TRIUM BLACKWALL EUROPE L/S FUND

EUROPEAN LONG/SHORT EQUITY

QUARTERLY NEWSLETTER

JUNE 2015

"WE LOVE REGULATION AND ETFS!" – PART II

In Part I on this topic, our last Quarterly Newsletter focused on regulation, why we believe that "it IS the ultimate destroyer of efficient markets" and how to benefit from this trend.

In Part II we focus on ETFs and passive investing, and why we believe that it will be "the FUTURE graveyard of investors."

If all the people running in the same direction, the world turns upside-down.

Passive investing through ETFs has been increasingly popular over the past decade. According to Blackrock, a total of USD 2.6 trn is invested in over 5,000 ETFs globally, taking an increasingly larger proportion of new allocations (about 20% by now).

There are obvious benefits to investing into the equity market on a low cost and long-term basis by using these instruments. While this certainly holds true when comparing ETFs to supposedly actively managed funds that are, in fact, "closet benchmarkers" (i.e. charging fees for activity but investing almost passively), we believe that the financial industry has a very bad track record on product innovation and holy grails often turn badly when extended to the extreme (eg shareholder value).

The main reservations we have regarding passive investing are as follows:

- Passive investing doesn't eliminate the risk of the investment itself. It only removes the risk of underperformance against a selected benchmark. Whether stocks included in this benchmark are good or bad companies, trading at good or bad prices, risk may not be properly managed.
- An index membership (in particular, of the key indices) is a manifestation of the past performance extrapolated into the future. Stocks become a member of an exclusive club after years of growth that is reflected in multiple expansion that lifts market capitalisation and trading volumes. For example, technology giant Apple entered the Dow Jones Industrial Index earlier this year and, while we don't know what the future looks like for Apple, we believe it's fair to say that share price performance from here on will be a shadow of the past 10 years.
- Investors preferring an index over a single stock lose the connection to what they own. Instead of understanding a single company, including management, operational edge, financials and many other determinants of true value, buying into an index means an increasing focus on price itself and not on the underlying value.
- The focus on price instead of value increases the liquidity or risk on-off mentality, which leads to indiscriminate buying and selling of stocks. In the absence of individual rational drivers, ETF investors might see other ETF investors as their main data point. This other-directed characteristic is particularly crucial at times of enthusiasm and panic.
- As a consequence of prior points, passive investors no longer participate in an active capital allocation process – and neither use their voting rights. However, differentiating between good and bad companies (despite all the errors made) is vital for the long-term health of a company, a sector and ultimately for an economy. And an active participation doesn't necessarily mean to be an "activist" shareholder as there are various ways to participate in this process.
- The world is changing at an increasing speed. The Internet has been disruptive for many business models and allowed new ones to flourish. Companies we didn't even know 10-15 years ago are now household names (eg Amazon). This has been reflected in the index composition, which itself is changing at an increasing speed. New technologies like 3D-print or robotics will accelerate this trend in the years to come. As a consequence, an increasing number of existing index constituents will be washed out, after declining in value first, while new ones will only come in after their strongest growth period. Passive investors will participate in the first ones in full but only marginally in the latter.

In contrast to passive investing, Blackwall only invests in a limited number of single stocks. This means that we aim to understand a company's value and can take advantage of passive investment trends in various ways for the benefit of our investors:

- Indiscriminate buying and selling by passive investors creates buying opportunities in undervalued stocks or shorting opportunities in overvalued ones.
- Understanding a company is vital to distinguishing between noise and real news. Admittedly, the difference between noise and real news can take some time to be priced in by the market but having an investment horizon of 3-5 years will almost certainly allow for this to be realised and provide a substantial outperformance against most passive/ETF trading strategies.

- At Blackwall, every single investment case undergoes a risk analysis before a position is entered. We want to understand what can go wrong. For example, among others, we deploy a "constructive destruction" technique by best-guessing what disruptive technologies might destroy our investment thesis for a company. This means that, while we are unlikely to find the next Apple (and frankly, this isn't our style to do so), we are unlikely to invest in companies whose business models may be soon structurally endangered. By avoiding them (or shorting if appropriate) and picking the sustainable ones for our long portfolio we believe we will outperform.

We strongly believe that the trends towards passive investing and regulation (as outlined in Q1) provide a set of unintended consequences which in turn allow for opportunities to benefit an independent and fundamentally based investment process. May both trends last for many years to come!

Portfolio structure

The market decline in Q2, provided us with the opportunity to start investing in additional great companies. Our investment holdings on the long side increased from 13 companies to 19. As we intend to manage a concentrated portfolio on the long side, within the UCITS rules, we are therefore close to the maximum number of investment ideas we will include at any given point of time.

As outlined in the March 2015 Newsletter, we use the concept of consolidating the portfolio holdings on the long side into a "combined entity" that allows us to illustrate the economics of the typical pro-forma company of the portfolio.

Financials	13	14	15E	16E
Sales	3616	3666	3930	4114
Gross Profit	1823	1862	1976	2086
EBIT	660	651	765	832
Net Income	453	456	524	576
FCF	312	336	445	490
Net Financial Debt	1572	1755	1257	1037
Shareholder Equity	2459	2635	3012	3333
Capital Employed	4503	4979	4994	5170

(Data in EUR mio)

Valuation Ratios	13	14	15E	16E
P/E	19.3	23.5	19.1	16.2
P/BV	2.8	2.8	2.6	2.4
EV/EBIT	12.1	18.8	13.8	11.8
Net debt/EBITDA	1.1	1.4	1.1	0.7
Dividend Yield	3.2%	2.5%	2.7%	3.0%
ROE	25.4%	22.6%	28.3%	28.7%
ROCE	21.6%	17.9%	18.9%	21.0%

Source: Bloomberg, Blackwall Capital Investment AG

On average, investors in Blackwall hold a mid-sized company with sales growing around 5-7% annually, EBIT compounding between 9-18% annually and net profit growing about 10-20%. In all three categories we believe the mid-term growth rates are more likely on the lower end of ranges, which still implies a healthy 10% on EBIT and net profit. Taking recent revisions into account, growth rates are similar to the consensus estimates for the Stoxx 600 (all consensus data from Bloomberg).

However, we strongly believe there are significant differences in terms of:

- Margins: the average gross margin is at 50%, compared to only 29% for the Stoxx 600; and the EBIT margin is at 19-20% compared to just 9-10%
- Return on Equity: the average company in the fund generates an ROE of 28-29% compared to a market average of only 8-10%
- Leverage: With 0.7-1.1x EBITDA, net debt remains low – compared to the Stoxx 600 net debt/EBITDA at 3.9-4.2x.

Overall, investors in our fund hold companies with a strong franchise (often without correlation to GDP – after all, who knows whether Europe will really recover in the years ahead) and superior margins, generating substantially higher ROEs at much lower debt levels. In Q2 we added companies which further improved the portfolio structure on all key metrics (except for leverage) – while market numbers deteriorated to some extent.

In terms of valuation, EV/EBIT is at 13.8x for 2015E and 11.8x for 2016E – this is below the market average of 16.5x and 15.3x respectively. However, it is not as low as it was at the end of Q1 which is predominantly due to the exit from two positions on the long side. Although we intend to hold stocks for a 3-5 year horizon, both stocks strongly re-rated (up by 50-100%) over a very short period of time (unfortunately not giving us enough time to build larger positions) to achieve our 5-year-target within 6 months – hence, profit taking and reinvesting into new ideas was the only logical consequence.

Best regards, Thomas Karlovits

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