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2018 Semi-annual letter

Barrage Fund

Management report

For the 6 month period ended June 30 2018, the S&P/TSX posted a return of 1.94% (including dividends) while the S&P 500 generated a return of 7.74% (in Canadian dollars and including dividends). For the same period, the Barrage Fund produced a return of 11.56% before fees and 9.31% after fees.

Since inception in 2013, the fund's annualized return has been 20.76% after fees. The fund has been fully invested for about a year and is composed of a dozen securities. As far as hedging the US dollar is concerned, we have now hedged about 50% of our exposure.

The S&P 500 index generated strong performance for the first half of 2018. As for the Canadian index, although its return has been lower, it has not gone into the pessimistic scenario we have long feared.

Since the Fund opened in March 2013, the annualized return of the S&P/TSX remains below 8%. This is respectable performance, but when compared to the 19% generated by its US "equivalent" over the same period, it highlights the significant opportunity cost for investors who would have preferred Canada to the United States since the crisis.

A small difference that makes all the difference

Suppose that two stock indexes produce returns whose difference is only 3% or 4%, what would be the magnitude of the impact to the investor in the long term? Let's use an example with a difference of 3%. Such additional performance may seem rather thin at first glance. Over a long period of time however, this difference does wonders to a portfolio. Over a 25 year period, a 15% return will add up to 33 times the initial bet, versus 17 times for a 12% return. Although in relative terms, the former yield is 25% higher, the final result is almost twice as much at the end of the period. A $100,000 portfolio would end the period at $3,300,000 instead of $1,700,000.

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Surprisingly, comparable results will be achieved using much smaller returns, such as 3% and 6%. In both cases, we get about double the original amount. In other words, in the long run, generating a few more percentage points of yield actually has a big impact on a portfolio.

Value vs growth

For about two years now, an idea has been circulating in the investment world that the "value" style of investing is out of favour, unlike the "growth" style which has gained in popularity. This type of distinction is confusing, since everyone has their own interpretation of what these styles imply.

But at Barrage, we do not make this distinction. Bargains can be present in both high-growth and mature companies. The value of an enterprise is the free cash flow it will generate in its lifetime, discounted to the present time. If the enterprise grows quicker, we will be willing to pay a higher price-to-earnings ratio. The problem lies in the perception of some investors that the price of a high-growth company is a more or less unimportant factor. Should we pay 30 times or 100 times earnings for high growth prospects?

Of course, even by paying 100 times earnings for an extraordinary company, the investor could make a profit over time. So, why linger over the price, if it's just a matter of time? If profits increase fivefold after five years, the price/earnings ratio will decrease to 20 times the initial price paid.

Such reasoning has a major disadvantage: these future earnings are not guaranteed. Should the company’s prospects be just slightly less than anticipated, a temporary or permanent loss is to be expected. In other words, ignoring the price ignores the margin of safety, which is supposed to protect us in the event of a negative scenario.

Growth stocks do not escape this reasoning, regardless of the forecast. When we find a security for which we expect 40% growth over several years and a fairly high rate in subsequent years, we calculate the present value of the expected cash flows. If our estimate is 35 times earnings, we will naturally want to pay less than 35 times. Thus, even at 25 times, the purchase can lead to a bargain, while for a security with much less interesting prospects, such a ratio would indicate a clear overvaluation.

Has the “value” style become obsolete? This idea seems absurd to us. Buying shares at a discount to intrinsic value will forever be a winning strategy. For many managers who call themselves "value", a stock trading at 20 or 25 times earnings can not be included in the bargain box. Yet, the crucial point is the *relative* value. At Barrage, we prefer to buy stocks that are worth 35 times earnings at 20 times, rather than 6 times if they are only worth 7. Our largest positions in the portfolio reflect this logic. The idea that we have now opted for a growth strategy, regardless of the price paid, is far from the truth!

Amazon

Here is a practical example of applying the “value” style on a stock that many experts and investors consider foreign to value investing, arguing that it is a growth stock.

Beginning in June 2017, we gradually built our position in Amazon. We used cash flow calculations for our valuation. Given the philosophy of founder Jeff Bezos, who prioritizes the reinvestment of profits to grow the firm, cash flows were more reflective of profitability.

Our estimate of intrinsic value was 40 times these cash flows, and we built our position at a price of 28 times, around $1000 per share. The stock, having appreciated to close to $1600 a few months later, was sold to seize other opportunities. The sale was made at a valuation of about 36 times.

In our opinion, we applied a value strategy on Amazon, based on our intrinsic value estimate of 40 times cash flows. We believe that all securities, regardless of their growth prospects, should be subject to the same rigorous valuation process. Without this discipline, there are no benchmarks for when to buy and when to sell. How do you know if a stock has become overvalued if you do not know its value?

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Our portfolio holdings

Facebook

This social networking giant is our biggest position. We had a weighting of about 5% prior to the Cambridge Analytica scandal, which occurred on March 19, 2018. After examining the facts and the probable impact of the scandal on the sustainability of the company, we seized the opportunity to substantially increase our investment, at prices ranging from $150 to $165. Compared to our intrinsic value estimate of $320 it was obvious that it was an extraordinary bargain. We think that the reaction of the markets following the scandal was exaggerated.

The results of the first quarter of 2018 have thrilled us. Earnings per share rose 60%, while operating margins improved from 41% to 46%.

We see a lot of growth in the long run. Average revenue per user ("ARPU") grew from $ 4.23 to $ 5.53 worldwide. In the United States and Canada, this figure reached $ 23.59 for the quarter ended March 31, an increase of 38% YoY. In Europe, this figure is almost three times lower, allowing us to hope for significant growth in the coming years. It should be noted that 3 years ago, the "United States/Canada" segment was at the same level that Europe currently is. When we look at Asia-Pacific data ($ 2.46, almost 10 times less than America), it's easy to see that Facebook has great potential for monetizing its platforms.

A significant part of these numbers come from the Facebook platform. Bear in mind that the Instagram and Messenger platforms are just starting to generate revenue for the company.

Ironically, following the Cambridge Analytica scandal, several users have disclosed their intention to change platforms, from Facebook to Instagram. If this is the case, the company then recovers in one hand what it loses in the other!

A business model unlike any other

Our 4 most important positions, Facebook, Alphabet, Naspers & Apple, possess particularly enviable business models. These companies benefit from an infrastructure whose costs are almost nil: the internet. Most companies must invest time and capital to further their growth. For example, a restaurant owner must find or approve the location of her future branches, provide funding and ensure that managers and employees abide by the company's rules and procedures for a consistent customer experience, not to mention all the advertising required to promote the brand.

A company like Facebook has an infrastructure that is already in place, as if the restaurants were already built and ready to operate. Facebook can then manage its platform remotely and at low cost. Each new user does not incur additional expenses. It can therefore expand its territory around the world without worrying about having to obtain additional capital. As a result, there are virtually no barriers to growth.

When General Motors faces increased demand for its sport utility vehicles, it must consider training new employees, converting its existing plant or creating a new one. Therefore, just as Tesla is currently experiencing, it can be very difficult to adjust to high demand. Conversely, a plan must be in place in response to a sudden drop in demand. That is why, even when these companies are doing well, their debt levels must be constantly monitored, due to the fact that in order to meet their capital expenditure requirements, manufacturers often resort to debt.

A company such as Facebook or Alphabet does not have this kind of problem. This is why more often than not, their balance sheets must bear the weight of....massive liquidity! While these companies generate huge profits, they have to decide where to invest all this money, given the low cost of their growth.

In light of all these facts, we are prepared to pay a higher price than for other companies that do not enjoy the same benefits.

Alphabet and Apple

We have significantly increased our weight in Alphabet, encouraged by the good results and its ever-growing dominance in online advertising. As for Apple, we have continued to hold the stock since 2013, while taking advantage of fluctuations to increase or decrease the position, which now ranks 3rd in the portfolio. The company continues to perform well. Since 2013, our estimate of its value has been revised upwards. It is now $255.

Naspers

This is a new position in the fund. This South African company has existed since 1915, and initially evolved as a publisher and printer of newspapers and magazines. Today, Naspers has become a multinational company that invests mainly in companies that profit from the development of the internet like Mail.ru in Russia (email and other), DeliveryHero in Germany (meal delivery) and Flipkart in India (a competitor to Amazon). Please note that their stake in Flipkart has just been monetized, generating a profit of USD 1.6 billion for Naspers.

The biggest investment of the company is its stake in the Chinese internet company, Tencent. In 2001, the firm acquired 46.5% of the shares of what was then a small Chinese company. This USD 32 million investment is now worth USD 145 billion. This is after having sold 2% ownership of Tencent for nearly USD 11 billion. However, the market capitalization of Naspers is only USD 110 billion!

This means that investors enjoy a 25% discount on their investment in Tencent, in addition to owning all its other entities for $0. Note that we believe that a sale of the Tencent shares would involve little tax liability, despite the large capital gain that would be realized. However, after selling shares for the first time recently, management has indicated that it would not reduce its position for at least another 3 years. As a result, Tencent will continue to be Naspers' main investment.

Tencent is a diversified company in several technology sub-sectors. It is the largest gaming company in the world. It is compared to Facebook in America, since it owns the platform WeChat, used by about a billion Chinese people. However, WeChat is much more than a social network, it allows its users to make online payments, play games, among many other features. In China, some call it the "App for everything".

Just like Facebook and Alphabet, we see high growth for several years for this company. Nevertheless, we remain cautious in the weighting we attribute to Naspers' shares. China is still a communist country. The internet giants of this great country, such as Alibaba, Baidu and Tencent, are navigating in the direction desired by the Chinese Communist Party. Any disapproval from the Party could seriously affect the businesses of these firms.

AIG

We have held this insurer for a few quarters while the new leader, Brian Duperreault, continues the transformation of the company. Since taking office a little over a year ago, Mr. Duperreault has hired 14 new people in key positions, which should significantly improve insurance underwriting and future profitability. So far, the changes have shown little improvement over past results, but with a little patience, the changes are expected to pay off. At the current price of $ 55, we arrive at a 40% discount to our estimate of intrinsic value.

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Administration

The Barrage Fund ended the first half of 2018 with a net asset value of $200.91 per unit.

Best Regards,

Patrick Thénière

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