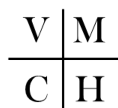

VMCH Corporation - Annual Report

VMCH Corporation performance (in USD)

	Annual percentage change		
Year	**in Per-Share Book Value (NAV) of VMCH**	**in S&P500 with Dividends Included**	**in MSCI Europe with Dividends Included**
2012	24.8%	16%	19.9%
2013	27.7%	32.4%	25.9%
2014	(2.7%)	13.6%	(5.6%)
2015	(1.4%)	1.3%	(2.3%)
2016	6.1%	11.9%	(0.4%)
Compounded annual gain	10.1%	14.6%	6.7%
Overall Gain	62.2%	97.7%	38.6%

"Life is like a snowball. The important thing is finding wet snow and a really long hill." – Warren Buffett

To the shareholders of VMCH,

In 2016, NAV increased by 6.1% compared with an increase of 11.9% in the S&P500, including dividends. MSCI Europe decreased 0.4% including dividends during the same period. Our 5-year annualized return to date was 10.1%.

Five years is already quite a time together, our faithful partners, and it is a good occasion for some introspection based on that longer term period. Has all that could be done has been done to achieve maximum returns? Are there any lessons for the future? Ronit and I discussed the matter, and following are the results of that discussion.

Once in a while every investor has to ask himself the following questions:

1. What is the quality of the investment analysis?
2. Did we buy at the right price?
3. Did we sell at the right price?

We have detailed records of every buy and sell decision. This includes a full pre-investment checklist, all the major data points for the investment, and investment rationale. It is done in real time and is also reviewed annually. Doing that, we learn from our experience and can also compare with investment records of other investors, with the goal of constant improvement of the process.

Generally speaking, there were no serious gaps between the perception of what we bought and what we sold. I am going to use some examples from prior years, because enough time has elapsed to draw some useful conclusions. For example, when we bought Enterprise Inns in early 2012, it was identified that the company as a whole had low operating leverage and high financial leverage, and that the nature of the business was a stable one. The shares were very cheap compared to cash flows. When we sold, it was the same company, only the price was higher. In retrospective, we sold at the right price.

In another case with Supervalu, the estimate of the business was the same as with Enterprise Inns. When we bought, we did so on the premise that the business was stable but of lower quality than something like Enterprise Inns. The lower quality was seen as acceptable at the time because the business was a supermarket business. However, even with such stability the lower quality eventually became a problem, and we sold before the value we originally envisioned could be realized. The analysis might have been right, but the decision to buy was the problem in this case – we needed to raise our bar for what we are prepared to buy shares in, which was done later and has proven effective so far.

Another case is Gevelot S.A.. The company was very cheap, no debt, and the business was of fair quality. We bought at a very attractive price and sold at a higher price, but not at full price. Here again the analysis was correct, the buy decision was good, but we should have been slower at selling.

And finally, to Renault S.A., an investment done right in all respects. It was identified that the company was trading at less than its 43% stake at Nissan. Market price for the entire structure was around EUR 10B, with the Nissan stake trading at 15B (P/E around 10), a finance arm worth at least 5B, and a car company with positive cash flow worth another 5-10B. This gap between the price of 10B and the value of 25-30B closed and the company was sold. The business was held for a total of 3.5 years. Once the value was identified, and the merits of the investment debated, then the decision to buy was relatively easy. Here the hard choice was not to buy when it was cheap, but to sell.

Selling is hard. You could sell something and it would go up 200% in one year. When you sell you always have to take into account that the company will continue to make money and grow, so if you held to it you would still get a return. It is unlikely that one will lose money by sticking with an investment even at full price. That what makes the decision hard – you have to say that something is much more likely to make a **significantly higher** return in the long term to be able to sell anything.

Note that this is a relative value judgment that can only be made looking ahead long term. In the long term, it is better to sell an investment that is trading at 80% of fair value, and buy another trading

at 30%. However, the former type has the annoying tendency to keep going up while the latter can languish and remain cheap for a while before shooting up in price. So after a year, what we bought might remain the same and what we sold might have risen 50%.

All investments have a certain cyclicality to them that makes the mighty fallen and the fallen mighty. When the great company encounters temporary setbacks it all seems gloomy for a while and then the inherent quality of the business shines through. It happened with Coca Cola in the 80's, and it will happen again many times in the future. What is important is to buy when everyone is terribly gloomy about it, and sell when everyone is happy to buy it.

Regarding our own record of buying and selling, the buying part appears to be fine. When something is cheap we buy without delay and we usually make a profit. In the cases the stock goes down it is almost always temporary and we always buy more, sometimes a lot more. These are the conclusions after much scrutiny of the record.

With selling, the same cannot be said, and this is where it gets rather interesting.

Selling

I made a table listing all the investments that were held for more than one year over the past five years. Each investment had its valuation and a price point to consider selling. The result was this table. Note that the numbers are an approximation.

1 year average	Year sold	Investment #	One year later	Two years later
	2012	1	30%	0%
	2012	2	200%	0%
75%	2012	3	0%	(40%)
	2013	4	0%	(50%)
	2013	5	0%	60%
0%	2013	6	(20%)	120%
	2014	7	0%	-20%
	2014	8	15%	0%
	2014	9	(50%)	30%
45%	2014	10	120%	50%
	2015	11	100%	50%
	2015	12	10%	5%
	2015	13	(30%)	N/A
	2015	14	50%	N/A
40%	2015	15	0%	N/A
		Unmarked average	85%	0%

The four investments marked in grey were sold for the reason that they reached fair value, were taken private or were deemed no longer safe. These were identified as when judgment was not so much involved in the sale process as it was clear that it had to be sold.

The other 11 investments in white were sold before they reached fair value. This was generally done to swap to more attractive investments at better prices at the time. This clearly involved a fair amount of judgment and this is what is being tested – has this judgment proven to be right?

On the left we see the average return of such investments the year later, had we not sold them. Below is an average for all years – 85%. Clearly this is highly irregular that on average, investments that were sold outperformed mightily the year after (though not the year after that). It would be much better for us to keep holding these one more year, as price converged with value, which was identified in the analysis phase. Selling too early has indeed cost us a lot.

In value investing, we often invest in unloved or forgotten businesses. These stay unpopular for a while, then at some point they are rediscovered and the price converges with value. By selling too soon, we broke this chain of events at too early a point – in some cases we sold just as the company was being rediscovered by the market.

It is like the farmer who plants seeds, toils for several months, and just before the harvest is ready he replants the field with another crop. It might be a better crop – but some of the former yield is lost and the new crop will take some time.

The effect of this is calculated in the following table, where I have taken the investments sold each year (about 33% of the portfolio each year) and assumed these were held as 33% of the portfolio for another year. The rest of the portfolio (66%) remains as it was. The idea is that the test portfolio will show the difference in annual returns had we not sold too early.

Year	**Portfolio Return (66%)**	**Past years' sales (33%)**	**Test Portfolio**
2012	24.8%	-	24.8%
2013	27.7%	75%	43%
2014	(2.7%)	0%	(1.7%)
2015	(1.4%)	45%	13.9%
2016	6.1%	40%	17.2%
Compounded annual gain	10.1%		18.5%
Overall Gain	62.2%		134%

The difference, as you can see, is rather dramatic.

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Based on the collective experience of many value investors, I believe this experience to be a consistent theme. Some investors, such as Charlie Munger are very loathe selling anything at all, and if they do sell, it has to be at the right price for that particular investment – except special cases, it is not constantly weighted against potential opportunities. Such opportunities become relevant only after selling at the **right price**.

Finally, a word of gratitude to our investors, who share our value investing philosophy and been with us throughout this journey.

“Better a patient person than a warrior, one with self-control than one who takes a city.”

Proverbs 16:32