Business Owner TGV vs. the DAX

Year	Annual % Change in Business Owner (1)	Annual % Change in the DAX (2)	Relative Results (1-2)
2008 (3 months)	-13.4%	-17.5%	4.1%
2009	31.1%	23.8%	7.3%
2010	27.0%	16.1%	10.9%
2011	6.5%	-14.7%	21.2%
2012	18.4%	29.1%	-10.7%
2013	31.9%	25.5%	6.4%
2014	24.9%	2.7%	22.2%
2015	46.7%	9.6%	37.1%
Compounded Annual Gain 2008 - 2015	22.7%	8.8%	13.9%
Overall Gain Sep 2008 – 2015	339.4%	84.2%	255.1%

The best year ever

Dear Co-Investor,

The NAV of Business Owner was EUR 439.38 as of 30 December 2015. The increase in NAV was 46.7% since the start of the year and 339.4% since inception on 30 September 2008. The Dax was up 9.6% and 84.2% respectively.

Not without some good fortune

The fund benefitted from two pieces of good fortune last year: the increase in value of the US Dollar and record low interest rates. I did not foresee either and even if I had done they would not have played any role in my capital allocation decisions.

Dollar tailwind

The fund benefitted from the rise in the Dollar as over the last three years or so I have been allocating more and more of our capital to US based companies such Berkshire Hathaway, Google and Credit Acceptance. Even newer additions in Europe, such as Novo Nordisk, generate the bulk of their earnings in the US.

The decision was not based on a macro analysis of the Eurozone's woes (real though they are) but because I saw better opportunities in the US and, to a lesser extent, China (whose currency closely tracks the Dollar). This is not just true for the companies I have invested in but also the wider universe of companies I have analysed but ultimately passed on. I can think of tens if not hundreds of US based businesses that have wonderful cultures, great competitive positioning and, importantly, long growth runways. In Europe the list is far shorter. There is no shortage of great companies in Europe, but most of them are more mature. It is rare to find companies such as Grenkeleasing or Novo Nordisk, where one can plausibly argue that earnings and hence intrinsic value can increase at 15% or more per year.

Perhaps the far greater number of dynamic companies in the US does indirectly say something about the economic vitality of the two economic zones and hence currencies, but if it does I would emphasise it was not what drove my capital allocation.

Interest rate tailwind

The fund also benefitted from the collapse in interest rates.

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Since a few years, I have increasingly been allocating our funds away from lower multiple companies where the cash flow is front-loaded towards companies with higher multiples where the cash flow is back-loaded (and hopefully greater in present value terms).

A good example of such a company is Novo Nordisk. Novo is the equity market equivalent of a thirty year government bond. Like a long dated government bond, its price has most probably benefitted more strongly from the fall in interest rates than its 10 year counterparts.

I know what you are thinking – "do I really want to be invested in a manager where returns are being driven by such good fortune?" To help you answer this, I am reminded of a quote attributed to the owner of a British soccer club:

"There are two types of desirable football manager," he opined, "the talented manager and the lucky manger. Frankly, I prefer the latter."

I hope you agree.

Not all luck

There is one thing I have been doing for many years now and has in my view been absolutely central to the fund's performance. I mention it not in the spirit of self-congratulation, but because there is far too little attention paid to it and it would be far better for society, not to mention individual fund's performance, if this was not the case.

I am referring to building an understanding of and conviction around a company manager's integrity and more broadly speaking a firm's culture (the two are closely connected as the tone basically comes from the top). Nothing has been more important to managing the fund over the last years than understanding management character.

This is probably counter-intuitive to many of you as investing in general and value investing in particular is considered a quantitative exercise – a race, if you like, to find the companies with the lowest multiples of book value, net-net working capital, or earnings. Judging a manager's character is, by contrast, a qualitative exercise, which cannot be expressed in figures or proven through regression analyses.

However, consider a handful of the key decision moments in just the 2015 calendar year:

- In the spring, Google plumbed a two-year low as European media companies delivered around-the-clock coverage of claims by the EU and competitors (though not consumers) that it was an abusive monopolist and should be broken up.

- In the summer, Baidu lost over a third of its value on fears that it would throw away all its capital on hopeless O2O investments and the Chinese economy was going to fall off a cliff.

- In the autumn, the VW diesel scandal broke pulling BMW down in its wake.

- More recently, Credit Acceptance's share price fell precipitously. Contemporaneously the New York regulator subpoenaed it regarding its lending practices.

Each of these episodes presented two scenarios and four possible outcomes: in the event that the fears proved overblown, one could either (a) make money by sitting tight or, better still, loading up, or (b) lose money by selling "in panic". In the event that the fears proved well founded, one could either (c) make money by cutting losses early or (d) lose money by "stubbornly" persisting with the original buy decision.

It sounds simple enough, but there is a catch. At the time, you have less than perfect knowledge and a window of opportunity of unknown duration but probably short.

Thus, I had no particular insight on Margrethe Vestager's intentions vis-à-vis Google, the scope of Baidu's ambitions in O2, the activities of Credit Acceptance's dealers in New York, nor – wait for it – the software running on BMW's diesel engines. On the latter point, I was deeply flattered by the number of emails addressed to me – a graduate of Modern and Medieval Languages – regarding the software in BMW's engines. Alas, it is not something I have ever given much thought to.

So what do you do when you appear to be flying blind in a crisis?

Recall that my research process revolves around three axes – an attractive price, a sustainable competitive advantage, and an honest and talented management. How much use was each of these in the aforementioned mini-crises?

<u>Price not much help</u>

I found low multiple to be of limited value in the above scenarios. For example, what use is it that the market was valuing Baidu's core search business on a single digit P/E if the fear is that its earnings are going to disappear into a bottomless pit of O2O investments ad infinitum?

<u>Competitive advantage not much help either</u>

Ditto for competitive advantage. What use is a strong conviction that BMW has a wonderful brand if the fear is that cheating on emissions leads to brand impairment, not to mention a huge cash outflow?

Neither my thoughts on valuation nor competitive advantage, though positive, were of much practical use.

<u>Trust in people key</u>

Contrast this with my thoughts on management quality:

- I have a strong belief that the key motivation of Larry Page and the vast majority of Googlers is to develop products which are useful, ubiquitous, and have the potential to change the world for the better.

- Robin Li is a wonderful owner-operator with the bulk of his net worth in Baidu stock. At the 2015 Baidu World, he stated to a room full of analysts seething over the short-term deterioration in earnings:

  "I don't really change my decision based on the day-to-day fluctuation in the stock price or investor sentiment. I really look at what's the best thing for the Company in the next 5 years, next 10 years, next 15 years."

  He believes the way to achieve this is to link Baidu's search engine with local services. European regulators would presumably agree given the lengths to which they are going to prevent Google doing the same in Europe. I agree too, but should the investments not work out, I would expect Robin, as a rational owner, to scale them back.

- I have been attending BMW investor events around the world for many years now. At every event, a focus on engineering excellence and a geek-like relish at meeting the EU's stringent CO_2 targets for 2020 comes across loud and clear. The chances that such a culture would tolerate a quick software fix to bypass a monumental engineering challenge strike me as remote.

- I have visited Credit Acceptance's collections department on two separate occasions over the last years. I was not sure what to expect beforehand as I had never visited a collections department before and, thankfully, have never been subject to one's attentions. Secretly, I was expecting a charged and aggressive atmosphere, lots of large, beefy guys, and perhaps a torture chamber in the cellar for the most indomitable cases. What I found was the complete opposite – a positive atmosphere where the collectors frequently expressed empathy with their customers and simply worked to find a win-win for all parties. The refrain I repeatedly heard was "How can we keep you in the car?" - by far the best case scenario for all parties despite the popular misconception that the lender benefits from a repossession. Credit Acceptance has been working on and refining its underwriting and collecting practices for over three decades. Not only do I think that it is fully in compliance, but I see this as a source of competitive advantage vs. newer players who simply have not been around long enough to see all the different pitfalls that can arise.

My belief in the character of our managers and the strength of our companies' cultures gave me the conviction to act quickly and decisively. In no cases, was I tempted to sell down a position. In most cases I increased our holdings, at times significantly. From today's perspectives, these decisions were all very profitable.

Can I be sure this conviction was not misplaced? Of course not. However, to beat the market it is only necessary to be right a little bit more than 50% of the time. I felt significantly more than 50% sure, perhaps as high as 90% sure. At the same time, the market seemed be put the probability of the risk not materialising at significantly less than 50%. Having the opportunity to place bets at odds of 2 to 1 or better with 90% confidence is a profitable business. It makes me excited about the future return potential of our fund should the market continue serving up such lucrative opportunities.

<u>Are not markets supposed to be efficient?</u>

If markets are supposed to be efficient, a legitimate question is why the market is overlooking such an obviously important factor as manager integrity. I can only hazard a guess, but I see three main reasons.

First, it breaks all kinds of societal taboos to comment on an individual's character in the negative unless that person virtually has one foot in jail. Thus, I cannot recall a single analyst report, out of the thousands published every year, where the analyst conjectured that the management <u>might</u> be dishonest.

Second, it is generally not considered to be all that important. Perhaps even the opposite is considered to be the case – in a dog-eat-dog world, nice guys finish last. If you have one foot in this camp, ask a VW shareholder if management character is worth paying attention to.

Third, it is widely considered too difficult to separate the pretenders from the real deal. As a purveyor of funds, I am inclined to agree. However, my better angels compel me to tell you it is actually not all that difficult. Choose your universe carefully, i.e. managers with long tenure and, ideally, significant skin in the game. Then study their track record, paying particular attention to how they behaved in times of economic duress and how they have treated the various employees, customers, suppliers and competitors they have touched over their long careers.

Fourth, the more quantitatively minded always want to have the last word.

One new investment

I added one new investment to the portfolio in 2015: the Seattle-based Trupanion.

Like last year's investment in Credit Acceptance, Trupanion came about through a referral - in this case from my friend Josh Tarasoff. Josh told me about the company whilst we were sitting in New York's Bryant Park in the spring munching on a Shake Shack burger – nobody should accuse me of not suffering for my art.

Trupanion provides medical insurance for pets in Canada and the US. Although insurance is an ancient industry, pet insurance in the US is relatively young and undeveloped. Around 1% of pets have insurance in the US. Accordingly, Trupanion too is a young company and is loss-making.

A business that will be around and flourishing in ten or more years' time?

The first question that probably springs to mind is should this business even exist and will it be around and flourishing in 10 or more years' time?

I feel less confident on this point than with our other investments, all of which have long, profitable histories, however there are compelling reasons why I think it is the case.

Historically, most pets have not been insured for three main reasons.

First, the insurance value proposition was, to put it mildly, not great. Typically, the monthly insurance premium was set at a low level based on "what the market could bear" as opposed to what was necessary to provide comprehensive coverage. To make the product work from an underwriting perspective, insurers wrote a large number of exclusions into the contracts including all the conditions the animal was most likely to be afflicted by. As a result, owners were left frustrated and vets were understandably reluctant to recommend getting insurance.

Second, there was little point. The range of treatments was relatively limited meaning that even in a bad case scenario the potential veterinary bill was not high enough to warrant getting insurance.

Third, pets did not have a particularly high status in the household. If an animal fell seriously ill, euthanasia was the most likely route that owners went down.

As of today, most of the above is no longer the case. Much of the progress in human medicine has trickled down to animal medicine providing a wider range of treatment options for all kinds of conditions. The highest veterinary bill that Trupanion typically pays out in a single month is US$40K or higher, making insurance a necessity for all but the wealthiest households.

Pets have become fully-fledged members of the family. According to a recent survey by the American Pet Products Association, nearly half of all dogs sleep in their owner's bed (frankly I struggle to believe this statistic…. our dog generally edges me out of the bed in the middle of the night).

Finally, the overall value proposition of pet insurance has improved greatly. Trupanion provides fully comprehensive coverage for all conditions including hereditary and congenital ones and places no restrictions on the vet in terms of what course of action she proscribes. Trupanion insurance costs more than products with exclusions but delivers when it is needed.

Several sources of sustainable competitive advantage

Insurance is rightly considered a tough business where few players make sustainably high returns on capital. What makes Trupanion different?

Territory partners

In contrast to other players, Trupanion has a physical sales force, known as territory partners ("TPs"). They regularly call on pet hospitals in their area. I had the opportunity to ride with two TPs – Holly and Jense – on two mornings during a trip to Seattle in the autumn. They are awesome. I was reduced to a physical wreck at the prospect of cold calling an unknown hospital and they just moseyed on in – time after time.

Strictly speaking, the TPs do not actually sell anything. Their job is to call on the hospitals, distribute referral sheets and product fliers, explain the product and the benefits to both the vet and the owner (the ability to give the best treatment to the pet free of any cost considerations), point out positive claims experiences since the last visit, and field any queries or deal with any problems. When everything goes to plan, the vets actively refer owners to Trupanion without any kind of commission or compensation.

The value of the TP's work was brought home to me on a visit with Jense to a hostile vet. She was upset about a relatively minor claim being declined due to a pre-existing condition. This goes to the heart of why most vets will not recommend insurance – the fear that it is ultimately a useless product. I do not know how the matter was ultimately resolved, but I observed how Jense listened to her concerns, promised to raise it back at HQ, and, to the extent Trupanion did not reverse its decision, offered to set up a call with Steve, Trupanion's head vet. Had Jense not been there in person to nip the problem in the bud, it is easy to see how the relationship would have been poisoned and the vet would have ceased to be a source of referrals.

Where is the moat? First, most of Trupanion's competitors do not have the scale to support a physical sales force. Second, they might not have the positive claims message to take to the vets. Third, they are too dependent on the online sales channel - putting physical sales people on the ground would create a channel conflict.

Data

Trupanion has by far the most comprehensive data in the pet insurance industry. Its database has been built over 15 years using over 7.5 million pet months of information and includes over 1 million claims.

In contrast to many other insurance markets, this data is proprietary to Trupanion and cannot be bought from a 3rd party service provider.

Trupanion collects data on many factors including breed, age, post code, and even hospital (some vets will proscribe a pill to a vomiting dog and suggest the owner comes back in a couple of days if the problem persists whereas others will run a full gamut of tests straight off the bat). Trupanion's competitors either do not collect the data (for example as a condition is not covered), or are smaller and lack comprehensiveness.

Trupanion's proprietary database allows it to underwrite more accurately and direct its marketing more effectively.

Cost advantages

In contrast to most competitors, Trupanion is fully integrated. It owns both the primary insurance company and the managing general agent, it owns its brand, it owns its data and it does not use reinsurance. By being vertically integrated, Trupanion estimates that it is able to take up to 20% of frictional costs out of the business.

Trupanion Express

Trupanion is rolling out Trupanion Express, a software which integrates seamlessly into a hospital's practice management software. Amongst other things, it provides instant feedback to the owner whether a condition is covered and provides direct payment to the hospital saving it credit card fees. As importantly, it saves the owner the hassle of filing an insurance claim and the hospital the hassle of producing its medical records.

Culture

Trupanion has a very strong culture based on "care for the pet". This is enforced by allowing associates to bring their dogs to work. When I visited the office in Seattle, it was literally filled with dogs. I believe on an average day, there are 250 dogs present (and a few particularly courageous cats).

People

I had the opportunity to meet with a broad cross section of Trupanion's people during a three day stay in their offices in Seattle last autumn. The welcome I received was incredible and I would like to express my thanks to everyone who took the time to meet with me and explain what they do. What I experienced there was a group of people who are confident, ambitious, energised and, above all, purpose driven. It does not take a huge leap of faith to believe they are going to steamroller all before them.

Potentially a huge upside

Trupanion is a higher risk proposition than our other investments. The flipside to this is that the potential upside is also far greater. In other words, I think we are getting paid for the greater downside, but of course only time will tell.

Pet insurance is at a very early stage in the US. As mentioned, insurance penetration is only approximately 1%. In markets where pet insurance is more established, penetration is far higher. For example, in the UK it is 25%. The hope is that in the very long term, the US market can replicate these penetration rates. This implies a very long runway for Trupanion *if* it and the other industry participants develop the market properly.

Style drift?

I want to highlight that Trupanion represents a departure in investment style to a certain extent. I cannot recall having ever before invested in a company which is at such an early stage of its development, and which is both loss-making and without any immediate prospect of turning profitable.

Some of you may take alarm at this.

Consider though that almost every new investment has been a departure to a certain extent: BMW was the first foray into large caps, Google into tech, Baidu into China, Novo into pharma, and so on. It is part of my ongoing effort to expand my circle competence, to learn and to improve. A less charitable interpretation would be that it is indicative of a creeping style drift. You will have to decide for yourself which camp you fall in.

Some additional ingredients

What certainly swayed me to making an investment in Trupanion were some additional ingredients which I have been increasingly placing more weight upon in addition to the usual ones of moat, management and price:

Purpose: I have increasingly come to see a purpose beyond simply making money as absolutely central to the long-term success and health of a company. In "Conscious Capitalism," David Mackey (the founder of Whole Foods) argues compellingly that businesses must have a higher purpose.

Alignment: I feel increasingly drawn to companies that create alignment, sometimes described as "win-wins", between different stakeholders. Darryl Rawlings, CEO and founder, is one of the most focussed people I have ever come across on creating alignment. One long-term shareholder described a conversation he had with a reinsurer at a time when Trupanion still used reinsurance. She told him Darryl was the only client who had ever shown concern that she would make a profit at the rate they had agreed.

Tax efficiency: Earning a profit is generally an indication of a good business but not always. In "Cable Cowboy" (the story about the cable industry pioneer John Malone), Robichaux describes how Malone was able to indefinitely postpone taxes by purchasing cable networks and writing them down as fast as the tax code would allow. The result was low GAAP net income but breath-taking free cash flow. There is an element of this to Trupanion's business model. It writes the customer acquisition cost down in the first month but the average pet retention is about 6 years.

Scale economies shared: This is a concept I first heard articulated in the peerless letters of investor Nick Sleep. The idea is that a company shares its economies of scale with the customer leading to greater customer demand which in turn sets off greater economies of scale. Costco and Amazon (which both happen to be based in Seattle) are classical examples of the power of this virtuous circle, or as Bezos would call it, "flywheel". Trupanion is an example of this phenomenon too – it writes to a far higher combined ratio than competitors, effectively sharing more of the insurance premium with the customer.

<u>Investor meeting</u>

Our investor meeting will take place this year on Saturday, 11 June 2016 in Bad Godesberg. Bring the family. As with last year, there will be a program for children including a trip to the Haribo factory outlet.

Yours sincerely

R. Vinall

Robert Vinall

Meggen, 27 January 2016