barrage capital

15 July 2021

2021 Semi-Annual Letter

Barrage Fund

Management Report

For the period of January 1st to June 30th 2021, the S&P/TSX posted a return of 17.28% (including dividends) while the S&P 500 returned 12.03% (in Canadian dollars and including dividends). The Barrage Fund's performance for the same period was 12.61% before fees and 10.60% after fees.

The Barrage Fund ended the first half of the year with a net asset value per unit of $295.64, from a starting point of $267.30 on January 1, 2021. The annualized return of the fund since inception in 2013 is 18.54% after fees. At the time of writing, the portfolio consists of 8 stocks, with a negligible cash position.

In place of holding an annual meeting this spring, we invited our clients to send questions to be answered in this letter. Among the questions submitted to us, we were asked why the fund has underperformed the indices since the start of the year.

The table of returns are reproduced below:

Year	Barrage	S&P/TSX	S&P 500*	U**
2013 (10 months)	28.48%	9.92%	28.08%	
2014	24.38%	10.55%	23.81%	
2015	0.79 %	-8.37%	21.65%	A
2016	42.03%	21.17%	8.21%	
2017	9.28%	9.02%	13.66%	A
2018	-6.06%	-8.854%	4.15%	A
2019	26.10%	22.64%	25.13%	
2020	25.93%	5.61%	16.32%	
2021	10.60%	17.28%	12.03%	AC
Average	18.54%	8.91%	18.21%	

** All returns converted to Canadian dollars*

*** U (underperformance) against the S&P 500 (A) and against the S&P/TSX (C)*

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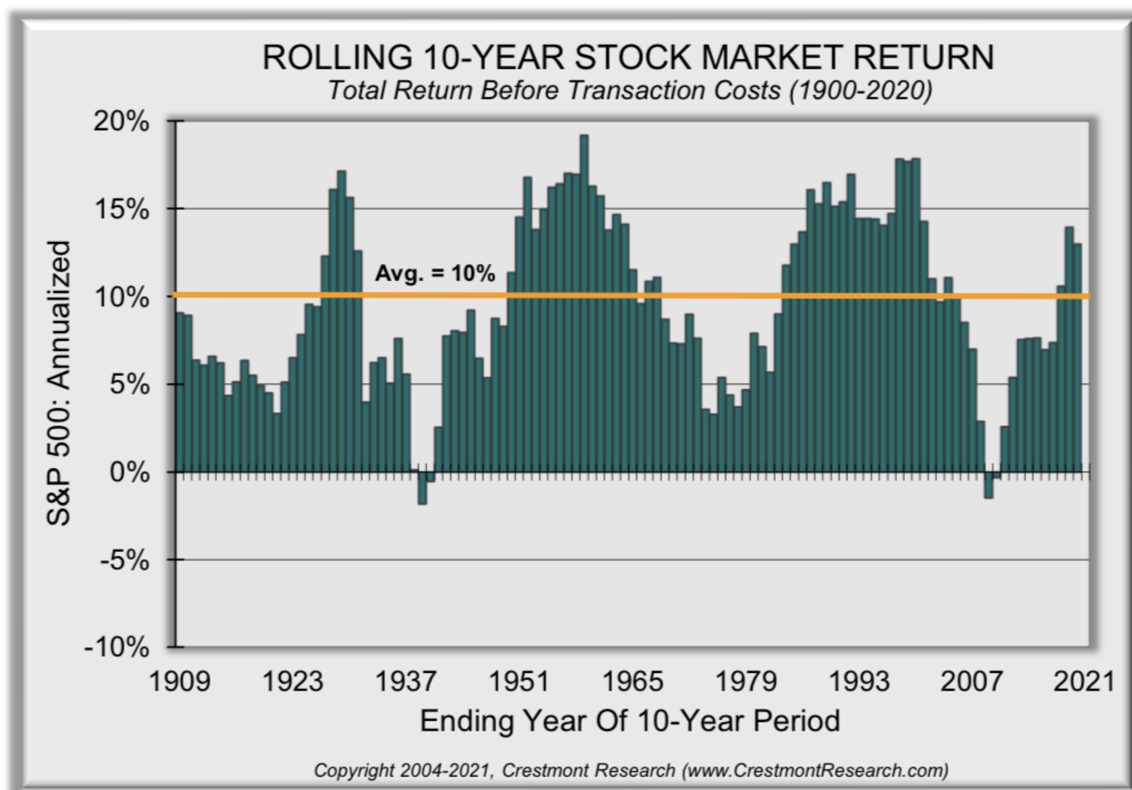
Over the past 8 years, the fund underperformed the US index for 4 years, or 50% of the time. Yet the compounded return during this time has been similar, exceeding 18% in both cases, and this is only a coincidence.

As for the divergence of returns from year to year, it simply means that the fund does not resemble the makeup of the index. We do not have positions in all sectors of the stock market, and we clearly favour some of them, such as online advertising.

With such high returns for an index, one might be tempted to conclude that investing passively is enough to achieve superior returns. The following graph, taken from the Crestmont Research website, shows the rolling 10-year performance of the S&P 500, at various times from 1909, through 2020.



These returns are in US dollars and do not take the variation of the Canadian dollar into account. In the long run, however, we believe that currency fluctuations are negligible. Also note that these returns include the reinvestment of dividends.

As we can see, investors have found themselves with negative rolling 10-year returns twice since 1909, in the 1930s and during the Great Financial Crisis of 2008. The patient investor knows that these types of situations are temporary. Time fixes everything!

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However, a few situations exist whereby the rolling 10-year returns exceed 17%, often leading to optimism among investors. Market participants, not having necessarily lived through or kept in mind the less prosperous periods, too easily forget that the historical average fluctuates around 10%.

However, a stock market drop of 22% in 2021 would reduce the 11 year annualized return to 10%. On the other hand, the return will fall to 0% with a 73% drop in the stock market. This is not a prediction of a stock market crash, but rather a simple observation of a possible return to the historical average. The markets could appreciate even more before giving ground. For example, the graph shows that by 1959 the 10-year rolling return had reached over 19%. If we take as a starting point the 9-year return on January 1, 2021, i.e. 15.3%, the index would need to rise 58% this year to end year 10 with an annualized return of 19%.

Practising the value investing style requires a lot of discipline, especially when the markets generate high returns over a long period of time. Bargains become harder to find, and it can become tempting to participate in the trends of the day.

These trends attract attention because of their spectacular nature. When they grow strong enough to influence markets (and in turn, the performance of stock indices), they overshadow more conservative ways of investing. Why go through so much trouble getting to know companies well when simply owning a cryptocurrency like bitcoin has brought a return of more than 200% per year since 2011? Imagine for a moment our underperformance if it had been included in the S&P 500 index!

A reader asked us whether the difference in returns between the fund and the indices since the start of the year was due to a change in strategy. The answer is no. Note that this underperformance should occur approximately one in three years, and more often in strong bull markets. If one day we are unable to find anything interesting to buy in the stock market, we would opt to stay on the sidelines, regardless of the present and future performance of the index. This could cause further moments of underperformance. Let us reiterate that our objective for the portfolio is based on limiting risk first, then long-term performance.

Learning From the Cultures of Our Companies

"Pierre, get over it. This is horrible. The last thing we would ever want to do is manage warehouses like this."[1]

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[1] *From the book "The Everything Store: Jeff Bezos and the Age of Amazon" by author Brad Stone (2013)*

The words are claimed to have been spoken in 1998 by eBay CEO Meg Whitman. Accompanied by the founder of the company, Pierre Omidyar, she had visited an Amazon distribution centre where new automation techniques were being developed. Omidyar looked impressed, but not Whitman.

Knowing how successful Amazon has been over the past 20 years, one would think that this negative comment about Jeff Bezos' initiative betrayed a lack of judgment or skill. Whitman, however, was able to increase Ebay sales from $4 million to $8 billion during the 10 years she spent as CEO.

These kinds of anecdotes remind us that no one is infallible. Just think of Warren Buffett, who preferred to invest in IBM rather than Alphabet 5 years ago. Any original idea is worth considering, despite the skeptics and risks. Jeff Bezos has successfully instilled a culture of innovation at Amazon. Through the essential elements of this culture, we find the taming of failure. Not only is it being considered, but Mr Bezos expects it. In other words, to be successful, you must first try. However, if failure is severely punished, it discourages initiative, depriving the company of new services or products that would have helped to strengthen its competitive advantages.

Amazon also believes that decisions should not be seen as irreversible. If the initial idea was not the right one, the project can be continued with a different idea, without the fear of seeing the venture cancelled. So it takes a great deal of open-mindedness, and we admire this culture, which has fostered the impressive rise of Amazon since its inception.

Ironically, we kind of borrowed a bit of that culture ourselves in order to see Amazon from a different perspective 4 years ago. For an investor, this translates into an ability to question themselves and reconsider an investment thesis. For a long time, after studying the world's greatest investors such as Warren Buffett, we have long viewed companies that generate little or no profit in a negative light.

Let's compare IBM with Amazon. In 2017, IBM posted average profits of US $ 12 billion per year over 5 years, compared to US $1.2B for Amazon. However, the market value of these two companies was US $160 billion and US $450 billion, respectively. At first glance, we see the enormity of the disparity in valuation: 13 times profits against 375 times. It is difficult to justify such a difference solely on the basis of just growth prospects! It was therefore necessary to be open-minded enough to look beyond the accounting profits.

At the time, Amazon was investing in the division that would ultimately become the most profitable within the company: AWS (Amazon Web Services). A large part of expenses were allocated to research and development, which resulted in considerable

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tax savings while creating a lot of value. So, on the one hand, we ended up with depressed accounting profits. On the other hand, we were investing in a segment that is worth around US $600 billion today, or 1.3 times the total value of the company 4 years ago! Its investors have been well rewarded: from 2017 to today, IBM's market capitalization has fallen by 20% while that of Amazon has quadrupled!

In the last quarter, Amazon posted total sales growth of 44%. Helped by the online transition due to the pandemic, sales in North America grew by 40%, and internationally by an impressive 60%. AWS, the division that is worth a fortune on its own, saw its revenue increase by 32%.

Following the end of the pandemic, the company predicts more modest results: 22% to 28% (in constant currency). We continue to believe that AWS is still a great growth engine for the company.

Questions from clients

For the remainder of the letter, we will follow up with direct answers to your questions. We will cover our other stocks through these answers.

What will be the potential impact of the following events on stock market:

- *the tax reform proposed by President Biden for corporations (tax rate from 20% to potentially 28%)?*
- *the management of debt which has gone out of control?*
- *the inflation rate rising sharply?*
- *the bond rate which increases by anticipation. Are we in the correction zone?*
- *the Canadian dollar reaching new highs*
- *are "green" companies the way to go in the future, from an investment perspective?*

First of all, we would like to stress that our investment strategy changes little or not at all depending on macroeconomic factors. A good, strong business remains that way in most economic situations. Because we are looking for stocks in companies that are conservatively managed, we eliminate a lot of risk.

For example, Facebook and Alphabet (Google) have US $84 billion and US $121 billion in liquid assets net of debt, respectively. They do not need external funding. One of the major risks associated with interest rates is the need to refinance debt when it comes due. Facebook and Google have enough cash to get through a severe crisis, without depending on anyone.

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We agree that US debt, as well as debt in general (sovereign, corporate and household) has reached elevated levels. The onset of high inflation is a risk, and we believe that our companies would then be able to increase prices in such an environment, which gives us some protection.

With regard to bonds, we have long believed that the return they provide does not compensate for the risk of inflation. However, we have no idea what will happen in the short to medium term, and to some extent, in the long term. If we've learned anything about macroeconomic predictions, it is that making them is enough to ensure that you are wrong from time to time. We prefer to be confident that regardless of the scenario, our portfolio companies will do well over the long term.

As for currency and interest rate risk, these are strongly mitigated by the high proportion of foreign revenues that our companies generate. For example, only 24% of Spotify's revenue comes from North America. Almost everything outside of the United States should be unaffected by the tax hike if it occurs.

Finally, we bring up the “green” companies that are currently popular. Most of our stocks would be perfect candidates. Netflix plans to become completely carbon neutral as of next year. As for Microsoft, it not only intends to become carbon negative by 2030, but also plans to have "withdrawn" all the carbon it has emitted since 1975 by 2050! Note, however, that we do not believe that our companies benefit from any valuation premium in relation to these efforts.

With all the reopening stock opportunities, none were selected and even after the partial sale of Activision, you invested in the same stocks. What makes you think diversification is not in order this year?

Let's go with an example. When Alphabet and Facebook announced their Q1 and Q2 2020 results, in the midst of the pandemic, we had very low expectations. The economy had been shut down by our governments, and most societies needed money to survive. Making deep cuts to advertising budgets would have been logical under these circumstances. However, Alphabet announced a 15% increase in revenues Q1, and 0% (constant currency) in the 2nd quarter. As for Facebook, its sales grew by 17% in the 1st quarter and 11% in the 2nd quarter of 2020.

The large advertising agency WPP posted revenues decreases of -3% and -15% for the same periods. However, we knew that it was much easier to cut an advertising budget with Alphabet and Facebook, since you can simply change the parameters in real time online (there is no multi-year contract). We were pleasantly surprised by the strength of

the results under the circumstances, and we therefore preferred to reinvest in our own stocks. Note that we were not disappointed with the recent results! In the first quarter of this year, we saw sales growth of 48% at Facebook and 34% at Alphabet.

As for the question of diversification, it should be noted that our companies already provide excellent diversification in terms of both their sectors of activity and their geographic territories. For example, owning Amazon means investing in retail, a retail platform, and cloud infrastructure. In the case of Netflix, 56% of its revenue comes from outside the United States and Canada. In the case of Facebook, it's 52%, and this figure is set to grow.

Several of our companies are also diversifying their activities. For example, Instagram (a platform owned by Facebook) CEO Adam Mosseri recently said, "*We're no longer a photo-sharing app…Let's be honest, there's some really serious competition right now. Tik Tok (owned by Bytedance) is huge, YouTube is even bigger, and there's lots of other upstarts as well…You will see us do a number of things, or experiment with a number of things, in this space over the coming months.*"

Instagram wants to focus its efforts on the following four elements: creators, video, shopping and messaging. Mark Zuckerberg recently gave an interview in which he foresees increased adoption of virtual reality products, which will allow people to meet remotely, and he believes that the signups for this kind of service will be comparable to the success of Peloton, the fitness bike company. Marketplace, the platform for sales and purchases between individuals, competes strongly with Craigslist and Kijiji. Diem, a stable value cryptocurrency will likely be released this year, and will replace the Libra project. The more time passes, the more our companies diversify in order to remain competitive!

What is the main attraction of Spotify? Although it is a popular service, it is not very generous with artists, it pays half as much as Apple. Podcaster Joe Rogan also strikes me as a ticking time bomb! What is your target price for this stock?

Following the significant drop in Netflix and Spotify, what do you think of the long-term prospects of these 2 stocks? Do you still have confidence in their respective business models?

We see similar business models in Netflix and Spotify. The first operates in video streaming, the second in audio streaming. However, Spotify is less advanced in the pursuit of its ambitions. It leads in the music business, with audio as the ultimate goal. Its founder, Daniel Ek, believes that it is necessary to stand out, and become a platform that offers more than just access to music. Spotify dominates the industry, with its 356

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million users. However, most songs can now be listened to through Youtube Music, Apple Music, and Amazon Music, making it a commodity. In aiming to become the leader in audio, Ek wants to create and acquire content that will remain unique and exclusive to Spotify. That's why he turned to podcasts.
Spotify will constantly seek to improve its offering, with better algorithms to bring music to the public on the one hand, and new tools for artists to create and distribute their music on the other. However, podcasts will allow the company to really stand out from its competitors. In the medium to long term, we believe that Mr. Ek will be able to find effective ways to monetize these podcasts, especially with advertising. We therefore have great confidence in management and believe that the stock is trading at an attractive price compared to the potential, at less than 6 times revenue.
Regarding the stock market declines of the two stocks, this is explained by the forecasts for subscriber growth turning out to be lower than expectations. Especially in the case of Netflix, the pandemic had brought a lot of new subscriptions, and a return to normal was to be expected. We are not overly worried, and have viewed these declines as buying opportunities.

After the close of the market, following their last results, Amazon was down sharply. That's still incredible given that the results surprised analysts. What is your point of view?

This kind of situation does occur quite frequently. Sometimes investors' expectations exceed those of analysts, creating sharp declines following earnings releases. It doesn't change our opinion. When a company publishes its results, we do our calculations again; and if the market offers us a gift, we accept it.

I was wondering why the position in Activision fell from 3% of the portfolio on December 31st to just under 1% on April 30th. Isn't that too quick to reduce the position in a stock?

We had a small position in this stock, and our degree of conviction did not increase thereafter. We therefore opted to reduce it when we needed cash to seize other opportunities. Our decision is in no way a result of the fact that we made a profit on the stock.

Do you have a large pool of companies in reserve whose stock you are waiting to drop before buying?

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Certainly! That's why we love stock market declines. As value investors, we need to be disciplined. What is seen in the portfolio is often only the tip of the iceberg, since we only include securities for which our degree of conviction is high enough, at attractive prices.

However, this does not mean that in the event of a stock market crash the portfolio will change drastically. Oftentimes, stock X on the watch list drops 30%, while stock Y in the portfolio drops 20%. If our level of conviction remains higher with stock Y, we will probably add to this stock if we have the cash to do so. As always, minimizing risk is the cornerstone of our philosophy.

I would like to know why you came back to Microsoft? Has their business model changed significantly? Are there new managers or has a division taken on more weight in the company?

First of all, it was the first time that we became shareholders of Microsoft. We had been following the company for a long time, but felt the stock was too expensive. Then, the meteoric rise of Azure (their cloud division) made the stock increasingly appealing to us. Following it closely, we were eventually able to buy in at a reasonable price.

In what way will the Barrage Fund, given its composition of securities exclusively in information technology, benefit from the rebound in the traditional economy (infrastructure and raw materials) currently boosted by the recovery plans voted by several states?

First of all, it is important to distinguish the bottom-up approach from the top-down approach. The first approach consists of studying individual companies to find the ones that interest us the most. The latter starts with a particular sector or trend, and ends up landing on one or more stocks. Seeking to take advantage of the economic rebound through the infrastructure sector is a top-down approach.

However, in applying our philosophy, we focus on individual stock selection, regardless of trends, making it solely a bottom-up approach. Our goal is not therefore to take advantage of certain trends, but these will in many cases strengthen our investment thesis. For example, Facebook and Alphabet are benefiting from the digital shift in advertising (we viewed them more as advertising than technology). We like these companies above all for their individual characteristics: exceptional leadership with a long-term vision, conservative balance sheets, clear competitive advantages, etc. In other words, we did not seek to invest in digital advertising at all costs, but we did want

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to be shareholders of Facebook and Alphabet. We believe that with this approach, we obtain the best risk/return ratio in the long term.

Regulation among the "Big Tech"

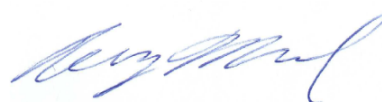
At the time of this writing, the American president Joe Biden signed an antitrust executive order containing some 72 recommendations involving a dozen federal agencies, targeting several of our stocks.

Why all the noise around "Big Tech"? Probably their large size. Merely discussing it can help to gain political capital. This is part of the reason why investigations into, criticism of, and threats against Big Tech will continue into the future. These companies continue to grow and will garner more attention. We remain confident that in the event of a break-up of these companies, a scenario more or less similar to that of Standard Oil is still possible, as we mentioned in our 2019 semi-annual letter. As long as our companies trade at attractive prices, the possibility of an instantaneous capital gain in the event of a break-up remains very real.

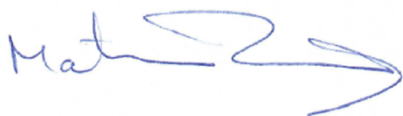
The markets often react negatively whenever such measures are announced, creating opportunities for short-term purchases of long-term investments. Absent the fear of the markets, we believe our securities would trade much closer to their intrinsic value.

Sincerely,

Patrick Thénière



Rémy Morel



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