



Investment Philosophy

SilverCross Global Small-Cap Fund invests in a portfolio of 25-35 high-quality smaller companies. It invests in companies with defensible business models across global developed markets.

The Manager applies four core principles in its stock selection. Its aim is to drive attractive long-term investment returns in excess of the benchmark while keeping portfolio turnover low.

Core Principles

- Create Value** with a sustainable business model.
- Compound Growth** thanks to a scalable business model.
- Undervaluation** implies an asymmetric risk / reward profile.
- Insider Ownership** ensures alignment with management.

End of a Decade

The Future Ain't What It Used To Be

The Remarkable Teens

The year 2019 will be remembered as the best of the decade in terms of stock price performance. This achievement was made a lot easier thanks to the significant decline in stock prices in the fourth quarter of 2018. By the end of that quarter, stock prices had fallen by at least 20% from their highs, depending on which index you look at. On a five-quarter basis, the performance is much less impressive. This is a good example why annual return is a pretty meaningless yard stick. It is very convenient, however. It's the time of year when the tax man wants to know how much your wealth has grown or shrunk. And he taxes you on it! It's also the time of year when social events allow for some bragging on investments gone well.

Whodunnit?

Key contributor to the year's good return has been the Federal Reserve's U-turn early 2019, when it decided to stop raising interest rates and consider easing its policy. The previous stock market decline was caused largely by fear about the effect of rising interest rates on stock prices and a recession. In July, the Fed initiated the first of three rate cuts. And late in 2019, it ended its balance sheet reduction plan, reversing course 180 degrees. You probably better know this phenomenon as Quantitative Easing.

The fear of a recession did not abate immediately, as the world faced an unprecedented amount of debt with a negative yield in August. Briefly, we also saw an inverted yield curve, which has historically been a reliable predictor of an oncoming recession. In fact, we would argue we have actually had a recession in 2019. It's just that it hasn't reverberated across all economic sectors. Industrial companies around the world have had a tough year. Car manufacturers are going through the worst period since the financial crisis of 2009 and more difficult years are sure to await them as electrification is accelerating.

The recession feared by most did not come. Isn't that weird? No, it's not. Since 1929, we have had 10 bear markets where stock indices decline by more than 20%, without a recession. When fear takes over, stocks can become very volatile. Unique is that the 2010s were the first decade without a recession.

Despite the endless uncertainties we have mentioned earlier stocks rose. We have consistently argued that we are not swayed by macro-related uncertainties that we nor the companies we invest in can influence. They are 'noise.' Stocks have climbed the proverbial "wall of worry."



As of 31 December 2019	2019	2018	1-Year	3-Year ¹	5-Year ¹	Inception ¹
SilverCross Global Small-Cap TR Net	53.9%	-6.9%	53.9%	16.8%	18.1%	18.8%
MSCI World Small Cap TR Net	28.7%	-9.6%	28.7%	7.8%	10.1%	10.9%

¹Annualised



Fund Details

Managers: David Simons
Chris Andrews

Fund inception date: 30 July 2014

Net Asset Value per share: 254.23

Currency: EURO

Share Class: A

Management Fee: 1.15%

Total Expense Ratio: 1.40%

Minimum Investment: 100,000

ISIN code: NL0010832242

Bloomberg: SCGSCFA NA

Rising stock markets in the face of unsettling news is not uncommon. It is actually quite normal. Remember 2009? The economy cratered while stocks posted the strongest return in decades. We all know that stocks anticipate rather than purely react to news. Yet this is a difficult concept to implement in an individual's investment strategy. It is much easier to be swayed by emotions based on what's on the front page of the newspapers. What has happened on the stock market in 2019, and during the whole decade for that matter, is possibly one of the clearest examples of why trying to time the market based on news flow or previous stock market moves is a fool's game. You won't win.

We believe that owning a portfolio of resilient companies eliminates the need and hopefully also the urge to time the markets. This is why we launched SilverCross more than five years ago.

By the end of 2019, many major stock indices around the world had increased by roughly 30%. As fantastic as this sounds and is, it is not a unique or standout performance. Since 1928, the S&P500 index rose by a larger percentage in 14 years, not counting quite a few years when returns were within spitting distance of the 31.5% recorded in 2019. Average annualized return for the S&P500 in the decade is good at 14%, but nothing we have not seen in previous decades. In the 50s, 80s and 90s, return was higher. Why are we writing this? Because we want to make clear that just because we have had strong recent investment results, this is by no means a predictor of weaker forward returns.

Looking back at the last decade, one of the standout trends has been the rise to prominence of technology companies. We all used their products and services already back in 2010. Companies such as Apple, Amazon and Google. Thanks to their unprecedented ability to scale their business with limited incremental capital needs, they conquered the world. This league of big tech was named the "FANGs" during the decade. This shows, sometimes the biggest investment opportunities stare you right in the face. Or as my first boss back in the 90s used to say: *"Het geld ligt op straat. Maar je moet wel bukken!"*

Stock market returns have varied widely across the world in the decade just behind us. Europe has severely underperformed the USA. Still looking at the AEX-index? Total return was 152% for the decade, versus 355% in Euro for US large-cap index S&P500. US small caps rose by 290%. The FTSE100 is up a paltry 114% for the decade. Japan recorded a total return in Euro of 194%. UK and Japanese small-caps rose 199% and 225% respectively.

Why we love cannibals

The word cannibal in the newsletter of an investment manager could be considered a bit odd. Or worse, when the report states that the managers actually love cannibals. Not to worry, we are not contemplating eating our SilverCross participants just yet!

Cannibalism can be applied to companies, just not in a literal sense. *"Pay attention to the Cannibals,"* Charlie Munger, the partner of Warren Buffett at Berkshire Hathaway, once said. This quote by Charlie Munger points to an often-overlooked corner of the stock market: cash-rich businesses that are consistently buying back shares, thereby generating tremendous value for shareholders.

It seems most of the financial media misunderstands stock buyback programs and the motivations behind them. Buyback programs are often given the derisive label of "financial engineering," and described as a poor management practice, even on financial TV-channel CNBC. While it is true that buying back stock at an expensive valuation is less than smart capital allocation by management, there is almost nothing more beneficial to individual shareholders than a stock buyback executed when the company's stock is selling at a discount to intrinsic value.

One of the most important tasks for executive management of a company is capital allocation. We carefully consider this when we qualify management of a company we analyse. Capital can be allocated in four broad categories:

1. Investment in the company to sustain or grow revenues and profits. A.k.a. organic growth;
2. Make acquisitions of other companies;
3. Pay dividends to shareholders;
4. Buy back shares.

While we always favour the first category, there may be a limit to the amount that can be allocated to organic growth. The business may not need a lot of capital to grow the business, the business may not have much growth potential regardless the amount it spends on innovation or the return it can make on incremental investments in the company may be unattractive.



Acquisitions can range from being very attractive to a terrible idea. It really depends on how this is done. The best are so-called tuck-in acquisitions that can be integrated into the existing business, taking out a lot of cost while leveraging the products and sales & support organisations. The worst are large acquisitions of companies that lead a company into a new market with a product unrelated to its existing core business. This is what is sometimes called 'diversification.'

Dividends are seen by many as proof that a company generates cash, not just accounting earnings. Some investors like or need an income stream from their investments and look for companies that have a high dividend yield. Understandable, but companies with a high dividend yield are often mature companies that are growing slowly or not at all. In many countries, dividends are an inefficient way to distribute profits due to taxation.

Share buybacks can be a phenomenally attractive way to return cash to shareholders, albeit indirectly. *"When companies with outstanding businesses and comfortable financial positions find their shares selling far below intrinsic value in the marketplace, no alternative action can benefit shareholders as surely as repurchases."* – Warren Buffett, 1984 Berkshire Hathaway Annual Report.

What are share buybacks precisely? When a company buys its own shares, it reduces the number of shares outstanding. This means that its net profit is divided over fewer shares, thus boosting earnings per share. This is why share buybacks are sometimes compared to cannibalism - the company is eating itself.

Outlook

Apparently, the Danish came up with the saying *"Making predictions is difficult, especially about the future."* It's a fitting start to this paragraph. We simply cannot know how the future will shape up. Some powerful trends are however likely to continue. Cloud computing appears to be in an early stage of its life cycle. Most companies still are not sold on bringing their data into the cloud with players such as Amazon or Microsoft. Artificial Intelligence and Big Data are other emerging technologies of which we have barely scratched the surface. Those companies applying new technologies will be the big winners of the decade ahead of us. It has been no different in decades past. It can be companies active in rather dull industries that can transform their business with new technology. We can think of Copart, one of the biggest contributors to return since inception of SilverCross. This junk yard operator has embraced technology and built an online auction platform that allowed its business to achieve scale not possible before.

5G is the newest technology that is set to be deployed in the years ahead. This technology is also going to transform businesses and consumers alike. Many more tasks will become autonomous in our lives, eliminating or at least reducing the need for human interaction or intervention. Voice-activated devices will play a role in this.

Robotics is another area where we can expect transformational uptake. Productivity gains are simply too high to ignore. For example, a store worker at Walmart can collect 80 products per hour from a back-of-the-store shelf. Walmart has developed an Alphabot robotic system, which collects 800 products per hour. Whereas robots have so far been used primarily for building cars, price declines for the machines increase the number of applications. Climate change is sure to become a major driver of stock prices in the years ahead. It appears the tipping point is coming closer – the point where politicians see that action is required now, not in five years. Massive investment in new technologies is required to make this happen.

The above developments are only as far as the eye can see. Expect to be surprised by many more yet to emerge trends.

The Future Ain't What It Used To Be

All this means change remains the only constant. And change is accelerating. The future rewards those who press on. The biggest risk we all face after a period of success is complacency. For companies, it means adapt or die. Disruption will alter the landscape of leading companies. The average time for companies to be included in the S&P500 was 24 years in 2016, down from 33 years in 1994, according to research provider Innosight. That firm predicts half of the companies now in the S&P500 will be replaced over the next decade. Expect retailers and traditional car companies to face even more significant challenges in the decade ahead. Currently smaller companies will emerge to replace the current leaders.



For us as investment analysts, our never-ending challenge is to steer SilverCross towards owning a number of companies that have the opportunity to scale their businesses and ultimately grow into large-caps in the years ahead. We have no time to become complacent. The opportunities that the new decade brings are simply too large and exciting! We just wish there were a few more hours in a day. As the late Steve Jobs fittingly said: *"Stay Hungry, Stay Foolish"* This is how we feel - today and hopefully for many years to come.

We wish you all the best for the 20-20s.

With kind regards,

David Simons & Chris Andrews

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