FortyTwo Capital

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**Annual Letter 2023**

## Portfolio Performance

| Year | FortyTwo Capital B.V.[1] | MSCI World Index ETF[2][3] | AEX GR[4] |
|---|---|---|---|
| 2022 | (18,1%) | (13,5%) | (11,9%) |
| 2023 | 24,2% | 19,9% | 17,3% |
| €1 investment on 1/1/2022 | €1,02 | €1,04 | €1,03 |

[1] Calculated based on the Modified Dietz return formula
[2] ISIN Code: IE00B4L5Y983 (in €, dividends accumulating)
[3] MSCI World Index is selected as benchmark since it a widely available proxy of the worldwide stock market
[4] Source: AEX GR from euronext.live.com (in €, dividends accumulating)

## In this Annual Letter

## 1. Strategy

Compared to last year, our portfolio strategy has seen what we would call a ‘natural evolution’. Last year, we defined three categories of stocks that we would like to be part of our portfolio. We experienced that these categories were distracting us from the essence of investing: finding companies that fit with our philosophy, led by high quality management teams, delivering great products and/or services, and are valued reasonable. Everything that keeps us from doing that should be considered ‘noise’.

Our efforts have resulted in a model that focuses on what we consider to be the essence of investing. Not surprising, the model is not all that different from what one finds at other investment firms. And that is alright with us, what matters is that this our model. It is one that we have truly internalized and that represents what we deem to be important to us. And to be frank, we are quite satisfied with the result, though we realize that the model will be subject to change and will look different over time.

After two years working together, two things have become increasingly clear to us. First, we both have a time horizon that is probably longer than that of the average investor. We are happy to hold positions for more than a decade (ironically, our 2023 trading activity suggests otherwise). And we believe we both have the character and discipline to ride out grinding bear markets. Having such a long-term horizon, we are also increasingly focused on finding those companies that are able to durably compound capital for a very long time.

That brings us to our second finding, one that beautifully ties into our horizon. And that is our increased focus on preventing permanent loss of capital. Achieving outstanding returns in the long run depends on two things: I) a return and II) the length of the period over which the return has been realized. We feel that the investment community is too focused on achieving returns in a single year (called outperformance). Instead, we believe it’s as important to find companies that have proven to be durable custodians of capital (i.e. part II of the equation).

The model below translates the above in a more tangible framework that helps us assessing if a company has the right characteristics for long-term returns. We have defined five overarching categories, each backed by three underlying dimensions. When a company scores well on all five of the categories, chances are very high that it will fit our portfolio. Admitted, our model is not perfect and will occasionally result in us forfeiting a perfectly fine opportunity, but that is alright with us.

| | |
|---|---|
| **1. Wide Moat**<br>The company’s offering is distinctively better than that of competitors resulting in pricing power | • **Economies of scale** leading to a cost advantage<br>• **Process power** resulting in superior product quality<br>• **Brand value** that has proven to be timeless and durable |
| **2. Favourable industry**<br>The structure of the industry in which the company is active is favourable | • **Growing & predictable** industry<br>• **Limited competition** due to monopolistic/ oligopolistic structure or niche market<br>• **High barriers to entry** in terms of time to develop product/ service (brand, capex, IP etc.) |
| **3. Capable management**<br>The company has a management team that we assess as knowledgeable and trustworthy | • **Long term perspective** underlined by statements and decisions made<br>• **Skin in the game** through joint ownership of the company<br>• **Significant tenures** and/ or family heritage |
| **4. Intelligent capital allocation**<br>Growth can be financed through internally generated cash flows combined with a strong balance sheet | • **Return on capital employed (ROCE)** of at least 15% (or at least increasing from 10%)<br>• **No emissions** or excessive debt issuances to finance growth<br>• **Capital allocation** decisions that we understand and consider to be rational |
| **5. Attractive valuation**<br>The price at which we can purchase stock provides attractive returns with low risk on loss of capital | • **Annual returns of at least 10-15%** (depending on company’s risk profile) are achievable<br>• **Chances of permanent loss** of capital are relatively small<br>• **Stock based compensation** has no or a limited impact on expected future returns |

To conclude this strategic update, we want to elaborate on our long-term objective with FortyTwo Capital. Are we planning on managing money for external clients some day? Are we keeping our fund indefinitely private? The honest answer is that we don't know yet. What we do know is that we envision being more than a firm that manages capital and realizes decent results. We feel that running FortyTwo is an incredible privilege that, if we remain successful, should eventually provide us with the opportunity to do something back for our communities.

That might not be the case for another half a decade or so, but we feel it is important to articulate the long-term destination of our fund. What this means is that we are willing to exchange parts of the monetary compounding in order to make a positive impact on other people. If done properly, this will be the start of a different kind of compounding, a kind that can only be measured in a social currency. This is the purpose that really inspires us, and if we are ever going to open up for new partners, we want them to endorse and share this purpose.

## 2. Looking back on 2023

### Market and economy

Where to start with our 2023 reflection? Once again, it was a year filled with turmoil and surprising developments that no one would have predicted on the first of January. It was the year of continued interest rate increases by central banks, a bond market crash, a US banking crisis, the Magnificent Seven stocks, the launch of the AI hype, the escalation of the Gaza conflict, a bull market rally in the final quarter, and the unfortunate passing of dear Charlie Munger.

Before saying a few words about our thoughts on 2023, we want to honor mister Munger who passed away November 28, then 99 years of age. The world lost a worldly man, full of wisdom, humor and with an impeccable moral compass. We can only be grateful for all the lessons that mister Munger has been willing to share with the world. Munger has had a great influence on Berkshire Hathaway and on many other investors, and we are certainly no exception. Thank you, Charlie! You will be missed.

To some extent, 2023 continued where 2022 left off. With both the Federal Reserve and the European Central Bank in continued focus. After more than a decade of loose monetary policy, inflation started surging during 2022. To get the escalating inflation under control, central banks around the world were forced to swiftly start raising interest rates in 2022. But the work done in 2022 wasn't yet enough. The fight against inflation continued in 2023 with four rate increases by the FED and six by the ECB.

The increasing interest rates caught some US banks by surprise which subsequently escalated in a banking crisis in March. What happened in a nutshell: rising interest rates cause the price of bonds and treasuries to fall. When financial institutions hold bond positions, they have to mark these positions to market. When bond prices drop, this results in a reported loss in the income statement. When bonds are hold to maturity, the loss is purely a paper one with no cash impact. However, when a company is forced to sell these bonds at a loss, it gets messy.

Running a bank is tough and requires a relentless focus on risk. In a competitive banking environment combined with historically low interest rates, some banks were seduced to extent the duration of treasuries in search for extra yield. A common practice that bears fruit most of the time, until it doesn't. When clients of Silicon Valley Bank started withdrawing money because of liquidity needs, the bank was forced to sell assets (i.e. treasuries) at a loss. What followed was an old-fashioned bank run that resulted in the banks' collapse within days.

This is a clear example of a second order consequence of the interest rate hikes. Most people think rising interest rates are favorable for banks because it provides banks higher interest margins. While this is also true, it clearly not always is. As investors, it is our job to think about risk when constructing a portfolio. As Morgan Housel puts it beautifully: "risk is what you don't see". As soon as you're able to articulate the risk, the risk becomes less risky. That's why we try to construct a portfolio that can weather risks that we did not anticipate.

Despite the increasing interest rates, the worldwide economy proved to be quite resilient. The labor market held up very well with unemployment at very low rates. Residential real estate prices were also firm with only the commercial real estate market impacted by higher rates. With the economy still going strong, corporate profits held up surprisingly well, with rate hikes only having a minor impact. Likely this is the result of companies being smart enough to renew their debt in 2020-2021 and lock in low rates for at least 5-10 years.

Talking about corporate profits and strong companies, we cannot ignore the dominance of the 'Magnificent Seven' stocks: Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia and Tesla. Their dominance is staggering and by the end of the year, their share of the World Index ETF (consisting of ~1.500 stocks) amounted to a whopping

18%. Apple was the worst performer, 'only' returning 49%. Nvidia came out on top with an astonishing 239% return in a single year. To shine some light on this development we have to touch upon Artificial Intelligence.

It is probably fair to say that Artificial Intelligence (AI) had a breakthrough year in 2023. It all started with the launch of OpenAI's ChatGPT in November 2022. Two months later, ChatGPT was the fastest growing consumer software application in history. Within months, AI became mainstream and countless OpenAI competitors emerged during the year. The AI revolution is made possible by the emergence of large language models (LLMs), algorithms that use massive data sets to understand, summarize, generate, and predict new content.

For now, the big winner seems to be Nvidia who's graphics processing units are a perfect fit for the type of computing power required for these large language models. At the moment, there is only one company able to manufacture the required advanced semiconductors: TSMC. And there is only one company capable of producing the advanced lithography equipment that one finds in TSMC's foundries: ASML. In a world in which semiconductors have made it to world stage of politics, their importance for the world in only increasing.

Reflecting on a year makes one realize how unpredictable the world really is. Who would have predicted that, despite rising interest rates, all major indices were up between 15-25% with both corporate profits and the labor market being extremely resilient? At FortyTwo, we try to position ourselves such that we don't have to predict the future. Because we know we can't predict what a complex moving system consisting of millions of moving parts is going to do. One thing we are certain of: never bet against human ingenuity!

### Our own development

Last year, we dedicated an entire chapter on our mistakes. We firmly believe that rubbing our nose in our own mistakes is probably the most effective way to learn painfully fast. That said, we decided to delete our dedicated mistakes chapter because we felt that explicitly searching for mistakes to fill a chapter is approaching the matter the other way around. We want to reflect free format on our development, the mistakes we made, and also on the things that we are proud of (also a chapter in last year's letter that we decided to remove).

So, let's talk about our development as investors in 2023. It is probably fair to say that 2023 was a year characterized by natural evolution compared to our first full year of 2022. Or in other words, learning by doing. During the year we simplified our strategy, improved our valuation models, and became more comfortable with taking larger positions in line with our conviction. As becomes obvious in the next chapter, all of this has resulted in some changes in the portfolio (hopefully for the better).

The complicated part of investing is that process and outcome are often separated by many years. Let's consider the example of Intel, a position that we sold in 2022. Intel reported $18,9 bn. of earnings in 2021, $8,0 earnings in 2022, and for the current trailing twelve-month period, Intel has reported a loss of over $1,6 bn. Meanwhile, the stock has appreciated more than 50% compared to our exit price. Did we make a mistake? Is the market seeing something we did not? We have no clue, and it will likely take another couple of years to find out.

With our continued development as investor, we became more comfortable taking bigger positions once the outcome of our analysis turned out positive. Being right is great, but being right without a proper position sizing is almost as frustrating as being wrong. In 2023, we sized our positions with more confidence so that if we are right, we are also getting rewarded for doing the work. To conclude, we will continue to evaluate our historical decisions in order to learn from them. And of course, we are curious to see whether Intel can turn things around.

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## 3. Our portfolio

We ended 2023 with a solid return of 24,2%. This is a return that exceeded our expectations since our two largest positions (i.e. Berkshire Hathaway and Markel), accounting for 30% of the total portfolio, lagged the market. However, this lag was more than offset by significant appreciation of the share price of Amazon, Microsoft, TSMC, ASML, and Persimmon. Diversification has done its magic for us in 2023. We ended the year with a large cash position, the result of selling Thor Industries at the end of 2023.

Not surprisingly, writing an annual letter with a positive return feels better than writing a letter with a negative return, as was the case last year. But we are in the game for the long haul and duly realize that extended periods of underperformance are unavoidable. Ironically, periods with negative returns are a net positive for the long-term investor who has excess capital available to invest. For us, the recent bull market rally means that we have become more fearful, putting even more emphasize on risk, as the market becomes more aggressive.

An overview of our portfolio per the 31st of December[5]:

| Company name | Allocation | Summary of thesis |
|---|---|---|
| BERKSHIRE HATHAWAY | 15,1% | Economic castle built on multiple solid foundations (i.e. insurance, energy, railroads, securities) with strong returns on capital, excellent management, and an exemplary (capital allocation) culture. |
| MARKEL | 14,9% | Insurer of choice for specialty insurance products (e.g. events) that is continuously diversifying its revenue stream via either acquisitions of wholly owned businesses or purchase of marketable securities. |
| AALBERTS INDUSTRIES | 8,7% | One of the dominant players in making buildings more sustainable & energy efficient via its piping and flow solutions. The 'Aalberts companies' are among the best in their industries. |
| CHRISTIAN DIOR | 7,1% | The king and queen of luxury products (via its stake in LVMH) with brands like Louis Vuitton, Moet & Chandon, Hennessy, and Tiffany. Strong corporate culture with a family that is playing the long game. |
| PERSIMMON | 6,9% | One of the largest homebuilders of the UK aiming at the lower end of the market. Given the demographics of the UK and its economic state (with high interest rates) we found this value play very attractive. |
| TKH GROUP | 6,6% | Diversified Dutch technology holding company that develops products related to smart vision, smart manufacturing, and smart connectivity. Capable management that focusses on the long run. |
| AMAZON | 5,7% | Market leader in cloud service offerings with AWS. The scale of the ecommerce business creates an unrivaled foundation on which new sustainable business models like advertising can emerge over time. |
| ASML | 5,5% | The undisputed leader (i.e., monopolist) in the fabrication of lithography equipment for semiconductor foundries (incl. servicing & maintenance) with an innovation roadmap for the upcoming decade. |
| INVESTOR AB | 5,3% | Swedish holding company that has been around for over 100 years with the founder family still running the show. Solid combination of listed companies and wholly owned subsidiaries (Patricia Industries). |
| INTERACTIVE BROKERS | 5,2% | Pure play American brokerage firm that is among the most efficient in terms of digitization and revenue per employee and with a unique introducing broker strategy. Founder is still majority owner and chair. |
| TSMC | 5,0% | The leading semiconductor foundry in the world that continues to increase its lead in producing the most advanced nodes (i.e. with the smallest nanometer size) of the world at unmatched scale. |
| MICROSOFT | 4,5% | The clear number one in integrated business productivity solutions and the preferred cloud & office supplier for large corporations and public institutions. Since 2023 also frontrunner in AI solutions. |
| MELEXIS | 1,2% | Belgium-based semiconductor company specializing in the design and production of integrated circuits, primarily for the car industry. Excellent track record and very capable management. |
| CASH | 8,3% | - |
| **Total** | **100%** | |

[5] Please see the appendix for additional details of our portfolio

## Portfolio thoughts

Concerning the individual positions, a few things stand out when looking at our portfolio (that is only a snapshot taken on the last day of the year). Similar to 2022, Berkshire and Markel remain our two largest holdings although their relative size has come down during 2023. This will probably continue as we prefer to allocate new capital to smaller and/or new positions.

Aalberts is third on the list, which frankly is not really justified looking at the cyclicality of some parts of the business and the corresponding risk profile. Also, the new CEO from outside Aalberts has to convince us that he is the right man for the job. It's likely that the relative allocation to Aalberts will be lower next year. Either because we sized our position down (not that likely) or because we extended other positions (more likely).

We started building stake in holding companies Christian Dior and Investor AB. Two fantastic companies with a great track record and with significant family ownership & involvement. We feel very good about owning parts of both businesses and remain keen on extending our positions during 2024. Hopefully, Mr. Market will present us with some attractive opportunities this new year.

Our preference for a proven track record and predictability is also reflected in the average lifetime of the companies in our portfolio: all of them are founded before 2000 and the average and median age are respectively 56 and 49 years of age. Research has shown that the longer companies exist, the higher the chances are companies keep existing, the so-called Lindy effect.

Looking back on 2023, we would have liked Microsoft and Amazon to be bigger positions at the start of the year. Both companies were relatively affordable in January of 2023, but we did not bite. This could very well turn out to be a mistake, though it could also be a form of resulting now that we know that both stocks performed great in 2023. It always will be the same: "you own too much of the losers and own not enough of the winners".

The smallest position concerns Melexis, which we thread as "library card". Our process allows for taking small positions in companies that we like, but for which the long-term thesis is not crystal clear yet or the valuation is not attractive enough. By taking a small position we force ourselves to follow the company more closely. Over time, we can decide to increase our position in line with our conviction or wait for a more friendly entry level.

## Positions closed

During 2023, we said goodbye to four positions. Three of them were already part of the portfolio year end 2022. and one position was bought and sold in 2023. In this chapter, we want to reflect on those decisions. That said, it is of key importance to distinguish between process and outcome. We might have followed a diligent process that resulted in a bad outcome. The other way around is also possible. For us, it is the process that matters.

Though both buying and selling positions are part of investing, we tend to minimize the selling part as much as possible. Therefore, we are not entirely satisfied with our trading activity in 2023 as our favorite holding period is forever. What happened? Why did we, despite our reluctance to sell, decide to exit four positions? Let's briefly discuss the cases in chronological order.

### I. Spotify

We sold Spotify after only a couple of months of owning it. We exited after the release of the Q4 2022 earnings that were received favorably by the market. However, we started realizing that for Spotify to be a good investment, key metrics like subscriber growth, average revenue per users (ARPU) and margin development, needed to develop such that we had to look way too far in the future.

In addition, we felt there was not enough evidence that the targets set were realistic, nor was it transparent enough to us how management anticipated to achieve these targets. Also, we increased our awareness on stock-based compensation resulting in ~2% dilution per year. Finally, we doubt that the moat of Spotify (i.e. network effects and scale) is as strong as investors believe. We believe the true moat belongs to the record labels.

These factors, combined with a firm appreciation of the price, made us decide to sell this company. We still feel that this founder-led company makes a fantastic product that is a win-win for the world. With that, Spotify is likely to become the worldwide platform of choice for audio. Time will tell if and how this translates in shareholder value, something we are uncertain of as of today.

### II. Alphabet

Not long after exiting Spotify, Alphabet was up for discussion and once again we concluded that for us, selling was the right thing to do. Early 2023, the OpenAI platform launched ChatGPT. The instant rise of the ChatGPT AI bot (and its spectacular abilities) sent shockwaves through the waters of Alphabet's moat. The launch of useful AI solutions could start a paradigm shift with high uncertainty Alphabet ability to stay on top.

We feel that the future for Alphabet is definitely cloudier than a year ago. Will the world use Google search as they have done in the past decade? Will AI result in new business models that can possibly threaten Google's dominance? To be honest, we have no clue where the market for online search (with advertising as business model) is heading. More importantly, these questions are nowhere near our circle of competence.

Combined with the significant level of stock-based compensation, we decided to exit our position. Also our position was fairly small, we did not want a small position to consume large parts of brain power. With stock prices now hovering >30% above our exit price, it's easy to fall into the bias of resulting (since the stock appreciated so much). Given our uncertainties around Alphabet, we believe it remains the right decision for us.

### III. Netflix

Perhaps not surprising given the exit of Spotify, we also sold our stake in Netflix. Although we like the company and its product, we doubt whether this company will be a good investment. Even if Netflix remains the number one streaming service for the next decade, we expect industry dynamics to be tough. Netflix has many competitors with deep pockets (e.g., Amazon); therefore, it is key to outspend their competition on content.

We think it could be possible for Netflix to outspend their competitors since they have the largest userbase (i.e., operational leverage). However, we don't like a business model that is based on 'investing' huge piles of money to stay ahead. In particular, because the 'content investments' have a pretty short lifetime as users generally don't watch the average movie or series for a second time.

Finally, stock-based compensation is also an important factor here. Even with hundreds of millions spent on repurchases, the number of shares outstanding has increased at our time of sale. We don't rule out the possibility that Netflix will prove to be a true compounder in the coming years, but for us there is too much uncertainty to hold on to this position with such a steep valuation.

### IV. Thor Industries

We took a position in Thor Industries early in 2023. Thor Industries, a market leader in motorized campervans and towable caravans, had come down significantly from its 2021 peak. We figured that the market offered us an attractive entry point into a cyclical company that could sharply rebound in the next 5 years or so. Though we think this is still a realistic possibility, we decided to exit our position by the end of 2023.

In hindsight, buying Thor Industries probably wasn't worth our time and energy. There are a couple of reasons for that statement. First, Thor's products are highly discretionary (meaning that people only buy when they have spare cash) and are therefore extremely cyclical. Second, it's active in a pretty competitive market in which it has to compete against strong competitors like Winnebago and Forrest River.

Finally, since the fixed cost base for a capital-intensive company is relatively high, profits vary hugely depending on the place in the economic cycle. When we normalize the earnings to a conservative number, we feel that the prospective returns were not attractive enough given the implicit risk. Selling Thor Industries felt like the prudent things to do. Since we already understand Thor Industries, we might get another shot in the future.

## 4. Outlook for 2024

The million-dollar question for 2024 is what Central Banks will do with interest rates going forward. Inflation cooled significantly in the second half of 2023 and is quickly approaching the mandate level of 2% in the US and EU. The stock market, hoping for a soft landing, reacted favorably, and ended 2023 on a high note. We notice that lower inflation is often confused with deflation. Lower inflation means that prices are still rising year-over-year, but at a slower pace than before. Deflation means that prices are declining year-over-year.

Inflation has been declining but has not reached the target level of 2% yet. Also, inflation peaked in the second half of 2022, therefore the comparison base for the second half of 2023 was relatively favorable. Historically, the economy has to be forced into a recession in order to get inflation back in control. In other words: something has to give/break. Is it different this time? Or did inflation only pause, to be followed by a 70s resurgence in 2024? We don't know but one thing is certain: lower interest rates act as an inflationary catalyst.

At FortyTwo, we continue to devote our time and energy into finding the world's greatest companies. Companies that possess such characteristics and are led by such management teams that our favorite holding period would be forever. Though we occasionally also see other opportunities in undervalued (cyclical) stocks, this will never be the main focus of our fund. We realize that we aim high and are subject to periodic disappointment with companies that fail our standards. But when we strike right, it will be worth it.

We look forward to what 2024 will bring and are grateful for the opportunity to run our own investment marathon, though we haven't even completed the first 5k.

Sincerely,

F.J. Jacobs
J.H.B. Klein Poelhuis
*January 2024*

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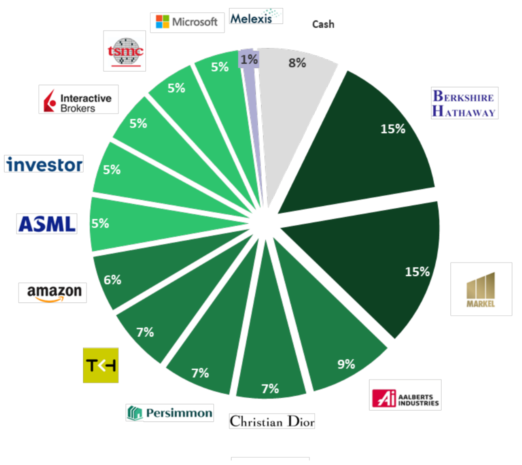
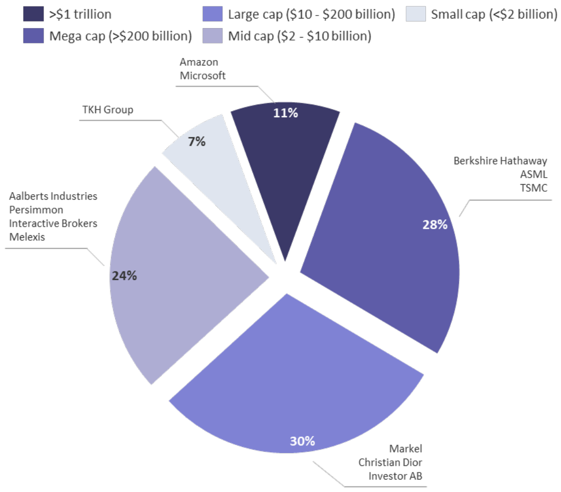
## Appendix

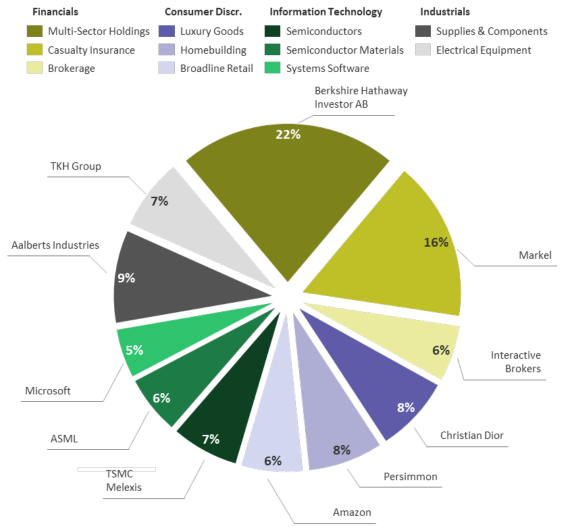
Distribution of portfolio across individual positions




Distribution of portfolio across market capitalization sizes




Distribution of portfolio across sectors & industries




Distribution of portfolio across regions