ANANDA
ASSET MANAGEMENT

LETTER TO ANANDA INVESTORS
DECEMBER 2022

#5

"COMPOUNDING"

Dear Fellow Investor,

Imagine it is 1626, and with a group of enterprising Dutch merchants, you are looking to buy some real estate in the United States. Ambitious and driven, you have your eyes on the whole of Manhattan. Crazy as it might sound today, you get the deal done… for a princely $24.

Details are sketchy – there was no Zillow, Rightmove, or SeLoger back then – but various historical documents corroborate such a transaction. With hindsight it looks like an exceptional deal. But how exceptional exactly?

Fig. 1:
A brilliant investment?

Source: AI generated image by DALL·E

Valuing Manhattan is more art than science, but over 400 years the law of compounding is so powerful that it does not require precision. Invested at 5%, the original $24 would be worth a total of $6bn today. Clearly below any realistic asking price. But at 7% the $24 become $10trn, a stretch. And at 8% $24 become $413trn, more than 4 times the global GDP.

Compounding is such a powerful force that it makes buying the whole of Manhattan for $24 look like an average investment.

It might feel like a weird time to talk about compounding: performance has been difficult over the last 18 months, and 2022 is shaping up to be the worst year since 1931 for 60/40 portfolios in a world shaken by a powerful combination of political issues (Ukraine, China, populism), monetary factors (inflation, tightening) and various disruptions (Covid, supply chains). But we are contrarians.

While statistically normal, times like these are challenging and offer a natural stress test for even the most balanced investment strategies. After all, adherence to any strategy is comfortable and pleasing when external elements concur to make it successful, but it is only when facing adversity that one tests conviction and long-term resolve.

When it comes to investing, several strategies enable compounding, at least if executed consistently. At Ananda our strategy to compound capital is to own advantaged businesses which show an ability to grow intrinsic value through the long term. Trying to buy them at reasonable prices when they are out of favour.

In the spirit of Christmas, this letter delves into the miracle that is compounding. Its difficulty, but also how it rewards the patient and the disciplined. What defines an advantaged business, and how we decide which ones we want to own. And why after a period of derating, we think prospective returns offered by such a strategy are very attractive, possibly tempting us to get fully invested for the first time since our launch nearly 4 years ago – now that would be nice!

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Compounding is beautiful. Albert Einstein, who knew a thing or two about physics, called the law of compounding "the most powerful force in the universe" and "the eighth wonder of the world". It has the magical power to transform the mundane into the extraordinary, as compounding is itself the combination of two miracles: positive returns, and time.

Its magnitude is so powerful that it is difficult to comprehend. We humans think in narratives and struggle to frame thoughts in non-linear ways. Thankfully there is a rule: **the rule of 72**. To find the number of years required to double an investment at a given rate, divide 72 by the interest rate. For example, it takes 5 years at 14%, 10 years at 7%, or 20 years at 3.5%. Conversely, at 14% money gets multiplied by nearly 16 over 20 years.

Its power is literally life changing. For the better, when one realises how important it is to start saving early in life. Or for the worse, as with the debt trap situations which so unfairly penalise those with poor financial education. **Compound interest is earned by the ones who understand it and paid by the ones who don't.**

Compounding is difficult. As with most things that can change dramatically one's life for the better, it can't be expected to be easy. Particularly when it comes to investing, a zero-sum game where not everybody can out compound at the same time in real terms. Charlie Munger said it best, "it is not supposed to be easy. Anyone who finds it easy is stupid".

It is difficult because **when capitalism works, returns get competed away** – rare are those who defy gravity for long. In a paper published in 2007 analysing 26,000 US stocks since 1926, Hendrick Bessembinder and his team found that only 49% of stocks produced a positive lifetime real return. And only 42% of them beat T-Bills. The forces of capitalism and mean reversion are strong. A phenomenon only accelerated by technological disruptions.

And it gets worse. Identifying assets able to compound is not enough. You must also pay a price that allows you to generate a decent return.

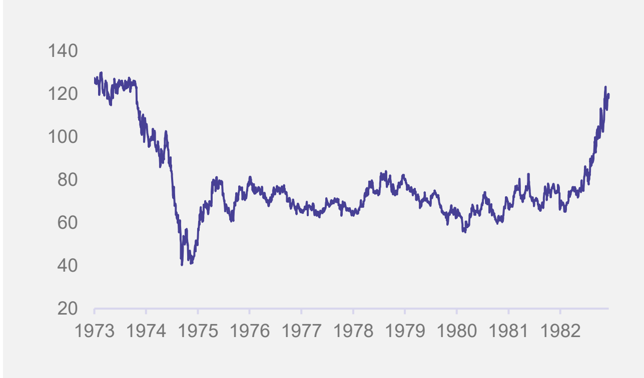
The importance of valuation diminishes as the investment horizon lengthens, but long term can feel awfully long. Some high-flying unprofitable tech companies will probably have to wait years – if ever – to reach the kind of valuations they enjoyed last year at peak euphoria.

Earlier in history, the period of the Nifty Fifty in the US in the 60s and 70s serves as a sobering example. These 50 businesses were considered so advantaged that they were considered "one decision stocks" (as in the decision to buy them). **The popularity of the concept pushed valuations ever higher and meant that perfectly good businesses subsequently offered very low or even negative 15-year returns.**

Between 1972 and 1982 Coca Cola grew profits by 10% per annum – that's 160% over the period using the rule of 72. A performance worthy of its then advertising slogan "Have a Coke and a smile".

Its stock price?...

Fig. 2:
Have a Coke and (try to) smile



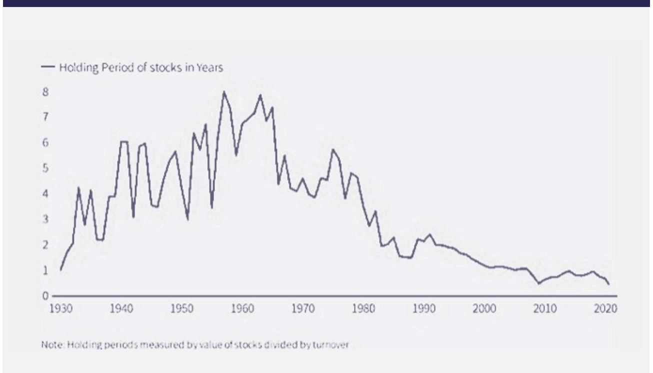
Source: Coca-Cola share performance rebased 1972-82, Bloomberg

… not so much, delivering a perfect round trip.

And that was Coca Cola, one of the most successful Nifty Fifty companies. Some, like Polaroid, were not so lucky.

And that was during a 10-year period of heavy inflation. A span longer than the prevailing average holding period which was four to five years in those days.

Fig. 3:
Average holding period of stocks at all-time low



Sources: NYSE, Refinitiv

For compounding to work, **a lot of calm and patience is required**. Imagine you have identified a great business, available at a price allowing you to compound interesting returns. You still must pass this most difficult test because returns are rarely delivered in a linear fashion. Volatility around the asset, or external events, will do their best to shake you off. Pushing you to cut your losses or take profits. New information will tempt you to "not sit on your hands but do something". Breaching the very first rule of compounding according to Munger: **"never interrupt it unnecessarily".**

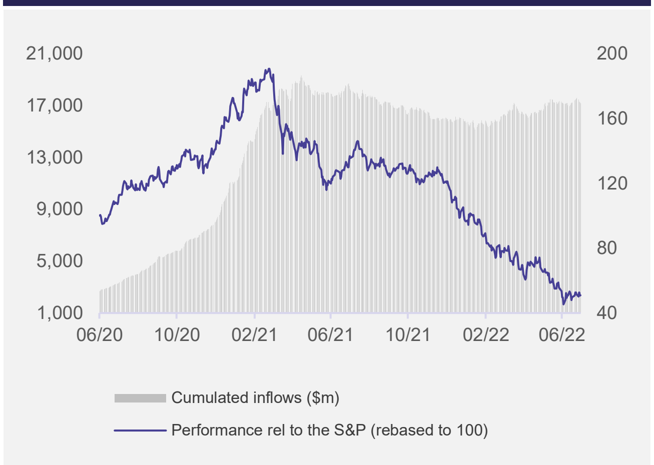
Patience with listed equities is difficult because **timing the market is ever so tempting.** Especially when things look very one sided. When everything appears positive, or, even more temptingly: when everything seems negative, like at time of writing. With war in Europe, record monetary tightening, hopeless political leadership and fast approaching recessions, it is only too tempting to press pause and wait for better days.

One is sometimes encouraged to act by mottos which sound good and are supposed to have been battle tested. A popular one at the moment is "don't fight the Fed". But long-term investors are generally well served to ignore this kind of advice. And that one in particular, given the Fed's bad habit over the last two decades of frequently being too late to act, only to end up doing too much.

Take the last two years. Going with the Fed meant buying long duration assets in the summer of 2020, when Jerome Powell was not even "thinking about thinking about raising rates". Holding on to them while the Fed was stimulating with careless abandon. Only to sell early in 2022 once they realised their mistake and started raising rates.

Looking at flows in and out of the poster child of long-duration assets – the ARKK ETF – during that period, **investors did exactly that. "Going with the Fed" by investing $15bn in the space of 12 months** (grey bars on Fig. 4 show cumulated inflows) from mid-2020. ARKK thereby became one of the world's biggest ETFs, and certainly the most talked about.

Fig. 4:
EmbARKKing with the Fed



Sources: ARKK Cumulated inflows ($m), Bloomberg

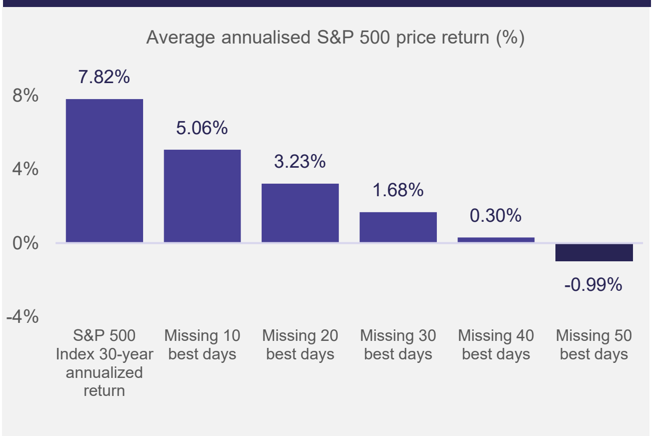
The relative performance of ARKK versus the S&P500 (blue line on Fig. 4) shows that between the moment Fed Chair gave you the all clear and the moment he changed his mind – ARKK lost 30% in relative terms. And then it got worse, with a gut-wrenching absolute peak-to-trough of 80%. And the misery might not even yet be over.

Unless you were a short-term trader and jumped out a quick six months after the all clear, going with the Fed proved very costly. Figure 4 tracking cumulated inflows shows that, sadly, very few investors did get out.

As unpleasant as it can be at times, we know from both theory and experience that **time in the market beats timing the market**. Despite their volatility and apparent randomness, markets remain amazing discounting machines making them very counter intuitive. For example many of the biggest gains for stocks occur in recessions and some of the worst periods occur in expansions.

And that's not even considering the reality of mathematics, which are ruthless when it comes to the impact of missing a few good days.

Fig. 5:
Missing the market's best days



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: September 1, 1992, through August 31, 2022, for the S&P 500 Index

Missing the best 50 days over 30 years – admittedly quite a feat – is enough to transform an 8% compounded annual return over the period into a negative 1%. In layman's terms, the difference for every dollar invested between $9.6… and 74 cents.

After 20 years investing in public markets, we are yet to meet someone who could successfully and repeatedly time the market – except for a few gifted short-term traders … and this is not for a lack of candidates!

For most of us, as Ken Galbraith put it, there are "those who don't know, and those who don't know they don't know". **But don't worry, knowing you don't know is already a key advantage.**

Sadly, it does not seem to be any easier when it comes to choosing and staying with an investment manager. Quite the opposite. It seems a dirty secret of our industry that due to human nature's pro cyclical temperament, **most investors underperform the investment funds they invest in, sometimes by a large margin.**

Imagine you had the vision – or luck! – to invest in the **Magellan fund run by Peter Lynch at Fidelity** from its inception in 1977 and stayed the course until his retirement in 1990. Throughout that period, he delivered an extraordinary 29% compounded annual return – double the performance of the S&P500 – turning every $1 invested into $27.

When looking at the logarithmic 14-year chart (Fig. 6), investing in the best performing mutual fund in the world throughout this period does look like a comfortable and enjoyable ride. But was it comfortable enough?

Fig. 6:
A comfortable ride?

Source: Bloomberg

It appears not: Peter Lynch calculated that throughout this period, the average investor in his fund only made c7% annually. A third of the performance of the fund.

This gap is surprising given the healthy long-term graph. But the small hiccups (the fund had six drawdowns of c20% or more during Lynch's tenure) were sufficiently uncomfortable to prompt investors to exit at depressed levels. Only for other investors (or maybe sometimes even the same!) to buy higher after periods of strong performance.

They say, "Past performance is not indicative of future returns". Regulators even require us to write this on all communications. But it might not be the best advice. The most profitable investments are made when investing in an asset or a strategy which has shown an ability to perform over the long term (i.e., showing strong historical performance), if possible after it went through a period of underperformance (i.e., showing bad recent performance) to maximise the entry point.

* * *

Acting long term and not using shortcuts like market timing make defining a robust investment strategy at the outset all the more important.

If you are going to stay on just one hill and let the snowball compound, you better choose one with a long, wide, and gentle slope. The hill we have chosen for Ananda is the wonderful universe of advantaged businesses.

But what is an advantaged business?

Buffett provided his response to this important question in Berkshire 1991 shareholder letter. "*An economic franchise arises from a product or service that: is needed or desired, is thought by its customers to have no close substitute and is not subject to price regulation. The existence of all three conditions will be demonstrated by a company's ability to regularly price its product or service aggressively and thereby to earn high rates of return on capital.*"

Starting with **pricing power** is great because it is the ultimate test. A company we admire and hold – Swedish Lifco – is a serial acquirer of niche manufacturers. After buying new businesses, they put through a one off mid-single digits price increase across all products, to test which are most important to customers. Hint: if people aren't willing to pay you attractive prices for your product, it's probably not an attractive product. Once they identify which divisions have the greatest pricing power, they increase R&D and sales efforts in those areas. Any product revealed to be more commoditised is de-emphasised. This gradually rebalances the company to where it can add value and focuses limited resources on the most impactful activities. Allowing Lifco to play to its strengths.

The ability to regularly raise prices is conditional upon a business having at least one source of competitive advantage. When it comes to identifying those, the Morningstar moat framework has stood the test of time. The framework cites **four key sources of sustainable competitive advantage.** Without at least one of these, a business will likely succumb to competition, impairing return on capital.

The first is network effects, which occur when the value of a good or service increases for both new and existing users as more people use it. For example, the futures exchange of portfolio company Intercontinental Exchange (ICE) enjoys network effects caused by the natural concentration of open interest and liquidity. As exchanges grow larger, more market participants are willing to provide liquidity, which attracts even more trading volume, which then attracts more participants, and so on; liquidity begets liquidity. In addition, the non-fungibility aspect of futures contracts means that contracts opened at a futures exchange must also be settled and closed at the same exchange, fueling large liquidity pools, and near-insurmountable barriers to entry.

Second are switching costs, obstacles that keep customers from changing from one product to another. Earlier this year – seizing the opportunity of a badly received acquisition – we invested in Masimo, a company that dominates the market for pulse oximetry (electronic clips that go over your finger to measure your blood oxygen level). Masimo first sells technology boards that go into patient monitors, then sells disposable sensors with a 5-to-7-year contract. It's a classic razor-and-blade business model. There is little reason for medical facilities to switch to a competitor since Masimo's products are technologically superior, but also because the installed base of machines makes switching expensive.

Thirdly, we look for structural cost advantages. One example in our portfolio is Interactive Brokers, whose electronic trading platform and ultra-low pricing have established it as the de-facto online broker for semi-professional traders around the world. The company's software-driven automation offers a cost advantage, allowing the company to undercut competitors on commissions and margin loan rates. This allows the company to market via word of mouth, leading to the industry's highest margins.

The fourth Morningstar factor is intangible assets such as patents, government licenses and brands. All our portfolio companies have intangible assets, although some are more powerful than others. Brands are valuable if they confer status, or lower search costs. There is a valid argument that the internet has eroded the value of the latter, so we tend to focus more on the former. Portfolio company examples include LVMH, whose collection of 75 distinguished "Maisons" is unparalleled.

Finally, it is difficult to overemphasise the impact **culture** has on long-term returns. Per Peter Drucker, "culture eats strategy for breakfast". Amazon for example has been able to develop several amazingly successful businesses, despite not benefitting from any profitable monopoly – unlike Google with search, or Facebook with the social graph for example – simply through relentless execution and their laser focus on customer experience. Deciphering corporate culture offers unchartered territory from which active managers can derive an edge. Examples in the portfolio abound of companies with unique cultures. From Danaher's culture of continuous improvement whose foundations lie in the Japanese Kaizen concept, to Constellation Software's culture of total accountability and independence, Hermes' culture of excellence, or Jet2's culture of frugality and customer satisfaction.

These things change with time, and **no business can compound shareholder value into perpetuity**. We hold investments where we are reasonably confident that the company will maintain its competitive advantages in the medium-to-long-term. When the conviction can't be developed, the opportunity quickly goes into our large "too complicated" pile.

Things change because the asset base of a company is dynamic. As assets become obsolete, as brands get tired, or technologies disrupted, the new replaces the old. **And management's ability to allocate capital becomes the main driver of returns**. We remember that in the long term, the majority of a company's assets will have been invested after our own investment.

Maths shows that for a company generating Returns On Capital Employed (ROCE) of 20% and lucky enough to reinvest half its cash flow organically, after 10 years the original assets only represent 34% of the total asset base.

Fig. 7:
The critical importance of capital allocation

Invested Capital	Y1	Y2	Y7	Y8	Y9	Y10
Start of the year	100	105	129	134	138	143
Cumulated depression	-5	-6	-8	-9	-10	-10
Post tax ROCE 20%	20	21	26	27	28	29
of which 50% reinvested into the business	10	11	13	13	14	14
End of year	105	110	134	138	143	146
	Y10	**%**				
Initial Capital	50	34%				
New Capital	96	66%				

Source: Ananda

The new 66% drive future returns. And from that standpoint not all businesses are created equal: **some are lucky and benefit from natural and long runways to which they can allocate capital**, making the process less daunting. Some are less fortunate.

For example, the risks involved in Lindt opening a new geography, or in LVMH expanding the product range of one of its star brands, are relatively controlled. Those companies have playbooks they can follow, experiences they can rely on. It makes those investments less risky than for example those facing a construction company deciding to enter the mobile phone industry.

This is a key advantage, as **when no simple option to allocate capital exists, bad things tend to happen**. Especially if the company is run by empire builders. The good news is that brilliant results can still be achieved out of very ordinary industries with limited opportunities for reinvestments. The likes of Berkeley group in the UK and NVR in the US are great examples. Two housebuilders operating in difficult industries, which through a relentless focus on returns rather than growth at any cost have been able to generate impressive results for their shareholders. It is the exception though, as management teams focused on growing intrinsic value per share rather than the overall size of their company are a rare occurrence, maybe because of the character traits of those who tend to get promoted to CEO.

Given how competitive the investment business is, **when future compounding is evident it gets reflected in the current valuation**, eating away future returns. As shown with Coca Cola earlier: paying upfront for the next ten years can prove costly.

High ROCE offers some protection, giving validity to the claim that in the very long run you cannot pay too much for a good asset. But this is not the case over a more realistic investment horizon of three to five years, where valuation matters a lot.

Figure 8 shows the annual returns achieved by investing in a company generating a 20% return on capital. Paying four times its book value and selling it at two times its book value. Over various investment horizons.

Fig. 8:
Different horizons, different returns

	Book value	
Entry Price	2x	4x
Exit Price	2x	2x
40 years	20%	18%
10 years	20%	12%
5 years	20%	4%
2 years	20%	-15%

“Overpaying” by a factor of two at entry degrades returns by only 2% per year over a 40-year period, leaving you with a still fantastic 18% annual return. But over 10 years, the annual return degrades to 12%. Over 5 years to 4%. And over two years it becomes negative 15%. Valuation matters.

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After such a long list of difficulties standing in the way of the investor trying to compound her capital, it is only fair that **listed assets also provide market participants with an unfair advantage.** One which possibly trumps all the negatives, at least for the courageous and independently minded: in liquid markets, there is always a panic somewhere. It doesn’t take much because of the well diagnosed **manic-depressive condition of Mr Market.**

Panics usually come with great entry points. Examples abound at the moment. In fact, there have never been so many among advantaged businesses since our launch in 2019. A result of a volatile period in which investors have been pushed to optimise ever more for the short term.

Nike needs no introduction. This amazing compounder has returned 55x over 30 years. But the company is going through a difficult period, with its stock price recently down more than 50% from its peak. The reason for the painful underperformance is not its rock-solid balance sheet, or any new structural issue. It is much more mundane: facing frequent production disruptions during Covid, strained global supply chains, and rolling lockdowns in China, Nike thought it prudent earlier this year to increase inventories. With the Western consumer fast retrenching, this decision is proving ill-timed and costly. It is forcing Nike to deal with inventories up 40% year-on-year, at the worst possible moment. The only way to solve such a problem – one the management is pursuing aggressively – is the dreaded inventory liquidation, aka mark-downs, hitting the gross margin and the bottom line.

While temporary in nature, those issues most likely mean a severe hit to earnings over the next 12 months. Faced with these gloomy short-term prospects, Nike is currently a very polarizing investment. Investors are split between those valuing it on the next twelve months earnings, who are running away, and those who consider the stock as ownership interest in a business they value on normalised profitability levels, and who focus on its long-term prospects.

There is no right or wrong. Both strategies can work when executed consistently. But you must know where you stand, on which hill you have decided to camp.

Needless to say, we find the prospect of owning such a great compounder, at one of its most interesting points in history (we suspect Direct-to-Consumer is a game changer that will increase returns, lower volatility, and make the company even stronger in the years to come) and at a reasonable normalised valuation very appealing.

And Nike is not the most extreme example. It is a good one though: if the market can panic on such a stalwart, imagine what happens with more average companies when they go through a soft patch.

* * *

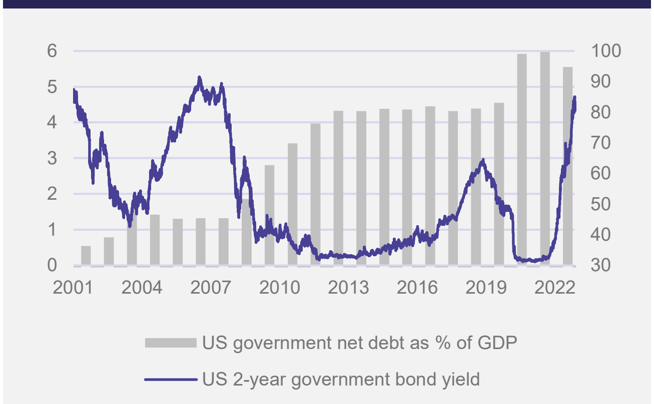
While there is never a bad time to implement a sound long-term strategy, there are moments which are better than others. And to follow up on the good news front, we think the current environment is one of them.

Over the past 18 months, the type of companies we have discussed in this letter – and that we so eagerly pursue – have suffered an important derating. In more mundane terms, their valuations have gone down, sometimes by a lot. A phenomenon which has impacted most **long-duration assets.**

This barbaric term comes from the mathematical reality that when valued through a Discounted Cash Flow, an asset able to grow quickly will be more highly valued, with a larger part of its valuation (the terminal value) residing in the later years. As opposed for example to strategically challenged assets, which only offer visibility a few years out (think coal mines or petrol stations) but deliver generous immediate cash flows. When interest rates go up (and assuming cash flows are unchanged), terminal values are mechanically disproportionately impacted, and the relative valuation of long-duration assets decreases versus the cheaper and sometimes strategically challenged ones.

This is what happened over the last 18 months, as **interest rates went up from abnormally low levels, at the quickest pace in the last 30 years** (blue line on Fig. 9). A move quite extreme when considering the record high level of debt in the system (grey bars on Fig. 9).

Fig. 9:
Fast & Furious 2Y bond yields



Source: USGG2YR, Bloomberg

The hit to valuations has been severe, as **low, and sometimes even negative rates had left the valuations of businesses with high terminal values exposed.**

The impact on share prices is magnified as the derating is mechanical and instantaneous, whereas the growth which makes those assets worthy of investment is by construction more linear. The exact opposite of course would happen should rates go down, boosting the returns of investors who got the opportunity to increase their exposure after this de rating phase.

While we find the topic of interest rates and inflation very interesting, and we can't pretend not to entertain a view on the current debate, **it is solidly outside our control, and something we don't act on.** And fortunately, in the long run it does not really matter.

The strategy we follow can sometimes be a poor inflation hedge (i.e., performance can suffer when inflation expectations increase brutally, as between mid-2021 and mid-2022), but it provides **a very strong inflation protection to the long-term investor**. Because the assets we own benefit from strong pricing power, high gross margins, and solid balance sheets, protecting their owners from the ongoing debasement.

Fortified by a long-term mandate, **our strategy in those periods is to stay the course and focus on what we do control:** monitoring our portfolio companies and optimizing the risk reward between our investments, to seize opportunities created by volatility.

While those periods can be stressful, they also offer plenty of advantages. The first one – especially important for a new fund – is to stress test the investment manager, and to check the alignment of its investors with the strategy. A second – more general – is to eliminate any complacency that might have crept up during boom times. The third – and not the least! – is to create the conditions for strong future performance. The simple framework we use to value the companies we own was showing in mid-October an upside only seen during a few weeks in March 2020. Reflection of a market pricing both higher rates, and a coming recession.

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Ananda is in the fortunate position of being totally independent as a firm, and of having long-term investors as clients. This allows us to avoid optimizing for the short term and maximise for the long term, never having to interrupt the compounding process.

It makes a period like today very interesting, as while quality has always been the focus for us, anxiety over the last eighteen months has pushed investors to shorten their investment horizon. This has created opportunities to increase even further the quality of our portfolio. Allowing us to invest in assets that we previously deemed too expensive and were patiently waiting to own.

When looking across our investments, a large majority of those listed for 20+ years have each enjoyed 12% or better compounded annual growth, seeing their value multiplying 10 times (or better!) over the period. And this is despite the recent correction which has left them generally out of favor, and trading on reasonable multiples.

Of course, taking comfort in how exceptional this group of companies has historically been at compounding is fraught with risks – because of the backward-looking nature of the exercise – but we find it interesting nevertheless given what we consider their very attractive current prospects.

No wonder our temptation to interrupt the compounding process has never been lower.

* * *

It will never be easy, and that is what makes the job so interesting. But thanks to your support, we are the proud owners of a remarkable collection of advantaged businesses which collectively boast solid balance sheets, strong pricing power, generate great returns, and are available at valuations we consider reasonable.

Partnering with the brilliant entrepreneurs managing these assets is both exhilarating and humbling, as we never forget that while we enjoy the ride and the returns, they are the ones doing the heavy lifting.

They are the reason why, despite the obvious political, economic, and social difficulties, we are more constructive about the future than ever.

From all the team at Ananda, we wish you a merry Christmas and a fantastic 2023!

- Louis Villa

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