Investmentaktiengesellschaft für langfristige Investoren TGV

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Dear investors

Attached, you will find the semi-annual report for the year 2018 provided by our sub-advisor JMX Capital GmbH for the sub-fund „Truffle“.

Yours sincerely

Investmentaktiengesellschaft für langfristige Investoren TGV

Semi-Annual Report 2018 of the Sub-Advisor

Dear investors,

The price development of TGV Truffle over the past six months has been positive. Amongst the positions, however, there were drastic differences in the price development. The fact that these individual price fluctuations added up to a plus for TGV Truffle is merely coincidental given the short observation period. As TGV Truffle currently holds a concentrated portfolio, substantial fluctuations in the share price are expected to occur in the future as well. However, I do not see fluctuations as an economic risk. Instead, I am focusing on ensuring that there are no sustained declines in the underlying company values of the shares represented in TGV Truffle. Whether these – hopefully rising or at least stable – values are evaluated differently in the short term due to fear or euphoria on the capital market, does not concern me.

Measuring and weighing

As always, please find the most important portfolio and performance data of TGV Truffle in the following table.

NAV as of 06/29/2018 in EUR	129.81
Total number of investments	10
Weighting largest investment	24.3%
Weighting Top-5 investments	81.8%
Weighting cash / fixed deposit	-0.6%

Alphabetical Listing of Top-5 Investments:

Amaysim

Alphabet

Rolls-Royce

Tripadvisor

Tucows

Period	TGV Truffle (in EUR)	Berkshire (in EUR)	*(Difference)*[1]	6% p.a. Benchmark	*(Difference)*[1]
2015[2]	-12.5%	-10.0%	*(-2.5%)*	+4.5%	*(-17.0%)*
2016	+18.1%	+27.5%	*(-9.4%)*	+6.0%	*(+12.1%)*
2017	+17.0%	+6.9%	*(+10.1%)*	+6.0%	*(+11.0%)*
2018[3]	+7.3%	-2.9%	*(+10.2%)*	+2.9%	*(+4.4%)*
Since inception[4]	+29.8%	+19.1%	*(+10.7%)*	+20.9%	*(+8.9%)*

Portfolio changes

Major portfolio changes in the past six months included the sale of Microsoft and the simultaneous increase of the Rolls-Royce position. Both investments are similar in many characteristics. Therefore, I will discuss them together in the following.

Microsoft has been a large, sometimes even the largest position in the portfolio since the early days of TGV Truffle. The sale concludes a highly successful investment: from 2015 to 2018, Microsoft not only outperformed both benchmarks in the portfolio but also outperformed virtually any other position in the TGV. Operationally, the company performed roughly as I predicted but some of the good price accretion caused the undervaluation of the stock to disappear. At a price of around USD 100, Microsoft is close to or has reached its fair value, so it made sense to recommend a re-allocation to more attractive opportunities.

The proceeds from the sale of Microsoft were used for the purchase of Rolls-Royce.

Rolls-Royce has also been a part of TGV Truffle portfolio from the beginning. The company is making sustainable progress in its transformation efforts, and substantial changes are already visible. Indeed, the company's financial reporting has improved significantly, which leads to more clarity about the probable developments over the next 5-10 years. It is becoming increasingly clear that around the year 2023, the company is likely to achieve at least GBP 1 per share in free cash flow. The current price ranges between GBP 9 and GBP 10, which corresponds to a free cash flow return of roughly 10%.

Of course, it will take a while before a free cash flow GBP 1 per share will be achieved. However, until 2023, the company will also generate substantial earnings, which may be distributed or used for share repurchases. There is also substantial evidence that the company's free cash flows will continue to

[1] Rounding can lead to minor deviations in the differences.
[2] 03/31/2015 – 12/31/2015
[3] 01/01/2018 – 06/29/2018
[4] Since 03/31/2015

grow for many years after 2023. Therefore, a reasonable free cash flow return in 2023 could be in the low single digits, which makes the price of more than GBP 20 plausible within five years.

Why does the capital market not realize this opportunity?

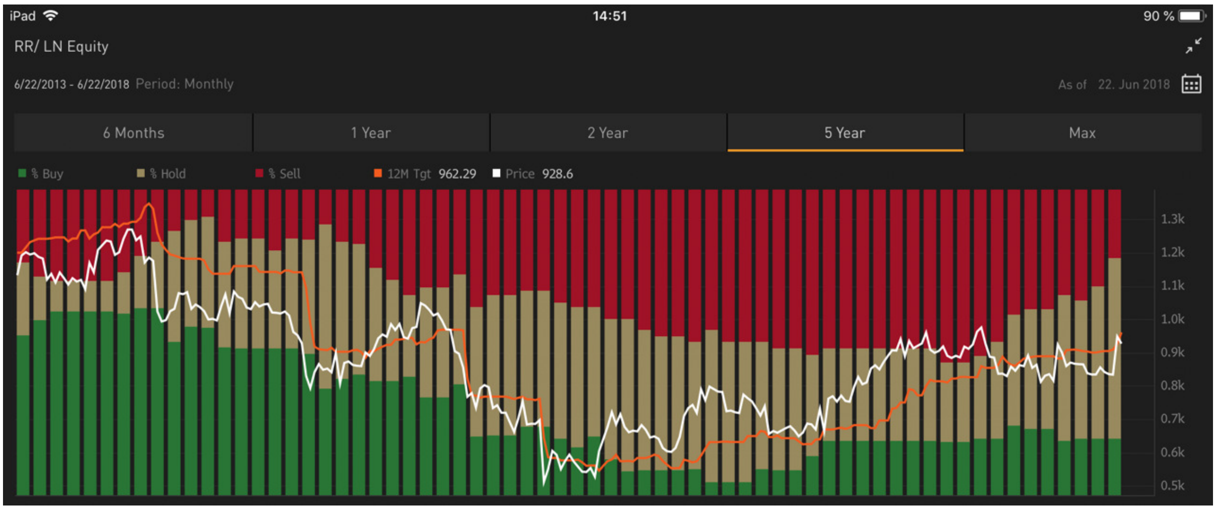
The reason for this is similar to the situation Microsoft was in in 2015. In the very first report for the first half year of 2015, I wrote:

"Of course, there are many analysts who focus on Microsoft as well and these analysts are all intelligent people who have better access to the management of Microsoft than me. The only problem is that the clients of the analysts are large active investment funds whose fund managers are not investors but salaried managers. These managers have to consider not only the actual investment risk, but also the career risk, should their own performance deviate too much from the benchmark. As a fund manager of a large investment company you can simply not afford trailing behind the market for a year or two (and heaven forbid if this is the case for an even longer period of time!). Consequence is a quite short-sighted focus on quarters, frequent trading to limit losses and making at best marginal decisions that deviate from the benchmark. (…) For Microsoft, this means that every year as many shares are traded as the company has issued. (…) Therefore it is hardly surprising how few questions the CEO of Microsoft gets actually asked about to long-term outlook of the company in the quarterly teleconferences. Granted, the analysts frequently ask for the expected tax rate for the next quarter – but given that focus, do they have a better understanding of the long-term value of the company than me?"

Swap the company names in the above text, and you have Rolls-Royce in 2018! Here, too, the consensus that the transformation is successful and the long-term prospects of the company are impressive is slowly building. It may well be that my colleagues at major investment funds and analyst firms share the view that Rolls-Royce can be worth a lot more on the stock exchange in five years. The problem is that around 45% of all fund managers stay in the job for less than two years and across all funds the average term of a fund manager is less than five years[5]! I know several colleagues whose investors react to weekly fluctuations with inflows and outflows. Weekly! At this point, I can only express my praise to you, dear investors: Since the launch of TGV Truffle, so far there was not a single query regarding the performance of TGV Truffle with the Investmentaktiengesellschaft für langfristige Investoren TGV or with me. This discrepancy – some are measured on a weekly basis, and others seemingly in more than three-year intervals – allows for the possibility of long-term outperformance of TGV Truffle. Your patience facilitates my work – thank you for that!

[5] Barron and Ni (2013). Morningstar ratings and mutual fund manager turnover. *Journal of Applied Finance*, 23(1), 95-110

But back to Rolls-Royce: Due to the short-term nature I just described, the focus of market participants is still on the developments of the upcoming quarter(s). Despite the recent good figures and a significantly improved corporate culture, the analysts' projections have only changed minimally. "Always keep a door open, just in case the share price stays volatile," seems to be the motto! In a graph it looks like this:



The first thing you notice is that as the price (white line) dropped in the left part of the chart, the sell recommendations (red bars) rose. It is hard not to get cynical about this. When the price bottomed out, more analysts recommended selling than buying. The opposite would have generated added value. It is also interesting to observe that in recent months, the number of sales recommendations has dropped and the majority of analysts recommend "Hold". Of course, there will be disappointments and uncertainties in Rolls-Royce until 2023. Of course, the stock will fluctuate significantly. However, unlike the analysts working for the big banks, I dare to recommend Rolls-Royce for purchase even today.

Mistakes

Especially if recent performance has been good, one's own ego can affect rational decisions. The post-mortem reflection of your own mistakes is then a sound basis for a verdict. Certainly, I have made enough mistakes that warrant an explanation over the past three and a half years!

Please find the list and the explanations for my biggest mistakes to date, listed according to my assessment of the negative impact on the performance of TGV Truffle. Two comments: First, not all mistakes have led to a loss. Failure to achieve positive performance is just as much a mistake as wrong decisions that have coincidentally led to good price performance. Second, not all realized losses are mistakes. For example, I do not consider recommending Aggreko a mistake, even though TGV Truffle has lost money. Instead, the company and the industry environment had changed, and a previously assessable situation became unpredictable due to turnover in the management team. In such cases, it is necessary to revise the original assessment. Then the potential for mistakes lies not in the declining price, but in sticking with a prior judgment that was proven wrong.

The “Hall of Shame”:

1. Last spring, I came across an interesting company: led by the founder and major shareholder, subscription model software product, an industry I know well, attractive growth, no debt, competitive advantage clearly visible and apparently extremely favorable valuation. At the same time, it was clear that the geographical location of the company headquarters was not en vogue at the time and therefore probably explained the undervaluation. Completely out of the ordinary – and brilliant – was a stock buyback in 2016, during which the company repurchased more than 25% of its share capital at then low prices, creating immense value for its shareholders. I did my homework and dug deep into the situation for over two months. The deeper I dug, the more I liked the company. At the same time, I got an excellent impression of the management from several phone calls. I decided to fly around the world at short notice and visit the company on site. There, the team took a lot of time to accommodate me, and I was able to experience the corporate culture. I still remember that in the evening of my return trip, I was sitting in my seat on the plane, thinking, “If this is not a buy, what am I looking for?” Back in Hamburg, I put together final notes and was about to recommend the stock as a large position for TGV Truffle. “Unfortunately”, the company reported excellent figures shortly after, and the price rose. And rose. And rose! I waited because the increase occurred with low trading volumes and I expected to get the shares at a lower price again. This did not happen to this day since the price is still thrice the level it was on the day of my visit! Bottom line: <u>If everything fits, five or 10% difference in purchase price do not matter.</u>
2. One of the biggest mistakes on the stock market is to rely on the judgment of other investors. <u>However, one of the most profitable strategies is to buy or sell together with people who, from an objective point of view, have better information.</u> A good example happened in 2015 with a company whose business model I had a reasonably good feel for. The company was in the midst of a transformation and the figures reported at that time were mediocre. It was not immediately apparent that the stock was undervalued. However, the company announced a massive share buyback at that time. Around that time, there were a few people on the supervisory board whose ability to allocate capital I was able to assess very well. In retrospect, it should have been crystal clear to me that a buyback would only have been decided if the shares were significantly undervalued. Although the figures painted an undetermined picture, the actors apparently had a better insight into the reality. Today, the stock is around three times the price at which the buyback took place, and the transformation is going better than expected.

3. Since 2015, TGV Truffle has invested multiple times when a company, as the strongest in its industry, found itself in a challenging environment. Often, the best-positioned industry leaders can use a crisis to their advantage, e.g. by recruiting employees from weak market participants or by purchasing competitors. However, I learned that relative strength is not synonymous with absolute strength. Although a company may sail through a crisis better than any competitor, a tide usually lowers all the boats. It seems opportune to recommend the relatively best companies in the industry much later in a crisis than was previously the case.
4. Similar to the previous aspect is a mistake my valuation technique. Often, in business valuations, I calculate a "normalized" earning power. For example, in the case of a cyclical company, to the average of boom and crisis profitability. However, if it is evident at the time of the investment that there are still a few lean years between the investment date and the return of the normalized earning power, this time delay must also be reflected in the valuation. Several times I recommended the purchase of cyclical stocks at too aggressive prices, which should – after clean assessment – only have been purchased at lower prices.
5. So far, I have structurally underestimated the value of having an excellent management team. This value is difficult to quantify, but potentially very large, especially in case of management's outstanding ability to allocate capital. It has happened several times in recent years that a management team surprised me in particular by meaningful, albeit unconventional, acquisitions. If the right form of financing is chosen at the right time (for example, when stock prices are high, payment is made in company shares), management can add significant value in one fell swoop.

Recommended reads

I have always loved reading biographies, and I remember well reading the autobiography of Jack Welch (the long-standing CEO of General Electric "GE") in 2002. Welch was a management icon then, and GE was the world's best-managed company. At the time, I devoured this exceptionally well-written book and kept leafing through individual chapters over the years.

However, since the early 2000s, GE's development took a dramatic turn: today, the company faces a host of problems and may not survive the crisis in its current structure. The drama of this development – in 18 years from Mount Olympus to a potential break-up – should teach every investor a fair amount of humility. Interestingly, until last year, Jack Welch's successor was responsible for GE and many of today's problems have arisen in the segments celebrated in the year 2000. What could have been known and how much is due to fast-changing circumstances?

Of course, the situation at GE is still in flux, and maybe the tragedy will end well. I recommend following the reporting on GE over the coming months closely. In particular, the American magazines “Fortune” and “Forbes” provide brilliant coverage of GE on a regular basis. Let me know if you want me to pass on good articles to you. At the same time, I would also recommend rereading the old Jack Welch biography and looking at the current developments in the context of the information available at that time. I cannot remember another case in which you can participate in a case study of the rise and fall of a company with such detail.

Outlook

Enjoy the summer; I am looking forward to reporting to you in early 2019.

Until then, thank you for your continued trust.

Kind regards,

Jan-Hendrik Mohr

JMX Capital GmbH