Our *Promise* to Clients

We are anything but just another Wall Street firm, and therefore not everyone who knocks on our door is an appropriate client for us.

Our clients are our partners, and just like partners in a marriage, we need to share the same values. Our values are spelled out in Six Commandments of Value Investing (read, listen).

We promise to be honest and transparent with our partners. We will invest their money with the same thoughtfulness, care, diligence, and slight hint of paranoia that we employ in investing our own (easy for us to do, as nearly all the liquid net worth of our portfolio managers and their families is invested in the same stocks our clients own).

We are a firm with a soul, and we'll never do anything that would put our interests before those of our clients.

We're not trying to be the biggest investing firm, just the best one. In addition to striving to provide great true-risk-adjusted returns, we'll deliver excellent customer service and a one-of-a-kind client experience.

December 3, 2021

Mr. Market was less than kind to our portfolio over the last few months, and especially the last few weeks. I cannot tell you how *little* it worries us what Mr. Market thinks about our stocks at any particular point in time. We love* our portfolio even if the Mr. Market doesn't fancy it today.

Also, before we take Mr. Market seriously, let us tell you about the rationality of Mr. Market lately. The World Health Organization (WHO) names each variant of the Covid virus by going to the next letter of the Greek alphabet. After Delta, which is currently the most predominant variant of the virus ravaging the world, there must have been nine others that were not important enough because we never heard of them. Why nine? Because when the latest variant of concern was found in South Africa, it emerged that the letter *Nu* was supposed to be applied to it. But *Nu* sounds a lot like new. WHO didn't want to confuse people, so it skipped to the next letter in the Greek Alphabet, which is *Xi* – oops, that's the Chinese supreme dictator. So, for the sake of global political stability, that letter was skipped, too.

Α Alpha (al-fah)	Β Beta (bay-tah)	Γ Gamma (gam-mah)	Δ Delta (del-tah)	Ε Epsilon (ep-si-lon)	Ζ Zeta (zay-tah)
Η Eta (ay-tay)	Θ Theta (thay-tay)	Ι Iota (eye-o-tah)	Κ Kappa (cap-ah)	Λ Lambda (lam-dah)	Μ Mu (mew)
Ν Nu (new)	Ξ Xi (zz-eye)	Ο Omicron (ome-cron)	Π Pi (pie)	Ρ Rho (roe)	Σ Sigma (sig-mah)
Τ Tau (taw)	Υ op-silon (op-silon)	Φ Fie (fie)	Χ Chi (k-eye)	Ψ Psi (sigh)	Ω Omega (o-me-gah)

This brings us to *Omicron*, the name of the latest variant.

This is where this story gets a bit more interesting.

There happens to be a cryptocurrency, one of thousands, that is also named Omicron. I still cannot grasp the logic behind it, but that cryptocurrency was up 900% on the day the South African variant was christened. There must have been a trading algorithm or a lot of bored investors looking for the next gamble, to drive something seemingly worthless up 900%.

That is the drunken Mr. Market that is pricing our stocks today.

I am going to repeat what you will find me saying several times in the attached letter: We own businesses that are priced, not valued, by Mr. Market thousands of times a day. We have done a lot of work on each company in the portfolio, and through diligent research we have reached the conclusion that each is worth more than the price it is changing hands at today. Are we going to be right about each and every stock? Of course not. This is a numbers game. But we use a time-tested methodology centered on common sense and the cash flows these businesses generate. Also, this is not our first rodeo. We'll go on making small tweaks, taking advantage of Mr. Market's manic-depressive moods, at least when it comes to anything that generates cash flows.

Of course, we could change our investment process and load up on the cryptocurrency called Pi Coin, which happens to take its name from the letter in the Greek alphabet that follows *Omicron*. But I think we all agree we should stick to our knitting, buying high-quality businesses that are significantly undervalued. (Anyway we already loaded up on pie during Thanksgiving.)

Our advice – enjoy this holiday season. Spend time with your loved ones; don't look at your portfolio. Let us worry about it – after all, we own the same stocks you do.

We wish you joyful and safe holidays.

*I shared a draft of this letter with some close value investing friends. A few of them politely pointed out that I should not use the word "love" to describe my views towards the portfolio. They are right. Love is almost by definition an irrational emotion. Our view towards stocks we own are not an affection or emotion. In fact, we work relentlessly to extricate emotion out of our process. We look at ourselves as scientists (we would wear white coats to work if we thought we would get away with it and not constantly spill coffee on them).

Our opinion on any company we own is just a thesis that will be validated or invalidated by time. We'd like to invalidate them before time does. So "love" is not the word that I should use to describe what we think of our portfolio, it is a flawed shortcut for saying – we own high quality, significantly undervalued companies that are run by good, sensible management teams.

Dear Client,

I was having lunch with a close friend of mine. He mentioned that he had accumulated a significant sum of money and did not know what to do with it. It was sitting in bonds, and inflation was eating its purchasing power at a very rapid rate.

He is a dentist and had originally thought about expanding his business, but a shortage of labor and surging wages turned expanding into a risky and low-return investment. He complained that the stock market was extremely expensive. I agreed.*

He said that the only thing left was residential real estate. I pushed back. "What do you think will happen to the affordability of houses if – and most likely when – interest rates go up? Inflation is now 6%. I don't know where it will be in a year or two, but what if it becomes a staple of the economy? Interest rates will not be where they are today. Even at 5% interest rates [I know, a number unimaginable today] houses become unaffordable to a significant portion of the population. Yes, borrowers' incomes will be higher in nominal terms, but the impact of the doubling of interest rates on the cost of mortgages will be devastating to affordability."

He rejoined, "But look at what happened to housing over the last twenty years. Housing prices have consistently increased, even despite the financial crisis."

I agreed, but I qualified his statement: "Over the past twenty, actually thirty, years interest rates declined. I honestly don't know where interest rates will be in the future. But probabilistically, knowing what we know now, the chances that they are going to be higher, much higher, are more likely than their staying low. Especially if you think that inflation will persist."

We quickly shifted our conversation toward more meaningful topics, like kids.

It seems that every year I think we have finally reached the peak of crazy, only to be proven wrong the next year. The stock market and thus index funds, just like real estate, have only gone one way – up. Index funds became the blunt instrument of choice in an always-rising market. So far, this choice has paid off nicely.

The market is the most expensive it has ever been, and thus future returns of the market and index funds will be unexciting. (I am being gentle here.)

You don't have to be a stock market junkie to notice the pervasive feeling of euphoria. But euphoria is a temporary, not a permanent emotion; and at least when it comes to the stock market, it is usually supplanted by despair. Market appreciation that was driven by expanding valuations was not a gift but a loan – the type of loan that must always be paid back with a high rate of interest.

I don't know what straw will break the feeble back of this market or what will cause the music to stop (there, you got two analogies for the price of none). We are in an environment where there are very few good options. If you do nothing, your savings will be eaten away by inflation. If you do something, you find that most assets, including the stock market as a whole, are incredibly overvalued.

This is why what we do at IMA is so important.

We are doing the only sensible thing that you can do today. We spend very little time thinking about straws or what will cause the music to stop or how overvalued the market is. We are focusing all our energy on patiently building a portfolio of high-quality, cash-generative, significantly undervalued businesses that have pricing power.

This has admittedly been less rewarding than taking risky bets on unimaginably expensive assets. It may lack the excitement of sinking money into the darlings you see in the news every day, but we hope that our stocks will look like rare gems when the euphoria condenses into despair. As we keep repeating in every letter, the market is insanely overvalued. Our portfolio is anything but – we don't own "the market".

*A question may arise: Why did I not tell my dentist friend to pick individual stocks? He runs a busy dental practice and wouldn't have the time or the training to pick stocks. Why didn't I offer him our services? IMA manages all my and my family's liquid assets, but I have a rule that I never (ever!) break – I don't manage my friends' money. I'll help them as much as possible with free advice but will never have a professional relationship with them. I intentionally create a separation between my personal and professional lives. After a difficult day in the market, I want to be able to go for beers with friends and leave the market at the office. Also, this simplifies my relationships with my friends. There is no ambiguity in our friendship.

Portfolio Update

Our thinking on most companies in the portfolio has not changed much since our spring and summer letters. To avoid unnecessary repetition, we'll only address companies where we have something new to add.

McKesson (MCK)

We have owned McKesson and its competitor Cardinal Health a few times over the last twenty years. This time around, we bought McKesson in November 2016 when the stock almost halved from a previous high. Going into 2015, MCK's business was overearning; it was benefiting from patent expirations of branded drugs. As a patent expires, a generic drug company that challenges the branded patent and drug distributors makes temporarily high profits for six months. In 2014–2015 there was a tsunami of branded drugs going generic.

In 2015 MCK was owned by growth investors that were looking for a continuation of double-digit earnings growth and price-to-earnings expansion. In 2016, earnings did not expand but contracted, and growth investors ran for the exits. The stock collapsed. This is when we made our first purchase (in this most recent ownership period). Our rationale was simple: We normalized (lowered) MCK's margins to pre-branded expiration levels, and the stock looked attractive. There was a lot to like – three drug distributors (McKesson is the largest) control over 90% of the drug distribution market. All three distributors are at scale and none has a competitive advantage against the others, thus none has a reason to start a price war.

Our thesis started to play out. Earnings stopped declining and were about to start growing, and then… Amazon announced that it was entering the retail pharmacy space. MCK stock dropped, and we added to our position. The market had misunderstood the industry structure. Amazon was not going to be competing with McKesson. McKesson has highly specialized warehouses; in fact, it is the Amazon of drug distribution. Amazon will be selling drugs online, and it doesn't have and most likely is never going to have enough scale to be a formidable competitor to a major drug distributor.

Our thesis began to prove out. The market started to agree with us, and then…

States sued drug distributors for their complicity in the opioid epidemic. I wrote a lengthy article on this topic. Bottom line: Drug distributors were not responsible for the opioid crisis, but they were the largest identifiable entity, and thus they got sued. The drug distributors could have fought and probably would have won, but the lawsuits would have been a long haul, and thus they have settled with the states.

The opioid mess is mostly behind us. What we have today in MCK is the largest drug distributor in the US, with a very stable and growing business – revenues are growing about 3–5% a year (depending on the level of inflation, maybe even higher). It is a very cash-generative business, doesn't need much capital to grow, and has a very high return on capital. McKesson has a significant competitive advantage against new entrants. It carries very little debt.

Owning the stock was very stressful at times (this is how opportunities are created) over the last few years but also very rewarding. After accounting for about $25 we made for McKesson's distribution of shares in Change Healthcare last year, MCK returned about 15–20% a year (this number will vary from client to client).

But the best is yet to come for MCK.

As of this writing MCK is a $220 stock. Its immediate earnings power is around $21 (up from $13–15 at the time of our first purchase). Historically, MCK has traded at about 15–17 times earnings, which would suggest the potential for a $315–350 stock price. The combination of revenue growth and share buybacks should result in high single-digit earnings growth. In four years, we get earnings of about $27–30, which gives us a price of about $400–500.

McKesson is a perfect business for the uncertain environment that lies ahead of us. The demand for its product is not dependent on the whims of the global economy. It can pass price increases on to its customers.

Pause for a second and ask yourself a question: How does the silliness of the stock prices of AMC, GameStop, or some overpriced electric vehicle company impact McKesson? It doesn't.

DXC Technology Company (DXC)

We can copy and paste what we wrote about DXC last time. This business has been improving every single quarter under the new management. The sales decline has been decelerating, and in a few quarters DXC will turn into a growing business. Its margins are expanding. As of this writing DXC is a $33 stock. Management is guiding for $5.25 of earnings in two years. Current earnings, after the company made a significant investment in its workforce, are approaching $4. We think management guidance is very conservative: DXC's earnings power is at least $6 and is likely to reach $8 in three to four years.

As DXC starts showing revenue growth, the stock will get rerated to 12, maybe even 15 times earnings. If managed properly, as it is now, this is a very sticky, cash-generative business. Competitors that DXC is emulating (and whose ex-employees are in the top ranks of DXC management) are trading at 17–20 times earnings. Our fair-value estimate for DXC is around $60 to $120.

Melrose Industries (MRO in London)

As a quick reminder, Melrose Industries is a British private equity firm that specializes in buying industrial businesses, improving them, and selling them. It has a tremendous track record of doing this – it has compounded capital in excess of 20% a year. A few months ago, it sold one of its businesses and paid us a 15 pence dividend – about 10% of its market capitalization. The stock is trading on the London Stock Exchange under the symbol MRO for about 1.60 British pounds.

A client asked, what is the upside in Melrose? Even though Melrose shows a loss in your statement, that loss is overexaggerated by the large dividend MRO paid us. We think it's a double from today's price. Today it's trading at about 8x post-pandemic, normalized earnings. This stock will require some patience, as its aerospace fortunes rely on the normalization of global travel.

Svenska Handelsbanken (Stockholm: SHB-A)

There is very little to report here. The company continues to mint money. It paid us a special dividend of 4.2 Swedish krona in shares of Industrivärden Security, which we intend to sell. (Svenska trades on Nasdaq Stockholm AB [the Swedish stock exchange] for about 100 Swedish krona.)

Qurate (QRTEA)

Qurate is the owner of QVC and HSN. The market presumes that QRTEA is guilty of being a melting ice cube – a business that will go away in the long run. For a year or two before the pandemic revenue declined a few percent a year. The management, which owns a lot of QRTEA stock, argued that it had made merchandising missteps and that the problems were not structural. The pandemic reinvigorated growth in QRTEA – people were locked up, and buying tchotchkes on TV became a source of entertainment.

QRTEA's chairman is Greg Maffei, John Malone's right-hand man and a terrific capital allocator. We got involved with QRTEA in August of 2020 when it announced that instead of buying back stock it would be returning capital to shareholders in the form of dividends. Our original purchase price was about $10.

This return of capital in the form of dividends was very important to us. Let me explain our reasoning. There is a very good chance that QRTEA is a stable and maybe even a growing business, but we are not sure. QRTEA generates about $2.50–3.00 of free cash flows. Even if the company starts declining, the decline will be slow (1-3% a year). QRTEA has a very loyal customer base that has a very low attrition rate. The return of capital in the form of dividends has de-risked this stock considerably. Since our initial purchase we have already collected $6 of dividends ($3 came in the form of preferred stock). Today we have only $4 of our initial capital at risk.

Last quarter was very difficult for QRTEA. The issues had little to do with demand; they were supply-driven. The company simply did not have enough product to sell. In fact, its customers spent 1.6% more time watching QRTEA's content. The supply issues are likely going to be hopefully relatively short-lived, and QRTEA's business will come back to a semi-normal cadence. Management has announced another dividend of $1.25 – at this point we have already received $7.25 of our capital back.

The stock sold off 27% on the day QRTEA reported its earnings. We increased our position in the accounts where we had cash or the position size was small (mostly in new accounts). It was not an emotional decision but rather a very calculated decision. We went back to our models, inputted very draconian assumptions, and still could not see how we could lose money on the stock. This combination of an insanely cheap stock and the return of capital in the form of dividends makes QRTEA an incredibly low-risk investment with tremendous upside.

Viatris (VTRS)

Viatris reported another good quarter. Business is clearly improving. This is what we wrote about Viatris' valuation (cheapness) in our last letter. Our thinking has not changed:

> Viatris has a $17 billion market capitalization. Lowered free cash flow estimates for 2022 are $4 billion, growing to $4.6 billion by 2024. We think there is a good chance these numbers are too low (sell-side analysts are as jaded with Viatris as we are). However, when the market actually sees these free cash flows on Viatris' financial statements (not just in endless promises), then it will believe them and likely slap on a 10 times multiple. The stock will double. If Viatris dares to show some growth of cash flows, then it may start trading at 12-14 times free cash flows. At today's price we see no downside and ample upside in the stock.

In 2021 and 2022 Viatris will be paying down debt by $6.5 billion. Also, the one-time merger integration expenses that run in the billions today will be behind the company and the company will have plenty of cash flows to raise its dividend. Over the next year or two Viatris is in the "show me the money" stage. Once it does, the market will reprice the stock.

A question arises: Why don't we buy more Viatris stock?

The stock is very cheap. However, we are not 100% comfortable with the new management (they came from Pfizer when Mylan merged with Pfizer's Upjohn unit). It is definitely an upgrade from the previous management team. A year ago, this management told us that Viatris would turn into a cash-generating, high-dividend-paying machine. They said that the days of (value-destructive) acquisitions were behind them. Though Viatris is very likely to become a cash-generating machine, on the last two calls we have heard mention of acquisitions again. Viatris' cheapness is appetizing, but we decided to take a wait and see approach. Despite improving fundamentals, we did not add to our position, though we were tempted.

Black Stone Minerals (BSM)

We added to our position in Black Stone Minerals or bought in the accounts where we were previously strapped for cash. This is what we wrote about Blackstone in the summer letter:

> Black Stone Minerals is not related to the Blackstone Group – a Wall Street firm out of New York. Black Stone Minerals was started in Texas as a timber company by the Carter family in 1876. About 100 years after its founding, Thomas Carter, a descendent of the founding family, changed the company's course. The company sold its interests in timber but kept mineral royalty rights and went on to acquire mineral rights from other timber companies, eventually becoming the largest mineral natural rights holder in the US (it owns 20 million acres). It's structured as a master limited partnership (MLP).

> BSM doesn't drill for oil and natural gas; it allows oil companies to extract oil and natural gas from its land, and in exchange for that privilege it receives about 25% of their revenues. We love this business model. BSM's costs are fixed and are relatively low. It doesn't have to spend a penny ever on capital expenditures, and it can just keep milking its reserves for generations. It has a debt-light, conservative balance sheet (it can pay off its debt with one year's cash flows). About 40% of its revenues come from natural gas and 60% from oil.
>
> When we analyzed BSM we modeled three scenarios: bear case – oil and gas volumes and prices stay at pandemic lows; base case – they return to pre-pandemic levels; and conservative bull case – they rise above pre-pandemic levels. In each scenario our goal was to forecast BSM's free cash flow per share. Our free cash flow per share is $0.90 in the bear case, $1.70 in the base case, and $2.40 in the conservative bull case. BSM is a $10 stock, and the company pays out 80-90% of its cash flows in dividends. We expect BSM to provide us a dividend between 7% and 20% going forward, depending on what the future holds.
>
> We were very optimistic about oil and natural gas prices before the pandemic. Our thesis is very simple: Low commodity prices cause reduce exploration and production and eventually cause high commodity prices. The pandemic only made the supply situation worse. As the global economy comes back online, so will the demand. It will take years for supply to catch up with demand, and thus in the interim we'll likely see much higher oil and natural gas prices. We view BSM as a perfect hedge against inflation and a weaker dollar. At this price we see no downside in the stock.
>
> One last thing: Thomas Carter owns 6% of the company. We don't have to worry about him making a dumb, value-destructive acquisition.

Part of this thesis has already started playing out – oil and natural gas prices are pushing multi-year highs. As of this writing BSM is trading at $12 a share. High prices will drive interest in drilling on BSM's land and thus result in higher revenues, which come with a nearly 100% margin. We still think BSM is incredibly cheap, and risk/reward is still very attractive – in the worst case it will be paying an 8–10% dividend, and the stock has little or no downside. On the upside, it could double or triple from this level if oil and natural gas prices remain at the level where producers earn a reasonable return on capital.

Tanger Outlets (SKT)

Our thesis on SKT continued to play out this quarter. Its occupancy rate continued to increase, up an additional 1.4% to 94.3% (its semi-normal occupancy level is 97%). Traffic at its outlets is back to pre-COVID levels. Sales per square foot of its tenants are up 13% to an all-time high. Most importantly, rent per square foot has started to go up again (we were watching this number closely). Retailers will go where the customers are, and the customers love SKT shopping malls. We think this improvement will continue. Our fair value for SKT is in the mid to high 20s.

Sale of Tesco (London: TSCO; American Depository Receipt: TSCDY)

We sold Tesco in Active Value Investing accounts but kept it in dividend accounts. Tesco has been a successful investment in some accounts and a mediocre investment at best in some older ones. Our thesis on Tesco for our original purchase was wrong. Tesco used to be the best retailer in the world, then it got fat, happy, and imperialistic. It had 30% market share in the UK (it's down to 27% now), and it took its success there for granted. It allowed its profit margins to go up to 6%. Pricing and quality of services deteriorated. This opened the door for discounters to waltz in and take market share from Tesco and its other fat and happy competitors. In addition, Tesco lost its focus, much like the British Empire did; it tried to conquer the world with its stores. It failed in China, Japan, the US, and Eastern Europe. It did succeed in Thailand and South Korea.

When we made our initial investment, we thought that we were protected by Tesco's real estate. However, Tesco's disclosures were very poor. A year after we purchased it, we discovered that the company did not own as many stores as we thought. It sold and leased back many stores. This mistake was avoidable. If a company has poor disclosures, we should just not buy the stock. If we look at our biggest mistakes over the years, they fall into two categories: poor disclosures/complex financials and bad management.

Analyzing management is a subjective exercise, and we are getting much better at that. And we do know upfront if a company's financials are overly complex, so that we cannot find enough information to properly analyze the business. In the case of Tesco, we had to fish out incomplete data points from management's presentations. That should have been a red flag.

Tesco's poor disclosures also brought on an accounting scandal. The management was fired and a new CEO, Dave Lewis, was brought in. Dave, who recently retired, was phenomenal. Fast-forward to today. Tesco is a much better company than ever in its history. Earnings have improved tremendously. Tesco is dominating online grocery shopping in the UK. However, it may never see 6% operating margins again – they will probably settle at 4.5%. We were wrong about Tesco's earnings power.

We still think the company is undervalued; therefore, we still own it in dividend accounts. We had more attractive opportunities elsewhere, and that is why we sold it in Active Value Investing accounts.

Purchase of Bolsa Mexicana de Valores (in Mexico, ticker BOLSAA), also called BMV

BMV is a Mexican Stock Exchange. Think of it as being both the NYSE and NASDAQ of Mexico. We had macro and micro reasons to buy the stock. Let's start with macro. The pandemic may not have driven a stake through the heart of globalization, but it has certainly changed its direction. We'll see more production brought back onto our shores and we'll be choosier about who our trading partners are. China will be on the short end of this stick. A lot of production will shift from China to friendlier countries. Mexico should be one of the largest beneficiaries– it is a democracy that shares a border with the US.

From a macro perspective, we wanted to have long-term exposure to Mexico, but we did not want to buy a mediocre business; we wanted to find a great one. We think we found one. This year we spent a lot of time analyzing stock exchanges around the world. We found that they are great businesses. They are usually either monopolies or, in a very few cases, oligopolies. An exchange is a two-sided marketplace, where liquidity (a large number of buyers and sellers) is a huge barrier for new competitors to overcome. When you buy or sell a stock or any other security, you want to make sure there is someone to take the opposite side of the trade.

This is a highly regulated business. Regulation creates another significant barrier to entry, as it usually benefits established, local players. For instance, Mexico passed a law that if you have a capital gain on a security or stock (foreign or domestic) that you bought or sold on the local stock exchange, you'll pay a lower capital gains tax. As a consequence of this legislation, 2,800 foreign companies (think Facebook, Apple, Samsung) are dual-listed on BMV and now account for almost half of trading volume.

BMV has one competitor, which has been around for a few years. So far it has been able to list only one company and has just 8% of market share trading. In our conversation with BMV management they have questioned that competitor's long-term financial viability.

BMV has multiple sources of revenue – they make a tiny fee on every transaction on the exchange. They charge a listing fee. They sell their data to other financial companies. BMV owns the largest (actually the only) security depository business in Mexico. Think of that as a giant database of every little security, be it derivative, stock, or bond; they are all listed ("held") there. It is almost like a VISA network for all listed securities in Mexico. Half of BMV revenues are subscription, non-trading-related recurring fees.

There are a lot of other things we like about the Mexican stock market and Mexico. Mexico has the lowest market capitalization-to-GDP compared of almost any developed or developing market. This gives BMV a long-term tail of growth. Retail investor participation has tripled over the last few years (through the opening of accounts). The Mexican government has decided to double the size of pension funds between 2023 and 2030, and this means a greater allocation to Mexican stocks and increased business for the securities depository unit. The culmination of all these factors should lead to 10–15% long-term revenue growth (in our models we are projecting 8%). We don't expect this growth to happen in a straight line. Though this is an incredibly stable business, we expect to see plenty of volatility in the rate of growth from quarter to quarter.

We are very impressed with BMV's management, which has created a lot of value, grown revenues, lowered costs, and had very good capital allocation. They own some BMV but not an enormous quantity. Judging by their actions, though, they've been terrific stewards of the business and its capital. BMV has not made large acquisitions and has no intention of making any.

BMV is trading at about 11–12x current cash earnings. Most exchanges trade closer to 20 times earnings, and there is no reason why BMV should not have a similar valuation in the long run. In our very conservative estimate of future growth, BMV is trading at 9 times what we expect it to earn in four years. BMV has a net cash balance sheet (no debt). It pays a 5% dividend (which is more than supported by its cash flows), and the company is using excess cash flows to buy its stock. To sum up, we own a terrific, well-run business, a monopoly with a high return on capital, a long runway of growth, and a nice fat dividend that we think will double over the next four years.

Purchase of International Money Express (IMXI)

IMXI requires us to examine two mental models (frameworks): myopic circles and David vs. Goliath.

Myopic circles

I don't smoke. This was not always the case with me. I smoked in my teens. I quit when I was 21. I was one of the first people in my circle of friends to quit smoking, then gradually all my friends quit smoking, too.

Today I don't have a single close friend who smokes. I didn't look for this outcome intentionally; I didn't stop being friends with smokers. Nor do I choose friends based on their (harmless, at least to me) vices. So this was not a conscious or even a subconscious decision. Very simply, people in my social demographic circles have a set of values, and a healthy lifestyle is one of them. It's very hard to have a healthy lifestyle and smoke.

Humans are tribal, and we try to conform to the values and behavior of our tribe. At some point in the late 1990s or early 2000s smoking stopped being cool and became uncool in my tribe. (For me, a girl I was dating was the impetus for my quitting).

On the other hand, I have a relative who smokes. This is where it gets interesting. He has a few dozen friends who smoke. His friends know a lot of people who smoke. The overlap between his circles of friends and acquaintances and mine is very small (near zero).

Why is this important? In my daily life I encounter very few people who smoke, and thus it is easy (if I am not careful) to form a belief that nobody smokes. When we started doing research on tobacco stocks, I was shocked to discover that 35 million Americans – 14% of the adult population – still smoke. The numbers are much greater in Asia and Eastern Europe.

Another example: vaccinations. If you are vaccinated, then it's likely that most of the people you know are vaccinated. Now, if you have a friend or a relative who is not vaccinated (other than for a unique medical reason), most likely that person knows a lot more unvaccinated people than you do. And his/her circle of unvaccinated friends and your circle of friends have little overlap.

This myopic circle framework applies to many parts of our lives. Here are more examples: What we watch on TV is influenced by our values and our willingness to share our experience with others; how we watch TV – over the internet or over cable; our political beliefs – we tend to surround ourselves with people we agree with; our shopping habits (our preferences for shopping at malls, on QVC, or online); even the type of cars we drive (electric vs ICE).

When we live in our micro circle we forget about the existence of other circles. If we are not careful, the lens through which we look at the world may get strongly tinted with our perspective and turn myopic.

You'd think that as you venture out on the world wide web this would change. It does a little, but not much. Maybe a guy you went to third grade with, who is now your Facebook "friend," has different political views from yours. You argue with him over the occupant of the White House and then de-friend or unfollow him. But mainly, your social networks will feed you content that agrees with your biases.

For an analyst (and, I'd argue, for a human being, too) myopic vision is dangerous. It leads to missing both opportunities and potential threats.

Let's look at another mental model.

A book that has had a profound impact on me not just as an investor but as a businessperson is Malcom Gladwell's *David and Goliath*. It reexamines one of the oldest biblical stories. Three thousand years ago in the Elah Valley of the Judean Mountains, an army of Philistines and an army of Israelites, led by King Saul, faced each other.

The armies were stalemated. To attack, either army would have to go down into the valley and then climb up the enemy's ridge. The Philistines ran out of patience first and sent their greatest warrior, Goliath, to resolve the deadlock in one-on-one combat. Goliath was a 6-foot 9-inch giant, protected from head to toe by body armor and a bronze helmet.

He yelled, "Choose you a man and let him come down to me! If he prevails in battle against me and strike me down, we shall be slaves to you. But if I prevail and strike him down, you will be slaves to us and serve us."

There were no volunteers in the Israelites' camp. Who could win a fight against this giant? Then an ordinary-looking shepherd boy stepped forward. His name was David.

To me, David vs. Goliath was always just an inspirational story about a young boy defeating an evil giant. Or as Gladwell puts it, for most people David vs. Goliath is a story of "when ordinary people confront giants."

But Gladwell presents the story in a very different light. When David goes to face Goliath, King Saul offers him his sword. David refuses. Instead, he picks up a few polished stones and throws them in his pouch. Gladwell explains that, as a shepherd protecting his flock, David was a skilled rock slinger.

When Goliath saw David, he yelled something along the lines of "Come here; I'll have a piece of you!" Instead, David kept his distance, then put a stone in the leather pouch of his sling, fired it at Goliath's exposed forehead, and struck him down.

Had David taken Saul's sword and gone to fight one-on-one, he wouldn't have had a chance. But where everyone saw strength in Goliath's physical might, David saw weakness. David was a craftsman rock slinger; he could knock a bird down in mid-flight with a stone – Goliath was a sitting duck.

Suddenly we see a very different story. Goliath's size, physical strength and armor are only competitive advantages if his opponent chooses to fight him in a conventional way, on Goliath's terms. But his strength can quickly be turned into serious weakness, as Goliath was immobile, slow and had no defense against a skillful rock slinger. In other words, Goliath brought a sword to a gunfight. Or in financial parlance, David turned Goliath's assets into liabilities.

I keep this framework in the back of my mind when I run IMA – the investment industry is full of Goliaths. Twenty years ago they would have had a competitive advantage over IMA – they would have had access to better tools and more information (before Regulation FD management would have whispered in their ear information it would not share with the public.) The internet and new regulations have changed all that. We don't have a large research department staffed with twenty analysts. Thank God!

We don't have the bureaucracy or the politics that comes with that sort of department. We chose to compete with Goliaths on our terms – we deliberately created a large network of investors we respect. We share our ideas with them, and in exchange they do the same. It's a two-way street. We have our industry or country experts to whom we reach out when we need to get constructive feedback on the idea we are pursuing. We even organize a conference, VALUEx Vail, open only to our network to foster this exchange. Large firms are also constrained by their size – we are not; we can buy a company of almost any size in the US or overseas. If our size becomes a constraint for us, we'll put the brakes on our growth.

The lesson of this story is to always look for asymmetry. When you face a formidable competitor, don't settle for symmetrical one-on-one combat; understand the competitor's strengths and see if you can turn them into weaknesses by changing the domain of the fight.

Now that we are armed with two mental models, let's tackle our latest purchase, International Money Express (IMXI).

IMXI is a money-transfer business (think Western Union). Most people reading this have probably not used Western Union or a similar transfer service in a long time. We mostly wire money between financial institutions or Venmo money to our friends. If you are a client of IMA, you have a bank and brokerage accounts. You probably lead a mostly cashless lifestyle and pay for everything with a credit or a debit card.

Let me take you out of your everyday circle and describe to you a different one.

There are millions of people in the US from Latin America; many of them are here legally, some are not. They work on farms, build houses, mow lawns – do jobs that we don't want to do. None of them are IMA clients, and I doubt that many of them read my newsletters (though they are welcome to). Every Friday, after they collect their pay, they'll go to a store, be it Walmart or a local bodega, cash their check, and send a large chunk of it to their family back home (it will cost them about $12.50 to do so). Their relatives go to a corresponding agent on the receiving side (usually a bank or a retailer), show ID, and collect the money in their local currency.

Most Americans (95%) have a bank account, but Latin America is seriously underbanked – only 35% of Mexicans have a bank account. Cash as a payment method is alive and well; it just lives in a circle that is far away from us.

Most of us don't even know that this market exists. But it does. Remittances to Latin America and the Caribbean topped $100 billion and grew 6% in 2020 (according to the World Bank). Despite the digitization of the world, the cross-border cash transfer market is alive and well.

This brings us to the second framework. IMXI is the David of cash remittance where Western Union is the Goliath. I don't want to paint WU as a villain; it is not (plus, its headquarters are a mile away from the IMA office). We used to own Western Union about fifteen years ago when it was part of First Data Corp. WU has the largest money transfer network in the world.

IMXI cannot compete with WU on the breadth of its network. But it doesn't need to.

Using WU you can send money from Acapulco, Mexico to Madras, India. Though you can do that, we discovered that very few people do. Most transactions happen in corridors. Usually, people from one country immigrate to another that offers better job opportunities and then send money to their relatives in the home country. There might be an Acapulco-Madras corridor, though I doubt it.

I used to think that profitability of the money transfer business depended on the size of a company's network. I was wrong. It is completely dependent on the sum of your successes in serving individual corridors. Western Union is involved in hundreds if not thousands of corridors, most of which are not particularly profitable.

Just as David took on Goliath, IMXI chose to compete on its own terms. It focuses only on two corridors: US to Mexico and US to Guatemala. In fact, the US to Mexico corridor is the largest single remittance corridor in the world. IMXI is run by Bob Lisey. Bob was at Vigo, which used to be a large player in the US to Mexico corridor. About 10 years later Vigo was sold to WU. WU proceeded to run Vigo into the ground. Bob has been running IMXI for about 10 years, and during his tenure IMXI's revenues have grown more than 20% a year. IMXI is consistently taking market share from WU and others in the US to Mexico and US to Guatemala corridors. It has similar market shares there now to WU's. IMXI achieved this success through focus and differentiated strategy.

WU is large and must focus on many corridors; IMXI only focuses on two. WU uses big box retailers (like Walmart) to service its US to Mexico corridor clients. IMXI has a sales force that recruits small convenience stores to use its services. (WU is usually not in those stores.)

IMXI costs about the same as WU, but it offers a much better product and service. It has a dedicated call center manned by Spanish speakers. The phone is picked up in 4 seconds. It provides check cashing, which WU doesn't. IMXI has better equipment and software, and thus it takes just seconds to complete the transaction, while it takes minutes on competing networks. This is a huge deal for store owners who have lines going out the door every Friday night. Using IMXI becomes an easy decision. And IMXI is not standing still; it is going to be introducing additional products in the future.

IMXI just reported that its revenues grew 26% in the latest quarter. We are not counting on this pace of growth to continue – in our models we've taken it down from 20% next year to 10% in four years (these are arguably very conservative assumptions). IMXI is a $16.30 stock as of this writing, and we expect it to earn $1.30 in 2021 and $1.60 in 2022. We are paying 10x next year's earnings. We get $2.50–3.50 of earnings in four years. At 10 to 17 times earnings, we get a fair value for IMXI of about $25–60 four years out.

Sale of Cardinal Health (CAH) and Purchase of McKesson (MCK)

We reanalyzed both CAH and MCK and arrived at the conclusion that though these businesses are very similar – both distribute drugs in the US – MCK is just a much-better-run company. The last two quarterly earnings reports reminded me of this again.

In Active Value Investing Accounts we sold CAH and bought MCK instead. Despite its slightly higher valuation, MCK offers a better total return.

We kept CAH in dividend accounts – it pays a nice dividend, which it should easily maintain and grow.

Q&A Section

Thank you for submitting your questions. I am going to try to answer as many questions as possible in this letter but won't be able to address all of them. The ones I don't answer I'll try to cover in future letters. And some of your questions got answered earlier in this letter.

Question: How do we construct portfolios and determine position sizes (weights) of individual stocks?

Answer: We have wanted to discuss this topic for a long time, so here is a very in-depth answer.

For a while in the value investing community the number of positions you held was akin to bragging on your manhood– the fewer positions you owned the more macho an investor you were. I remember meeting two investors at a value conference. At the time they had both had “walk on water” streaks of returns. One had a seven-stock portfolio, the other held three stocks. Sadly, the financial crisis humbled both – the three-stock guy suffered irreparable losses and went out of business (losing most of his clients’ money). The other, after living through a few incredibly difficult years and an investor exodus, is running a more diversified portfolio today.

Under-diversification is dangerous, because a few mistakes or a visit from Bad Luck may prove to be fatal to the portfolio.

On the other extreme, you have a mutual fund industry where it is common to see portfolios with hundreds of stocks (I am generalizing). There are many reasons for that. Mutual funds have an army of analysts who need to be kept busy; their voices need to be heard; and thus their stock picks need to find their way into the portfolio (there are a lot of internal politics in this portfolio). These portfolios are run against benchmarks; thus their construction starts to resemble Noah’s Ark, bringing on board a few animals (stocks) from each industry. Also, the size of the fund may limit its ability to buy large positions in small companies.

There are several problems with this approach. First, and this is the important one, it breeds indifference: If a 0.5% position doubles or gets halved, it will have little impact on the portfolio. The second problem is that it is difficult to maintain research on all these positions. Yes, a mutual fund will have an army of analysts following each industry, but the portfolio manager is the one making the final buy and sell decisions. Third, the 75^{th} idea is probably not as good as the 30^{th}, especially in an overvalued market where good ideas are scarce.

Then you have index funds. On the surface they are over-diversified, but they don’t suffer from the over-diversification headaches of managed funds. In fact, index funds are both over-diversified and under-diversified. Let’s take the S&P 500 – the most popular of the bunch. It owns the 500 largest companies in the US. You’d think it was a diversified portfolio, right? Well, kind of. The top eight companies account for more than 25% of the index. Also, the construction of the index favors stocks that are usually more expensive or that have recently appreciated (it is market-cap-weighted); thus you are “diversified” across a lot of overvalued stocks.

If you own hundreds of securities that are exposed to the same idiosyncratic risk, then are you really diversified?

Our portfolio construction process is built from a first-principles perspective. If a Martian visited Earth and decided to try his hand at value investing, knowing nothing about common (usually academic) conventions, how would he construct a portfolio?

We want to have a portfolio where we own *not too many* stocks, so that every decision we make matters – we have both skin and soul in the game in each decision. But we don't want to own so few that a small number of stocks slipping on a banana will send us into financial ruin.

In our portfolio construction, we are trying to maximize both our IQ and our EQ (emotional quotient). Too few stocks will decapitate our EQ – we won't be able to sleep well at night, as the relatively large impact of a low-probability risk could have a devastating impact on the portfolio. I wrote about the importance of good sleep before (link here). It's something we take seriously at IMA.

Holding too many stocks will result in both a low EQ and low IQ. It is very difficult to follow and understand the drivers of the business of hundreds of stocks, therefore a low IQ about individual positions will eventually lead to lower portfolio EQ. When things turn bad, a constant in investing, you won't intimately know your portfolio – you'll be surrounded by a lot of (tiny-position) strangers.

Portfolio construction is a very intimate process. It is unique to one's EQ and IQ. Our typical portfolios have 20–30 stocks. Our "focused" portfolios have 12–15 stocks (they are designed for clients where we represent only a small part of their total wealth). There is nothing magical about these numbers – they are just the Goldilocks levels for us, for our team and our clients. They allow room for bad luck, but at the same time every decision we make matters.

Now let's discuss position sizing. We determine position sizing through a well-defined quantitative process. The goals of this process are to achieve the following: Shift the portfolio towards higher-quality companies with higher returns. Take emotion out of the portfolio construction process. And finally, insure healthy diversification.

Our research process is very qualitative: We read annual reports, talk to competitors and ex-employees, build financial models, and debate stocks among ourselves and our research network. In our valuation analysis we try to kill the business – come up with worst-case fair value (where a company slips on multiple bananas) and reasonable fair value. We also assign a quality rating to each company in the portfolio. Quality is absolute for us – we don't allow low-quality companies in, no matter how attractive the valuation is (though that doesn't mean we don't occasionally misjudge a company's quality).

The same company, at different stock prices, will merit a higher or lower position size. In other words, if company A is worth (fair value) $100, at $60 it will be a 3% position and at $40 it will be a 5% position. Company B, of a lower quality than A but also worth $100, will be a 2% position at $60 and a 4% position at $40 (I just made up these numbers for illustration purposes). In other words, if there are two companies that have similar expected returns, but one is of higher quality than the other, our system will automatically allocate a larger percentage of the portfolio to the higher-quality company. If you repeat this exercise on a large number of stocks, you cannot but help to shift your portfolio to higher-quality, higher-return stocks. It's a system of meritocracy where we marry quality and return.

Let's talk about diversification. We don't go out of our way to diversify the portfolio. At least, not in a traditional sense. We are not going to allocate 7% to mining stocks because that is the allocation in the index or they are negatively correlated to soft drink companies. (We don't own either and are not sure if the above statement is even true, but you get the point.) We try to assemble a portfolio of high-quality companies that are attractively priced, whose businesses march to different drummers and are not impacted by the same risks. Just as bank robbers rob banks because that is where the money is, value investors gravitate towards sectors where the value is. To keep our excitement (our emotions) in check, and to make sure we are not overexposed to a single industry, we set hard limits of industry exposure. These limits range from 10%–20%. We also set limits of country exposure, ranging from 7%–30% (ex-US).

In portfolio construction, our goal is not to limit the volatility of the portfolio but to reduce true risk – the permanent loss of capital. We are constantly thinking about the types of risks we are taking. Do we have too much exposure to a weaker or stronger dollar? To higher or lower interest rates? Do we have too much exposure to federal government spending? I know, *risk* is a four-letter word that has lost its meaning. But not to us. Low interest rates may have time-shifted risk into the future, but they haven't cured it.

Question: When should we expect to see client letters?

Answer: A few years ago, I stopped calling these letters quarterly and came up with a fancier term – *seasonal*. When you say "quarterly" folks expect them to come out right after the quarter ends. What I found was that right after a quarter end, I have a good idea how our stocks did but often have no new insights as to how our *businesses* are doing. I've been waiting to write these letters until after our companies report their quarterly earnings. This way I get more insights into their business. They usually report earnings 30–45 days after the quarter officially ends. Then it takes me a few weeks to a month to write this letter, and so these letters usually come out about two months after the quarter ends.

Question: We own a lot of high-dividend-paying companies. How much does the dividend factor into the decision to buy one of these companies?

Answer: In our analysis, dividends are one of the inputs in the total-return calculation.

Total return = stock appreciation + dividends.

To take it a step further, we can break up stock returns into two components: earnings growth and price-to-earnings (valuation) expansion/contraction.

So the comprehensive total-return formula looks like this:

Total return = Earnings growth + price to earnings expansion + dividends

The higher the dividend yield, the less other engines of total return must work.

Question: How different is the taxation of the dividends of these companies for retirement and non-retirement accounts?

Tax treatment of MLPs (master limited partnerships) is a bit tricky. In the taxable accounts, their distributions mostly count as return of capital. This reduces your cost basis and you get taxed when you sell the stock/units as short- or long-term capital gains.

In non-taxable accounts you're allowed to have $1,000 of unrelated business income a year. Most distributions are not income but return of capital, though there could be some tax leakage in IRAs. The stocks we own today are so cheap and so attractive that we believe this tax leakage in IRAs is worth it, especially given the lack of good alternatives in today's market.

Question: If the yield is so high and the company is solid, why not use MLPs as a cash position.

Answer: Let me answer this question through a very real example. I was extremely comfortable with Tanger Outlets (SKT) in January 2020 when we originally bought the stock. We'd done a lot of work on it. Its dividend was well covered. It was a very high-quality, well-managed REIT. We liked the management a lot. It was run by a second-generation owner-operator. SKT was experiencing short-term, fixable issues. We bought it cheap.

A client reached out to me in January 2020 asking if we should just put all his cash in SKT. I advised against it. I told him, "Risk happens," and SKT is not a riskless security.

And then… the pandemic knocked on our door, shopping malls closed, SKT had to cut its dividend, and the stock collapsed. It was a 3–5% position, and we added more to it when it declined and came out fine at the end. Imagine, though, if we had used SKT as a cash substitute, if it was a 30% position. We would have lost plenty of sleep over it. When you have a diversified portfolio of stocks, there is some safety in numbers.

The same logic that applies to MLPs applies to other high-quality dividend stocks. Risk happens. We are comfortable with them in the portfolio setting, but we wouldn't have the same level of comfort if each stock represented a very large portion of the portfolio.

Question: Quite a few months ago, you mentioned that IMA might consider setting up a separate "ex-US" stock fund. As we recall, at the time you expressed the view that non-US stocks might have greater opportunity for further appreciation than entirely US-based stocks. Is that idea still alive or has it been "thrown in the wastebasket"?

Answer: We are still thinking about it, but it's a 2022 project. We want to make sure we do it right. In the meantime, we have incrementally increased our exposure to foreign stocks. However, international investing comes with its own unique challenges. Here is one example. We were analyzing a very cheap and high-quality Japanese company. Then, when we talked to TD Ameritrade, we discovered that if we were to buy it, TD would not be able to price the stock on a daily basis in US dollars (though the stock is very liquid in Japan). Foreign markets are cheaper than the US, and we keep looking for new companies to add to our portfolios; but obviously, we cannot own companies that are not priced daily.

Question: Now that the infrastructure bill has passed, and the Build Back Better bill is being considered, please comment on whether this injection of trillions of dollars into the economy will or will not affect inflation and why.

Answer: Fitch and Moody's think it won't be inflationary, as infrastructure spending will improve productivity. They may be right about the benefits to productivity in the long term. The skeptic in me, however, says it is impossible to add billions of dollars of spending to an economy that is suffering from a deficit of available labor and not see inflation, at least in the short term.

Question: How are we positioning the portfolio for inflation and a potential selloff that it may trigger?

Answer: We don't know what the stock market will do next. We have opinions and hunches, and we never act on them. We never try to predict the market's next move. Neither we nor anyone else is good at it. The only thing we can do is to trim the sails of our portfolio to align with the winds of inflation. We've been doing this.

High-valuation stocks will get destroyed – we don't own any of those. Long-term bonds will not do well, either. Our goal is to have a portfolio of businesses that have pricing power and buy them at great valuations. This has been our single focus, and we are comfortable with how our portfolio is positioned for inflation.

We receive a lot of questions about inflation. I want to refer you to three articles I've written on the topic.

Inflation Update – Not Transitory, Yet

How We Invest in Inflation

Inflation is Here, But for How Long?

An additional thought: Undervalued companies that can raise prices are the best place to be during inflation. Inflation will compress the valuations (price to earnings) of fantastically priced companies. This is less likely to happen to the stocks we own. At the same time, companies will be passing on cost increases, and thus their earnings will get an additional boost from inflation.

Question: Do you have a plan to protect the portfolio if the market goes into a panic free fall?

Answer: There is absolutely nothing we can do to *fully* "protect" the portfolio if the market goes into free fall. Even if the put options were cheap today and we could hedge, they would still be too expensive to hedge the full portfolio.

Folks that run long-short portfolios might be able to "protect" a portfolio through their short book by betting on the decline of some stocks. However, I have many friends who run long-short portfolios or short-only portfolios, and they have been in a world of pain for many years. They'd go long common sense (what we do) and short insanity. What they have discovered is that in the short run insanity has no bounds. The problem when you are short "insane" stocks and they double or triple on you is you're in a world of immeasurable hurt. That the short run turns into the long run because you have to cover your short position (buy back the stock) at a tremendous loss that you have cemented till the end of time.

To be a good short seller your DNA has to confer immunity to pain when a stock doubles or triples on you (you are down 100-200%). I have never shorted a stock in my life and never will.

The best protection against stock market declines is to make sure the businesses you own are worth a lot more than what you paid for them.

Let's try a new analogy. Let's say someone insults me. My first instinct is to get upset and react. But then I'm reminded by the Stoic philosopher Epictetus to "Remember that the person who taunts or hits you does not insult you, but your opinion about these things as being insulting does. So whenever somebody upsets you, know that it is your own opinion that upsets you. Accordingly, first strive to not be carried away by the appearance. For if you take the time and pause, it is easier to control yourself."

Why should I be upset at Mr. Market for calling our stocks ugly and taking them down 30%? That's just his opinion. Once Mr. Market sobers up, he'll change his mind. There is a saying, "Don't take criticism from someone who you wouldn't take advice from." We work very hard at analyzing and valuing each company we invest in so that we don't have to take advice from a deranged Mr. Market.

So how do we protect your and our portfolio if the market goes into free fall? By playing a very different game. By not trying to protect the portfolio from temporary declines. Yes, you read that right. What does it matter if on any given day moody Mr. Market coughs up the opinion that our portfolio should be priced 30% lower? That's just Mr. Market in one of his depressed moods. We don't need to do anything about it. The value of businesses we own has not changed by 30%, and that is all that really matters in the long run. *Long run* is the key term here.

If you don't have a long-term time horizon you should not be in stocks, period. If your personal situation doesn't allow you to tolerate a 30% decline of the portfolio, please give us a call. We'll need to discuss allocating a portion of your portfolio to cash. If you'll need some funds over the next three to five years, you'll need to set them aside in cash. These funds should not be in stocks.

Question: What stock in our portfolio do you forecast to have the greatest room for growth in the next couple of years and why?

Answer: The answer is in the winter 2020 letter. There I walk through most of our holdings and share our thinking about their expected returns.

If you don't have a copy of the winter 2020 letter, email ops@imausa.com and we'll (re)send you a copy.

Question: Which stock in our portfolio missed your expectations the most, and what were your assumptions during the evaluation that turned out to be a miss for this stock?

Answer: Mylan (now Viatris) and Babcock. Mylan was avoidable – we were attracted by its insane cheapness but did not like the management. We went into this purchase with our eyes wide open that the asset was very cheap but the management was mediocre at best. No matter how eventually it plays out, buying Viatris was a mistake.

Babcock disclosed that one third of their business was overstating earnings. We did not see that coming. We put it in the bad luck category. Both Viatris and Babcock will likely turn out to be okay investments.

Question: Are there certain business sectors you see being most favorable to a value investor during the next couple of years, and why?

Answer: I'd say not sectors but factors. Value investing has been in the doghouse for a long time due to low and declining interest rates. At low, actually negative, real (after-inflation) interest rates, any stock with a sci-fi business plan and possible earnings decades into the future got a valuation as if we were already living in that future. As interest rates settle at a higher level, value investing – a commonsensical way of looking at business – will be in vogue again.

Question: Being a German citizen, I might be negatively biased against Uber, as German court rulings against Uber are probably particularly problematic, and yet these legal issues do not seem endemic to Germany. The question is, how do you allow for legal issues when estimating future profits of a company – Uber is, of course, just a current example.

Answer: There are two questions here, one specific to Uber and one that applies to any company we own.

Let's start with Uber. Most of Uber's legal issues stem from three sources:

First, it disturbs the status quo of legal monopolies – taxis. Taxis are a highly regulated monopoly. In NYC, for instance, the government allows only so many "medallions" (tax licenses) to be issued, and each medallion used to sell for millions of dollars. In the UK taxi drivers had to go to school for a few years so they could navigate London streets without a map. As you can imagine, GPS made that skill obsolete. Germany has similarly restrictive laws.

Uber is a disrupter – it is a much better service than a taxi, so consumers love and vote for it with their hard-earned dollars every day. Eventually in most jurisdictions the archaic laws have been changed. Today Uber is a legal competitor to taxis. After enough German citizens take Uber while travelling in other countries, I suspect that Uber's legal problems in Germany will go away. This logic also applies to other countries where Uber is currently "breaking the law."

The second source of Uber's legal problems is the legal status of its drivers. Again, current laws were not really made for today's gig economy. Maybe I am naïve, but I believe that at the end common sense will prevail and governments worldwide will come up with a third, hybrid category that classifies Uber drivers (and other gig economy workers) somewhere in between contractors and employees.

The third source of Uber's legal problems is a problem shared with all companies that have legal issues. Some legal expenses are going to hang around Uber's neck for quite a while, and these few hundred million dollars that the company spends every year on legal costs will make lawyers richer and Uber slightly poorer. Every company we own is being or has been sued in the past. That's life. We look at these lawsuits pragmatically as an expense item on the income statement and as negative cash flows. One thing we've learned over the years is that governments want to punish companies for their misdeeds but are always careful that these punishments bite but don't kill. Killed companies go bankrupt and employees lose their jobs – governments don't want that.

Question: I read recently a book called *The Outsiders,* by William Thorndike. When you research various companies, how easy is it to find the CEOs who are strong capital allocators? For example, those who prefer share buybacks vs. high dividends. Also, CEOs who focus on cash flows. How easy is it to find companies run by CEOs who focus on cash flows over reported net income, dislike dividends (because of tax), are very disciplined if they do acquisitions, use leverage selectively, buy back shares generously when valuations are attractive, care about tax minimization, and run their corporate firms in a decentralized manner?

Answer: Amen to everything you wrote. At IMA we make a distinction between "professionally" managed companies and the ones run by owner operators. If we could, we'd love to own only companies that are run by owner operators who own a lot of the stock. I've stressed this point many times before in these letters: People, management matter. Every time I have compromised on management – bought a company with questionable leadership – to get the stock cheaply, I have paid for it, dearly. We own a few companies that are run by owner operators and are always looking for more.

Owner operators create value not just because they buy stock instead of paying dividends, but because they don't misallocate capital. They make appropriate capital allocation decisions consistently. I'd argue that a lot of "professional" managers are aware of what the right capital allocation should be, but they behave like "hired hands." Their incentives are to maximize their own pay, and they really don't care in what state they'll leave a company after they are done with it and move on to something else.

We are not stock buyback maximalists. I understand the tax advantages of stock buybacks versus dividends. But today companies are buying their stock indiscriminately, whether it's undervalued or not. We are proper capital allocation maximalists.

Question: I am a relatively new client. I have noted an approximate 4% swing in portfolio value even though the overall market has remained relatively steady. Is this normal for value stocks in a sideways market?

Answer: Our portfolio is very different from "the market." It comprises a small platoon of eclectic businesses that are in many different industries and even countries. Investor enthusiasm over how they are priced at any given point in time is completely random and has little to do with what these businesses are worth. A lot of the time their price action has to do with extraneous factors, including investor interest in shiny objects. We pay very little attention to these movements because they are mostly noise and carry little to no data with them.

The most consistent advice we give to all our clients – though few take it – is, don't look at your portfolio on a daily basis. I wrote about that in this article.

Question: How is our portfolio going to be impacted by the transition to new "greener" energy sources? (VK: I rephrased the question.)

Answer: The transition to "green" energy will be rocky, expensive, and not-so-green – our CO_2 emissions will likely go on rising. The beauty of being in my seat: IMA clients are not paying me for political views or political correctness. I am getting paid for pragmatism. Let me make this point clear – I want clean air and I don't want temperatures to rise. Really, my coworkers at IMA put a parka on when they come into my 65 degree overly-air-conditioned office. Spending the formative years of my life in Murmansk, a city located above the Arctic Circle, where the ground was permafrost, must have rewritten my DNA. As you can see, I have personal reasons not to be a fan of global warming. I also very much want to leave a better planet for future generations.

Now that I have hopefully convinced you that "Big Oil" is not my middle name, let's discuss a topic that should *not* be politically sensitive but somehow is – energy.

Solar and wind are not good sole sources of energy – they are intermittent, relying on the kindness of Mother Nature, who is temperamental and not always kind. To compensate for this weakness in our green sources, when Mother Nature takes a break, we need either cheap *and* ample batteries (we have neither), or to turn on peak demand power plants that run on natural gas (if we are lucky) or coal.

Being rich has allowed us to develop what some call "luxury beliefs" – ideas and beliefs that make us feel good about ourselves but that horribly fail upon contact with objective reality. We ignore inconvenient truths about our green energy weaknesses and keep marching on, trying to convert an even larger portion of our economy to wind and solar power.

The US is not the only country that is inhibited by luxury beliefs. Take Germany for instance. After Japan's Fukushima incident, it gave up nuclear and went "green." Except that "green" was anything but. Germany's CO_2 emissions went up and so did its electricity prices. Yes, the coal-fired peak power plants that Germany uses to provide electricity on the days when the wind doesn't blow or the sun doesn't shine are more expensive and produce more greenhouse gasses than nuclear power plants. Another example, just a few months ago, electricity prices in Europe skyrocketed because (I kid you not), the wind stopped blowing in the North Sea.

When it comes to power generation, luxury beliefs are dangerous. Electricity is anything but a luxury; it is a necessity. In addition to powering the internet, which allows us to watch cat videos on Facebook, it is what separates our society from our ancestors in the Stone Age. As we keep decommissioning nuclear power plants and going "green," in the end we'll go "brown" as our CO_2 levels mount, or in the worst case it will simply be lights out as we are forced to ration power.

China is not as rich as we are and struggles with horrendous air pollution which must be killing tens of thousands of people a year. China cannot afford luxury beliefs; it is pragmatic. It has announced that it will be building 150 (!) nuclear power plants over the next twenty years.

Still, I am optimistic about future greener, more stable sources of energy. Billions of dollars are being poured into research and development of alternatives to fossil fuels. Just as we have seen with Covid vaccines, if incentives are high enough, scientists and entrepreneurs make great efforts and success follows. This is the beauty of capitalism. Unfortunately, for the short run, and fortunately, for the long run, there is a good chance these incentives will only become greater over the next few years, as energy costs globally are likely to skyrocket.

Doubling or tripling electricity bills and $6-9 gas prices will bring pragmatism back and divorce us from luxury beliefs in solar and wind. I have a hunch higher energy price will trigger more politicians calling for FTC investigations into utilities and energy companies. Politicians know the true cause of high energy costs: the capital cycle (low oil and natural gas prices result in less exploration and production of oil) and their own policies (throwing sticks in the wheels of energy and pipeline companies, decommissioning nuclear power plants, doubling down on wind and solar). Politicians will deflect their responsibility onto "evil big oil." I really don't want to come back in my next life as an oil company – I am damned if I produce and damned if I don't.

These are my thoughts on investing during climate change – in the short run we'll most likely have higher energy prices, which in the future will bring us more truly green energy.

Question: Do you think some of your accounts may end up with surplus cash positions because of current (elevated) valuations? What's your advice, if any, on how to manage surplus cash in a low-interest-rate environment and expectations of rising inflation, the subjects you described in your recent emails?

Answer: Our cash balances are a byproduct of the attractiveness of opportunities we see at any given point in time. Interestingly, despite the market being very expensive and some parts of the market toying with insanity, we are still finding, without compromising on quality or valuation, companies we really like. Looking internationally has something to do with it.

If the market continues marching higher and our stocks start hitting their fair value, we'll be selling, and this will cause cash balances to rise. We'll try to maximize what this cash earns. In the past we bought Treasury bills. Today Treasury bills yield very little. The last thing we want to do with this cash is to "reach for yield" by buying something risky or illiquid (I discussed this above).

Question: We would like you to address your thoughts on precious metals as a hedge against rising inflation, continued reckless government spending, and the potential devaluation of the dollar, given all of the helicopter money that has been dropped in the past two years. Also, what are the chances that the dollar will lose its status as the world's reserve currency? Should we be concerned about these issues as it relates to our portfolio and everyday living costs?

Answer: I addressed this topic head on in this article: ***"Beloved Country. Unloved Hedge."*** We have a tiny exposure to gold (and we hate it). We have been slowly increasing our allocation to foreign undervalued, high-quality companies, which should do much better than inflation.

Question: What is the end game? Do you expect that at some point the S&P 500 companies will fall as people will realize that they are overvalued, while value companies will retain their valuations?

Answer: I discuss this topic in much greater detail in these two articles:

- **Nifty FAANG and Other "One Decision" Investment Strategies**
- **Sideways Market**

This was also the topic of my two books, *Active Value Investing* and *The Little Book of Sideways Markets*. The price-to-earnings ratio stops going up, then starts declining, and these stocks fall as valuation decline overpowers their earnings growth.

If you look at what happened to Walmart, Microsoft, Cisco, and many other great (non-dotcom) companies in 1999, they did not stop being good companies, but their price-to-earnings got decimated, their stocks declined, and it took investors a decade or longer to get their money back. This has happened many times throughout stock market history. Looking at what companies or a portfolio does in the short term is pointless. Our stocks barely budged in 1999, while Walmart, Microsoft and Cisco, which were very expensive at the time, marched still higher.

Tribal Dinners & What Worries Me the Most

In 2021 I made a goal to see clients – the IMA tribe – when I came to a new city for business or pleasure. So far, we have had tribal dinners (and a breakfast) in Chicago, Santa Fe, Newport Beach, Richmond, Atlanta, and Fort Lauderdale. These events are very informal. There is no presentation. A small group, ranging between six and twenty, gets together over a good meal, enjoys a conversation, gets to know one another, and I answer questions.

We welcome IMA clients to bring their family members and a friend or two to these gatherings, but they are not marketing events. We put these dinners together for the IMA team to meet our clients and for IMA clients to meet the team. Our ultimate goal is to build a strong IMA tribe. I intend to continue this into 2022.

These dinners also allow me to measure the temperature of what worries clients. In late November we had a tribal dinner in Fort Lauderdale. Inflation was the number one worry on everyone's mind. I have written three articles on this topic – I referenced them above, so I won't bore you with them again.

One question stood out to me: "What stands between you and long-term investing success?" The answer just rolled off my lips. I was on my second beer, so my response was completely manufactured by my subconscious: "Clients!"

I truly believe in what we do. I, and the IMA team, will be learning and evolving and hopefully getting better. But our values will not change. We won't own the latest and the hottest stocks; instead, we'll be armed with our *Six Commandments of Value Investing*; we'll strive to be rational, and process-driven. We'll have our own money invested along with our tribe's. **Our goal is to produce the uninterrupted compounding of your and our wealth.** We aim to grow it at the highest rate possible without taking existential risks. We'll be honest – not just tout our successes but also admit our mistakes. And we will make mistakes. We'll try very hard to limit the impact of mistakes on the portfolio.

I am confident in our ability to navigate whatever the economy and the world throws at us (short of nuclear war). But every client comes to us with their own background, their own experiences and biases. This is why I want to meet as many clients as I can and host these dinners. This is why I write these long letters. I want to bring you around to our way of thinking. Paraphrasing Buffett, we get greedy when others are fearful and fearful when others are greedy. At the opposite times when most people do.

For this relationship to work, we need three things from you: Buy into our philosophy, have a long-term horizon, and do your homework (i.e., read these letters). If you are reading this sentence, unless you skipped directly to the end to see how this movie would end, you are doing your homework. Thank you!

As always, should you have any questions or require any additional information, please do not hesitate to contact us.

Enjoy and Prosper,

Vitaliy N. Katsenelson, CFA

Chief Executive Officer

And

Michael L. Conn, CFA
Chairman