barrage capital

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2019 Semi-Annual Letter

Barrage Fund

Management Report

For the 6 month period ended 30 June 2019, the S&P/ TSX posted a return of 15.70% (including dividends), while the S&P 500 returned 12.90% (in Canadian dollars and including dividends). The performance of the Barrage Fund for the same period was 20.89% before fees and 19.33% after fees.

Since the fund's inception in 2013, its annualized return has been 17.70% after fees. At the time of this writing, the portfolio is comprised of 10 stock and has a 13% cash position.

The S&P 500 index continued its good performance during the first half of 2019, which has resulted in an exceptional annual compound return over the past 6 years. In the midst of these good results, we have to acknowledge the drop in US corporate tax rates, from 35% to 21%, which has contributed in part to the extension of the bull market.

Will we experience a recession soon? As usual, we remain silent on the subject. However, we know one thing: sooner or later it will happen, and we are closer to it than before. Only 6 months ago, investors were very worried about the specter of economic decline. After a stock market jump of nearly 13%, the subject is no longer in the news. Yet this risk is still there!

The dismantling of our businesses: a threat?

Massachusetts Senator Elizabeth Warren has declared war against the big corporations of this new era. She has said that if elected president in 2020, her administration would breakup Amazon, Facebook and Alphabet. For example, Facebook may have to divest the WhatsApp and Instagram platforms. After this separation, these entities would compete with each other, ending the concentration of power in the hands of a single company.

First of all, if such an eventuality comes to pass, it could be a long time before its execution. Secondly, we can take a look at history to form an idea about the ultimate outcome of a threat like that.

By the end of the 19th century, John D. Rockefeller had to face similar pressures. There was a lot of frustration in the air that eventually led to the breakup of his company, Standard Oil. Ida Tarbell was one of the first journalists to report on that era. Like many other oil producers, her father had been ruined, unable to compete against the undisputed leader in the industry. She wrote 19 articles and a book on the subject that was published in 1904. Everyone pointed to Standard Oil which, at its peak, controlled about 90% of the entire market. As the company generated remarkable profits, it ensured its domination, spreading its activities to railways, gas and electric lighting.

It was only many years later, in 1911, that the famous dismantling occurred. Standard Oil was broken up into....34 companies! What was the result for John D. Rockefeller, the biggest shareholder? While enjoying more than a decade of retirement, and playing golf regularly, his shares doubled. If that was his eventual outcome, we can easily imagine worse situations! Former US President Theodore Roosevelt had fought for many years against monopolies. Frustrated with the result, he declared that the Wall Street prayer was: "Oh Merciful Providence, give us another dissolution!"

Today, Standard Oil is gone. But its breakup gave birth to the following companies whose names we know today: Chevron, Mobil, Marathon and Amoco. They have prospered for decades.

Looking at companies that are currently benefiting from the digital revolution, we do not see why a similar scenario would prove any different. Far from fearing a dissolution in the case of Facebook or Alphabet, we welcome this event with a certain indifference. Indeed, we believe that the divisions of these companies would be given more value on the stock market separately than together. For the "value" investors that we are, this scenario does not worry us much.

However, we do not consider it likely that such a breakup will occur. In France, a bill aimed at a 3% tax on GAFA revenues (the acronym referred to here represents Google, Apple, Facebook and Amazon) has just been approved. France hopes to raise 400 million euros annually with this project.

In Europe, where the GAFA stocks are heavily criticized and subject to new regulations, in May 2018 we witnessed the introduction of the General Data Protection Regulation (GDPR). So far, we have seen mixed results. For Facebook, the results for the first quarter of 2019 have been encouraging. In Europe, despite this new measure, the number of users has increased by approximately 2%, while the revenue per user (ARPU) has increased by around 18%.

Ironically, many of the rules put in place could strengthen the competitive position of our companies. More is being done in response to the many criticisms of the videos/content on social networks and data protection standards. The companies are also investing in artificial intelligence to review content and increase the level of security. These expenditures are in the billions of dollars. With such high fixed costs, it's difficult for a competitor to carve out a place among the tech giants. Hell is paved with good intentions: governments want to limit the power of these gigantic companies, but the means to achieve it has created a competitive gap that could ensure their domination for a long time.

Avoiding mistakes: more important than making the right moves

What return should be made to recover an 80% loss on a security, using the same capital? It takes nothing less than 5 times the remaining capital, or a 400% return. As "value" investors, we strive to abide by Warren Buffett's first two investment rules:

Rule # 1: Never Lose Money.
Rule number 2: Never forget rule number 1.

We have seen an extended appreciation in stock market values since the financial crisis of 2008, coupled with the technological upheaval created by the ongoing development of the internet. As a result, in recent years, the portion of the market that has not experienced this appreciation has become infested with value traps. However, little by little, they are disappearing, as the allure of low prices of these stocks gives way to harsh realities. Bed Bath & Beyond is probably an example.

At the time of writing, the company announced comparable sales were down 6.6%, 2.8% worse than expected. Five years ago we wondered about the future value of this company. Growth slowed significantly, rising 1.7% in the second quarter of 2014. Comparable sales were up only 0.4%, and profits were down. The stock market price had become interesting, something that rarely happens with a company that has performed so well in the past. From 1993 to 2013, sales grew by 22% per year on average. The company aggressively bought back its shares. From 2011 to 2016, Bed, Bath & Beyond spent a total of US $7.5 billion for this purpose (between $40 and $77 per share), compared to its profits, which totaled US $5.6B.

However, we had doubts about the return of growth. Would the company weaken in the transition to online shopping? Was the particular nature of its goods (fabrics, curtains, towels, blankets, etc.) more immune to a change in the habits of consumers, who often wanted to touch the product before buying it?

A few years later, the stock is now at a fraction of its value, trading at $11. Competition intensified, effectively undermining sales growth. Activists are trying to force a turnaround at the company, changing its strategy and its leaders. Obviously, the higher stock price in the past few years did not reflect this scenario. The stock seemed like a bargain at $60. This kind of mistake produces disasters in a portfolio, and without claiming to be able to avoid all of them, we try to minimize them at all cost.

Alphabet and Facebook

We were pleased with the results announced by Alphabet, despite a drop in first-quarter profits. They were affected by a penalty of US $1.7 billion, handed out by the European Union. The company was criticized for abusing its dominant position in its negotiations with AdSense partners. Google Adsense is a monetization program for website publishers. This was the 3rd penalty in 3 years. Last year, the target was its dominance in mobile, and the year before, it was criticized for manipulation of online shopping search results. The sum total of these fines is US $9.3 billion. Note that two of these cases are currently on appeal.

These attacks by regulators confirm one thing: Alphabet enjoys a sustainable dominant position, without having to spend large sums to stay at the helm of its industry. If it were not the bad press from its many critics, the stock would probably trade at a much higher price. The company's sales grew 19% (with no currency effect) in the last quarter, annualized cash flows are approaching US $50 billion, and the company has more than US $110 billion in liquid assets on the balance sheet.

The cloud division continues to contribute to its growth. Alphabet remains the no. 3 player, far behind Amazon and Microsoft, but this division reportedly recorded a revenue increase of 83% in the first quarter, which brings it ever closer to its competitors.

As for Facebook, without surprise, its profits were affected by the large investments planned for strengthening security and safety, as well as by a charge related to the investigation by the FTC (Federal Trade Commission). The company predicted a cost of US $3 to $5 billion, and therefore recorded a charge of US $3 billion in the first quarter.

Just recently, the final amount was disclosed, and set at US $5 billion. This will result in an additional charge of US $2 billion for the second quarter that has just ended. This is obviously a one-time cost. Add to this the significant investments in security and safety that have increased the number of employees by 36% over the past year, we can understand why profits fell by 51%, while sales grew by 30% (excluding currency effects).

From now on, we expect the return of profit growth. The company will benefit from economies of scale in its investments, and non-recurring expenses should be less significant in the future.

Amazon and the Innovator's Dilemma

The stock is back above the $2,000 mark, after hitting a low of about $1,350 in December of last year. This opportunity allowed us to become shareholders again (long live the fears of recession!). As the shares have risen sharply in the last 6 months, we have already begun to reduce our position, despite the excellent results in the last quarter.

Sales grew by 19% (excluding currency effects), and free cash flow by 32%. Amazon Web Services (AWS) sales contributed strongly to growth, with a 41% increase. Although our weighting in the portfolio is adjusted according to the valuation of the security, our interest in the company remains the same. Amazon is full of useful lessons for the investor, especially in this present era, where many industries are being disrupted.

The founder and CEO, Jeff Bezos, was heavily inspired by a particular book: The Innovator's Dilemma by Harvard professor Clayton Christensen. This 1997 book explains the fundamental difference between sustaining innovation and disruptive innovation.

Sustaining innovation stems from a natural reflex. A company designs a product and constantly strives to improve it. This contributes to the increase of its sales. Its shareholders continue to be enriched, and customers benefit from a strong product. Everybody is happy.

Disruptive innovation happens when a dominant technology ends up being replaced by a new product or service. This type of innovation does not usually provoke the same reflex. The case of Kodak is a good illustration of this idea. In the 1970s, this company literally dominated its market in the United States. In 1975, they invented the digital camera. What did they do with this invention?

Kodak responded as many companies react when they find themselves at the front of the pack for a long time. To see the photos, you had to connect the camera to a television. "No one will want to look at pictures on a television screen," said the management. They quickly used this explanation as an excuse to not push the new product. In reality, this invention had been perceived from the outset as a threat. Kodak generated money throughout the photo process: it held 85% of camera sales and 90% of the film sales. Why cannibalize a machine that was so well oiled and lucrative?

This decision left the door open to competitors, such as Sony and Canon. When Kodak decided to catch up in digital, it was already too late. In 2012, the company declared bankruptcy. Amazon on the other hand, wants to avoid becoming the next "Kodak" at all costs. About 15 years ago, Jeff Bezos came into the office of Steve Kessel, one of his top executives, and gave an order: "I want you to proceed as if your goal is to put everyone selling physical books out of a job!"

This is how the idea of developing a digital reading device, the famous Kindle, was born. Amazon's executives were frightened to suffer the same fate as the music industry, where the Apple iPod had created disruption. Amazon had become an undisputed leader in the sale of physical books. The shift to digital technology in books would sooner or later become a major threat. With the dilemma of the innovator in mind, Jeff Bezos did not hesitate to try to cannibalize the sales of his own company.

As Christensen said in his book, adopting disruptive technology can be costly for a company, but ignoring this technology can be much more expensive. It is in this spirit that Amazon has adopted a culture of innovation, which has led it to think long-term and take the lead in a new sector. AWS is a good example of the application of this approach, which has been admired by Warren Buffett. In 2017, he said this about AWS: "Bezos thought he would have 2 years of runway. He got 7. You do not want to give Jeff Bezos a seven-year head start."

Apple

This company has almost always been in our portfolio since the fund's inception. We rigorously apply our philosophy by adjusting our target weight constantly. The scandal at Huawei and fears of a recession had created an opportunity to buy new shares at attractive prices. We reduced the position when the stock appreciated quickly.

We have become more cautious about the prospects of the company. Despite the impressive effort devoted to creating recurring revenues through the various services (App Store, Apple Music, iCloud, license revenues, etc), sales of cell phones remains an important segment. More than 80% of total sales come from products (including the iPhone), which requires a lot of innovation to continue growing. With the death of Steve Jobs and the recent departure of Jonathan Ive, a major contributor to the design of Apple's success, the challenge is higher than before. We also see the possibility of saturation in the markets served by Apple. Although still optimistic about its future, we revised its value, somewhat reducing our estimate of the stock market discount.

Administration

Barrage Fund Net Asset Value

The fund ended the first half of 2019 with a net asset value of $200.86 per unit compared to a value of $168.32 as at January 1, 2019.

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Online statements

We remind you that CIBC Mellon, the Barrage Fund administrator, now provides online access to your monthly statements and tax slips. If you have not done so already, we invite you to sign up for this free service and optionally stop receiving statements by mail.

Enhanced Statements

In an effort to continually improve our service offering, in conjunction with CIBC Mellon, we are making a few changes to the monthly statements for your accounts held with Barrage Capital. In particular, "Net Deposits" and "Gain/Loss" columns will be added to the current format of monthly statements. The purpose of this amendment is to provide more clarity about the amounts invested and the total gains from these investments. For example, prior to this amendment, the investor had to deduct the amount received in distributions from book value in order to calculate their gain. We are waiting for this new statement format to be introduced in the fall.

Annual Meeting of Unitholders

Once again this year, the annual meetings of the Barrage Fund unitholders held in Montreal and Québec City were a great success and the Barrage Capital team was delighted to have met many of you.

The Montreal meeting was held at full capacity (100 guests) and more than 50 people attended the Quebec meeting (a record). We wanted to thank you for making this event such a great experience and we can not wait to see you there next year!

In closing, we thank you for your confidence in Barrage Capital. Your managers and the administrative team work in your best interests to provide you with an enriching value added.

Sincerely,

Patrick Thénière

Rémy Morel

Mathieu Beaudry

Maxime Lauzière