been in our favor that the company should have survived a severe crisis without any outside help from bankers or the government. Forward-looking corporate management of this kind and the rejection of high financial indebtedness is practiced by all the managers responsible for the ten largest holdings inside the Patient Capital Fund.

The year 2020 ended with price gains after all. In the future, I expect that we will experience many years with positive stock market returns, but at some point there will also be another drastic drawdown like the one seen in February/March 2020 (the question is not *if*, but only *when*). You can see some longer lasting drawdowns on the stock market in the exhibit below, colored in red for the S&P 500 during the period 1990-2020. The volatility seen there is inextricably linked to investing over several cycles and represents the price for attractive long-term returns.




As can be seen on the left, every dollar invested in the S&P 500 increased by a factor of 21x between 1990 and 2020 ($ 1,000 → $ 21,000). This corresponds to an annualized return of >10%. The path to this double-digit return was not linear, however. On the right you can see what the identical performance ($ 1,000 → $ 21,000) would have looked like in a world *without volatility*. **However, this is inevitably**

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**a paradox. Because without volatility, stock returns would be SAFE and for (supposedly) safe returns on the bond or money market investors are currently willing to accept negative or, at best, returns of 0-1% p.a.** Without volatility, the stock market would trade many times higher today and the prospect for future increases would be meager in consequence (at best 1% p.a., see data series in yellow).

* * *

The bottom line is the following: collectively bad emotions during temporarily drastic drawdowns are the only reason why stocks should generate significantly higher long-term returns than non-volatile asset classes that do not cause investors any fear. Anyone who is not willing to accept that experiencing volatility is the price for attractive long-term returns on the capital market will have to be satisfied with what non-volatile alternatives can offer (e.g. currently a 0.01% return on savings accounts).

In the fund we are invested in profitable, growing and resilient companies. In the event of future drawdowns, I hope that you will be able to hold onto your shares in the fund with a relatively good feeling. Superb discipline would include aggressively expanding your total investment on the capital market when others are fearful during turbulent market times. Because only when collective fear is pervasive will there not only be a limited number of attractively priced stocks but unbelievably cheap bargains everywhere. **The price that investors have to pay to increase their stake in these bargains, however, is an emotional one.** It is made up of enduring further volatility while the bottom is not yet in sight and accepting discomfort during the process of buying more.

Since I started advising the fund I have invested ~100% of my liquid assets in the fund and will not make any investments on the capital market other than to acquire additional shares of this fund. This explains why, on the one hand, I have high expectations concerning the long-term development of the fund and, on the other hand, I am going to see and experience exactly the same intra-year drawdowns as you.

January 10, 2021

*More information at:* [www.patient-capital.de](http://www.patient-capital.de) *as well as* [www.patient-capital.de/aktien-wissen](http://www.patient-capital.de/aktien-wissen)

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