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January 16, 2018

Annual Letter 2017

Barrage Fund

Management Report

For the period between the 1st of January and 31st of December 2017, the S&P/TSX index generated a return of 9.02% (including dividends), while the S&P 500 produced a return of 13.66% (in Canadian dollars, including dividends). The Barrage Fund returned 11.66% before fees and 9.28% after fees during the same period.

At the end of the year, the fund consisted of 10 stocks and a small cash holding. Our levels of cash holdings fluctuated greatly during 2017. At the end of the first half of the year, 29% of the fund was held in cash. Our cash level remained high for several months and then, as opportunities arose, we were able to deploy all our available capital.

Market Commentary

Our two key indexes performed well throughout the year. On the US side, fiscal reform probably contributed to this performance. The corporate tax rate was reduced from 35% to 21%. Repatriated foreign earnings were subject to a tax rate of 15.5%. This bodes well for companies such as Apple, who according to some estimates could bring $200 billion back into the country. In all probability, part of this money will be redistributed to shareholders, either through dividends or share buybacks.

In 2016, China and Brexit made the headlines and created anxiety in the markets. We did not experience any similar events in 2017, which contributed to the excellent performance of the S&P 500. The S&P 500 is currently trading at more than 25 times earnings, compared to its historic average of 15. Is this valuation exaggerated? We don't think so, given the context of very low interest rates, and with the impact of fiscal reforms on profits still to come. This said, bargains have become rarer, although happily, this did not prevent us from deploying our cash holdings in the second half of the year, as we will see.

The Madness of Bitcoin

During the last few years, we have witnessed the spectacular rise of bitcoin, a virtual currency, which is the product of a technology revolutionizing the way that we complete transactions.

However, it is important to make a distinction between the technology behind it and the cryptocurrency itself. As Warren Buffett noted in 2014, we can draw an analogy with the way that cheques are used by the banking sector to transfer money. For a long time writing a cheque has been a practical method to transfer funds between bank accounts. At the same time, we place no intrinsic value on a cheque book; it only serves as a means to effect the transfer. We should use the same logic when thinking about blockchain technology. Its utility resides solely in the transmission of money from one entity to another.

Apparently, the number of bitcoins will be limited to 21 million, creating a market scarcity that justifies its vertiginous rise in value. We would give more weight to this argument if bitcoin were the only cryptocurrency available, whereas in reality, there are now a wide range of virtual currencies, such as Litecoin, Ethereum, Zcash, Dash, Ripple, Monero, etc. In other words, we could create an infinity of monetary units, somewhat similar to a bank sending you as many cheque books as you request.

We will conclude this subject with a recent comment from Warren Buffett, who reiterated his opinion regarding this type of currency at the beginning of 2018:
“If I could buy a five-year put on every one of the cryptocurrencies, I'd be glad to do it but I would never short a dime's worth.”

The Canadian Market

Unsurprisingly, the Canadian stock exchange continues to underperform in comparison with its US equivalent. There is nothing to indicate that we should change our expectations in the near future. High levels of household debt, in combination with real estate prices that have become unaffordable in several cities, do not bode well for the future. Once again this year, we found our best opportunities on the American continent south of the border.

The unemployment rate, at 5.7%, has now crossed the barrier that it reached just before the financial crisis of 2008. A difficult employment market, twinned with the desire of the Bank of Canada to contain real estate price rises, should lead to interest rate rises. In the event of a recession, there will probably be a marked reduction in the value of the stock market, which will eventually lead to the appearance of bargains.

Our Portfolio

Charter Communications

Charter is a new stock in our portfolio. This company supplies residential and commercial cable services throughout the United States. At first glance, such a company would seem unlikely to be very profitable. During the last 5 financial years, cumulative profits have reached USD 2.6 billion, or an average of USD 520 million per year. This is relatively little compared to its stock market value of almost USD 100 billion.

John Malone, an experienced veteran of the industry, owns 27% of the stock, either directly or indirectly, and has a significant influence on the company's business decisions. Mr. Malone has more than 40 years of experience in the cable industry and has long demonstrated his acute business sense. He excels in both completing transactions and forming strategic alliances that will benefit his companies. He has always prioritised the creation of wealth, as opposed to ledger profitability.

For approximately 25 years, Mr. Malone lead the cable giant Tele-Communications Inc. (TCI Group). When he took charge of TCI in 1973 it was experiencing financial difficulties and had only 100,000 subscribers. Eight years later, TCI had become the largest cable company in the US. In 1999, it had 11 millions subscribers and was sold to AT&T for USD 48 billion. Its performance on the stock exchange was spectacular: between 1974 and 1997, its share price multiplied almost 5600 times!

Malone mastered a concept which was little known on Wall Street at the time: Earnings Before Interest Taxes, Depreciation and Amortization (EBITDA). Occasionally, EBITDA can be used to camouflage a lack of profits, as we have seen in the oil industry in recent years. However, when management looks to maximize its use of resources by reinvesting its liquidity to generate value in the future, the absence of earnings becomes a fiscal advantage because it minimizes tax obligations. Often, this strategy can lead to negative reactions from shareholders and financial analysts, who too frequently only consider ledger profits in their valuations. Several years ago, in responding to a group of dissatisfied investors at TCI, Malone declared, "If you're going to ask about quarterly earnings, you're at the wrong meeting, and you probably own the wrong stock."

During the summer of 2017, the Japanese conglomerate Softbank made an offer of $540 per share for Charter. This offer was turned down by Charter's management because of the payment methods which were proposed to meet the $540 per share valuation. In a recent interview with Mr. Malone, we learned that Charter Communication has received three other purchase or merger propositions since this offer. Having purchased our shares in Charter at an average price of $335, any offer in a similar level ball park to the Softbank offer would generate a significant profit from our position.

It should be noted that it would not only be Mr. Malone who would profit from the sale of the company. The two main leaders of Charter, its CEO, Thomas Rutledge, and its CFO, Christopher Winfrey, own shares to the value of USD 250 million and USD 150 million respectively.

Many investors fear that subscribers will abandon cable services in favour of web based TV services. To use Netflix or Amazon Prime Video all you need is a good internet connection. Despite this, Charter is not losing subscribers; even if they abandon cable, they need improved internet connectivity to consume content, which generates greater profits for the company at the end of the line.

Charter, like several other companies in the sector, has a monopoly position in several US cities, operating as the sole supplier of high speed internet services. Moreover, the company anticipates that it will be able to significantly improve its bandwidth speeds with a relatively small outlay of capital.

Amazon

Amazon has the largest position in our portfolio, which may surprise some investors. This company has a net accounting profit of barely USD 2 billion per year, against a stock market valuation of USD 600 billion. A glance at the financial statements of the last 10 years shows us that sales have grown strongly, at around 27% annually, in contrast to profits, which have grown more modestly. It could be reasoned that this trend shows a prioritization of growth at all costs, to the detriment of profits. Actually, Mr. Bezos demonstrates both great ambition and a particular capacity to see the long term view; he reinvests the earnings that the company generates.

Similar to TCI and Charter Communications, Jeff Bezos does not seek to declare taxable profits just to please Wall Street. To understand his way of thinking, we should rewind to 1991, when he drew a line under a promising career at DE Shaw, a New York investment firm, where he had become a vice president at only 26 years of age, and where he appeared to have a stellar future.

Jeff was intrigued by the arrival of the internet. In his opinion, this new technology would change the world, and he wanted to create a company that could exploit this huge development. As his career was already assured, he wanted to avoid making choices that he might regret in his old age. Therefore he decided, that even if he failed, he should never regret having tried. Moreover, if he was correct about the internet, and he didn't take a shot at it, he was 100% certain that he would regret it later. He made the big leap. He called his decision making process "The Regret Minimization Framework."

This framework is the anchor behind Amazon's decision making process. According to Mr. Bezos, in order to invent, one must experiment, and if one already knows the result of an experiment in advance, by definition it isn't an experiment. Thus, experimentation is a strategy that Amazon employs regularly. Many companies do not dare to attempt new things because of the fear of failure, which hinders them from developing new ideas that could revolutionize the industry.

We should underline that Amazon uses this strategy in a particularly effective manner. When a project isn't working, it abandons it quickly and concentrates its resources and energy in projects that are more promising.

In 2016, Amazon spent USD 16 billion on research and development, more than either Alphabet, Microsoft or Apple, and significantly more than Johnson & Johnson or Pfizer. Through trying various ideas over the years, Amazon has come to dominate two important sectors: online retail and cloud based web services. In the first of these, Amazon has a 44% market share (if third party sales are included), in comparison to a 4% market share for Walmart. It swoops up around half of all new online sales. Its cloud based web services subsidiary, AWS, has 35% of the market, and AWS's annual growth rate during the last quarter was 42%.

According to a recent UPS survey, 29% of Americans begin their online research by going to Amazon's website, which is almost twice the number who begin on a search engine such as Google. This allows the company to gather vast quantities of useful data to enhance its database and better target online advertising towards its clients.

Even though online advertising is dominated by two large players, Alphabet and Facebook, we believe that this sector could become a significant growth engine for Amazon. This market generates estimated annual revenues of USD 200 billion and internet distribution offers substantial economies of scale.

Incorporating into our calculations levels of growth that we believe are reasonable for the three main areas of growth (retail, cloud services and online advertising), we arrive at a true valuation for Amazon of $1,640 per share, which compares to our average purchase price of $1,000 per share. We are constantly reviewing this valuation; the company is evolving in a dynamic industry and with high levels of revenue growth and cash flows, adjustments will be necessary over time.

Allergan and BT Group

These stocks have had a negative impact on our performance in 2017, as they lost favor on the stock markets. Concerning Allergan, revenue losses from Restasis, a medication for chronically dry eyes, has undermined the confidence of investors in the company's future performance. We significantly reduced our position when the share price reached $250, but repurchased as the price fell reaching a low of $160. The poor performance of this stock, along with that of the BT Group have impacted our returns for 2017. Despite this, we remain confident in their prospects, which created purchasing opportunities, allowing us to invest some of the liquidity that we had accumulated up to June 30th.

Sales of Autonation, General Motors and Citigroup

We let go of our holdings in Autonation and General Motors this summer, mostly because of our fears for their longer term prospects, even though their valuations were still of interest.

Citigroup's share price approached our market valuation, and we preferred to replace it with stocks from other financial institutions.

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AIG and BCS

We have reinvested in AIG. The new CEO, Brian Duperreault, is focussing on radically changing its operational methods, notably with regards to how they manage risk in insurance underwriting. To improve the quality of its underwriting, he is surrounding himself with the best people in the industry. We believe that these changes mark a turning point for AIG.

Barclays is a new stock in our portfolio. This British bank is trading at a high discount on its value, and it is in the process of restructuring, which should improve both its risk profile and returns on capital. The management is also expected to increase its dividend payment if it achieves its objectives, which should provide an interesting catalyst for an improved stock market valuation.

Administration

The unit of the Barrage Fund ended 2017 with an asset value of $220.67 and a distribution of $36.87 per unit. Following the disbursement of annual distributions, the asset value of a unit began 2018 at $183.80. Unit holders who have opted to automatically reinvest their distributions will see their new number of units in their first account statement for the year.

Best regards,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière