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Letter to Investors: 2017 Review

Dear Investment Partner:

In 2017, our portfolio gained **30.7% gross**, or **25.3% net** of all fees. The S&P 500 had a very strong year, rising **21.8%** including dividends.

It was a good year for stocks, and so unsurprisingly, it was a good year for our holdings as well. The three biggest drivers of the performance were Apple, Verisign, and Tencent. These stocks gained 46%, 50%, and 114% respectively in 2017, and this trio collectively represented about half of the portfolio during most of the year. I will touch on Apple and Tencent in this letter, since Apple remains our largest position and since I added to Tencent recently. I sold Verisign last week to invest in a couple new ideas that I think offer more value (which I will discuss in future letters). To a lesser extent, we also profited from a couple other core holdings that have been discussed in the past, as well as a few minor special situations.

But I also made some mistakes this year. First off, my mistakes this year included a couple investments that turned in mediocre results, which is unfortunately a result I would expect to occur fairly regularly: mistakes are part of the game. Luckily, stocks that performed below my expectations this year had a very negligible effect on the results.

Selling Too Early

A more significant mistake resulted from selling too early and holding too much cash as a result. Cash was a drag on performance, especially in the second half of the year when roughly 20% of our portfolio was in cash. It was a mistake to sell our bank basket (JPM and BAC). The large banks are benefiting from a variety of fundamental tailwinds like higher interest rates, a stronger economy, the prospect of lower regulation, and lower corporate tax rates. Balance sheets are the strongest they've been in decades, and lots of excess free cash flow will be used for buybacks and dividends. Banks are big, unexciting, and slow growing, but they are durable businesses with predictable earning power. They remain as competitively positioned as they were a couple years ago when we were buying them, and while their stocks have appreciated, they aren't expensive.

Unfortunately, I didn't recognize this and was selling when I should have been holding. The lesson here is to be reluctant to sell good companies with steadily rising intrinsic value, especially when cash is the alternative. A better approach is to wait to sell until a better opportunity comes along, or

until you believe they are overvalued (because when you think good companies are fairly valued, they are often still undervalued).

You might think this heuristic is too influenced by the fact that stocks marched straight up last year, as holding just about anything would have been better than cash. I've considered this point, but over time, stocks will outperform most other asset classes, and will certainly earn higher returns than cash. There will always be times here and there where cash proves to be valuable, but over a 20-year period, the drag from holding cash will be much more significant than the one-time benefit we would get from taking advantage of any downturn with "dry powder".

Anchoring

Finally, the most significant mistake this year involves anchoring bias, which is **not** buying a stock that has gone up recently, despite still being clearly undervalued. The result is missing out on gains that should have been made. This error is completely inexcusable, and it has resulted in a significant amount of foregone value that we should have captured. Unfortunately, this error wasn't an isolated incident during 2017. In fact, it has resulted in a heavy opportunity cost over the past few years as well.

The good news is that I am much more conscious of my own pitfalls. I realize you may question the optimistic tone of that statement, but I believe a necessary step toward getting better as an investor is to first possess the willingness to be honest with yourself about what needs to improve. The ability to look at yourself in the mirror and recognize imperfections (not a challenging task for me, both metaphorically and literally) is the key to long-term staying power in this game. One imperfection that looks like an ugly mole that I've finally come around to recognizing is the **bias toward not wanting to pay a higher price for a stock that continues to offer significant and obvious value**. I intend to work at removing the mole.

"Do Your Job" - Some Thoughts on Large-Caps

Bill Belichick has a simple phrase that he repeats over and over to his players: "Do your job". The implication is that each football player has a specific assignment on the field, and he should focus on that job, trust his teammates, and avoid all of the peripheral distractions that occur during each play. I think investors sometimes lose sight of what their assignment really is.

I know that our current portfolio is not going to score any style points for originality with you. But luckily, my job isn't to be original. My job isn't to make a herculean effort to figure out complex situations before everyone else. My job isn't even to locate undervalued stocks that no one else knows about. Unlike the figure skaters in PyeongChang, you don't get extra points for higher degrees of difficulty in investing. Sometimes great investment ideas are original and sometimes situations are complex, but these are neither necessary nor sufficient conditions for great long-term returns, and thus they are not boxes that I attempt to check.

My job is simply to attempt to **compound our capital over time at the highest possible rate with a minimal amount of risk**. I try to achieve this objective by seeking out undervalued stocks of good companies that I think I understand well. I am completely indifferent to whether the market

cap is large or small, or whether the company is widely-followed or completely unknown. And as I've talked about many times, stocks of even the largest companies in the market can move a surprisingly large amount above and below their fair values (see here for related comments).

We happened to find value in a few of these large-cap stocks in recent years (Apple, the banks, and Tencent for example). **This won't always be the case**. Expect some "original" and more exciting ideas on occasion, but don't be disappointed by the familiar. I'm looking at stocks of all sizes, but **my main assignment is to just look for great value**. I'll keep striving to "do my job".

Apple

Apple is a company that exemplifies what I am referring to when I mentioned that large caps can become dramatically undervalued from time to time.

During the two years we've owned the stock, the company generated over **$100 billion of free cash flow**, which is equal to about 20% of the market cap at the valuation where we made our first purchase (at around $95 per share). Most of this cash was returned to shareholders via buybacks and dividends. The company isn't resting on its laurels though - this excess free cash was what was left *after* spending $24 billion on capital expenditures *and* $22 billion on R&D**,** a big chunk of which should be considered growth investment. Apple is an absolute cash machine.

The market continues to value Apple as if it were a typical hardware manufacturer, destined to see its margins erode as competitors develop a better mousetrap. But Apple is a computer company that got into the music business, then phones, then tablets, not to mention software. The Apple Watch didn't exist a few years ago, but the company is now the largest watch maker in the world. As I said a couple years ago in a letter to investors, Apple's brand has proven to be effective at transcending products and even industries. While technology is fast-moving and ever-changing, I think it's very predictable that Apple will have long lines outside its stores five and ten years from now, regardless of what products those customers are waiting for.

The biggest disconnect between my view and the market's perception of this company relates to the predictability of Apple's revenue. Apple has 1.3 billion active devices around the world (up 30% in just two years). These devices act like digital storefronts, and they are producing a growing stream of recurring revenue from apps, music and storage. More products increase the amount of service revenue, which increases the likelihood that users will return to buy the next iPhone as well as a growing variety of other hardware products.

It's a virtuous circle of sorts that I think the market has underappreciated, both in terms of its predictability (over 90% of iPhone users return to buy another iPhone) and its pricing power (Apple sold 77 million phones last quarter alone, despite the average price of those phones rising by $100).

Imagine if Facebook, in addition to its high margin advertising revenue, could sell a $1,000+ piece of high-margin hardware every few years to each of its 1.4 billion users. That is Apple's business. In 2017, Facebook's platform produced $40 billion in ad revenue, while Apple's 1.3 billion devices

helped it rake in $31 billion in service revenue. Apple just gets the added kicker of selling a few hundred million devices each year for over $200 billion as well. That's nice work if you can get it.

What's the "Catalyst"?

I'm not a big fan of seeking out "catalysts" (a competitive corner of investing that is filled with numerous pitfalls). Having said that, Apple also benefits significantly from the new tax law, and while this wasn't part of my investment thesis, there is a cherry (a very big cherry). For a one-time tax bill of $38 billion, the US Treasury gets a shot in the arm (on its own, this amount equals about 13% of the total US corporate income tax paid by *all* companies last year), and Apple gets to bring back its massive $270 billion offshore cash hoard. Sounds like a win-win.

The company stated that they intend to bring their net cash balance (cash minus debt) to "zero", and this likely means one of two things: an acquisition, a dividend, or one of the largest corporate stock buybacks of all-time (or possibly some combination of those three). To demonstrate how much this cash is worth, Apple could buy around 800 million shares (about 16% of the company) at the current price. And this is just the cash it has in the bank today - each year another $50 billion or so piles up that the company has to figure out what to do with. First World problems, to be sure…

What's interesting is that despite the appreciation in the stock over the past couple years, the shares remain remarkably cheap. Apple will earn around $60 billion of free cash flow this year, which is about $12 per share, most of which will find its way back to shareholders. The company has $125 billion in net cash after accounting for all debt and taxes owed, which is around $25 per share. This means that at $160 per share, excluding excess cash, we get one of the world's greatest and most profitable companies for around 11 P/E. That still seems too cheap.

As I discussed above, investing in Apple won't win me any stock-pitching contests. But again, investing is not about being original, it's about looking for the most amount of value with the least amount of risk. I think Apple, at the current price, meets this objective, and likely offers above average returns with far below average risk. A slightly higher valuation combined with some dividends and a much lower share count could yield 40-50% returns or so in a couple years without the market cap being dramatically higher than it is now. Sometimes, the market advances these expected returns more quickly, in which case we would consider selling Apple for more enticing opportunities with higher prospective returns. Until then, we'll remain very patient and pleased shareholders of one of the world's greatest companies.

I size positions according to my evaluation of potential risk, with the largest holdings being the least likely to see losses. Because of the low likelihood of permanent capital loss coupled with above average potential returns, Apple currently occupies 28% of our portfolio.

Tencent

Tencent (TCEHY) was our third biggest contributor to performance, but our biggest gainer in percentage terms, as the stock more than doubled in 2017. Much of that increase was justified by increasingly dominant operating results, and in terms of business momentum, Tencent continued to stampede ahead.

The company's growth actually accelerated last year, with revenue and earnings growth topping 50%. Tencent did about $35 billion in revenue last year, but when you look at the businesses that the company participates in (and leads) such as social media, communication, video content, payments, ecommerce, cloud and gaming - industries that collectively make for an addressable market well over $1 trillion - it's clear that there is still a very long runway ahead for Tencent.

When we invested in Tencent a little over a year ago, the company was valued around $250 billion ($25 per share). We paid roughly 24 times what I estimated the company would earn in the following 12 months, which was a price that I thought was very cheap for a great business that will have far more earning power in the future than it does today.

This price actually turned out to be only around 21 times free cash flow, as earnings grew faster than expected. The free cash flow is growing at more than 50%, and will be $17 or $18 billion or so this year. This means at double the price ($500 billion), the stock still only trades around 28 times the free cash it should generate this year. This doesn't get value investors excited, but for a business growing at 40-50% (a rate of growth that will slow but will remain above average for many years), I think this actually remains significantly cheap, especially when your average wide-moat, blue-chip stock with a single digit growth rate has a P/E ratio that isn't much different than Tencent's.

By my preferred definition of value - the present value of the future cash flow - I still think Tencent is very cheap. I used the recent market downturn to add to our position around $51 per share.

P/E Ratios - Context Matters!

When talking about stocks with high P/E ratios - and we own a few of them currently - I think it's important to revisit the fundamental topic of valuation. The way I think about the value of a business is very simple. It's the same way I thought about apartment buildings or rental property when I invested in real estate. **The intrinsic value of any business is the present value of all of the cash that you can pull out of the business in the future.**

This means that what a company earned last year is irrelevant to the valuation. Of course, last year's earnings might be viewed as a proxy for future earnings, but the value of a business is not derived from what it earned last year, it is derived from what it will earn going forward.

I think this is important to keep in mind, because I see a lot of emphasis placed on last year's earnings (and thus the P/E ratio or P/FCF ratio), and much less emphasis on what a company will be earning in say four or five years, which is an estimate that is critically important if you plan to be a long-term owner of a stock.

There is an idea out there that implies that assuming a certain amount of growth is heresy for value investors. To me, there is no conceptual difference between thinking about the future of a lousy business and thinking about the future of a great one. **In every investment, an investor is making an assumption, either explicitly or implicitly, about the future earning power of the business**.

A stock that is judged to be cheap at 8 P/E is implying that the denominator (the earnings) will remain stable in the future. It is no more or less conservative to think about the future earning

power of a company that is valued at 8 P/E than one that trades at 40 P/E. In some cases, the 8 P/E stock might in fact be undervalued; in other cases, it might be vastly more expensive than the one that trades at 40 P/E.

What matters is not the P/E ratio, but the current price relative to the intrinsic value, and the intrinsic value is the total of all the future cash flow, discounted at some interest rate.

Conclusion

Markets have been volatile recently. I have been more active with making actual investment decisions in the past couple weeks than I was for all of 2017. I am excited about the prospects for the companies we own, and despite the unusually high number of large cap stocks, I believe the portfolio is primed to do very well over the coming years, both in absolute terms and relative to the general market.

I'm also excited about a few new ideas, which I continue to evaluate, and which may show up in the portfolio soon. Recent investments made in January and February will be discussed in future letters, but in the meantime, feel free to reach out anytime with any questions.

Our business grew nicely in 2017, and I feel extremely lucky to have such a like-minded group of long-term investors who trust my judgment and believe in our approach to investing. Thank you for your continued investment in Saber Capital.

Your Partner,

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Appendix

Here are a few letters and write-ups I've done that further discuss my investment approach as well as my thinking on some of our recent investments:

Investment Philosophy

- Saber Capital Investor Letter – 2016 Review (2/10/2017)
- Saber Capital Investor Note – Time to "Zoom Out" (Election Comments 11/15/2016)
- Saber Capital Investor Letter – 2017 Mid-Year Update (8/15/2017)
- What Is Your Edge? (12/12/2016)

Investment Write-ups

- Tencent's Wide Moat (TCEHY)
- Markel: A Compounding Machine (MKL)
- Berkshire Hathaway is Safe and Cheap (BRK.B)
- The Toll Road of the Internet (VRSN)
- Bank Stock Review (JPM, BAC)
- Apple's Key Competitive Advantage (AAPL)

I will also publish new content on Saber's website periodically, which will be updated here:

- Saber Capital Management Commentary

Disclosures

**Returns are based on the "Saber Capital Portfolio"—a real money account that is managed alongside all other accounts. I also refer to this as Saber's model portfolio. Performance data of this account is produced directly from Interactive Brokers. It is important to note that each client may experience slightly different results from the model depending on the timing of deposits, withdrawals, the fee structure specific to each account, and other timing issues. The valuations of your investments at the time of purchase may be significantly different than the valuations at the time of purchase in the model because of these timing issues. I expect the net results of the model account to roughly equal the results of client accounts over time.*

The gross returns of the Saber Capital Portfolio are taken directly from Interactive Brokers. The net returns are estimated using a 1% management fee and 15% performance fee. Your net returns could vary from the model depending on the fee structure of your account. Your personal account statements with your account specific performance net of all fees will be coming in the mail each quarter, and can also be accessed anytime online. Please note that any performance fees earned during this year will show up in the following year's 1st quarter statement. Also note that the time weighted return (TWR) on your account specific performance summary is net of all fees.

Please contact me with any questions about your statement, returns, fees, or anything else related to your account.