VMCH Corporation performance vs the S&P500

Year	Annual percentage change in Per-Share Book Value (NAV) of VMCH	Annual percentage change in S&P500 with Dividends Included	Relative Results
2012	24.8%	16%	8.8%
2013	27.7%	32.4%	(4.7%)
Compounded annual gain	26.2%	23.9%	2.3%
Overall Gain	59.3%	53.5%	

To the shareholders of VMCH Corporation,

In 2013, NAV per share increased 27.7%, compared with 32.4% for the S&P500. Note that, 70% of the investments held throughout the year were in European companies – which means that short term comparability with the S&P500 is problematic. Longer term comparisons should be more revealing. The reason for holding most investments in Europe had nothing to do with macro considerations, but with the simple fact that there are a lot more cheap companies in Europe (including the UK) than in the US. This year, this gap widened rather than closed, affecting our performance.

Beyond that, I was relatively conservative with capital allocation during the year, demanding a significant margin of safety before making an investment. Being fearful while everyone is greedy definitely impacts returns in the short run, but it keeps you in the game for the long run.

Today, some investors seem to forget about risk. During the last year, there was a flood of high tech IPO's, many of which clearly do not have a profit model to match their valuation. Some other companies are simply trading at insanely high valuations. Hugh Hendry recently commented that: "Crashing is the least of my concerns. I can deal with that, but I cannot risk my reputation because we are in this virtuous loop where the market is trending".

Others are a lot less cheerful. As Seth Klarman wrote earlier in 2013: "Only a small number of investors maintain the fortitude and client confidence to pursue long-term investment success even at the price of short-term underperformance. Most investors feel the hefty weight of short-term performance expectations, forcing them to take up marginal or highly speculative investments that we shun. When markets are rising, such investments may perform well, which means that our unwavering patience and discipline sometimes impairs our results and makes us appear overly cautious."

A good example of what Klarman had in mind is the story of Rick Guerin. Rick was an associate of Warren Buffett and Charles Munger in the early days when the three of them managed their own investment partnerships. During 1965-1983, Guerin's partnership arguably had the better results of the three, most notably during the 60's when Rick managed 180% in 1967 and 171% in 1968.

The good times ended in the recession of 1973-1974 as Rick's partnership was down 62%, and Rick himself was likely personally levered. Since then he dropped off the radar, and very few people know of him today. According to Warren Buffet, the difference was that Charlie and he always knew that over time, both of them would be very wealthy. They weren't in a hurry – but Rick was. He wanted to get rich too quickly, and used too much leverage. This cost him everything when the market turned.

To stay in the game, one has to say no when the odds are not heavily in his favor. It also means being conservative with leverage and position sizing. On the other hand, we will not sit on cash as long as there are enough good ideas that meet our criteria to invest in. And right now – there are.

In May 2013, the company welcomed Ronit Ezer as an additional Director. Mrs. Ezer is the CEO of a product engineering company she founded over 20 years ago. Her role in VMCH is to supervise internal control processes, meet with investors, and provide business advice. I am very happy to have such an accomplished businesswoman onboard and believe this is an important achievement for the company. As of today, there are two directors at the company – Ronit and I.

As a result of this cooperation several internal control processes were implemented, one of which is an investment checklist. Ronit and I started with a draft and borrowed from multiple sources. The process includes a post-sale evaluation, to systematically learn from mistakes and possibly add to the checklist. This tool should lower the number and severity of investment mistakes in the future, which hopefully means higher returns at a lower risk. Here we learned from the experience of Mohnish Pabrai.

Pabrai started his investment partnership in 1999. All was well until the 2008-2009 financial crisis, where Pabrai's partnership was down 70%. Although he recovered after a few years, this taught him that if he wanted to continue to run a concentrated portfolio, he had to minimize his mistakes. He then researched the blunders of the great investors before him, and added some of his own. The exercise yielded 60-70 questions, each related to a specific investment. Since he began applying the checklist, he claims to have made almost no mistakes.

This process of continuously adding and refining the investment checklist can be seen in the following example. During our review of my investment decisions in 2013, we identified that in some cases, I tended to invest in cash heavy/bond like companies as a substitute for holding cash. Thinking about that, Ronit and I decided that it is preferable to hold actual cash until we have an opportunity to invest it in a real business that passes the checklist. Hence we added the following question to the checklist: "Is there a business?"

This is not to say we would not make such investments at any price – just that we should have a relatively high threshold of expected return and low risk in order to make such an investment, and then hold it for some time like any other. During 2013, we held Alternative Asset Opportunities PCC Limited (TLI) as a cash substitute, and sold after a few months in order to invest in a great business. The problem was that we took a 15% loss on the sale, because it was essentially a long duration bond and not a real cash substitute. So the general lesson is – invest in businesses, otherwise hold cash.

Another decision taken towards the end of 2013 was regarding short positions. For over a year we held a small short position in Fortescue Metals Group Limited (FMG). Although I believe that this particular company is likely worth zero in the foreseeable future, I closed the position. Why is that?

The problem is with the nature of the short position concept in itself. I know of many awful companies that are worth zero or simply ridiculously overpriced. There is no shortage (forgive the pun) of candidates for a nice short portfolio, which essentially works as leverage. It is like a loan that possibly doesn't have to be repaid. However there are a few practical problems.

The first is that a short position needs at least (if not more) the amount of research as a long position – but you can't take large short positions due to the risk of being wrong. That means that at best, you have to accept holding many small short positions, each requiring much time and effort to research and follow. We held one small position, but in order to make a real difference we needed a lot of those – which would have consumed a lot of resources better applied to finding good companies to invest in as opposed to betting against.

The second issue is the nature of the risk itself. When you buy a stock, the worst thing that can happen is losing that much money. But when you sell a stock short – you can lose a lot more than the original position. This little problem coinciding with the fact that your whole portfolio serves as collateral, can mean serious trouble at some point in life. And for what? A bit of leverage to spice up returns? It's not really worth it. A good investor can get an above average return just by buying and holding companies, becoming very wealthy in the process. There is no point at all in jeopardizing many years of hard work by playing silly games with leverage. See the earlier comments regarding Mr. Guerin.

Moving on to some happy moments!

During the year, I stumbled on a profitable Graham Net Net – a French company called Gevelot SA. This company produces metal parts for the automotive industry. It had a positive net cash position, current assets of about EUR 120M and total liabilities of about EUR 70M. Market capitalization was EUR 38M. The company was producing around 5M, maybe 10M in FCF per year. One third family owned. An absolute no brainer. Two months later, with the stock 60% higher and no longer a Net Net, we sold. This is the kind of situations I love.

Another interesting opportunity was presented by Ebix Inc. After reporting that Goldman Sachs offered 20$ per share for the company to go private, for a moment the stock got as high as 21$ - not bad considering that in such cases the stock should probably trade slightly lower than 20$ in part due to risk of the deal being cancelled. We sold at 21$. When the deal fell through two months later, we had the opportunity to buy the same shares at around 10$. The stock market is an amazing place.

Finally, an announcement. Some of you may have noticed that we no longer make public our current holdings as we have done in the past. This information will continue to be provided exclusively to our shareholders, together with the financial reports.

In closing we would like to thank our shareholders. Ronit and I are often pleasantly surprised by their intelligent questions and suggestions. We like to choose our partners as we choose our friends.

Regards,

Eduard Gorban Ronit Ezr