RICHTWERT CAPITAL

Rational by Design, Fair by Choice

PARTNER LETTER 2018

The time to invest is when you're getting a lot for your money
regardless of what the economy or markets will do the next day, month or the next 1-3 years.

"I like Richtwert because Bahram invests like a businessman and treats customers very fairly.
He knows what is important in business, looks for the most attractive companies, waits for the market to misjudge them and invests opportunistically.
His own capital is invested in the same way and I only pay for success."

Stephan Marchner

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PERFORMANCE OVERVIEW

EUR	RICHTWERT (EUR)	iShares S&P 500 (EUR)	iShares MSCI World (EUR)
2014 (Aug - Dec) ...……	12.0%	7.2%	4.6%
2015 ……...	-1.1%	0.2%	1.4%
2016 ……...	7.8%	9.6%	7.6%
2017 ……...	11.5%	18.8%	16.5%
2018……	0.7%	-7.7%	-9.6%
2019 (Jan – Mar) ....……	21.3%	12.7%	12.0%
Compound Annual Gain……	11.0%	8.4%	6.6%
Overall Gain ....……..	62.6%	45.4%	34.6%

CHF	RICHTWERT (CHF)	iShares S&P 500 (CHF)	iShares MSCI World (CHF)
2016 ……...	5.9%	8.8%	6.8%
2017 ……...	21.3%	18.3%	16.1%
2018……	-2.7%	-8.4%	-10.2%
2019 (Jan – Mar) ....……	20.2%	12.7%	11.9%
Compound Annual Gain……	13.4%	9.2%	7.0%
Overall Gain ....……..	50.3%	32.9%	24.6%

USD	RICHTWERT (USD)	iShares S&P 500 (USD)	iShares MSCI World (USD)
2016 ……...	3.3%	11.9%	7.8%
2017 ……...	26.5%	21.8%	22.5%
2018……	-3.7%	-4.4%	-8.4%
2019 (Jan – Mar) ....……	18.8%	13.7%	12.4%
Compound Annual Gain……	13.2%	12.8%	10.0%
Overall Gain ....……..	49.5%	48.0%	36.1%

Small deviations in calculations may occur due to rounding.

RICHTWERT (EUR): Performance incl. gross dividends, after costs, before profit share in EUR
iShares S&P 500 (EUR): iShares S&P 500 EUR Hedged ETF (Acc), Performance incl. reinvested gross dividends, after costs in EUR
iShares MSCI World (EUR): iShares MSCI World EUR Hedged ETF (Acc): Performance incl. reinvested gross dividends, after costs in EUR

RICHTWERT (CHF): Performance incl. gross dividends, after costs, before profit share in CHF
iShares S&P 500 (CHF): iShares S&P 500 CHF Hedged ETF (Acc), Performance incl. reinvested gross dividends, after costs in CHF
iShares MSCI World (CHF): iShares MSCI World CHF Hedged ETF (Acc), Performance incl. reinvested gross dividends, after costs in CHF

RICHTWERT (USD): Performance incl. gross dividends, after costs, before profit share in USD
iShares S&P 500 (USD): iShares S&P 500 ETF, Performance incl. reinvested gross dividends, after costs in USD
iShares MSCI World (USD): iShares MSCI World ETF, Performance incl. reinvested gross dividends, after costs in USD

Dear Partners and Co-Investors,

In this partner letter I will cover the following:

- Our investment objectives
- Our portfolio's market performance
- Our portfolio's business performance
- The gap between market and business performance and why it pays to invest like a business owner?
  - incl. Amazon's Jeff Bezos in a 1999 Interview
- Three of our portfolio companies (Apple, Blackstone, Facebook)
- Where we are today and what may lie ahead
- Our portfolio positioning

INVESTMENT OBJECTIVES

I repeat the objectives we defined in our Partner's Manuel in every partner letter so that we can compare our results to our goals. Having said that, please be aware that our performance period is still too short to be meaningful. We need a history of 5-10 years for the performance period to become meaningful.

I can't promise you any results, but I do want you to know, the qualitative and quantitative goals Richtwert is aiming for.

Our qualitative goals over the mid- and long-term are:

1. *To protect the purchasing power of our wealth.*
2. *To maximize our wealth.*

You can find more details regarding our qualitative goals in our Partner's Manual.

Our quantitative goals over the mid- and long-term are:

A) To achieve average annual rates of return before profit-share and taxes of at least 10%

or

B) to exceed the S&P 500 index performance (hedged in our reference currencies) by 3% on average before profit-share and taxes.

Ideally, we want to meet all goals, but I will be satisfied if we meet either goal. For instance, if we achieve goal A) but fail to meet goal B), I believe the performance of the S&P 500 index is exaggerated and that future returns from the S&P 500 will be lower allowing us to meet goal B) in the future. On the other hand, if we achieve goal B) but fail to meet goal A), I believe the performance of the S&P 500 index has been too low and that it will improve over the course of the next years. Our performance should also improve in absolute terms as long as we continue to perform better than the S&P 500.

Therefore, if our record is better than any of the targets mentioned above, I believe we have been successful. If our record fails to meet both targets, I believe we should look for alternative ways of investing our capital.

Regular readers of this letter know that market and business performance can deviate significantly in the short-term, therefore I present them separately. In the long-run, however, stock market performance reflects business performance.

MARKET PERFORMANCE

At Richtwert we have *one* investment strategy but due to client preferences this strategy is implemented in multiple reference currencies. In 2018 our portfolios' market performance was +0.7% in EUR, -2.7% in CHF and -3.7% in USD. In relative terms, our portfolios outperformed their benchmarks by 8.4% in EUR, 5.7% in CHF and 0.7% in USD.

	EUR	CHF	USD
Richtwert Portfolios	0.7%	-2.7%	-3.7%
S&P 500 (EUR, CHF: hedged in EUR/CHF)	-7.7%	-8.4%	-4.4%

If you didn't follow markets in 2018, you may think it was a boring year, but it wasn't. After significant market volatility during the first three quarters, our portfolio had appreciated by approximately 15% in EUR, 12% in CHF and more than 11% in USD. Then markets and our portfolio fell rapidly during the fourth quarter.

As I had communicated to you in prior partner letters and in "Why You Should Hope Your Stocks Go Down?", I had hoped markets would fall. Stocks of a few very strong firms fell more than 30% - 40% in a short amount of time and gave us a terrific opportunity to increase our investments at very attractive prices. So, we did. Unfortunately, it didn't go beyond that. As of end of March, the S&P 500 index has risen 13.7%. Our portfolios are up 19% - 21%. The last two quarters demonstrate how quickly people's sentiment can change from highly optimistic to almost hopelessly pessimistic and back to optimistic.

There is always a great amount of discussion about the economy and markets: Can things continue? Is the next recession near? Is there a debt bubble? What will central banks do? What about interest rates and inflation? What about trade disputes? The list goes on …

In my opinion, time spent trying to *predict* what will happen in the economy and the markets, is time wasted. There are too many variables at play and too many people trying to predict, for this to be a useful activity. History proves that businesses adapt and do well over time. And over time markets reflect business results. *The time to invest is when we're getting a lot for our money regardless of what the economy or markets will do tomorrow, next month or the next 1-3 years.*

However, the fact that economic events and markets can't be reliably predicted, doesn't mean we can't prepare. On the contrary, it means we *must* prepare. There are both significant risks as well as tremendous opportunities that have led me to invest our capital the way it is positioned today. We will get to those at the end of this letter but let's first examine how our portfolio companies performed from a business perspective.

BUSINESS PERFORMANCE

A few weeks ago, I had the pleasure to be with two long-time and close friends who are also fellow Richtwert partners[1] (clients) since day one. As we were discussing investments, I mentioned that while stock valuations have risen materially since I started Richtwert, I clearly prefer our current portfolio to our portfolio a few years ago. I said: "I've learned a lot during the last years. The businesses we are invested in today are much stronger and more undervalued. They're performing very well." One of my friends responded: "And in a few years you will probably say the same thing again." After a brief pause, he continued: "And if you're doing your job well, you *should* be saying that again in a few years!"

I am happy and grateful to have smart and long-term minded partners like him and you. And I hope I will be saying the same thing to you all again in a few years' time.

Using end of 2018 portfolio weights, our portfolio companies as a group achieved profitable growth of approx. 16% in 2018. If we use average 2018 portfolio weights instead, then the growth rate would amount to 13.5%.

Earnings based on accounting standards such as GAAP and IFRS have always been rough approximations of reality. Recent changes to accounting standards coupled with the increased importance of intangible assets have resulted in more significant distortions. Therefore, I use my best *conservative* judgement to calculate our companies' earnings based on what I consider to be economic sales, costs and profits. Judgements are subjective and can be wrong, but they are necessary, nevertheless.

[1] For those new to Richtwert: I call my clients "partners" because that is the way I view and treat them.

Here are just two examples for required adjustments, there are many more:

- When Apple invents in a new programming language, spends on marketing it and teaches tens of thousands of adults and children how to program with it, the associated costs are usually reported as an immediate expense. However, these are long-term investments in Apple's eco-system that should be expensed over many years.
- When Facebook triples the number of employees to review content by hiring 20'000 in a short amount of time, it's unreasonable to believe that the number of employees will continue to increase as fast in the following years. Of course, the same applies to artificially high growth rates when prior year profits were understated.

Where reasonable and possible, I try to correct for these distortions. I believe earnings calculated this way reflect the earnings power of our portfolio companies better than reported earnings.

Growth rates of 13.5% - 16% are remarkable for many reasons:

1. So many have been and continue to be very concerned with the economy.
2. 10-year interest rates in the developed world are below 0% to 3%.
3. Our portfolio companies are of significant size and they were highly profitable to begin with. At Richtwert, we don't conduct Venture Capital/startup like investments.
4. Some of our largest investments really shine after times of crises. They are patiently preparing and waiting for their next sizable opportunities.
5. In choosing our investments, I always emphasize risk control. Translated into growth, I clearly prefer *reasonably certain* growth over *speculative* growth.
6. In calculating the growth rate, I used pre-tax figures so that the growth rate is not distorted by the significant U.S. corporate tax cuts that started in 2018.
7. Despite the strong performance, my estimate of our portfolio's Price to Earnings ratio (P/E ratio) was below 14 at the end of 2018.

In fact, measured on a year-end portfolio weight basis, 70% of our portfolio exceeded, 25% met, and only one company accounting for 5% of our portfolio performed below my expectations. You should be aware that year-end portfolio weights can contain a degree of survivorship bias. Using average 2018 portfolio weights, 60% of our portfolio outperformed, 28% met, and 12% underperformed my expectations.

The following table provides you with more details and context about our portfolio's business performance and my expectations. This level of business performance underscores my conviction that we are invested in a group of very well managed businesses serving attractive markets with strong and durable competitive advantages. Despite their strengths, they were significantly undervalued by the market at year-end.

Company	Change in Moat?	Growth vs. My Expectations	Business Performance vs. My Expectations	Assessment
Berkshire Hathaway	Unchanged	Equal	Met	Operating businesses growing at attractive (above average) rates Strong capital allocation via investments except for one investment which hasn't met expectations
Blackstone	Widened	Higher	Outperformed	Significant outperformance vs. public markets Strong growth in Assets under Management Many promising new initiatives Did exactly what they said they would do
Undisclosed 1	Unchanged	Higher	Outperformed	Remains focused on competitive advantages (low cost, speed, convenience, superior risk management, personal interaction) 20% growth outperformed my expectations Prepared for entry into new large markets
Undisclosed 2	Unchanged	Higher	Outperformed	Both execution and intelligent stock repurchases were above my expectations
Undisclosed 3	Widened	Equal	Outperformed	Business growth met my expectations, but the quality of their results strongly outperfomed my expectations. Invested in new business areas while remaining patient and opportunistic with existing business areas.
Wells Fargo	Unchanged	Lower	Underperformed	Focusing on rebuilding trust is the right thing to do but increased internal focus also brings distractions which prohibit growth in the short-term.
Undisclosed 4	Widened	Higher	Outperformed	Met my expectation with being available on Internet TV bundles; Exceeded my expectations with owning content in sports Golf, Cycling and focusing on content that entices people to watch and do things (hobbies) Attractive current business growth despite investments for future growth
Alphabet	Widened	Equal	Met	Continuous improvements in Search (Discovery) and Assistant, enabling many more devices with Assistant Investments in Artificial Intelligence increasingly visible in products (Search, Assistant, YouTube, devices) YouTube also used for learning, researching and taking actions E-Commerce doing better than I thought Other Bets performing well Overall very good performance met my expectations based on price we paid
Apple	Widened	Higher	Outperformed	Still widening the moat despite size (focus on privacy, education, wearables, health, user experience, retail as a place to meet and learn) Outstanding product quality as proven by satisfaction scores Growing wearables very well Strengthening Eco-System even further (Swift language, App Stores) Increasingly pushing into corporate market, services growing well
Facebook	Narrowed	Higher	Met	Significant privacy mistake a few years ago but worked diligently in 2018 to restore confidence as far as possible Competitive advantages still significant Overall growth in daily active users (even in USA and Europe) Very sizable business areas yet to be monetized
Undisclosed 5	Widened	Higher	Outperformed	Main business performed well (+25%) despite very significant regulatory headwinds against the company Strong capital allocation resulted in strong investment gains Long-term orientated and focused on building great businesses internally
Undisclosed 6	Widened	Higher	Outperformed	One of the very few leading data-driven insight companies. Widening their moat via insights to manage their customer' value chain (product design, manufacturing, marketing, sales, payment, and delivery).
Undisclosed 7	Widened	Higher	Outperformed	IT business continued to grow faster than I expected Higher services growth which enjoy more attractive margins Enormous customer trust A market leader in artificial intelligence, user interface and automation Successful push into new and promising service areas
Undisclosed 8	Unchanged	Equal	Met	Most significant business segment faced regulatory challenges but could still grow Rest of the business doing very well with untapped pricing power Long-term orientation and continuous investments in their eco-system Difficult to determine whether their moat widened but I don't believe it narrowed

THE GAP BETWEEN BUSINESS AND MARKET PERFORMANCE AND WHY IT PAYS TO INVEST LIKE A BUSINESS OWNER?

How is it possible that our portfolio stocks declined by -3.7% measured in USD while their businesses achieved profitable growth of 13.5% - 16% in 2018?

One reason could be that they were overvalued, which is another way of saying the market was expecting even higher growth rates. With interest rates below 3% and our portfolio's P/E ratio below 14, we can rule that out.

So why did so many intelligent, educated, strongly motivated and well-informed experts with significantly more resources than Richtwert not invest in and thereby bid up the stock prices of our strong yet undervalued businesses? Is it possible that they're right, and I'm wrong?

The future will always be uncertain and only time will tell, whether I am right. What I do know from experience is that people often react emotionally and not rationally in the short-term and that we have at least two critical structural advantages at Richtwert most others lack. These can explain why we may see opportunities others either miss or can't pursue.

1. I invest our capital like a business owner:

A successful business owner is rational, value-oriented, risk-averse, long-term oriented, independent and focused. I don't know any successful business owner who would sell his successful business because he or she fears a recession, inflation, rising interest rates, trade disputes, elections, geo-politics or other similar factors. Yet these are the main reasons why most people (professional and individual stockholders) decide to sell their stocks.

Such factors may be important in the short-term, but they are not reliably knowable, and their importance decreases in the long-term. Therefore, I ignore them at Richtwert. Instead, I focus on factors that are both important and knowable with reasonable certainty. These include the business characteristics of a few firms as well as their customers, suppliers and competitors; the intrinsic value of these businesses; and their market price.

If our capital is fully invested in a few strong undervalued businesses and we happen to have a recession tomorrow, I don't mind. On the contrary, just like a business owner I look forward to our businesses benefiting from harsher conditions in the mid- & long-term (see "Why You Should Hope Your Stocks Go Down?").

Most stockholders can't copy business owners because they are short-term oriented and in too much of a hurry to get rich. Stocks go up and down all the time and can be traded instantly. The temptation to get in and out at the right time and the emotions that come with the ups and downs are too strong. Additionally, they've been taught to diversify extensively. Therefore, they invest in too many firms and rob themselves the opportunity to know those businesses well. Without this knowledge they can't value their investments independently. As a result, they confuse market price with value and act accordingly.

Some professional investment managers are aware of these deficiencies, but their incentives conflict with their clients' interests. They invest other people's money and don't have skin in the game themselves. Making matters worse, their incentives are usually short-term in nature and not performance based. Therefore, they can't copy successful business owners either.

2. Our interests are aligned (We sit in the same boat):

Besides managing Richtwert, I have almost all my family's net worth invested as a client alongside your capital. In addition, you don't pay any management fees at Richtwert that would encourage me to raise or keep assets regardless of attractive investment opportunities. And finally, as demonstrated in this letter I go to great lengths to explain our business owner approach, so I don't have to worry about you pulling out your capital when the market temporarily disagrees with the decisions, I take on your behalf. This gives me the freedom to invest like a business owner.

With the very generous and unfair help of hindsight, I invite you to see this instructive interview with Jeff Bezos, Amazon's Founder and CEO. I'm not sharing this to criticize the analyst or to imply that I would have done a better job. My intention is first to highlight how a business owner thinks and acts and second to point out that this is also what I strive for when I invest our capital at Richtwert.

Here, we clearly have a businessman who cares and thinks deeply about the business he is running and about what is important for the company to succeed – namely *to focus on the customer experience*.

On the other hand, we have an investment analyst who despite being well-intentioned can only afford to think superficially about the business. Instead of listening and looking for *enduring competitive advantages* such as culture, intense customer focus, long-term orientation, scale, and cost advantages, he is looking for *short-cuts* (Is the company a pure-internet company or not?) to make a quick decision. I would do the same if I also had to invest in many businesses. Fortunately, I don't have to.

There is one more priceless lesson here: Shortly after this interview Amazon's stock price decreased from a high of $106.69 in December 1999 by *nearly 95%* to $5.97 in September 2001. Imagine experiencing such a decline, thinking the market knows more than you and selling Amazon in September 2001. You would have lost the opportunity to multiply your capital *337-fold* in 17 years (a compound annual return of almost 41% from the low of September 2001 and a still outstanding 18.8% compound annual return from the high of December 1999). Of course, probably no one except Jeff Bezos would have been smart enough to hold on to the stock, but if this example doesn't prove the potential of investing like a business owner, then nothing else will.

THREE PORTFOLIO COMPANIES (APPLE, BLACKSTONE, FACEBOOK)

Next, I will share three of our investments with you. My objective is to show you how I think and act when investing our capital. We'll experience both rough seas as well as sunny periods. At all times, the only aspects that can be controlled are how I evaluate and value businesses and how we think and act about markets. What I mean by that, is:

1. Stocks are not some abstract construct but rather ownership interests in businesses that have intrinsic values.
2. Companies' stock prices sometimes deviate significantly from their intrinsic values.
3. The market is not there to tell us the *value* of businesses but rather to serve us *prices* at which we may choose to buy or sell ownership interests in businesses when it makes business sense.

If you are an existing Richtwert partner, then knowing more about our investments and markets hopefully enables you to remain long-term oriented and stick to Richtwert even during challenging times. These can be times when our investments experience significant quotational losses and/or underperformance against our benchmark. Moreover, you'll be able to evaluate whether our performance is the product of skill or (good/bad) luck. If you are considering joining Richtwert, this will enable you to make a well-informed decision for or against Richtwert.

Since our goal is to invest in undervalued businesses, our portfolio companies must either be overlooked, out of favor and/or underestimated. Therefore, I'm sure that some of our investments will come as a surprise to some of you. Nevertheless, I hope you will keep an open mind and welcome your feedback, especially when you disagree.

APPLE
(as of January 2019)

Do I understand Apple?

Apple's mission is to improve the world by enriching people's lives with superior quality products and services that are beautifully designed and easy to use.

Apple is the world's leading company for consumer products and software (smartphones, tablets, PCs, wearables, operating systems, software applications) and services (product insurance, entertainment, education, news, productivity, payment, health care and many more).

Does Apple have a favorable mid- & long-term future?

The market for intelligent and personalized consumer products, software and services is very large and will continue to grow at attractive rates due to their ever-increasing role in our daily lives as most things around us become connected, smart and personalized. The challenge and the opportunity is to earn consumers' trust by making them secure, safe and a joy to use.

Apple is a very value-driven company and clearly stands for improving the world. It enforces its values through actions such as focusing on ease of use, creativity, curation and safety of content, privacy, education, health and the environment.

Apple is also a very innovative company. It didn't invent the first music player or the first smartphone or the first tablet nor the first smartwatch, but Apple certainly made and continues to make the best and earns the most. The company is often criticized because people believe the company is not innovative, but Apple's competitive advantage has never been to be the first but rather the best in innovation. Moreover, Apple's capabilities span across hardware, software, and services which enables the firm to innovate holistically. Its ability to enrich people's lives via human-centric innovation by reducing complexity for its customers is unparalleled and a clear differentiator. As computers become more capable and complex Apple's advantage will likely grow.

Apple has a very large and loyal customer base due to deserved trust, which is reflected in industry-leading satisfaction scores, repeat purchases and its ability to keep customers in the world's most profitable eco-system consisting of Apple products, software, and services that customers love. This eco-system is a very robust entry-barrier for any competitor and enables Apple to take its time with introducing new technologies. To illustrate its economic advantages, you can, for instance, look at the Apple Watch. Since introducing the Apple Watch just three years ago, the company has become the world's largest seller of luxury watches. That's not a bad achievement considering the watch industry has existed since the 15th century.

Furthermore, Apple's customers possess above average purchasing power and with an installed base of 1.5 billion devices as well as high switching costs and leading distribution capabilities, Apple is positioned well for continued success.

Are Apple's managers trustworthy, capable and motivated?

Apple's managers are long-term oriented and focused on making the world a better place. This is evident by their focus and actions and by the products and services they bring to the market. They are clearly proud of their work and the impact they have on people's lives. What is more, they have not only generated great value for Apple but lifted entire industries for component producers, app developers, content creators, educators and health care providers.

Most of the executive managers at Apple were hand-picked by Steve Jobs and Tim Cook. They share high integrity, passion and intellect. Many also hold a significant number of Apple's stock.

Apple is also a shareholder-friendly company as well as an intelligent allocator of capital. It usually acquires smaller companies with attractive talent and technologies and has a successful track-record of significant stock repurchases.

Can we become part-owners of Apple at an attractive price? (as of January 2019)

In my view, Apple is greatly misunderstood. It has $130 billion in excess cash and trades at a P/E ratio of 10. People wrongly think of Apple as a hardware and an iPhone company. Time will likely prove *again* that Apple is unique in their capability to combine hardware, software, and services into highly desirable and holistic *solutions* that delight and enhance peoples' lives. At current market prices Apple provides a significant margin of safety.

BLACKSTONE

(as of January 2019)

Do I understand Blackstone?

Blackstone is the world's leading alternative investment manager. Its investments span real estate, credit, private equity and hedge funds, areas in which it has the largest scale. It started with assets under management of $400'000 in 1985 and is entrusted with approximately $430 billion today. Blackstone has about 2500 employees across 23 offices worldwide and provides financial security to millions of employees, retirees, sovereign wealth funds, and the world's largest institutional and individual investors.

Blackstone's business model requires limited internal capital, is scalable, produces high margins on recurring revenues and generates attractive free cash flow.

Does Blackstone have a favorable mid- & long-term future?

According to PWC client assets entrusted to asset managers is expected to be around $100 trillion[2] in 2018 and is likely to continue to grow at around 6% annually. This means Blackstone's current share of this market is less than 0.5%. Due to the following competitive advantages I am confident that Blackstone will continue to gain share.

Blackstone's superior long-term track record has earned it trust with the largest investors worldwide. It has delivered attractive performance even during challenging times and has proven to benefit from such times.

It has very stable management and investment teams, a consistent culture of sharing insights and applies the same risk-averse investment approach and senior management across all investment businesses.

Blackstone also benefits from long-term capital that is usually locked-up for years as well as from dry-powder to invest and can afford to be patient.

Its leading scale, brand, and stability attract and retain superior talent and other companies which recognize that they can create more value under the Blackstone platform. Moreover, its scale, reputation, and operating capabilities provide Blackstone with greater insights and often enable it to acquire investments without paying the highest price. Furthermore, recognizing the late stage of the economic cycle and the risk of rising interest rates Blackstone has started many promising growth-oriented investment areas where Blackstone can apply its unique strengths.

As the investment world becomes increasingly focused on passive investing on the one hand and very active investing on the other hand, Blackstone is ideally positioned to benefit as a highly patient, capable and opportunistic investor and a one-stop shop for alternative assets.

Are Blackstone's managers trustworthy, capable and motivated?

Stephen Schwarzman, Chairman and CEO of Blackstone, co-founded Blackstone in 1985 with his former boss Pete Peterson (former U.S. Secretary of Commerce and Chairman, CEO of Lehman Brothers). Observing his achievements there can be no doubt regarding his capabilities and motivation.

He is currently the controlling shareholder of Blackstone with approximately 19% of the economic rights and 47% of the voting rights. His salary consists of $350'000 base salary and income through his ownership in Blackstone. The remaining executives and directors own approximately 9% of Blackstone.

Stephen Schwarzman loves his creation and I believe he will do everything in his power to look after Blackstone's reputation and competitive position. As the largest shareholder he will also ensure that managers do not self-serve.

Mr. Schwarzman is also known for his philanthropic activities which are focused on education, peace between China and USA and artificial intelligence.

Can we become part-owners of Blackstone at an attractive price? (as of January 2019)

The main risks for Blackstone are acting in a way that would hurt their reputation, not being able to raise capital and not being able to put capital to work intelligently. For reasons mentioned above, I view these risks as remote.

Blackstone's current P/E ratio is below 11. Given its wide competitive advantages, the proven track record of benefiting from crises, the attractiveness of its business model and the tailwinds it enjoys, I believe we are being offered a terrific bargain and a wide margin of safety for an excellent business.

[2] Asset & Wealth Management Revolution: Embracing Exponential Change, PWC, https://www.pwc.com/gx/en/asset-management/asset-management-insights/assets/awm-revolution-full-report-final.pdf

FACEBOOK

(as of January 2019, except for 2018 financial figures reported in March 2019)

Do I understand Facebook?

Facebook employs around 35'000 people and serves roughly 2 billion consumers daily as well as 90 million businesses. Last year it grew both sales and profit by almost 40% generating nearly $56 billion in revenue and $22 billion in earnings. Consumers use Facebook for free to connect and communicate with each other and with businesses, to be closer to family and friends, to discover relevant information, content and events, to be entertained, to buy and sell products and services, to find jobs, to raise funds and to volunteer, to get help in case of emergency and even to find a partner. Businesses and organizations use it to reach consumers effectively, either for free or via advertising.

Does Facebook have a favorable mid- & long-term future?

Facebook serves about 60% of the world's population above the age of 15 outside China. Hence, going forward it will more difficult to achieve further *user* growth. Nevertheless, Facebook is growing its user base at healthy rates in emerging countries and is holding on to users in developed countries.

User growth is important but so is user engagement. As people's attention and time continue to move from traditional to digital and mobile channels, business follows. Herein lies Facebook's next phase of growth potential:

- Facebook has 4 leading platforms in Facebook, Instagram, WhatsApp and Messenger and is working on more.
- However, only Facebook and Instagram have really been monetized so far. Both are highly profitable today, but there is still a lot of potential to enrich both and to capture a larger share of global business moving online.
  - According to GroupM, a global marketing service provider, businesses spend around $1 trillion annually on marketing. Facebook has roughly 5% of this market but is likely to earn more in the future as marketing and commerce continue to become digital and the lines between the two continue to fade.
  - Moreover, it's noteworthy that Facebook users outside the U.S. make up 90% of all users but only account for roughly half of its revenues. Facebook could benefit materially as their earnings power increases.
- This leaves Facebook with Messenger and WhatsApp, the two leading messaging platforms outside China. Their appeal to people and businesses is growing because they provide richer and more intuitive interaction. Both are replacing phone calls, e-mail, video conferencing and meetings as the main way of communicating.

What makes me believe Facebook is likely to own an attractive share of these opportunities?

First, Facebook's scale speaks for itself. 2 billion daily users and 90 million businesses don't lie. Facebook's services are useful to a large portion of the world's population.

Second, Facebook's network scale is self-reinforcing: more users attract further users, further content and more businesses, which in turn attract more users. As the network grows so does its value for most participants and their loyalty to the network.

Third, the more people interact using Facebook's services, the more Facebook learns about them. As a result, it can do a better job bringing people and businesses together. Businesses can reach the right consumers more effectively and consumers receive content and ads they are likely to be interested in.

Fourth, its suppliers predominantly provide the content and services on Facebook for *free*, but it gets better. If you think of advertising as information, as I do, often suppliers pay Facebook to advertise their content and services. Most people find ads annoying, but they don't have to be. Done right and targeted well, ads can be valuable both for companies as well as for consumers. In my personal experience, ads on Facebook and Instagram are refreshingly relevant, useful and engaging.

Fifth, low-cost supply, digital services and enormous scale mean that Facebook has very low marginal costs and operates as a low-cost operator. As such, it can serve businesses at favorable prices. It can also serve businesses others can't serve profitably. This is not only great for Facebook but also for small businesses that can't afford to reach consumers via traditional marketing. In a global survey, half of the small businesses on Facebook said that they are hiring because of growth they're able to achieve through Facebook. These tens of million businesses not only hire and pay employees, they also invest and create demand for other businesses. Such a multiplier effect means we are not talking small numbers here. Facebook is increasing World GDP, and this doesn't end with businesses and their employees. Consumers also benefit from greater choice, lower prices and free services.

Sixth, because Facebook can distribute costs between more users, it can afford to pay higher prices for attractive content or services it can't get for free. These attract and retain even more consumers.

Clearly, Facebook's competitive advantages are significant and there is a straightforward path to growing them over time.

Still, competitive advantages don't come without risks. Arrogance, bureaucracy and complacency can creep in and derail even the strongest firms. Keeping communities safe is a challenge even in villages. Now, imagine a global community of more than 2 billion people. Chances of something going wrong somewhere are practically 100%. Also, many users use Facebook's social media platforms passively to discover and receive information but do not contribute actively. They tend to be less loyal users. Network scale is self-reinforcing, but it goes both ways. When people start leaving a network, its value decreases for users which can set in motion a reverse effect, especially when people join a competing network. Knowing a lot about users comes with great responsibility to keep that knowledge safe and to use it for their benefit. Finally, being too successful creates a lot of envy. As strong as Facebook is, it isn't invincible.

2018 was Facebook's most difficult year due to mistakes it made in prior years. Facebook did a poor job educating users about the extent they were sharing their data with 3rd parties until 2014. It was also unaware of bad actors using unexpected forms of manipulation to mislead and divide people. When it became aware, it underestimated the magnitude of the problem. Facebook was also too slow to react to privacy concerns in general. As a result, it lost trust with a portion of its users in 2018.

While its mistakes deserved scrutiny, many competitors including the press who have lost much of their advertising business to Internet companies like Facebook as well as politicians eager to attract votes saw a rare opportunity to attack a company that had tripped. They went well beyond Facebook's mistakes and blamed it also for many other societal issues. Of course, with so many people using Facebook, it is a mirror of our society. I doubt this means Facebook is solely responsible for fixing them. In addition, it's easy to find and criticize errors *in hindsight*.

Facebook is a tool and a platform. Tools and platforms magnify our capabilities. Most use them to achieve great things, but some use them to cause harm. Because Facebook is a powerful tool and platform, it magnifies our capabilities more. For example, besides the very significant economic benefits to the world mentioned before, people have raised over $1 billion for great causes on Facebook[3]. In addition, people use Facebook across the world to connect and support each other during times of crises[4,5]. On the flip side, the ability to cause harm is also greater.

In my opinion, the anti-Facebook rhetoric is misplaced and exaggerated by people with self-interest motives. Unfair as it is, it's in Facebook's best interest to ensure its community is a safe place people trust. Fortunately, it has distinct advantages to bring to the challenge. The company is purpose-driven with plenty of highly motivated and technologically skilled employees. Furthermore, people generally can't post information to the wide public anonymously on Facebook. This puts Facebook is in a good position to detect and stop bad actors. This will never be perfect, but Facebook can make it ever more difficult for people to cause harm.

I regard Facebook as a clear net positive for the world and the steps Facebook has taken since 2018[6] show that they've learned from past mistakes. Additionally, I'm hopeful that Facebook will find new ways to encourage even more of its users to be active. With 2 billion users it certainly has enormous potential to be more valuable to more people and it will have no one to blame than itself if it fails to do so.

<u>Are Facebook's manager trustworthy, capable and motivated?</u>

Facebook's mission is to give people the power to build community and to bring the world closer together. Mark Zuckerberg, Facebook's founder, Chairman, CEO and its controlling shareholder, strongly believes in making the world more open and connected. I was deeply impressed by his speech to Harvard students[7] and by his letter to their newborn daughter[8]. He is an idealist and optimist who is not afraid of dreaming big, taking decisive action and being misunderstood. Here are some of his words that resonated strongly with me: *"Anyone taking initiative will get criticized for moving too fast, because there's always someone who wants to slow you down." … "In our society, we often don't do big things because we're so afraid of making mistakes that we ignore all the things wrong today if we do nothing. The reality is, anything we do will have issues in the future. But that can't keep us from starting." … "The greatest successes come from having the freedom to fail."*

[3] People Raise Over $1 Billion for the Causes They Care About on Facebook, November 14, 2018: https://bit.ly/2T8XnN8
[4] Facebook Crisis Response: https://www.facebook.com/about/crisisresponse/
[5] Facebook's Disaster Maps Help Rescuers Know Where They're Needed Most, April 9, 2018: https://bit.ly/2GKfJl1
[6] Facebook Newsroom: https://newsroom.fb.com/news/
[7] Mark Zuckerberg Harvard Commencement Speech 2017: https://www.youtube.com/watch?v=QM8l623AouM
[8] A letter to our daughter, Mark Zuckerberg, December 1, 2015: https://bit.ly/21HXVav

His decision to forgo current profits by investing heavily in Facebook's current platform (artificial intelligence to flag bad behavior and tripling the size of the security team from 10'000 to 30'000 employees) as well as continuing to invest in new initiatives despite immense pressure, proves that he is also long-term oriented. I have no doubt in his character or ambition.

Together with Sheryl Sandberg (Chief Operating Officer), who is one of the most business savvy persons I am aware of, Mike Schroepfer (Chief Technology Officer) and Chris Cox (Chief Product Officer) Facebook has an impressive management team.

Can we become part-owners of Facebook at an attractive price? (as of January 2019)

When we first invested in Facebook in 2016, I estimated that we are paying a price equal to 22-23 times next year's owner earnings for a strongly protected business that will grow around 20% annually for the coming years. As it turned out Facebook grew by more than 50% in 2017, so I decided to increase our investment. Due to its challenges in 2018, we were able to increase our ownership even more at a price I estimated to be equal to 16-17 times 2019 earnings.

I believe the market gave us an exceptional opportunity in 2018 to own more of a purpose-driven business with dominant global market positions protected by a wide moat, a long runway for growth and run by an excellent team at an attractive price.

WHERE ARE WE TODAY AND WHAT MAY LIE AHEAD?

Ever since the last crisis people have discussed and tried to foresee the next crisis. Those familiar with Richtwert and my thinking know that I don't believe in trying to predict and that I am against trying to time markets. Of course, if you keep predicting a crisis you will be right eventually. What people forget are all the false alarms that cost investors enormously. The last 10 years are a great example: Between March 1, 2009 and February 28, 2019, the S&P 500 Index has gone up more than 4.6 times including reinvested dividends. Missing such an opportunity is no small mistake.

So how do we invest, if we can't predict? We *prepare*. We prepare, because we *know* all our investments will experience a crisis at some point. In order to prepare, it's helpful to know where we are at:

We have experienced a growing economy and rising markets - at least in the U.S. - for almost 10 years. Asset prices have risen due to productivity gains[9], reinvestments, money printing and low interest rates. I see the following threats and opportunities.

Threats:

- Very low interest rates and fear of volatility (I call it "volatility phobia") have resulted in risky behavior:
  - Real estate in advanced European countries is expensive.
  - Many government bonds have negative real yields, some even have negative nominal (before inflation) yields.
  - Spreads between more speculative bonds and bonds with lower credit risk are narrow:
    - Argentina was able to borrow money for 100 years at 8% p.a. and "investors" were even willing to lend more than Argentina was asking for[10], although it defaulted on its debt 8 times during the last 200 years.
    - EU countries that were bailed out during the last crisis enjoy very low interest rates again.

Europe, Middle East & Africa 10-Year Government Bond Yields

COUNTRY	YIELD	1 DAY	1 MONTH	1 YEAR	TIME (EST)
Germany »	0.07%	+0	-2	-58	3/8/2019
United Kingdom »	1.19%	+2	+4	-30	3/8/2019
France	0.40%	-2	-13	-48	3/8/2019
Italy	2.50%	+4	-45	+50	3/8/2019
Spain	1.04%	+1	-18	-38	3/8/2019
Netherlands	0.15%	0	-4	-53	3/8/2019
Portugal	1.34%	+1	-30	-51	3/8/2019
Greece	3.74%	-3	-24	-40	3/8/2019
Switzerland	-0.39%	-1	-4	-45	3/8/2019

Source: Bloomberg

  - Investment grade corporate bonds have become riskier while their yields have declined:
    - More than 50% of US investment grade corporate debt has the lowest quality rating BBB[11].
    - Credit quality has also declined:
      - Net leverage of BBB rated nonfinancial corporates has risen from 1.7 in 2000 to 2.9 in 2017[12] (net leverage is defined as (total debt – cash – short-term investment) / EBITDA.
      - EBITDA (earnings before interest, taxes, depreciation and amortization) is by itself a dangerous way to look at profitability, but many firms use "adjusted EBITDA" to treat costs such as depreciation, restructuring, stock-options and taxes as non-existent or non-recurring. Considering the difference in interest rates for investment and non-investment grade bonds, it's not surprising to see some being creative with their results.
      - Additionally, money has been lent with less restrictions in the form of covenants which means companies can more easily act in ways that could endanger their ability to repay loans.
      - Companies have logically used the market's willingness to lend to borrow capital with longer durations. Longer duration bonds suffer the most from potentially rising interest rates.

[9] You may have heard from economists and politicians in the news that productivity gains have been at record lows. I don't know how they measure productivity but looking at what is happening at work and at home - with the internet, mobile devices, apps, globalization, the cloud, machine learning and artificial intelligence - I doubt they are getting it right. We are in a phase of rapidly expanding productivity, which may explain why so much money printing by central banks over so many years has not caused higher consumer price inflation.

[10] How Argentina went from selling 100-year bonds to an IMF rescue in a matter of months, May 12, 2018: https://bit.ly/2uKIQMJ

[11] A $1 Trillion Powder Keg Threatens the Corporate Bond Market, October 11, 2018: https://bloom.bg/2ydMUXK

[12] Investment Grade Credit: Be Actively Aware of BBB Bonds, January 2018: https://bit.ly/2K4LZkV

    - While the day of reckoning may have been pushed out, problems will be more significant once that day comes.
- The U.S. economy is growing but U.S. government deficits are at record levels.
- All this financing will need to be replaced. The crucial questions are: *Can it be replaced when needed, and at what cost?*
- Corporate earnings may be artificially high due to low interest rates, low inflation as well as fiscal and monetary stimulus.
- Economic growth has been slow in the developed world despite intensive and prolonged monetary and fiscal stimulus because aggregate demand has been low. Probable causes are slowing population growth and a sharply growing wealth gap[13]. The resulting inequality has led to increased envy, popularism and anti-capitalism.
- Europe continues to fall behind in critical areas such as technology and globally leading companies.

Opportunities:
- The world economy is growing.
- Hundreds of millions in developing nations have been lifted out of poverty into middle class and many more will follow.
- Corporate earnings growth hasn't been excessive. Therefore, a future correction may also be less excessive.
- So much discussion and worry about markets is healthy because many of the existing risks are priced in markets.
- Considering the low levels of interest rates, we are nowhere near extreme market valuations in the stock market.
- There are still some excellent businesses available at bargain prices.
- Technology and productivity are advancing rapidly. Both will not only increase our wealth and quality of life but also enable us to make the world more sustainable over time.
- As information becomes increasingly universally accessible, it has the potential to create more equal opportunity.

Don't be misled by the long list of threats and the short list of opportunities. It's better to be careful than sorry. On balance, I'm very optimistic long-term because attractive prices compensate for many risks and because the power of technology and productivity will very likely overrule other factors.

Today, we use WhatsApp or Facetime to reach those dear to us across the world instantly and in a rich format at virtually no cost. Soon we will be able to interact with businesses, doctors, service providers and all sorts of organizations the same way, with the only distinction being that the interaction will be much richer, more immersive and more productive than it is today.

I also disagree with people complaining about our dependence on technology. We use technology because it enhances our capabilities. Yes, we are dependent on wheels, engines, electricity, computers, the internet, smartphones, social media and soon artificial intelligence, but only because they allow us to do so much more. This is just the beginning.

Imagine the number of lives, the time, space and resources video-conferencing and self-driving cars can save. I can only imagine what we can achieve by reallocating resources dedicated to driving to more useful activities. Think about abundant, cheap and renewable energy. Wouldn't this allow us to combat global warming and create a more sustainable world? How about the potential of artificial intelligence, 3D printing, microsensors and synthetic biology to improve our health, well-being and quality of life?

The great thing about observable risks and opportunities is that we can try to prepare for them. However, there are no guarantees. Our preparation may not play out as we hope, and the most dangerous risks are those we're not aware of. The only way we can cope with uncertainty is to keep a long time-horizon, be humble and open-minded, always insist on a margin of safety, spend less than we earn and continue to learn.

[13] A Guide to Statistics on Historical Trends in Income Inequality, December 11, 2018: https://bit.ly/2BpVNMK

HOW IS OUR PORTFOLIO POSITIONED?

How do we deal with the risks and opportunities mentioned?

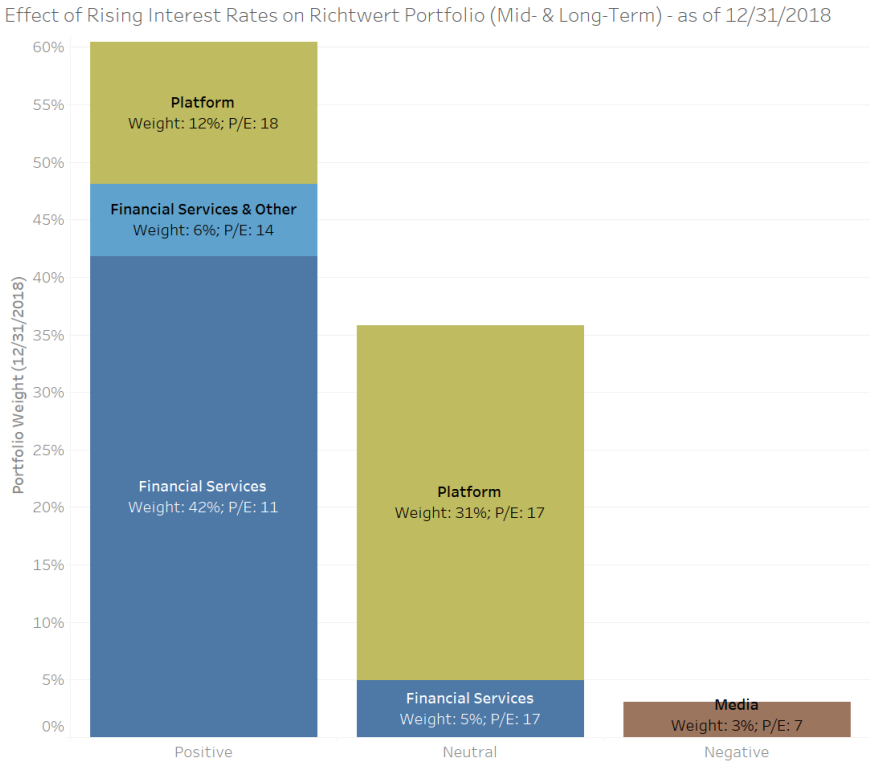
- We avoid expensive assets such as sovereign and investment grade corporate bonds and expensive real estate.
- We protect ourselves against a potential rise in interest rates and against crises by avoiding firms that rely heavily on financing and by investing in firms that provide financing instead; by investing in businesses which benefit from crises; and by insisting on financial strengths, competitive advantages and a margin of safety in every investment.
- We protect ourselves against a potential rise in inflation by investing in businesses with pricing power.
- We invest in businesses that have the potential to grow faster in a potentially low-growth world.
- We may hold cash if I fail to find sufficiently undervalued businesses.

One important distinction is needed before we look at our portfolio: I try to *protect* us against *potentially* rising rates and crises, but I'm *not betting* on that. In fact, I expect our portfolio to perform well even if rates stay low and the economy does well.

All comments regarding our portfolio are as of year-end 2018 unless stated otherwise.

Approx. 60% of our portfolio is likely to benefit from rising interest rates mid- and long-term because these businesses enjoy low-cost capital on the one hand and provide financing to other firms either in form of lending or in form of acquiring other businesses on the other hand. Most of these firms are also cheap because low interest rates generally pose a headwind. Yet despite low rates, they are performing well to extraordinary well. In my view, investors are too busy with theory and concepts to see reality and we can benefit even more materially mid- & long-term in case interest rates rise significantly.

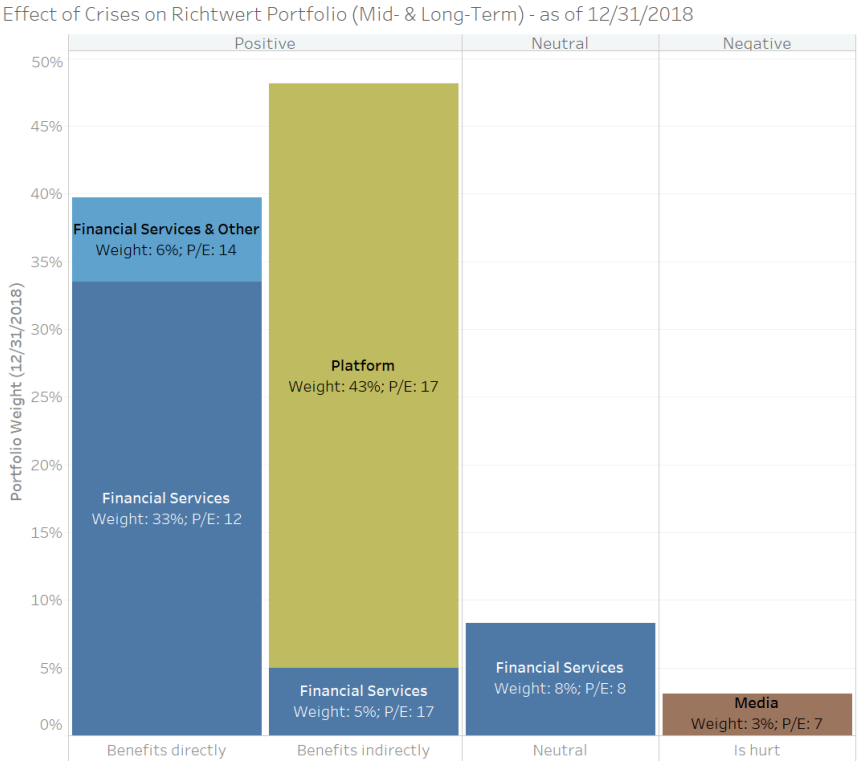
Another 36% portion of our portfolio is protected to a degree against rising rates because our firms have rock solid financial strengths and low-cost capital. Many of them have ample excess liquidity and all generate strong cash flows.



Roughly 40% of our portfolio can be characterized as *anti-fragile*, meaning they would benefit directly from a crisis due to their business model. As outlined above, Blackstone is a prime example.

Other companies accounting for 48% of our portfolio have enduring competitive advantages that enable them to widen the gap between themselves and the competition during crises (see also "Why You Should Hope Your Stocks Go Down?").

Only 3% of our portfolio is not well protected against rising rates or crises but given the attractive valuation, we have a satisfactory margin of safety.



Given our companies' competitive strengths, I have no doubt in their ability to pass on inflation to their customers. Some even have a degree of untapped pricing power enabling them to potentially raise prices higher than inflation.

Our portfolio is nearly divided equally between *very well run, yet undervalued financial services firms* and *dominant, yet undervalued platform companies*. In addition, we have a small investment in a *media business*.

Apart from providing essential services to the economy, I admire our financial services firms' strengths and profitability despite the somewhat unfavorable environment most of them face. They deserve great respect for their achievements. Apart from financial strengths, scale and low-cost capital they are either very innovative or protected by regulation or both. Of course, I also very much like that they provide us low-cost insurance against rising rates and crises. By the way, "low-cost insurance" is an understatement, because in fact we are being paid for holding this kind of insurance. Investing truly is the greatest business of all!

Our platform companies are the new facilitators of the economy. They rethink what is possible, enhance productivity, provide us with ease and quality of life, help other firms transform and earn extraordinary returns doing so. I can hardly wait for their next life-enhancing innovations and the benefits we will gain as investors and as a society.

I expect our portfolio to serve us well and welcome the next crisis that will inevitably come at some point.

Thank you for your generous trust and partnership. I look forward to your feedback and to questions you may have.

Sincerely yours,

Bahram

Bahram Assadollahzadeh, January - March 2019

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