To: All investors in **Quality & Value**

From: QV26

Date: 7 February 2017

Re: December 2016 Quarterly Letter

Housekeeping items

Before we start with our commentary, we want to take this opportunity to inform you that we have a new (and better) website. We are at www.qv26.com. Currently, the purpose of the website is to provide a summary of what we do, how we do it, and what we believe in, primarily to those who don't know us yet. If you regularly read our letters, though, there's nothing there you don't already know.

Going forward, we intend to make this website our primary vehicle of communication with our existing and prospective investors. We will soon add a section with references to interesting books, as well as copies of articles and papers that we're reading, and over time we will probably start a blog (compatibly with the availability of the most precious resource on earth: time). We will, in a nutshell, make our relationship with you more continuous and smooth, one where your feedback and comments will be valuable and always appreciated.

Finally, and this is important, the password you were issued when you registered in our *old* website is no longer valid. So, you have to go visit our *new* website and register in order to be able to access sections that are not visible to unregistered visitors.

Performance and portfolio statistics

The fund's *value* per share is currently **€177.4** vs. €184.3 at the end of the third quarter, for a decrease of **-3.74%**. Our cash position went from 25.62% of the fund at the end of the third quarter to 45.99% at the end of the fourth quarter. Therefore, the decrease in the fund's *value* per share is the natural (and mathematical) consequence of the increase in its cash position (more on this later). Also, as could be deducted by these numbers, the *value* per share of the fund's *invested* portion has actually increased over the period.

As for *price* performance, the fund was *up* **15.84%** in the fourth quarter of 2016, vs. +5.25% for the Euro Stoxx 600, +9.60% for the Euro Stoxx 50, +8.43% for the Russell 2000, +3.25% for the S&P 500 and +1.58% for the MSCI World. On a 2016 full year basis, the fund stands at **+11.11%** vs. -1.37% for the Euro Stoxx 600, +0.70% for the Euro Stoxx 50, +19.48% for the Russell 2000, +11.96% for the S&P 500 and +4.57% for the MSCI World. Over the fourth quarter, the US Dollar, the Canadian Dollar and

the British Pound *appreciated* against the Euro by +6.81%, +4.31% and +1.64%, respectively.

A performance comparison with indexes is always misleading, as an index is by definition fully invested whereas we held an average cash position of almost 30% in 2016. A truer comparison should be done between indexes and the invested portion of our fund. But then again, holding cash is part of our strategy and we believe that stripping it out would be unfair. Also, given our investable universe (North America and Europe), our performance should really be more meaningfully compared to a combination of the S&P 500 (USA), the Euro Stoxx 600 (Europe) and the TSX Composite (Canada). A blend of these three indexes, constructed by using the same weights that these geographies have in our portfolio, would have yielded a +8.73% in 2016.

Our portfolio today includes 15 companies with an average market capitalization of €11.3bn, for a total invested of 75.76%, so we still have work to do to get to our ideal *fully-invested* status of 20 positions in high-quality companies.

Within the invested portion of the fund, seven companies are listed in the U.S., for a total US Dollar exposure of 59.95% of the portfolio; five companies are European, of which four listed in Euros and one in British Pounds, for a total Euro exposure of 22.79% and a British Pound exposure of 6.08%. Finally, we own three Canadian companies for a total Canadian Dollar exposure of 11.19%.

Our largest three positions take up, respectively, 9.64%, 9.20% and 9.07% of the fund (cumulatively 27.91%), while our three smallest positions stand at, respectively, 0.70%, 1.02% and 2.23% (cumulatively 3.95%).

Our first full year

2016 has been the first complete calendar year for Quality & Value, and this is our first full-year letter to investors. We are proud of having passed this landmark and very excited about our investment process going forward.

Speaking of investment process, this seems like a good time to spend some words on the evolution that such process has undergone since the launch of the fund.

We've always been fundamental, bottom-up, long-term oriented value investors. The way we think about investing is *simple and transparent*: figure out the value of high-quality companies, buy them when their price is way below their value, and hold on to them for the long run. Simple, because once you have an idea of value the rest is straightforward, intuitive and logical. Transparent, because that's all there is to it: no complicated trading strategies, no exotic derivative structures, no black boxes.

So, the foundation of our process has always been (and always will be) a *buy-and-hold* approach. Businesses take time to create value, and nobody can say with certainty when such value will be reflected in the stock prices. In other words, you need to have a long

term orientation and an unusual amount of patience. But what happens while you *hold*? Well, in a traditional buy-and-hold approach, nothing: you just sit on your hands and wait for prices to reflect values.

Over the last one and a half years, though, we realized that the traditional buy-and-hold approach doesn't say anything about portfolio management: once you bought, you might as well go on vacation. We believe that an effective and well-rounded investment process shouldn't just stop at the acts of investing and divesting, but it has to include a set of portfolio management rules that must be applied consistently, with rigor and discipline. That is why we decided to tweak our process and make it more dynamic while we hold on to our companies.

We wrote about our portfolio management rules extensively in our prior letters, so you should already know all about it. Like the rest of our investment process, such rules are *simple and transparent*: (a) every position starts with a portfolio weight determined by a proprietary formula mainly based on its Value-to-Price (V/P) ratio; (b) the V/P moves with changes in price (continuously) and value (less frequently); (c) when the V/P increases (because P goes down, V goes up, or both) we buy more shares and increase the portfolio weight of the position, when the V/P decreases (because P goes up, V goes down, or both) we sell some shares and decrease the portfolio weight of the position. But, keep in mind, we don't do this every day. We set a V/P range within which no trading gets triggered. Only when the V/P moves outside of the range, we give order to buy or sell. This ensures that, on average, we will only execute a limited number of transactions per month.

We like to call our approach *buy-and-optimize*, instead of buy-and-hold, as by applying these rules we make sure that our portfolio is always (and continuously) *optimized*: positions that have gone up a lot in price will have a small weight, whereas those that have gone down a lot will have a large weight. Additionally, our portfolio is better protected: small weight positions are the ones with a higher probability to experience a price drop, thereby inflicting less damage to the portfolio if and when such drop occurs; large weight positions are the ones with a higher probability of a price increase, thereby contributing more benefit to the portfolio if and when such increase occurs.

By paying attention to portfolio management, we have significantly improved our investment process, as well as performance: this past year's numbers almost entirely reflect the implementation of our portfolio management rules. We believe this "adjustment" made a lot of sense and is going to be there to stay for the very long run. It is the product of our ever evolving mindset: if you have rock-solid principles, there's always the chance to learn, experiment, and improve without losing sight of your fundamental investment philosophy.

Uncertainty vs. Risk

As stated many times in our past letters, we are not in the prediction business. We are unable to predict the future, and believe nobody is able to do it. We don't know what's

going to happen to interest rates, the dollar, or the stock market next month or next year. Nobody does. What we do know, though, is that the next few years look more uncertain than ever: on the future looms an unpredictable new U.S. presidency, an unpredictable Brexit (with multiple outcomes for both the U.K. and the European Union), an unpredictable Putin's Russia, an unpredictable North Korea, the terrorist threat of ISIS, a possible return to some form of protectionism after decades of globalization push, and so on.

Uncertainty is simply not knowing what's going to happen in the future. Many people tend to identify uncertainty with risk, but it really has nothing to do with risk. Risk has to do with a range of possible outcomes, each with its own probability. Assessing risk means assessing those probabilities: a task that is 100% subjective.

Michael Mauboussin, whose insights we always find fascinating, in his book "*The Success Equation: Untangling Skill and Luck in Business, Sports, and Investing*", nailed the distinction between uncertainty and risk in a very interesting way. Risk is when we don't know what any future outcome will be, but we understand the probability distribution (for example, the roll of a die). In this case we have risk, but we don't have uncertainty: we don't know what the outcome of the roll of the die will be, but we do know it's going to be one of six choices. This is not uncertainty, it's an unknown outcome with well-defined possibilities. Uncertainty, on the other hand, is when we don't know what the possible outcome might be, because we don't know what the probability distribution looks like. In other words, Mauboussin's view is that the future is always unknown, but that does not necessarily make it "uncertain": if we know the distribution of possible future events, then we can assign a probability to the ones that would have a negative effect on us, thereby evaluating and pricing risk.

Risk is something that can be assessed and priced, uncertainty isn't. Living amid uncertainty makes us unable to predict, as we have no idea of any possible outcome.

Being unable to predict does not mean that we will do nothing. The rational thing to do in front of uncertainty is to get prepared. Getting prepared is an activity that is mostly *defensive*: we spend a great deal of time selecting and analyzing those high-quality companies that we're confident will satisfy the needs of humans and businesses in any environment, while generating lots of free cash flow. Selecting high-quality companies is our first and most important line of defense, where we focus our efforts: there is no better protection than owning companies that consistently have high returns on capital and are able to protect them in the face of strong competition or adverse macroeconomic environments. By owning these types of companies, we know that time is on our side and that wealth is being created for the shareholders no matter what. Sometimes, as you know, we do not purchase right away those high-quality companies that we selected and analyzed, but we include them in our watch-list and are ready to purchase them only when the market gives us the price we like. When that happens, our defense turns into *offense*: price is what triggers our market actions, both in portfolio construction and portfolio management. It is the dimension that pushes us to play offense by buying or selling; it is what determines the margin of safety of an investment. We believe our investment process blends defense and offense in a very effective way.

Sometimes the market penalizes the price of companies by mistaking uncertainty with risk. If something is not predictable (i.e., its distribution of possible outcomes is unknown), then it's automatically risky. First of all, we've got news: few things are predictable with accuracy, because the future is inherently uncertain. Second, if all that's unpredictable is risky, then it's really difficult to find something that it's *not* risky. Third, if risk is all around us, then we should be able to assess and price it.

As written many times on these letters, the only risk that matters to us is the probability of a permanent loss of capital. In an investment's distribution of possible outcomes, a permanent loss of capital is only one of the outcomes, and, as such, should be assigned a probability and priced. The fact that if something is uncertain then it's automatically priced for a catastrophe is not the way to go about assessing risk. It's a mental shortcut dictated by fear and panic, two emotions that should never influence an investment decision.

Yet, they do all the time.

A case study in market inefficiency: Qualcomm

Qualcomm (QCOM), a well-known company that we've owned since the very beginning of the fund, has been a recent victim of the uncertainty/risk market way of thinking.

QCOM develops and commercializes mobile telecommunication technologies. In particular, they have developed, and are a leader in the commercialization of, two key digital communication technologies: CDMA (Code Division Multiple Access) and OFDMA (Orthogonal Frequency Division Multiple Access). These technologies are currently used to transmit a wireless device user's voice or data over radio waves using a public cellular wireless network. As QCOM owns significant intellectual property applicable to products that implement any version of CDMA and OFDMA, any company seeking to develop, manufacture and/or sell products that use CDMA- and/or OFDMA-based standards will require a patent license from QCOM. The company's business is comprised of two segments: QCT (2/3 of revenues), through which they develop and supply integrated circuits and system software primarily based on CDMA and OFDMA technologies, and QTL (1/3 of revenues), through which they grant licenses or rights to use portions of their intellectual property portfolio in exchange for royalties or license fees.

QCOM has many of the characteristics of the typical high-quality company that we like to own:

- Business with general quality attributes. QCOM makes products that *(a)* are needed or strongly desired, *(b)* do not have close substitutes, *(c)* are not subject to price regulation, and *(d)* are not depended upon the price of a commodity.

- Strong and sustainable competitive advantages. CDMA and OFDMA are the technological standards used in worldwide mobile communication systems. Virtually every mobile communication device utilized in the world includes components built with QCOM's patented technologies. Besides selling its own chips, QCOM collects royalties on the sale of every device embedding its technologies. Barriers to entry are high, as it would be practically impossible for a new entrant to gain market share by replicating and improving QCOM's technologies. Additionally, QCOM has been spending an average of $3.2bn in R&D every year for the last decade, with such average approaching $5bn in the last five years (on $23-24bn of average revenues over the same period, making average annual R&D expenses more than 20% of revenues). It would be extremely difficult for a new entrant to catch up technology-wise while the incumbent keeps spending that much in R&D every year.

- High Return On Invested Capital (ROIC) and strong cash flow generation. QCOM's competitive advantages are reflected in its performance: ROIC has averaged 33.3% over the last five years (34.1% over the last decade), while every dollar of sales has been turned into 23 cents of free cash flow. Moreover, incremental ROIC on a five-year rolling basis has averaged 29.6% over the last 12 years, a sign of management's above-average capital allocation capabilities.

- Conservative balance sheet. The company has currently $29.8bn of cash and $11.7bn of debt. With negative non-cash net working capital of $3.0bn and long-term assets of $17.6bn, shareholders' equity is approximately equivalent to cash.

- Valuation. QCOM is currently priced at a discount to our estimate of Economic Book Value (normalized net operating profit after taxes – NOPAT – capitalized at 10%, with zero value attributed to growth), with a three-year average free cash flow yield of almost 7% (sum of last three years' free cash flow divided by sum of last three years' enterprise value).

On the basis of the above characteristics, it's no surprise that QCOM has been one of our core holdings since the beginning of the fund.

On January 20th, 2017, "*Apple filed a complaint against the Company […] seeking declarations with respect to several of the Company's patents and alleging that the Company breached certain agreements and violated federal antitrust […] laws.*" (from QCOM's last quarterly report).

This news took QCOM's stock price down by almost 21% in just a few market sessions.

But what's going on exactly between QCOM and Apple? In a nutshell, Apple thinks that QCOM's business practices of charging license fees on the total price of the phones that use modem chips built with QCOM's patented technologies are unfair. Apple has been using QCOM's modem chips (or QCOM's mobile communication technologies) in iPhones for a while now, and the commercial relationship between the two companies has always been strong. During the last earnings release conference call, QCOM's CEO Steve Mollenkopf said "*Historically, we've had a strong relationship*

with Apple, and they have been a long standing and valued customer. We intend to remain a good supplier to Apple, even while this dispute continues, and believe there is no better long-term partner for Apple than Qualcomm and our industry leading technology.". Apple has been using QCOM's mobile communication technology simply because it's the best available on the market. They have recently switched to an inferior Intel modem chip in some models of the iPhone 7 (the AT&T version) and this decision didn't play out well in terms of performance. Then Mollenkopf went on saying: "*But in the end, this is a commercial dispute over the price of intellectual property. They (Apple) want to pay less than the fair value that Qualcomm has established in the marketplace for our technology, even though Apple has generated billions in profits from using that technology.*".

QCOM has been charging license fees on its proprietary technologies since their invention; it's an essential part of their revenue model: QCOM is effectively a technology producer, an innovation machine, widely recognized as such by the entire industry. In turns, the entire industry, while utilizing QCOM's superior communication technologies, has never disputed the fact that such technologies should be paid for. These practices created a dominant position that represents the essence of QCOM's competitive advantages. Such dominant position has been attacked before on an anti-trust basis in several countries, and QCOM has been fined for that, but no governmental body ever disputed the fairness of their business practices. Apparently, though, Apple doesn't like that, and decided to undertake a legal assault on QCOM despite the fact that, without QCOM's technologies, their iPhone business operations (as well as market success) would be seriously impaired. So, who's risking more here – in our opinion – is Apple, and not QCOM (for which Apple is a very important customer, but just one).

The market, however, got scared and reasoned in different terms (fear and panic are rarely conducive to effective reasoning), taking down QCOM's stock price on the basis of what we believe is a mix of the uncertainty/risk misjudgment (high uncertainty = high risk) and poor understanding. On January 25th QCOM announced very strong quarterly results, but the market ignored them, thereby continuing to focus on the Apple dispute.

We have carefully reviewed the QCOM/Apple dispute and concluded that the company's fundamentals and business prospects had remained intact. To us, there's a high likelihood that the Apple dispute will be resolved with an out-of-court settlement, and that the two companies will continue to do mutually beneficial business together, as none of them can afford to lose the other (in this respect, as said, who would have more to lose, if anyone, would be Apple). So, in our opinion, this is a low uncertainty, low risk situation.

Valuation-wise, finally, nothing had substantially changed. Coherently with our portfolio management rules, then, we took advantage of the drop in QCOM's stock price and increased our position to approximately 5% of the fund, from a little more than 1% (QCOM's stock price had increased substantially before the Apple lawsuit, thereby taking its V/P ratio closer to 1.00x).

On keeping cash

As illustrated above in the *Performance and portfolio statistics* section, even though during the last quarter Quality & Value enjoyed a strong price performance, the cash component of our portfolio increased from 25.62% at the end of the third quarter to 45.99% at the end of the fourth quarter, while our invested component decreased accordingly.

We manage the portfolio in a way that, as the V/P ratio of some of our positions decreases towards 1.00x, we are forced to reduce them in favor of positions that became more undervalued (whose V/P ratio has increased), if any, or, alternatively, in favor of cash. As said, this practice allows us to continuously optimize our portfolio by always keeping its V/P ratio as high as possible.

Whenever you see an increase in the fund's net cash, therefore, you can be sure that all our positions' prices have gone up (their V/P ratios went down) and that we were not able to find replacements with a good V/P ratio or a satisfactory margin of safety. In such cases we are happy to hold cash and enjoy its optionality.

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You'll hear from us again with our next quarterly letter around the end of April. As usual, please do not hesitate to call or write us if you want to chat.

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