Letter To Partners

11/06/2025

Dear Partners,

On June 11, 2025, we completed one year of the partnership. During this period, our net return, after taxes and fees, was 23.05%. The S&P 500 (with dividends) returned 13.85%. We performed 9.2% above the average.

Our strategy is centered on buying businesses that we understand and can reasonably value—at prices that offer a sufficient margin of safety. This margin is essential because it ensures that even when I'm wrong (which has happened, and will happen again), we don't suffer substantial losses. We have no geographic or currency constraints. Our goal is to invest your capital in businesses we believe can deliver exceptional long-term performance.

Naturally, our pool of opportunities is limited—particularly during periods of elevated valuations. So, when attractive investments do arise, we're prepared to take concentrated positions. These can sometimes represent 10–20% of the portfolio's total NAV.

Over the past year, approximately 35% of your capital was allocated to cash and fixed income instruments. This wasn't entirely by design. At various points during the year, we felt that the returns offered by fixed income were more compelling, on a risk-adjusted basis, than those available in equities. Additionally, the cash reserve allowed us to act during short-term market pullbacks, when certain stocks became reasonably priced. Due to our aversion to risk, we will usually perform better during years when the broader market is performing below average.

The Importance of a Margin of Safety

The concept of a margin of safety is a cornerstone in both engineering and investing.

In engineering, it serves as a safeguard against the unknown. For instance, if a bridge is expected to carry 10,000 kg, it wouldn't be designed to support only 10,001 kg. Instead, it might be built to withstand 20,000–30,000 kg. This margin helps infrastructure endure unpredictable stresses—ranging from heavier-than-expected loads to natural disasters. Because the consequences of failure can be catastrophic, regulations often mandate these safety buffers. Unfortunately, no such safeguards exist in investing.

In financial markets, investor expectations tend to erode the margin of safety. When markets are optimistic, companies that are performing well today are priced as if that success will persist indefinitely. But even modest setbacks can lead to sharp declines in the value of such companies when priced for perfection.

We avoid these situations. I am not confident in my ability to predict the future. We will leave room for error in our assumptions. If we think a business is worth $1, we aim to buy it at 60¢ or below. That way, even if we're wrong in our assumptions, we limit our downside.

To drive this point home, I'd like to share how our margin of safety protected us from capital impairment in a struggling industry.

We invested in China Meidong Auto Holdings (1268.HK) in August last year. Meidong operates the largest network of Porsche dealerships in China and also represents other premium foreign brands like BMW, Lexus, Toyota, and Audi. Following the pandemic, the country's ongoing housing crisis caused a significant decline in demand for luxury foreign vehicles. Porsche sales dropped 40%, from 95,671 units in 2021 to 56,887 units in 2024. In an effort to revive volumes, automakers introduced steep price cuts, which had a cascading impact on Meidong's profitability. The company's gross profit per car fell from 6.8% to -6.2% over the same period.

My original thesis assumed a recovery in market conditions by late 2024 or early 2025. That hasn't materialized. In fact, we now expect further deterioration in unit sales through 2025, which will continue to pressure margins.

In short, my assumptions were significantly off — the market turned out worse than we expected.

However, our margin of safety on the valuation side proved critical. We purchased the stock at an initial price of HKD 1.94 per share, a level at which the business would still be worth more even if it earned nothing from new car sales for at least five years. This view has held up. The share price has since risen to HKD 2.34, representing a gain of 20.6% from our entry point.

This reinforces why I insist on maintaining a margin of safety. It cushions us when my predictions are wrong—which they inevitably will be from time to time.

Why do businesses fail?

As long-term investors, our greatest risk comes from businesses that can't survive economic and industry cycles. A company can recover from setbacks, but once it fails entirely, there's no coming back. This is a permanent capital loss.

We constantly study why businesses die and how to avoid those at risk. Based on our portfolio experience and the inanities observed from past scenarios, four main causes stand out:

1. **Excessive Leverage**
   Debt is a double-edged sword. It can accelerate growth but is dangerous in downturns. Leaders often extrapolate good times, ignoring industry and systemic risks. This usually leads to excessive borrowing during favourable times. In recessions, refinancing becomes harder and costlier (yields creep higher), compounding financial strain.
   An incalculable effect of debt is its limiting factor for a business to invest in new projects or opportunities. Indebted businesses are unwilling to take the risk to invest in leading technologies. If prolonged, this usually ends up in competitors capturing market share, and shrinking cashflows: further distressing the ability to make debt repayments. We prefer businesses that grow with internal capital—even at the cost of lower ROE—over those chasing debt-fuelled expansion.

2. **Poor Cost Discipline**
   When profits soar and management basks in success, it's easy to adopt a more lavish lifestyle. This often breeds a culture of unnecessary spending that gradually spreads throughout the organization—like a virus. One *superstar* CEO infamously travelled with two private jets—just in case one failed. Expenses are sticky and hard to cut once embedded. Companies that lack cost control struggle when growth slows. Andrew Carnegie often pointed out that, while profits and prices are cyclical, costs can—and must—be tightly managed. Cost savings are permanent business gains.

   Mark Leonard, CEO of Constellation Software, exemplifies this mindset of cost control:

   > *"This year I'll take no salary, no incentive compensation, and I am no longer charging any expenses to the company... I've traditionally travelled on economy tickets and stayed at modest hotels because I wasn't happy freeloading on the CSI shareholders and I wanted to set a good example for the thousands of CSI employees who travel every month. I'm getting older and wealthier and find that I'm willing to trade more of my own cash for comfort, convenience, and speed"* (Shareholder Letter, 2014)

3. **Resistance to Change**
   Many leading businesses are overtaken by younger, leaner competitors because they resist change. Adapting to new realities often involves short-term pain—but it's essential for long-term survival. Legacy bookstores, for example, failed to respond to Amazon's rise, even as they saw the floor being swept out under them. Comfort in a familiar model made them blind to the value of an online distribution model. As William Burroughs put it, "If you're not growing, you're dying." In a world where change is constant, we value businesses that embrace reality and make tough decisions to endure.

4. **Luck**
   Luck is the unexpected entry on this list. We can't ignore the role luck plays in business survival. Natural disasters, wars, regulatory shifts, and pandemics can wipe out even well-run companies through no fault of their own. Such is the nature of capitalism. While we can't control these forces, we must acknowledge them before assigning blame to those working hard to steer a business.

We are closely watching what may bring a company to its knees. Although we cannot be 100% sure of failure, or its absence, we will continue monitoring our portfolio companies.

Summary

Over the last year, our portfolio earned 'look-through' earnings of approximately 6% of the portfolio value, post tax. That is, our share of income from the net profits of all portfolio holdings. This amounts to 8–9% pre-tax (depending on the tax-rate within each geography). Given that we have a mix of assets invested into stocks and bonds, we will aim for 9–12% yield on our look-through pre-tax earnings in the future. These earnings will not correlate with our short term portfolio value because markets can move erratically based on sentiment.

This year has been eventful, and I have learned a lot in the process. Thank you for entrusting me with your capital.

Thank You,

Ronit S. Kothari

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