FortyTwo Capital

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Annual Letter 2022

FortyTwo Capital

Portfolio Performance

Year	FortyTwo Capital B.V.[1]	MSCI World Index ETF[2][3]	AEX GR[4]
2022	-18,12%	-13,54%	-11,92%
€1 investment on 1/1/2022	0,82	0,86	0,88

[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 €, including dividends)

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1. About ourselves and our strategy

We are Fabian and Jan, founders of FortyTwo Capital with lives that have many parallels. We both went to college during the same period and during these years we became good friends. We both spent several years working as consultant for Deloitte. And currently, we both live in the same neighborhood. Accidentally, we started to dedicate much of our time understanding the stock market and how to become better investors. As a result, we discussed our latest insights regularly as well as the companies we held in our private portfolios.

As we discovered that our investment philosophy was quite similar, we decided to join forces and to start an investment firm together. We wanted the company's name to represent something important to us, something dear to our heart. Since we are both passionate about endurance sports, a resemblance to the marathon came to mind. The mythical distance of 42,195 meter (hence FortyTwo), that according to ancient history, Pheidippides ran from the city of Marathon to Athens to deliver news to the capital that the war was won. We hope our story ends on a happier note as story goes that Pheidippides died right after arrival.

To us, the marathon acts as metaphor for our investment philosophy. Running a marathon is far from easy and requires a decent preparation process, the discipline to divide one's energy, and the mental strength to persevere when the going gets tough. A marathon is about compounding on the lessons learned from previous endeavors and from life in general. We believe the similarities between a marathon and investing are striking. Investing requires the same qualities and that is how we have structured FortyTwo Capital. Let us elaborate.

In the world of investing, you can pick a portfolio out of countless listed companies. To create some order in that world of chaos, we defined a number of characteristics that correspond to our own personal values. We believe that acting according to these do's and don'ts will make our life easier.

We do invest in companies that…

- ✓ …have a business model that is backed by strong cash flows that we can understand
- ✓ ...have high historical returns on invested capital
- ✓ …have experienced management teams with proven ability, high integrity, and skin in the game
- ✓ …show strong capital allocation discipline
- ✓ …use debt purposefully, intelligently, and conservatively

We do not invest in companies that…

- ✗ …have not reported positive free cash flows or positive operating cash flows yet
- ✗ …are within 1 year after their IPO (i.e., Initial Public Offering)
- ✗ …are highly capital intensive active in competitive industries (e.g. car manufacturers)
- ✗ …sell products that we would not consume ourselves (e.g. tabaco or gambling services)
- ✗ …have close to no capacity to determine prices themselves (e.g. natural resource companies)
- ✗ ...require significant upfront investments for an uncertain future payout (e.g. biotechnology)
- ✗ …have a disproportionate relation between equity and liabilities (e.g. banks)
- ✗ …have a business model that we do not entirely understand
- ✗ …offer products or services for which we do not understand the added value
- ✗ …have a strategy for the next 5-10 years that is unclear for us
- ✗ …have a short term focused management (e.g. empire building, revenue focused, low tenure)
- ✗ …have a long-term debt position that we consider to be unintelligent or irrational

Now that we have reduced our investing universe by a significant margin, we try to look for companies that fit into one of our three pre-defined categories. Ideally, we try to construct a portfolio with a healthy representation of all three categories. However, we depend on the opportunities presented by the market. If that means that we have to temporarily sacrifice one category for bargain deals in the others, we would be happy to do that.

In addition, we consider our investing universe to be global. Though we are very careful investing in companies headquartered in countries in which we feel that the jurisdiction, governmental influence, and currency is less stable than we are used to in Western Europe. Investing in the Western world is already hard enough, we feel that there is no immediate need to make things more complicated than necessary.

I. Solid growers	II. Strong compounders	III. Diversified holdings
Companies with stable and moderate growth (i.e., single digits) in mature industries	Companies with a profitable growth track record; often with a high valuation and optionality	Companies with a wide diversity of cashflows, a great leadership, and strong capital allocation discipline

I. Solid growers

For this category, we aim to find companies active in markets with favorable and mature industry dynamics. We want to be convinced that these companies have an edge over their competitors. For example in terms of scale, a unique culture, the management team or an innovative product feature or service. Since these companies are not growing fast, free cash flow is mainly allocated to dividends and/or buybacks. Our goal is to buy these types of companies with a relative high margin of safety and hence we wait for temporarily misperceptions in price.

II. Strong compounders

For the second category, we look for companies that have already proven to be able to generate significant and increasing cashflows. We want those companies to be active in markets and/or industries that still possess sufficient runway for (double digit) growth. Ideally, these companies have some form of optionality by experimenting with new products or services. Free cash flow is to a large extent dedicated to increasing the company’s competitive position. Preferably the founder is still involved and/ or management’s long term focus and conviction is being underlined by firm insider ownership. These companies often trade at relatively high valuations, but occasionally buying opportunities arise during market turmoil, as was the case in 2022.

III. Diversified holdings

The companies in the third category have a lower risk-reward profile, as they are already diversified by nature. Hence, we believe they provide downside protection to our portfolio but also spectacular returns if managed with the right discipline. Buying at incidental dips in price and holding for an extensive period is of key importance. We want to make sure that the holdings we own have exceptional management teams with equally high integrity. Next to that, an undisputed track record of capital allocation for a prolonged period of time is crucial, as we believe this is the most pivotal activity for these types of companies.

2. Our process

We believe that nobody is able to predict the market in the short term, nor is it possible to have any control over our results on the short term. However, something we can control is our investment process. In our opinion, good results in the long run are the outcome of adhering to a well-defined process. By time and time again executing our process, learning from past experiences, and continuously improving our process, we believe we can achieve excellent results over longer periods of time.

The magic trick here (just as everywhere in life) is the concept of compounding. By becoming just a bit better every day, one can achieve something remarkable over time. Though it is important to remain patient and disciplined. We are working with checklists to protect us (to some extent) into falling prey to one of the many biases. Let us elaborate on some of the most important parts of our process.

Checklist

Once we start studying a potential and interesting company, we use our checklist. The checklist first helps us to define some general characteristics of the company (e.g. how does it earn money, what are the market shares etc.). Then it is followed by a list of binary questions across six categories (market, competitive position, balance sheet & periodic reports, management & workforce, capital allocation, and valuation). These binary questions have as purpose to include as many as possible aspects that shapes a company's future in our analysis. In the "The Checklist Manifesto: how to get things right", Atul Gawande explains how checklists provide protection against both failures of memory and attention. Although the checklist eventually leads to a numerical score, the qualitative aspect of this process is most valuable to us.

Valuation sheet

Doing valuations helps in understanding what is currently priced in by the market and allows us to do scenario analysis. However, we don't believe that we are able to determine the specific intrinsic value of a company. But we are convinced that by being "approximately right" (instead of being precisely wrong), our assessment of the risk-reward trade-off improves, and we prevent paying too much. Still valuations are something to be cautious about. It's easy to play around with variables and come to a price which would justify a purchase.

Key data sheet

Once we decided to take a position in a company, we create a 'key data sheet'. This is an overview of company specific data as well as data related to the competitive landscape the company is operating in. By penciling out the most important data points and how these need to develop, we constantly keep track of our buying thesis. Additionally, it makes it significantly easier to zoom out and have a look at the long term trend of the company. We update the information after each earnings release.

Quarterly scoring sheet

Finally, we use the 'quarterly scoring sheet' to make a qualitative overview of both positive as well as negative points, that came across during the earnings call of a company in portfolio. After this qualitative analysis, we score the information presented on a one to five scale in order to easily identify the long term trend. One or two disappointing quarters are generally not a sell sign, however if the trend extends to multiple quarters this for sure will be different.

3. Looking back at 2022

In hindsight, our first year of allocating capital at FortyTwo was one not soon to forget. 2022 was a year full of events that were not widely foreseen at the outset. The invasion of Russia into Ukraine is definitely the most tragic occasion of the year. An armed conflict that in terms of its antiquated warfare, feels like one fought decades ago, with thousands of unnecessary casualties on both sides. Entire Ukrainian cities have been destroyed and many families lost both their homes and loved ones. It is sad to witness that despite all historical progress we made as civilization, a handful of people can tear this progress apart in a heartbeat.

Despite the extensive set of sanctions imposed by the West on Russia, the war might only have increased Russia's power. Europe has completely underestimated its reliance on Russian natural gas. What followed is a textbook example of price elasticity. Due to the imposed sanctions, Russia decided to limit the supply of natural gas to Europe. But Europe did not have an alternative to Russian gas. Therefore, demand remained high, but supply was severely constrained. The net effect for Russia was a significantly higher price per unit distributed.

This phenomenon acted as a catalyst in an inflationary environment which already started to manifest itself earlier in the year. Loose monetary policy before the Covid-19 crisis became even looser during two years of Covid. In part, stimulating measures were prudent to prevent companies in impacted industries from going belly up. However, the Federal Reserve, but mainly the European Central Bank only removed their foot from the gas once it was already too late. The genie was out of the bottle and only drastic measures could put it back in.

What followed was a year in which inflation skyrocketed and central banks were forced to quickly pivot to tightening policies. For the first time in many years, central banks were forced to raise interest rates. Years of monetary stimulus, in which demand has been pulled forward by 'free money', came to an end. The cheap credit lifeline for many below par companies slowly drifted away. For many, this came as an unexpected (and undesired) surprise and the stock market reacted wildly. All major markets ended the year significantly lower.

The category of unprofitable tech stocks were hit most severely. Multiple companies saw their market capitalization tank by over 70%. It was more than 20 years ago that we witnessed a similar retraction during the Dotcom bubble. History doesn't repeat itself, but it sure does rhyme. But not only unprofitable tech was hurt, also profitable tech stocks were impacted (including the ones in our portfolio). Not to the same extent, but still severely enough to impact our portfolio significantly. The good news: we were able to increase our positions against a lower cost base. So in the long run, the net effect will be positive.

It is tempting to think that the world was a better place in 2021 before all worldwide turmoil happened. Before Russia invaded Ukraine, before the high inflation, before a looming recession in 2023, and before boiling tension between China & Taiwan in the South Sea. However, as investors we have to extend our horizon beyond what we currently see unfolding in front of our eyes. At FortyTwo Capital, we remain optimistic about the long history of human ingenuity to find solutions for (nearly) all problems.

4. Our current portfolio

By the end of 2022, our portfolio currently consists of ten positions of which eight are listed in the United States and two in The Netherlands. The three largest positions are holding companies with a wide variation of underlying operating businesses and diversified income streams. Given the position sizing, we feel that our portfolio is more diversified than one would argue at first glance.

The remaining positions in portfolio are all companies with a significant technology component. We feel confident that these companies are positioned very well to benefit from a world that is increasingly becoming dependent on advanced digital solutions. However, in the short run these companies all have experienced headwind to varying degrees.

Our annual result is a return of **-18,12%** over 2022. Actually, it doesn't feel like such a bad year to us. The reason for that is two-fold. First, we used the 'Modified Dietz return' to calculate our performance. In this formula, the annual result is divided by a time weighted average of the funds available. For example, when new funds are added to the portfolio on July 1st, these funds only count for 50%, since they have been available to us for half a year. As we deployed most of the funds in the second half of the year, the time weighted average of the funds available was relatively small, leading to an amplified negative return.

But most important, we are net buyers of stocks for the next decades. That means that lower prices allow us to buy higher quantities, which will benefit our portfolio in the long run. At FortyTwo, we feel very strongly about this contrarian attitude. All too often, we see investors (but unfortunately also executives) focusing on the short term, thereby negatively impacting long term results.

Company name	Allocation	Long term destination
MARKEL	24,01%	Insurer of choice for specialty insurance (e.g. events) that continuously diversifies its revenue via acquisitions of wholly owned businesses or marketable securities.
BERKSHIRE HATHAWAY	16,89%	Economic castle built on multiple foundations (e.g., insurance, energy, marketable securities) with strong returns on capital, excellent management, and an exemplary (capital allocation) culture.
AALBERTS INDUSTRIES	11,74%	One of the dominant players in making buildings more sustainable & energy efficient via its piping and flow solutions. The 'Aalberts companies' continue to be among the best in their industries.
TSMC	9,05%	The leading semiconductor foundry in the world that is increasing its lead in producing the most advanced nodes (i.e. with the smallest nanometer size) of the world at scale.
ASML	8,16%	The leader (i.e., monopolist) in the fabrication of lithography equipment for foundries (incl. servicing & maintenance) with a rolling innovation roadmap for the upcoming decade.
MICROSOFT	7,29%	The undisputed number one in integrated business productivity solutions and the preferred cloud & office supplier for large corporations and public institutions.
SPOTIFY	7,20%	The one and only platform in the world for music, podcasts, and audiobooks for both listeners as well as creators and the music labels. For customers, monthly membership renewal is a no-brainer.
ALPHABET	6,97%	Maintaining position as the most dominant advertising company in the world. Google Cloud will scale to a top-3 cloud platform and the other bets division will occasionally deliver new products/services.
AMAZON	5,10%	Market leader in cloud service offerings with AWS. The of scale of the ecommerce business creates an unrivaled foundation on which new sustainable business models can emerge over time.
NETFLIX	3,58%	The unquestionable king of video streaming with the greatest (original) content for the most diversified global audience. Netflix is perceived as 'must have' by its customers.
Total	**100%**	

Positions closed in 2022

We (un)fortunately felt that we had to sell our (only recently opened) position in Intel. For decades, Intel was the undisputed leader in manufacturing advanced microchips. What now remains is a company that is desperately trying the play catch up with TSMC and Samsung. During the first half of 2022, the post-Covid 'chip shortage narrative' was as strong as it's ever been. We figured that the total market would somehow be big enough for Intel to have a fair & profitable share. We were wrong.

We completely underestimated the power laws of the semiconductor industry. Manufacturing microchips is extremely capital intensive and over the years the industry consolidated to only a few companies able to manufacture the most advanced chips: TSMC (the clear market leader) and Samsung (although struggling). Catching up is like falling from a treadmill at 12 km/h and get back on it at 15 km/h (e.g., nearly impossible). Ironically, Intel's co-founder Gordon Moore predicted decades ago that the cost of establishing a foundry (i.e., semiconductor manufacturing facility) would double every couple of years. He was right.

We also did not put enough weight on judging the strategic choices Intel made over the years. Intel once founded the x86 architecture, on which historically all Windows computers relied. However, this architecture proved not to be suitable for mobile devices because of its high energy demand. For this application, the ARM architecture turned out the be more efficient. Intel fell prey to the innovators dilemma, not willing to (partly) sacrifice its current cash cow in order to stay relevant in the long run adopting the ARM architecture.

The mistake we made was investing based on 'hope' and insufficient industry knowledge during the moment of purchase. Hope is not a strategy, certainly not in the world of investing, where all too often hope comes down to postponed disappointment. However, we corrected the error within a few months after we deepened our understanding of the semiconductor industry. Unfortunately, we had to pay hard cash for this lesson and sold the position with a loss of approximately 30%.

5. Our mistakes

Rubbing your nose in your own mistakes might very well be the best way to prevent yourself from making the same mistake again. That's why we will never ignore the possibility to critically reflect on our past behavior in order to learn a lesson or two. Apart from the Intel mistake of "buying on hope" described above, we made a number of other mistakes that we would like to emphasize here.

But before indulging ourselves in our mistakes, we want to address our process. In our opinion, it is crucial to separate process from outcome. The mistakes we describe here are all process related. It could very well be that, in the future, Intel will become a marvelous investment (i.e., the outcome). However, we believe that our buying process was wrong, and that our selling process was right (based on the information at hand). Also, it could very well be that in other cases our process was right, but the outcome will turn out unfavorable.

Rushing a buy decision

We made a number of buying decisions before we were finished with doing proper quantitative and qualitative analysis. In the case of Alphabet and especially in the case of Amazon, this has resulted to initially buying against prices that factored in extremely bullish scenarios. Given the historical track record, it is certainly not impossible for these types of companies to live up to these high expectations, but had we first completed our analysis, we would have decided to wait until we could purchase with better risk-reward prospects.

If 2022 has proved anything, then it is that even the companies with the widest competitive advantages, can show steep price declines in a short period of time. Hence the lesson is that even if we make a buy decision for the perfect company, we have to do the math before taking a position. And then remain patient until Mister Market is presenting us the right opportunity.

Buying without assessing a company's qualitative long term destination

This may sound as a no-brainer, but only by explicitly defining why a company would still be around in a decade, we feel we can weather short term fluctuations in stock prices. A good example is Netflix, that we initially bought right after a steep decline in price (from a high of $700 per share to below $400). Although we did some scenario analysis in this case, we lacked the true conviction in the company's ability to be the ultimate king of streaming.

We failed to buy more shares when the price dipped again (well below $200) after one quarter of negative subscriber growth. It's only then that we felt inclined to start doing the real work and really get to know Netflix. When our research was finished, the stock was up more than 50% again. Put differently, we missed an opportunity to buy more shares of a wonderful company at a discount because we did a poor job at the outset.

Sucking our thumb

Another mistake is not being on top-off price developments for the stocks we did our homework on. On our wish list are a number of extraordinary companies and we should act once these stocks hit our estimated intrinsic value. The example here is ASML, one of the first companies on our wish list but perceived by us as too expensive. For most of 2022, the stock traded at values well below €500. We estimated that a reasonable intrinsic valuation would be around €500 and anywhere near €400 would be considered very attractive.

Somewhere during October, we missed a one-day opportunity to buy ASML well below €400. We decided that it might go lower and apparently wanted to suck our thumb for a little bit more. Only the miss out on this spectacular opportunity. Luckily, we were wise enough to buy shortly after, but with a price >25% higher than that dip. The lesson here: if we did our homework and are convinced of the fundamentals of a company, we should seize the opportunity once it presents itself.

6. What we are proud of

Learning from one's mistake is important, but we consider cherishing the things that are going well already also as very important. As soon as we would no longer enjoy doing our work at FortyTwo Capital, we would very soon be tired of it and start investing passively. For us, it is important to have fun, enjoy the journey and celebrate the moments that are worth celebrating! Let us list a couple of things that we are proud of.

Developed our own approach

As we mentioned in section two, we feel that having an investment approach is vital. At FortyTwo Capital, we are proud of last year's work to develop such an approach. We spend many (evening) hours discussing the things that are of key importance to us. Before long, we had an extensive list of everything that we considered to be important. From management incentives to the nitty gritty details of the balance sheet.

However, what is most complicated is to keep things simple and usable. A process is only valuable if also used. Therefore, our process had to be intuitive to use and not too time consuming. We spend a significant amount of time distilling our process down to (what we belief is) the essence. We are pretty satisfied with the result and have a good time using what we developed on a daily basis.

Defined our philosophy

In the first section we laid out some of the characteristics that we are (not) looking for in a company. Next, we defined three categories of companies that we consider to be the basis of our portfolio. By putting all of this on paper, we feel more relaxed. It is way easier for us to discard sexy ideas that do not possess the predefined characteristics. Hence, we can spend more time of the ideas that are worth working on.

We are also satisfied with the three different categories. It feels balanced to have a portfolio that consists of a number of solid growers, a number of promising strong compounders, and implicit diversification via a number of holding companies. Ironically, we spend an awful lot of time coming up with this simple and intuitive distinction. As Charlie Munger is known saying: "It is simple, but not easy."

Extending positions in market turmoil

We founded FortyTwo Capital during the end of a bull market (December '21) that started after the brief Covid crash in March 2020. Some of the positions we entered during the first half of 2022 hit new 52-week lows on a regular basis. Our starting capital soon was worth less than the amount we started with. We would be lying if we said that we are completely immune for these paper losses.

However, we should not invest in stocks if we are not able to weather an occasional steep downturn. We sticked to our plan and we kept adding to our positions being convinced of the underlying fundamentals. This so called 'averaging down' is something up for debate. Many would argue that waiting for momentum to turn around would be the better strategy. However, we feel comfortable buying more of companies that we consider to be undervalued and keep them for a very long time.

7. Outlook for 2023

At FortyTwo, we will never predict what is going to happen in a single year. Once we do and start to behave like fortune tellers, we'd advice you to run away and never look back. We believe that the time it takes the earth to travel around the sun, is simply too short for a mere mortal to make any prediction. That does not mean that we are not excited for what's to come this year. We do look very much forward to next year and do want to give a brief outlook for what we want to achieve in the next 12 months.

First of all, we aim to keep improving both ourselves and FortyTwo Capital a little bit every day. Small incremental changes will eventually lead to exponential outcomes. Not only do we want to learn from the mistakes we make along the way, but we also want to keep cherishing the many things that go well already. We foresee both goals will be reflected in periodic improvements in our investing process.

We aim to deploy at least the same amount of capital in 2023 as we did in 2022. In part, by incrementally increasing current positions that we feel are currently undervalued. But mainly we want to establish new positions in our 'solid grower' bucket. We haven't executed on that part of the strategy in 2022 and we hope to find a couple of attractive stocks that we would feel comfortable holding for a very long period of time.

In terms of the current portfolio we are very much looking forward to 2023. We foresee a reasonable chance that 2023 will be a year of lower growth than many investors have been used to during recent years. But we would argue that's fine. The best companies will nevertheless be able to get stronger in comparison with direct competition. In the long run, the best companies only benefit from challenging times.

In the meantime, we plan to invest our time to deepen our knowledge of the semiconductor and payments industry. Both industries play a crucial role in our society, and we would like a more profound understanding. We made some progress in 2022 but we feel we are just getting started.

Regardless of what inflation and central banks will do in 2023, we are confident about the companies in our portfolio. We feel that we own excellent businesses with pricing power led by capable and trustworthy management. In the long run, that will eventually manifest itself.

To come back to the analogy of the marathon, we have not even completed our first mile!

Sincerely,

F.J. Jacobs
J.H.B. Klein Poelhuis
January 2023