barrage capital

February 28, 2024

2023 Annual letter

Barrage Fund

Management report

For the period of January 1st to December 29th 2023, the S&P/TSX index posted a return of 11.75% (including dividends) while the S&P 500 generated a return of 22.90% (in Canadian dollars and including dividends). The return of the Barrage Fund for the same period was 92.34% before fees and 90.14% after fees.

Commentary on the markets

"Volatility transfers wealth from those who cannot handle it to those who can."

If we had to come up with a quote to describe the last two years, it would be something like the above. We have recently seen several respectable portfolio managers react poorly to stock fluctuations, particularly in so-called "technology" stocks. A good example is Meta Platforms:

Source: Tikr

Even the best investors sometimes make glaring mistakes. Some of them were full of praise for the quality of Meta's business model, its management and its competitive

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position. When the stock crashed, they changed their minds, only to miss the rebound later.

This kind of example, just like with Netflix (see our 2022 annual letter), encourages us to maintain a humble attitude towards the markets. Despite our experience in the stock market, we are not immune to the emotions that strong market fluctuations can cause. For anyone invested in technology in 2022, this was a tough test. It took a lot of conviction to “buy in” at the trough rather than giving in to second-guessing, and therefore selling at the worst time. Netflix and Meta are two stocks that we bought more of close to their lows. This allowed us to obtain better results despite Spotify’s weaker performance. At $250, the stock remains far from its peak of $357.

Charlie Munger

On November 28th, we learned the sad news that Charlie Munger, Warren Buffett's partner, died at the age of 99. We would like to dedicate part of this letter to this famous investor, who is a source of inspiration for adherents of Value Investing.

Mr. Munger is recognized for his ability to develop mental models. These allow concepts to be simplified for better understanding. One of the most important models is that of the circle of competence:

“People chronically mis-appraise the limits of their own knowledge. That’s one of the most basic parts of human nature. Knowing the edge of your circle of competence is one of the most difficult things for a human being to do. Knowing what you don’t know is much more useful in life and business than being brilliant.” -Charlie Munger

An investor should therefore only invest in companies that they understand well. This may seem obvious, but ego can cause an investor to overestimate their actual knowledge and believe they have mastered a subject.

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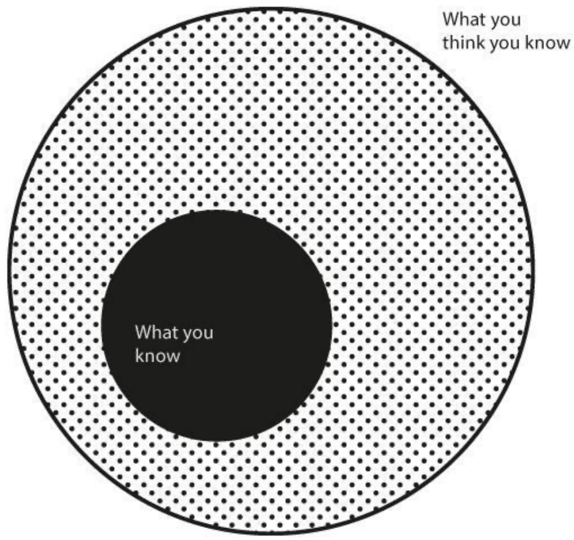

Source: Farnam Street

When we are asked a question, for example during an annual meeting, and we don't know the answer, we are not afraid to say "We don't know." This way we define the limits of our knowledge and we can study the subject if necessary.

"We have three baskets for investing; yes, no, and too tough to understand." -Charlie Munger

As we've said many times, we don't invest in what we don't understand, even if it's "the next hot trend." We can, of course, try to widen our circle by analyzing an area that we know little about. However, understanding a company and its industry forms the basis of a valuation. Without sufficient knowledge, we could make costly mistakes.

Sometimes this caution leads us to make what may appear to be errors of omission. We considered Nvidia 2 or 3 years ago. Our observation at the time was that we did not understand it well enough, making it difficult to estimate a valuation 5 years into the future. So we decided to pass. However, at the time of writing these lines, Nvidia has the wind in its sails, and has just surpassed the stock market value of Alphabet. It can be difficult to maintain discipline when it comes to your circle of competence!

Source: Tikr

Charlie Munger is also known as a man who does not mince his words, here is what he said about people who try to predict the economy and financial markets:

"People have always had this craving to have someone tell them the future. Long ago, kings would hire people to read sheep guts. There's always been a market for people who pretend to know the future. Listening to today's forecasters is just as crazy as when the king hired the guy to look at the sheep guts."

Articles offering economic forecasts attract many readers. However, they can sow fear and negatively affect investors' decisions.

In recent years, many recessions have been predicted by economists, but they have not occurred. We invite you to consult this link which lists all the recessions that were predicted for 2021 and 2022 in the United States. None of them came to fruition and many investors missed out on return opportunities by withdrawing their investments from the markets.

Since it is unfortunately not possible to predict the economy, we prefer to focus on the study of individual companies. We verify that the companies in our portfolio can weather turbulent periods. We believe that it is more favourable to invest in a company for the long term, rather than trying to predict the future of the economy and constantly adjusting our portfolio accordingly.

"The big money is not in buying and selling, but in the waiting." -Charlie Munger

Here's one last quote from Charlie Munger, which explains our point about volatility quite directly:

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"If you are not willing to react with equanimity to a market price decline of 50%, two or three times a century, you're not fit to be a common shareholder and you deserve the mediocre result you are going to get compared to the people who do have the temperament..."

Results of our companies

Meta and Alphabet

The last quarter of the year was simply spectacular. Meta grew its profits by more than 200%, with revenues up 25% (22% in constant currencies). Last year, founder Mark Zuckerberg declared that he would make 2023 the year of "efficiency." After hiring heavily in the pandemic years, during which technology companies competed with each other for the best employees, a return to equilibrium was necessary. Management has really taken action, reducing its workforce by 22% over one year.

The combination of increased revenue, lower expenses and even a lower tax rate produced an exceptional profit. Operating margins have exceeded 40% over the last two quarters. However, if it were not for the losses caused by their Reality Labs division, profits would be almost 30% higher. The significant investments made in this division are necessary to build a long-term ecosystem, where Meta can reduce its dependence on the giants Apple and Alphabet for the distribution of its services. However, at any time, management could reduce or temporarily cease these investments to pursue other opportunities if it deems it appropriate.

For the first time in its history, Meta will pay a dividend. An additional share buyback program of US$50 billion was also announced.

As for Alphabet, revenues grew by 13%. YouTube has started to accelerate its growth again, with a 15% increase, while Google Cloud continues to perform well by growing 26%. The profitability of this last segment is still improving, with a 9% operating margin. However, much remains to be done to catch up with the leader, AWS, whose operating margin is 30%.

Despite the good results of these two companies, their stock prices are still far from the valuations we think they deserve.

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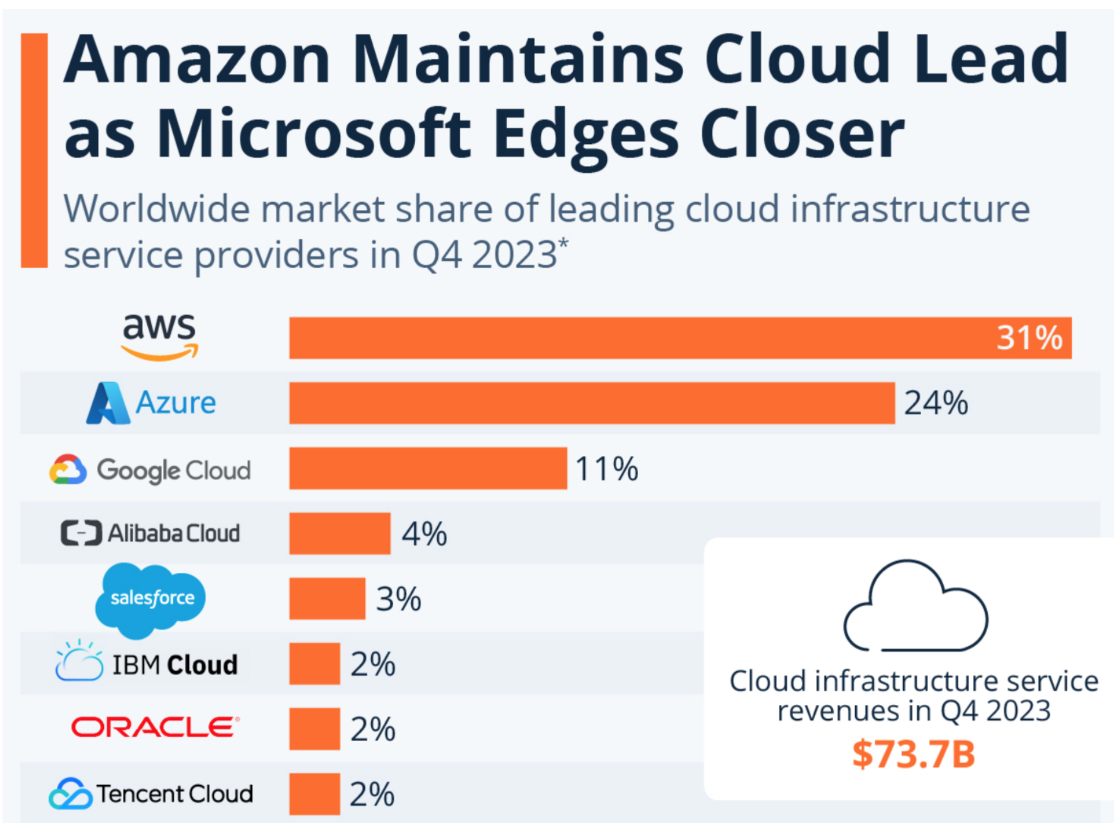
Microsoft and Amazon

Microsoft's revenues grew 18% last quarter, and profits rose 33%. With the recent stock market surge, the company now has the largest market capitalization globally, at over US$3 trillion, surpassing the former leader, Apple. Even taking into account currency fluctuations which added 2% to results, such growth is impressive for a company whose revenues reached approximately US$250B on an annualized basis, with operating margins of 45%. We believe that artificial intelligence will help maintain some growth for years to come. Ece Kamar, director of research at Microsoft, said this in a podcast in April last year: "*I saw some mind-blowing capabilities that I thought I wouldn't see for many years to come.*"

Azure and the cloud division saw their sales increase by 30%. In terms of market share, Microsoft is getting closer to the leader, AWS:



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Netflix and Spotify

The growth in the number of users continues for these two streaming giants. Netflix had more than 260 million subscribers at the latest results, an increase of 12.8% compared to a year earlier.

(in millions except per share data)	Q4'22	Q1'23	Q2'23	Q3'23	Q4'23	*Q1'24 Forecast*
Revenue	$7,852	$8,162	$8,187	$8,542	$8,833	$9,240
Y/Y % Growth	*1.9%*	*3.7%*	*2.7%*	*7.8%*	*12.5%*	*13.2%*
Operating Income	$550	$1,714	$1,827	$1,916	$1,496	$2,420
Operating Margin	*7.0%*	*21.0%*	*22.3%*	*22.4%*	*16.9%*	*26.2%*
Net Income	$55	$1,305	$1,488	$1,677	$938	$1,976
Diluted EPS	$0.12	$2.88	$3.29	$3.73	$2.11	$4.49
Global Streaming Paid Memberships	230.75	232.50	238.39	247.15	260.28	
Y/Y % Growth	*4.0%*	*4.9%*	*8.0%*	*10.8%*	*12.8%*	
Global Streaming Paid Net Additions	7.66	1.75	5.89	8.76	13.12	
Net cash provided by operating activities	$444	$2,179	$1,440	$1,992	$1,663	
Free Cash Flow	$332	$2,117	$1,339	$1,888	$1,581	
Shares (FD)	451.6	452.4	451.6	450.0	444.3	

Source: letter to shareholders from the Netflix website, 4th quarter 2023

In 2022, the company announced a new subscription plan with ads, at a reduced price. This offer is now very popular and helps attract new subscribers. In the last quarter alone, the number of subscribers to this plan increased by 70% compared to the 3rd quarter of 2023.

Last January, Netflix announced a new agreement with WWE, the famous professional wrestling organization, at a cost of US$5B. Starting in January 2025, Raw shows will be shown exclusively on Netflix, and for the first time in 31 years, WWE shows will no longer be available on linear television. On average, Raw wrestling attracts more than 1.5M viewers each week on the *USA Network* channel and it will now be presented live on Netflix.

At Spotify, the number of monthly active users reached 602 million in Q4 2023, an increase of 23% compared to last year. The number of paying subscribers increased by 15% compared to 2022, reaching 236 million.

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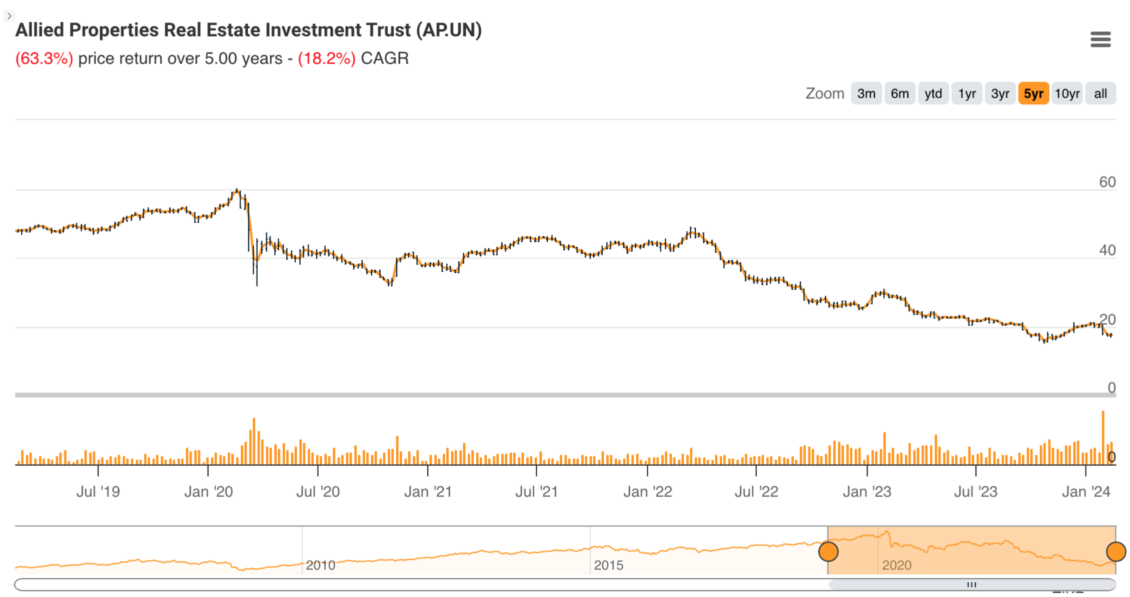
Like Netflix, the music company also signed an important agreement at the start of the year. At a cost of $250 million, Spotify will retain its license to distribute "*The Joe Rogan Experience*." It is the most listened to podcast in the world, averaging 11 million listens per episode.

Unlike the first contract, Joe Rogan's podcast will no longer be exclusive to Spotify. It will be available on other platforms, but Spotify will control the ads. With a larger audience, the company is banking on higher advertising revenue. During the latest earnings call, CEO Daniel Ek said that the exclusives ultimately had a positive impact on the platform, but that the opportunities on the advertising side would be more interesting.

Canadian Real Estate

We started investing in real estate! Rising interest rates have created some opportunities in the commercial sector, particularly in office spaces.



Source: Tikr

We acquired units of Allied Properties. Ironically, this is the landlord for our office. So we've had a taste of how they operate. As we can see above, the pandemic had a negative impact on the stock at the start of 2020, causing it to lose around a third of its value. The final blow came in 2023, when interest rates rose and stayed elevated. At $17 per unit, the stock pays an annual distribution of more than 10% (paid monthly).

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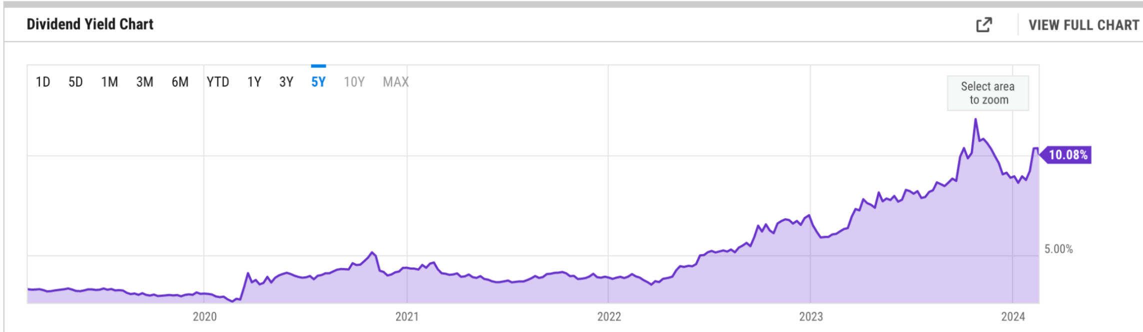

Source: YCharts

As we can see above, the yield is normally less than 5%. With the fall in the unit price, it's increased proportionally. Too often, when the yield becomes very high, it is a sign of weakness. The danger in most of these situations lies in the company's financial condition. We need to make sure it generates enough cash to cover this payment, even in a recession.

Currently, the distribution ratio corresponds to 80% of cash generated by operating profits before amortization. We would be concerned if this ratio reached 100% or more. The financial statements show losses for recent quarters, given the application of IFRS accounting standards which are required for Canadian companies. In the United States, real estate investment trusts (REITs) systematically amortize the cost of their buildings. In Canada, the value of buildings must be reviewed on a regular basis. Consequently, this creates accounting profits in a real estate boom, and losses when the sector experiences a downturn. As a result, we attach little importance to the book value on the balance sheet. We rely more on current and expected rents, as well as the company's ability to manage its debt.

We talked about Canadian real estate for a long time in our earliest letters to investors. Now we've finally made our first investment. Normally we are rarely interested in REITs. This type of vehicle is mainly aimed at investors looking for income. Although the distribution yield may be attractive compared to other types of investments, we believe that the overall yield (distribution and capital gain) does not sufficiently compensate for the risks involved in the majority of cases. Real estate is an asset class sensitive to economic cycles. The return should compensate for the risks of recession or rising interest rates, as we are experiencing at the moment.

The stock touched $60 in 2020, and is trading today at $17. Distribution income will never compensate for such a drop, for those who rely on it and may need liquidity. Conversely, investors who buy into the stock at the current price benefit from the potential for a large capital gain, while earning a higher income in the meantime.

At a 10% distribution rate, we receive income equivalent to the long-term average stock market return. As for capital gain, we believe that a 100% gain in the short to medium term is not an unreasonable expectation. If the stock returns to $30 (half of its previous high), the distribution yield will be approximately 5%. Such a scenario would be possible in a context where interest rates began to fall.

Note also that the office rental sector is suffering from a higher than usual vacancy rate since Covid, and that employers are increasingly encouraging their employees to return to offices. We therefore have two factors that would help the stock rise: a drop in interest rates as well as the rise in the occupancy rate. We could also add a 3rd factor: distribution. At a 10% yield, it is clear that investors fear a sharp deterioration in the sector. If these fears fade at all, the yield will once again attract income investors.

Conclusion

We hope this financial information has been useful to you.

We would like to take this opportunity to thank you for your trust, for your collaboration in the annual update campaign and for your participation in large numbers at the annual meetings.

We look forward to seeing you in June 2024 for the next meetings.

Sincerely,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière

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