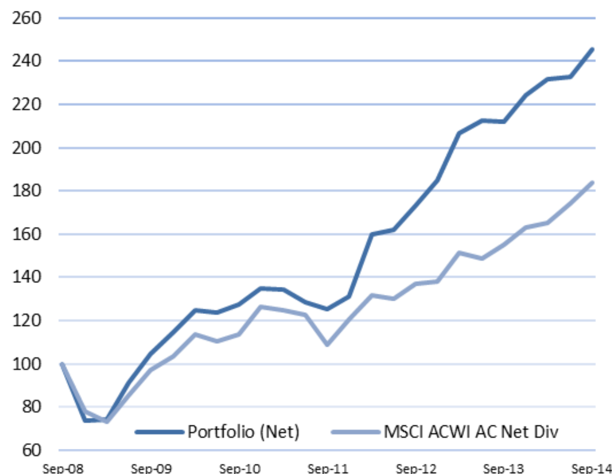
CORE PORTFOLIO Q3 2014

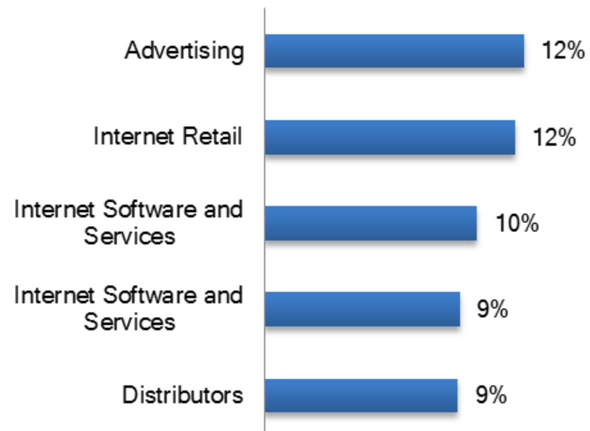
iolite

Performance			EUR[1]	Index[2]
Inception Date:	01 October 2008	Quarter	5.5%	5.3%
Portfolio Style:	Value / Total Return	Year-to-Date	9.5%	12.6%
Manager:	Robert Leitz	Since inception (annualized)	16.1%	10.7%
		Since inception (cumulative)	145.5%	83.6%

Performance in EUR



Top 5 Positions



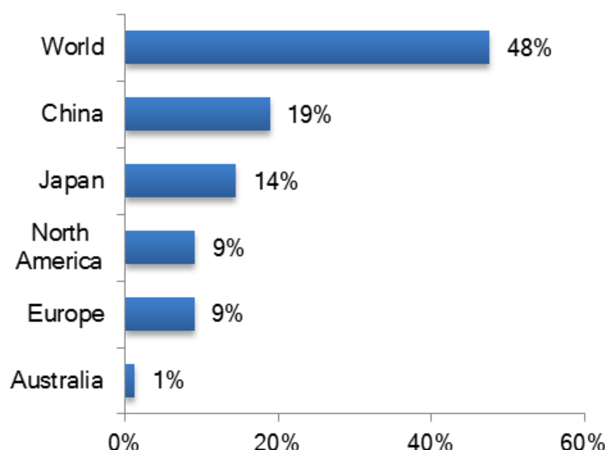
Market Review

Global equity markets continued to rise, with a strong recovery seen in China. The US dollar strengthened against most other currencies in September, as the US Federal Reserve noted a gradual improvement in outlook for the economy and said it expected to end its extraordinary bond-purchase program in October and start raising interest rates from near-zero back to more historically typical levels next year. Meanwhile in Europe, ECB chairman Mario Draghi announced a plan to purchase more than EUR 1 trillion of asset-backed securities to encourage lending. Alibaba, China's largest e-commerce company, went public on the New York Stock Exchange in what was branded the biggest-ever listing in the US. Buyers did not seem to care about the deal's structure, which failed to give shareholders ownership or control of the company's assets. Geopolitically, the situations in the Ukraine and the Middle East showed no signs of relief. Student protests in Hong Kong for more democracy gained momentum late in the quarter. The Ebola virus continued to spread in West Africa.

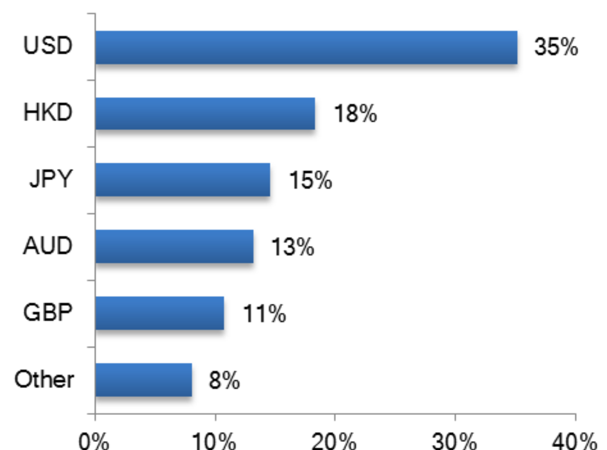
Portfolio Review

With a quarterly net performance of 5.5%, the portfolio outperformed the index by 20bps. I sold two positions at a net cumulative gain and added back a position that the portfolio had previously held.

Geographic Breakdown by Revenue Market



Geographic Breakdown by Listing Currency



[1] Net returns: no leverage, after all costs (no management fee, 25% performance fee for returns greater than 4% p.a., high watermark)

[2] MSCI All Country (DM+EM) World Index All Cap (large+mid+small+micro caps), net dividends reinvested

QUARTERLY REVIEW

For the quarter ended September 30, 2014, the portfolio returned +5.5% in EUR (-1.3% in USD), net of all fees. Since inception on October 1, 2008, the core portfolio has generated net cumulative returns of +145.5% in EUR (+126.4% in USD) and annualized net returns of 16.1% in EUR (+14.6% in USD). A euro invested at inception has turned into €2.46. I consider unleveraged long-term absolute performance far more important than relative performance against a benchmark.

Key contributors to the portfolio's performance for the quarter included a strengthening of the US dollar (if performance is measured in euros), strong operating results of some holdings, multiple expansion of Chinese and Japanese positions, as well as a strong run of an Australian investment (Cabcharge) that I exited after a holding period of just a few months. However, the portfolio's performance was hurt by a position in a US technology stock, Telenav, and a new holding that dropped 16% in market price just after I purchased it late in the quarter.

Thoughts on portfolio positioning

I have managed this portfolio for six years now and thought I would share a few thoughts on my investment approach and how it has changed over the last few years, along with the global market environment and many lessons learned. Although it is common to evaluate a manager's investment skill based on past returns alone, I think it is more appropriate to concentrate on the "how" – his investment decisions and the reasoning behind them considering the information available at the time. Was the manager just lucky, did he just ride a trend, and how repeatable is his success going forward?

When I started out in the midst of the financial crisis in 2008, it was very easy to pick big, stable businesses at low valuations (meaning: low risk, high return expectations). For example, eBay was trading at less than five times free cash flow – at this valuation, while the risk of permanent capital loss was very small, the chance to generate returns greater than 20% was very high (either supported by cash generation or multiple expansion). I ended up buying a basket of stocks with a similar profile, some of them well-known names (eBay, Carrefour, Munich Re, Kraft Foods, Starbucks, Walgreen, McDonald's, Microsoft) but also smaller, lesser-known names (Orpak, Aspen Insurance Holdings, A.C. Moore, GFK, Paypoint).

By around 2011, markets were back to their pre-crisis levels and the rising tide had lifted most boats. The low-hanging fruit had been picked. As already mentioned in my last letter, many investors (Buffett disciples included) have since started paying up for companies. To justify higher prices, investors are increasingly talking about growth, hidden values (sum-of-the-parts valuations, restructuring potential) or financial gimmickry (refinancings, spin-offs, etc.). Others talk about quality: quality of a business and quality of management.

Having studied many portfolios from fellow value investors and having seen how many portfolios suffered severe losses of more than 50% in 2008, I've become very wary of paying a high price for anything. In my analysis, a substantial part of losses in value portfolios in 2008 was caused by holding on to stocks trading at high valuations – whether the underlying businesses were of high quality or not. Another question is what quality actually means. As much as we all love wide moat businesses that keep growing with minimum capital requirements, it's much easier to spot them in hindsight than to anticipate their success with foresight.

I could sum up several examples where a business' perceived superior quality shows some weakness if thoroughly challenged. For instance, Tesco, considered almost an infrastructure-type of investment, is now unexpectedly struggling with competition from hard discounters such as Aldi. Apple's profits are heavily dependent on sales of a premium cell phone – a product subject to severe technological disruption and ever-changing consumer taste. In essence, even to the trained eye a company might look like a safe compounder – until it suddenly doesn't anymore.

So, as global markets rose and the easy picks became rarer, I continued to invest in companies with low valuations – albeit of lesser prominence. My favorites became companies with high net cash levels and positive cash flows, those for which I assumed some safety net in the company's assets or management's quality at low valuations. This approach was essentially following the footsteps of investors I consider role models, who had made their most successful investments in option-type situations with asymmetric risk-reward characteristics. The idea was (and still is) that a portfolio of investments where the upside is significantly higher than the downside will do well over time, despite a few losers that are essentially built into the equation.

So far, the strategy has worked quite well. I also believe that the portfolio's returns have been less correlated to the overall market development as the comparison with the MSCI World Index might suggest. Since I kept selling stocks when they became expensive, returns were driven by the underlying assets rather than market trends or sector rallies.

Still, I made a few costly mistakes that could have been avoided. In some cases, I attributed value where there was none, in others I just overpaid. Here are a few simple but important lessons learned:

- Negative working capital can be a structurally cheap and efficient way to fund a business as long as it is stable or growing. However, any conservative valuation should treat it for what it is: leverage (which will become obvious in a restructuring situation).
- Weak earnings quality can often be exposed by a rigorous analysis of capital expenditure and capital expenditure efficiency. For example, companies with long-life assets often show higher "EBIT" than the comparable (and arguably more relevant) cash flow measure "EBITDA less capex" – as can be explained by inflation, temporary maintenance underspending, costly technological upgrade or asset replacement requirements. In the media space, many companies report inflated earnings by overcapitalizing development, IT, R&D, or product licensing costs.

- Beware of businesses operating in weak momentum environments (e.g. due to regulatory changes, industry overcapacities, technological disruption or product substitution), as this might lead to accelerating earnings and asset price erosion.

Most of my mistakes were caused by overpaying due to lack of experience or rushing into investments where I didn't want to miss profit opportunities. In the future, I shall be more patient in waiting for truly exceptional investment opportunities. This goes along with the affirming realization that, despite an increasingly expensive market, these last few years offered plenty of attractive opportunities.

All that said, an old quote found new resonance with me: "Nobody ever got fired for buying IBM." In other words: it's easier to justify losses or underperformance when purchasing shares everybody knows and loves. The flipside is that it is also more difficult to market a portfolio of undervalued nobodies, as clients might make the error to perceive such a portfolio to be of higher risk versus a portfolio of "blue-chips" or "story" stocks.

Despite these challenges, iolite will continue to pursue an investment strategy that focuses on asymmetric risk-reward situations, where the upside potential is significant and the downside is protected at the valuation levels seen at the time of capital allocation, as this seems a reasonable thing to do. I am in it for the long term, and you should be too.

Change in Benchmark Definition

The MSCI World Index used as the portfolio's benchmark until now only included developed markets and excluded small and micro caps as well as dividends. From now on, performance will be compared to the MSCI All Country World Index, which includes stocks of all capitalizations in developed and emerging markets and with net dividends reinvested. I believe this benchmark is a slightly more suitable way to measure global equity market performance than the one previously used. MSCI estimates this index covers approximately 99% of the global equity investment opportunity set. Please note that an index investor would probably have to bear costs not captured in this measure, such as account and management fees.

Upcoming Conferences

I will be presenting investment cases at two conferences in November: one at the European Investing Summit 2014 (www.valueconferences.com) and another at the first Czech Investment Conference (www.ceskainvesticnikonference.cz). The latter is organized by fellow fund-manager Daniel Gladis. His fund, Vltava Fund (www.vltavafund.com), was ranked the 11th best-performing equity fund in the world by Eurekahedge in 2012, based on its 216% three-year performance from 2009 to 2011.

I am also really looking forward to participating in VALUEx for the fourth time in 2015 (www.valuex.ch), a great event to meet and learn from fellow value investors in two stunning locations: Zurich and Davos. Many thanks to Guy Spier and John Mihaljevic for organizing!

Portfolio Outlook

According to my fair value valuation estimation, the portfolio has one of the best return potentials in a long time. This is due to improved earnings outlooks of the companies it holds, a reallocation of funds to new opportunities (some which relate to past positions) and a decline in market prices of some holdings even though I consider the story and intrinsic valuation unchanged.

As always, I am happy to answer your questions and receive feedback.

Robert

CLOSED POSITIONS (Q3 2014)

Position	Sector/Industry	Listing Currency	Absolute Return (in local currency)	IRR
Cabcharge Australia	Diversified Support Service	AUD	35%	89%

Cabcharge Australia Limited is engaged in taxi-related services and is also involved in bus and coach services through its interest in an associate. The company provides booking and dispatch services for various Australian taxi services, and its products include taxi management system software as well as mobile electronic payments systems. Cabcharge owns Black Cabs, Melbourne's second-largest taxi company, as well as Newcastle Taxis and Melbourne's Arrow Taxis. CDC, a joint venture formed between ComfortDelGro, one of the largest land transportation companies in the world, and Cabcharge, is recognized as the largest private bus operator in Australia and operates under brands that include Westbus, Hillsbus, Hunter Valley Buses in New South Wales and Eastrans, Westrans, Davis and Bender in Victoria. Together with ComfortDelGro, Cabcharge also owns CityFleet UK, a provider of account, booking and dispatch services for taxis and private hire vehicles in London, Edinburgh, Aberdeen, Birmingham and Liverpool.

At the time of purchase, shares of the company had traded down due to regulatory pressure (Western Australia had decided to cut Cabcharge's surcharge for providing taxi payment services from 10% to 5%) and because of perceived long-term threats (essentially from Uber, a smartphone application that connects drivers with people who need a ride).

In my analysis, the impact of the regulatory change was quantifiable and not as severe as the headlines suggested. While I believe Uber offers a great service, I thought the market overestimated the speed of its impact on traditional taxi companies. Taxis are a heavily regulated market and many customers tend to be loyal out of convenience. For example, elderly people (a large customer segment) are likely to stick to traditional taxi companies for years to come. Lastly, it seemed the market failed to put the right value on Cabcharge's highly profitable joint ventures with strategic partner ComfortDelGro, possibly as its earnings are reported below EBIT.

I exited the position when the stock reached my fair value estimate after it had rallied 35% in just six months, resulting in an annualized return of 89%.

Position	Sector/Industry	Listing Currency	Absolute Return (in local currency)	IRR
Telenav	Application Software	USD	-18%	-14%

Telenav develops navigation software. Historically, the company generated most of its revenue from partnerships with wireless carriers such as AT&T, Sprint, and T-Mobile. Key suppliers of maps were TomTom and Navteq. Over the last couple of years, this traditional business segment has dwindled due to the rise of smartphones and increased competition from Google, Apple and Microsoft. In an attempt to diversify, Telenav aggressively pursued two alternative growth areas: in-built automotive navigation systems and ad-driven apps based on open source maps. Over the last two years, the company has become a key developer of automotive navigation systems for Ford and a Top 5 OEM. Over the last twelve months, Telenav has secured top engineering talent and assets regarding Open Street Maps (OSM, the Wikipedia of maps): Steve Coast, the founder of OSM, and Skobbler, the highest-rated and most popular OSM app developer. The company has around 900 employees and is headquartered in Sunnyvale, California.

At the time of purchase, the company was trading close to its net cash level and at just 1-2 times average free cash flow of fiscal years 2011-2013. I expected Telenav's cash burn to peak at around $20 million in 2015 and then to recover given its turnaround plan and convincing product pipeline. I believed the upside in case of a successful turnaround was far higher than the downside, which was limited given the company's net cash balance. I expected (and still do) the new OSM-driven business model to yield higher returns of capital employed and provide a better business moat. It is widely accepted that intelligent mapping solutions will continue to grow in importance with a wide array of attractive earnings streams in search, personalized advertisement, mobility solutions and user intelligence. Telenav's move towards OSM will lower the company's cost base and increase the quality level of its services (e.g. through the introduction of crowd-sourced traffic updates).

However, when the company reported fourth quarter earnings on July 31, 2014, it revealed that it expected its cash burn to be higher at around $40-50 million in 2015 and its share count (despite ongoing buybacks financed out of the company's substance) to increase due to dilutive stock-based compensation (about 10% of market capitalization). I decided to exit the stock after updating my thesis for the expected higher cash burn, lower cash balance and increased share count. Annoyingly, the stock rallied 50% in the weeks following my sale.

PERFORMANCE & BENCHMARKING

%	in EUR (net of fees)						in USD (net of fees)					
	Q1	Q2	Q2	Q4	Year	Index	Q1	Q2	Q2	Q4	Year	Index
2008 (Q4)	-	-	-	-26.2	**-26.2**	**-21.9**	-	-	-	-26.3	**-26.3**	**-22.7**
2009	0.7	22.6	14.7	9.5	**55.0**	**32.3**	-4.6	29.9	18.4	7.8	**58.0**	**36.6**
2010	8.8	-0.7	3.2	5.7	**17.8**	**22.5**	4.1	-10.1	15.8	3.3	**11.8**	**14.5**
2011	-0.5	-4.3	-2.3	4.6	**-2.7**	**-4.9**	4.3	-1.9	-9.9	1.2	**-6.7**	**-8.0**
2012	22.1	1.2	6.8	6.9	**41.1**	**14.6**	27.5	-3.8	9.1	9.0	**45.9**	**16.4**
2013	11.7	2.8	-0.3	5.8	**21.2**	**18.3**	9.2	4.0	3.3	6.7	**25.2**	**23.6**
2014 (YTD)	3.3	0.5	5.5		**9.5**	**12.6**	3.4	-0.1	-1.3		**2.0**	**3.2**
Last 12M					**15.9**	**18.6**					**8.8**	**10.7**
Annualized					**16.1**	**10.7**					**14.6**	**8.7**
Total					**145.5**	**83.6**					**126.4**	**65.2**