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QUARTERLY LETTER
TO OUR CO-INVESTORS

MAY 2024

MAY 2024

Dear co-investor,

The start of 2024 has once again been very positive for global equities, continuing the excellent performance already shown in 2023. Our Horos Value Internacional and Horos Value Iberia funds have been part of this trend, posting returns of 5.9% and 1.1%, respectively.

Of course, as we usually emphasize, these results are merely anecdotal, as our goal is to deliver sustainable and satisfactory returns over the long term. Hence, we always share the performance that Alejandro, Miguel and I have achieved in our joint career as a portfolio management team. Specifically, at the time of writing, the cumulative returns in these almost twelve years of track record amount to 287% and 217% or, in other words, 12.0% annualized in the international strategy and 10.5% in the Iberian strategy. [1] These figures compare with 11.7% and 7.75% annualized, respectively, for their benchmarks. As a result of this work, in 2024 we have been nominated again as best fund manager and best group in Iberian equities by the prestigious fund analysis firm Citywire.

I would like to take this opportunity to inform you that this will be the last time we report on the performance of our benchmark indexes. The increase in costs which we would have to assume to continue comparing our performance with that of these indexes was the main reason behind this decision. In addition, this comparison seems secondary to us given our very active management style (separate from the indexes). Precisely, I would like to devote this quarterly letter to discuss the rise of index investing in recent years and, in particular, its impact on the stock markets and on the active management of mutual funds.

Thank you for your confidence.

Yours sincerely,

Javier Ruiz, CFA
Chief Investment Officer
Horos Asset Management

[1] As of May 7, 2024. The data includes the performance of the portfolio management team in its previous professional period working for another asset management firm (from May 31, 2012 for the international strategy and September 30 for the Iberian strategy, until May 22, 2018 in both cases, when they joined Horos AM).
Past performance is not a guarantee of future performance.

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Executive summary

If I subscribed to the efficient market theory I would still be delivering papers.
— Warren Buffett

2024 is so far another strong year for the stock markets, with significant gains in most indexes. A performance that in recent years has been very difficult for active fund managers to match (let alone beat), and which continues to raise doubts about the value of separating from the indexes. This undoubtedly explains the surge in assets and variety of index funds over the last two decades, and especially over the last ten years. However, are these dynamics sustainable in the long term? Is there still a place for active managers in a market increasingly dominated by passive management? At Horos we are convinced that this is the case, and we will devote this letter to try to prove it.

As usual, we will also discuss the most significant changes that we have made to our portfolios during the first quarter. Among others, we can highlight that Horos Value Internacional initiated three new positions. Specifically, we invested in the Spanish stainless steel manufacturer **Acerinox**, in the French nursing home and health center management company **LNA Santé** and in the French IT services company **Aubay**. Meanwhile, both Horos Value Internacional and Horos Value Iberia fully divested (in April) the stake in **Renta Corporación**.

An existential doubt

For most of us, trying to beat the market leads to disastrous results.
— Jeremy Siegel

As our most experienced co-investors know, at Horos we always try to be transparent and provide continuous information and education. The aim of this exercise is none other than to help our clients to better understand our investment philosophy, the decision-making process we follow and what they should expect from our products. Otherwise, it will be much more difficult for them to enjoy the fruits they have been sowing. That is, satisfactory and sustainable returns over the long term. For this reason, in addition to publishing quarterly letters such as this one, we hold an annual investor conference, participate (occasionally) in various financial forums and, of course, hold meetings with clients and potential investors. I mention the latter because we are observing a similar, very significant pattern in many of our meetings. A recurring question haunts us: **why invest in an actively managed fund, if index funds or passively managed funds deliver *higher returns* with *lower risk*?**

This question alludes to the two concepts most studied throughout the history of financial markets: return and risk. However, before going deeper into these ideas, it is interesting to begin by checking whether or not index investing is really outperforming actively managed funds. Is this the case? Yes, indeed. In fact, a devastating study (which can be qualified in some relevant aspects, though, as we will see below), published in March this year by S&P Global, concluded that only one out of ten equity mutual funds beat the Standard & Poor's 500, the main US stock market index, over periods of more than 10 years.[2] This same analysis produced a (slightly) less disastrous result for global equity funds. Given this empirical evidence, it is totally understandable that any investor should consider the need to complicate his life by entrusting his savings to managers who try to add value to their investors with their stock picking (as we humbly try to do here at Horos). It is not unreasonable either to think that, probably, **many people question whether valuing companies makes sense** based on what I have just discussed. Of course, this is a challenge struck directly at the core of our identity as investors, demanding a thorough analysis.

[2] Di Gioia, D., Edwards, T., Ganti, A.R., Nelesen, J. and Longo, S. (March 6, 2024). SPIVA U.S. Year-End 2023. *S&P Dow Jones Indices*.

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The unbeatable chimpanzee

For investment purposes, there are very few investors that shouldn't behave as if markets are totally efficient.
— Eugene Fama

One of the perennial debates in financial markets is whether it is really possible to beat the market (i.e., stock market indexes). As in other disciplines, the academic world has tried to find an answer to this dilemma. Possibly, the germ of this "revolution" originated in the mid-1950s, when the famous economist **Paul Samuelson** (Nobel Prize winner and author of the best-known economics textbook in history, with the permission of Gregory Mankiw's, which was studied by yours truly) picked up on the ideas of the brilliant French mathematician **Louis Bachelier**, who already in 1900 defended, without saying so explicitly, that the fluctuations in asset prices that make up the stock market follow a sort of random walk or, in other words, that it is impossible to predict their behavior and benefit from it:

> *The (mathematical) expectation of the speculator is zero.* [3]

Later, in the 1960s and 1970s, the economist (and also Nobel Prize winner in Economics) **Eugene Fama** drew on some of Samuelson's ideas, as well as those of Benoît Mandelbrot (to whom Nassim N. Taleb dedicated his popular book ***The Black Swan***), to develop the theoretical framework of efficient markets through his famous paper *Efficient Capital Markets: A Review of Theory and Empirical Work*.[4] In this work, Fama sows the idea that **a market is *ideal* or *efficient* when its prices reflect ALL available information**. As a corollary of the above, when a market is efficient, investors will not be able to generate excess returns sustainably.

Specifically, Fama establishes three hypotheses or levels of efficiency, which have been studied for many years in most finance qualifications: weak, semi-strong and strong. Under the **weak hypothesis**, an investor could not beat the market by using historical patterns of stock prices, because past prices would not influence future behavior (random walk) but could rely on public information concerning companies (e.g., the evolution of their financial results), since this would not be picked up quickly by the investment community. Therefore, under this hypothesis of weak efficiency, momentum and technical analysis or similar investment strategies

[3] Jean-Michel Courtault, Youri Kabanov, Bernard Bru, Pierre Crepel, Isabelle Lebon, et al. Louis Bachelier On the centenary of Théorie de la Spéculation. Mathematical Finance, 2000, 10 (3), pp. 339-353. halshs-00447592; Mandelbrot, B. B. (2008). *The (Mis)Behaviour of Markets. A Fractal View of Risk, Ruin and Reward*. Profile Books.
[4] Fama, E. F. (1970). Efficient Capital Markets: A Review of Theory and Empirical Work. The Journal of Finance, 25(2), 383–417. https://doi.org/10.2307/2325486

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would not have the potential to generate excess returns over the market, but those based on fundamental analysis (such as the one we value investors profess) would. In the case of the **semi-strong hypothesis**, all public information, including companies' income statements, balance sheets and cash flow statements, would already be contained in the share price, so that fundamental analysis would not provide value to the investor either. Finally, under the **strong hypothesis**, not even private or insider information (i.e., information that is only known and used illegally by a company's management team) could achieve excess returns, as it would quickly leak into the market.

Fama concluded in his study that empirical analysis provides evidence that markets meet the weak and semi-strong hypotheses and that, therefore:

> *For the purposes of most investors the efficient markets model seems a good first (and second) approximation to reality.*[5]

Indeed, **for advocates of efficient markets, there is no such thing as a free lunch**, or at least not for too long. **Burton Malkiel**, possibly one of the staunch defenders of this market efficiency, explains it very well in his best-selling classic ***A Random Walk Down Wall Street***, when he relies on the anecdote of the $100 bill that the finance professor and one of his students come across. Upon seeing it, the student stops to pick it up, but the professor discourages him by saying, "Don't bother—if it were really a $100 bill, it wouldn't be there."[6] Therefore, if there were an arbitrage opportunity, i.e., a risk-free profit, it would quickly vanish because the investment community would have already tried to exploit it to the point of disappearing.

In fact, in the first edition of his book in 1973, Malkiel concluded that a chimpanzee throwing darts at *The Wall Street Journal* would build a stock portfolio that would perform just as well as that of professional investors. This led him to the conclusion that "what we need is a no-load, minimum-management-fee mutual fund that simply buys the hundreds of stocks making up the broad stock-market averages."[7] In short, in the early 1970s the academic world issued a challenge to the financial world and, of course, someone would soon take up the gauntlet.

[5] Fama, E. F. (1970). *Ídem*.
[6] Malkiel, B. G. (2007). *Un paseo aleatorio por Wall Street. La estrategia para invertir con éxito*. Alianza Editorial. (English version: *A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing*)
[7] Marks, H. (June 18, 2018). Investing Without People. *Oaktree Capital*.

An investment for the masses

Don't look for the needle in the haystack. Just buy the haystack!
— John C. Bogle

Indeed, that same year, **Rex Sinquefield** (who later co-founded Dimensional Fund Advisors) launched the first index fund open to the general public.[8] Sinquefield was a student of Fama at the University of Chicago and, in his own words, experienced a kind of epiphany when he heard him talk about efficient markets. This led him to introduce the first replicas of the Standard & Poor's (S&P) 500 index.[9] The high costs of trading securities and the low liquidity of many companies meant that the product could not initially buy all the names that made up the index, but this did not prevent the funds from performing very similarly to the index. The invention was a success and reached a size of 12 billion dollars within a few years.[10] However, it was another figure who will always be remembered as the one who democratized investing in the stock market: **John C. Bogle**.

Bogle showed, from a very young age, his interest in financial markets and, in particular, in mutual funds. In fact, his university thesis at Princeton focused on explaining what a mutual fund manager should be like, as well as a defense of this product.[11] **It is ironic that the greatest proponent of the history of index funds was, in his early days, a great advocate of actively managed funds**.[12] Walter Morgan, a Princeton alumnus, impressed by Bogle's thesis, hired him to work at Wellington Management Company, the fund management company of which he was CEO. There, Bogle experienced a meteoric rise that saw him succeed Morgan at the helm of this prestigious firm. However, after leading the merger of Wellington with another Boston entity in a misguided attempt to navigate the Nifty Fifty bubble, the subsequent poor performance of the business following the stock market collapse caused his dismissal.[13] Bogle went on to found **The Vanguard Group**. The rest is history.

Today, **Vanguard** is the second largest provider of Exchange-Traded Funds (ETFs) in the United States, the world's largest market, where it has been gaining market

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[8] In 1971, Wells Fargo launched the first indexed portfolio, but exclusively managed for Samsonite's pension fund. Wigglesworth, R. (2021). *Trillions. How a Band of Wall Street Renegades Invented the Index Fund and Changed Finance Forever*. Penguin.
[9] Soriano, D. Z. (May 9, 2019). The Book of Booth: Index Fund Pioneer Rex Sinquefield, '72. *Chicago Booth Magazine*.
[10] Wikipedia (page visited on April 25, 2024); Schaefer Riley, N. (October 26, 2012). Meet One of the Super-PAC Men. *The Wall Street Journal*.
[11] Bogle, John C. (1951). The Economic Role of the Investment Company. Princeton University.
[12] Wigglesworth, R. (2021). *Ídem*.
[13] Elkins, K. (December 21, 2018). Jack Bogle shares the $1 billion investing mistake that cost him his job. *CNBC*.

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share to reach the estimated 29.5% it currently holds.[14] The asset management giant **BlackRock** is the leader, with a market share of around 32.5%, thanks to its acquisition a few years ago of iShares (in Europe they control c.45% of the market). The third is **State Street**, with a very significant size, although smaller than the previous ones (around 15% market share).[15] These three entities therefore account for more than 75% of the ETF industry in the United States, demonstrating the benefits of scale in a product that tries to reduce costs as much as possible so as not to be separated from the index it replicates.

Not only that, as a result of their outperformance relative to actively managed funds, **index funds exceeded the volume of assets under management in the United States by active funds for the first time in history in 2023**.[16] In fact, the actual figure for "passively" managed assets is much higher, as it would have to include, among others, private strategies (such as portfolios managed by entities, including **BlackRock** itself, for large pension funds and sovereign wealth funds) and closet indexers, i.e., funds *disguised* as active but which are virtually indistinguishable from their benchmarks.

Obviously, all this has led to the personalities of Bogle and index funds being revered by all and sundry over the last few decades. Of course, their greatest praise has come from the academic world, where Paul Samuelson went so far as to call the index fund one of mankind's greatest inventions:

> *I rank this Bogle invention along with the invention of the wheel, the alphabet, Gutenberg printing and wine and cheese.*[17]

Much more remarkable, however, has been the fervent defense of this product by the greatest investor of all time. Indeed, Warren Buffett has always maintained that, for most people, the best way to proceed is to invest in an ETF that replicates the S&P 500. Even more, more than fifteen years ago, Buffett issued a challenge to the hedge fund industry to prove that their fees were exorbitant. The bet, accepted by Protégé Partners LLC, consisted of putting the S&P 500 against a basket of hedge funds selected by this firm for a ten-year period (from January 1, 2008). The result? An overwhelming victory for the index.[18] Without a doubt, this Buffett "campaign" was one of the biggest and best advertisements that **Vanguard**—one of its ETFs was used for the bet—and the rest of the index fund industry could have

[14] Greifeld, K. (December 13, 2023). Vanguard Is Closer Than Ever to Ending BlackRock's ETF Reign. *Bloomberg*.
[15] Brewster, L. (February 7, 2024). Vanguard Eclipses BlackRock for Equity Market Share. *Yahoo! Finance*.
[16] Sabban, A. (January 17, 2024). It's Official: Passive Funds Overtake Active Funds. *Morningstar*.
[17] Powell, R. (July 13, 2017). One of the greatest inventions. *TEBI*.
[18] Floyd, D. (June 25, 2019). Buffett's Bet with the Hedge Funds: And the Winner Is … *Investopedia*.

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ever dreamed of. The reality is that, with totally different styles, both Bogle and Buffett always advocated common sense, long-term investing, hence their mutual admiration for each other. There is no better reflection of this than Buffett's words to Bogle when he passed away five years ago:

> *If a statue is ever erected to honor the person who has done the most for American investors, the hands down choice should be Jack Bogle.*[19]

In summary, based on what we have just discussed, we can highlight three very relevant aspects of index investing. First, if markets are efficient, no one can sustainably beat them. Secondly, the empirical evidence of recent times seems to support this idea. And finally, the theoretical efficiency of markets and the outperformance of indexes have led to the relentless rise of index funds. But are financial markets really efficient? Do index funds contribute to their efficiency? Will they continue to outperform actively managed funds? These are certainly very pertinent questions that I will try to answer in the next few pages.

Not all markets are equally (in)efficient

Value investing is predicated on the efficient market hypothesis being wrong.
— Seth Klarman

The efficient markets hypothesis, as shown above, is totally tied to information and, more specifically, to how it is gathered and processed by investors. On this basis, if public information (and private in its strongest version) is widely known by all, it should be impossible to beat the market, since asset prices will quickly price in any new information that appears. Therefore, **to achieve this ideal of efficiency, markets must meet three requirements: free entry for new investors, low costs of accessing information and competitive environments.**[20] This should lead us quickly to the conclusion that, at any given time, some markets will be more efficient than others, depending on how well these three conditions are met.

Consider the specific case of Chinese companies listed on the Shanghai and Shenzhen stock exchanges (A-shares) and on the Hong Kong stock exchange (H-shares). Restrictions on the **movement of capital** (and therefore of new investors) imposed by the Chinese government mean that many citizens can only buy A-shares, which means that these securities trade at a significant premium (currently

[19] Melloy, J. (January 16, 2019). Warren Buffett says Jack Bogle did more for the individual investor than anyone he's ever known. *CNBC*.
[20] Cochrane, J. (May 20, 2014). Eugene F. Fama, Efficient Markets, and the Nobel Prize. *Chicago Booth Review*.

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more than 45%) over their H-shares listed on the Hong Kong stock exchange.[21] Such restrictions on capital flows make it impossible to close this inefficiency, as the arbitrage opportunity is not realizable by the investment community. On other occasions, as noted in our last quarterly letter (see **here**), investment restrictions can be more subtle, such as the imposition of a fund's prospectus not to invest in a particular asset or, directly, policies set by the fund manager itself (as with mutual funds, usually managed by banks, which cannot separate themselves excessively from their benchmarks' performance). While inefficiencies related to Chinese companies will persist as long as capital controls exist, in other instances, truly active funds might exploit these arbitrage opportunities. Indeed, the more investors attempt to exploit this inefficiency, the quicker the market will become efficient.

The second condition for a market to be fully efficient, as we have seen, is to have minimal **information access** costs. Imagine, for a moment, what tools an investor had at his disposal in the 1950s and 1960s, when a young Warren Buffett obtained his highest returns. Indeed, Buffett did not use the Internet or Bloomberg to gather information about companies. There was no such possibility. Buffett and other bargain-hunting investors relied, at best, on **Moody's** manuals, which compiled the most relevant financial data on the country's leading listed companies. Literally thousands of pages to work through:

> *When I started, I went through the pages of the manual page by page; I mean, I probably went through 20,000 pages in Moody's industrial transportation, banks, and finance manuals, and I did it twice.*[22]

However, the fact that we now have access to the internet or Bloomberg is not sufficient to eliminate frictions in accessing information. In fact, I always remember this anecdote from our previous professional stage, more than ten years ago, because it is very illustrative. My colleague Alejandro spent a morning reviewing the French companies with the largest capitalization on the French Alternext (an index similar to Spain's BME Growth, which is now called Euronext Growth) to look for any new investment ideas. After that first look, one company in particular caught his eye: **Groupe Guillin**. This company is Europe's leading manufacturer of thermoformed packaging for the food industry. Well, what was his surprise when he discovered that Bloomberg did not have updated financial information for this company for the last two or three years. This made the apparent valuation of **Groupe Guillin** much less cheap than it really was. Not only that. At that time, to

[21] If the reader is curious, he can follow the evolution of this premium with the Hang Seng Stock Connect China AH Premium Index on the Hang Seng Indexes website.
[22] Mahmood, H. (June 22, 2023). How Would Warren Buffett Invest A Small Sum Of Money? *LinkedIn*.

access this information you had to register in a hidden section of the company's website, generating a significant friction in the access to data for the investment community. As a result, **Groupe Guillin** was trading at a ridiculously low valuation. We did not hesitate to invest in the company, making it the top position in our international portfolio for several years. Our investment more than quadrupled in a very short period of time, solely by putting in a little more effort than the rest of the investment community in seeking information. As a reminder, we have also been shareholders of this wonderful company for several years in our Horos Value Internacional fund, although access to information is no longer as limited as it was back then.

The third and final requirement for a market to be efficient is that it is **competitive**, i.e. that there are many investors participating in it. Why? Because if there is no interest in an asset then inefficiencies will not close or will take much longer to do so. Consider another example that we have repeated many times: the **Hong Kong stock exchange**. After years of declines there is no interest in this market, resulting in liquidity (the traded volume of its stocks) plummeting. Consequently, the value discovery process of companies is not taking place, leading to huge inefficiencies. What can make this change? As also detailed in the past quarter, a turnaround in investor sentiment or, directly, the emergence of catalysts (such as corporate deals or management decisions that help uncover this value). We like to point out that **opportunities are usually found in ponds where fish are plentiful and fishermen are scarce or, in other words, in markets that are not very competitive and inefficient**.

In short, with these simple examples we have been able to see why equity markets, or at least some of them, are far from efficient and, therefore, why as investors we can try to exploit these opportunities by assuming less risk. In Buffett's words:

> *Observing that the market was frequently efficient, EMT adherents went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day.*[23]

At its core, this is the essence of value investing. If inefficiencies did not exist, we could never aspire to beat the market. However, even under the assumption that the market is efficient in the sense of Fama, it is not clear that this approach is entirely well-framed. This leads us to try to answer the second of the three questions posed above: do index funds contribute to the efficiency of markets?

[23] Hagstrom, R. (2013). *The Warren Buffett Way*. Wiley.

Irrational exuberance

I believe the market accurately reflects not the truth, which is what the efficient market hypothesis says, but it accurately and efficiently reflects everybody's opinion as to what's true.
— Howard Marks

It is ironic that Eugene Fama shared the Nobel Prize in Economics with Robert Shiller, whose studies show that financial asset prices are prone to extreme boom and bust cycles, generating potentially exploitable inefficiencies.[24] Indeed, as the development of behavioral economics by, among others, Daniel Kahneman and Amos Tversky also proved, human beings are far from being rational and, therefore, share prices reflect or are impacted by many more factors than simply the available information (as Fama advocated).[25]

> *I also hope to challenge financial thinkers to improve their theories by testing them against the impressive evidence that suggests that the price level is more than merely the sum of the available economic information, as is now generally thought to be the case.*[26]

Supporters of the efficient market hypothesis, including Fama himself, have responded to these studies with research of their own that concludes that the market is indeed efficient, but that excess returns can simply be obtained by incurring greater risk. Specifically, Fama and his collaborator Kenneth French proved that certain investment characteristics or factors can play a differential role.[27] Thus, investing in cheaper or smaller companies can generate higher returns because, they argue, the investor would be assuming greater risk (hence the term *risk premium*). In the first case because, supposedly, a cheaper company than the market may be going through a business slump or have a higher financial risk and, in the second case, because the investor will always prefer greater liquidity. Of course, this and other studies were the starting point for what is known as **factor investing** (other factors have been included over time, such as momentum, quality or dividends).[28]

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[24] Shiller, R. J. (2015). *Exuberancia irracional*. Deusto. (English version: *Irrational Exuberance*).
[25] Lewis, M. (2017). *Deshaciendo errores: Kahneman, Tversky y la amistad que nos enseñó cómo funciona la mente*. Debate. (English version: *The Undoing Project: A Friendship that Changed the World*).
[26] Shiller, R. (2015). *Ídem*.
[27] Fama, Eugene F & French, Kenneth R. (1992). "The Cross-Section of Expected Stock Returns," Journal of Finance, American Finance Association, vol. 47(2), pages 427-465, June.
[28] Luque, F. (January 3, 2017). El Factor Investing: ¿En qué consiste? *Morningstar Spain*.

One cannot help but wonder to what extent these academic debates are so relevant in a world in which index investing is playing a more and more decisive role. Indeed, as Michael Green (chief strategist at Simplify Asset Management and former portfolio manager of the Thiel Macro hedge fund, owned by the famous U.S. entrepreneur and investor Peter Thiel) warns, the debate ceased to make sense as soon as the indexes abandoned their historical role as mere benchmarks and became, through index funds, a very active part of the stock markets.

Green argues that **markets are becoming increasingly inelastic** or less sensitive to the prices at which they trade.[29] In an elastic market, investors would sell the shares of companies that had risen too much, as their expected future returns would be lower, and vice versa, they would buy the shares of companies trading at more attractive price levels. However, in an environment where index funds continue to see steady capital inflows, the inelasticity of the market as a whole increases. Why? Quite simply, because the index fund simply buys the shares of the index it replicates, regardless of whether they are cheap or expensive. As a second derivative of all this, some studies argue that for every new dollar that wants to buy all the shares of an index, its stock market value must rise by five dollars for the transaction to be executed.[30] The reason? There seem to be several factors, but a relevant one is the restricted supply of shares: the greater the volume managed by index funds, the fewer shares available to the public for trading (free float). As in any market, mismatches between demand and supply must be adjusted via prices. **The greater the bottleneck, the greater the inelasticity of the market and the necessary price movement**.

But to what extent is the rise of index investing impacting the markets? Like they say, correlation does not imply causation, but (coincidentally) momentum strategies (based on the past evolution of stock prices) or larger companies (present in the most representative indexes that replicate index funds) have outperformed over the last ten years, while strategies based on fundamental analysis (such as value investing) or smaller companies (generally also within the value style) have performed the worst.[31] In addition, the U.S. stock market has benefited the most from these trends, (coincidentally?) achieving extraordinary returns over the period. Consequently, its valuation has reached levels rarely seen against its historical average and are significantly higher compared to other global stock markets.[32]

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[29] (August 23, 2023). Tier 1 Alpha: A Massive Paradigm Shift In Market Fundamentals. *HedgeEye*.
[30] Gabaix, Xavier and Koijen, Ralph S. J. (May 12, 2022). In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis. Swiss Finance Institute Research Paper No. 20-91, Available at SSRN: https://ssrn.com/abstract=3686935 or http://dx.doi.org/10.2139/ssrn.3686935
[31] Index Investment Strategy: Factors (March 2024). *S&P Dow Jones Indices*; The Consequences of Passive Investing. *Acheron Insights*.
[32] (March 31, 2024). Guide to the Markets. Europe 2Q24. *J.P. Morgan Asset Management*.

I insist that it is difficult to distinguish here the true significance and impact of index investing in the performance of equity markets. I am also well aware of the role that other factors have played in the outstanding returns of the U.S. stock market (such as its companies' higher profitability, quality, more aggressive capital allocation or having the world's largest technology giants), but as our much-admired David Einhorn's Greenlight Capital recently pointed out:

> *In fact, so much more money is allocated to passive strategies that they are no longer price takers (…). Instead, these strategies have become price makers, where their flows are an important driver of price.*[33]

In short, it is very likely that the rise of index funds is contributing to distort the behavior of stock markets, which brings us to a great paradox: **index investing is based on the theoretical efficiency of the market, but does not contribute to its achievement or maintenance over time**. In fact, it seems to encourage inefficiency to increase. This led, a few years ago, an investment strategist at Bernstein Research to say, ironically, that passive investing is worse than Marxism, since the latter at least tries to allocate resources in some way.[34]

Considering all this, let us try to answer the third and final question: will index funds continue to outperform actively managed funds?

Past returns do not guarantee…

Inefficiency doesn't make it easier for all investors to beat the market.
— John C. Bogle

To try to answer this important question, we are going to focus on two very relevant aspects of the historical outperformance of index funds: one concerning the performance of actively managed funds and the other that of index funds. Let us start with the first one. If you recall, at the beginning of this quarterly letter, we highlighted a devastating study that proved the abysmal superiority of index funds over actively managed funds. However, it is interesting to ask to what extent all the (de)merit is attributable to the managers of these mutual funds. As we already mentioned a few years ago (see **here**), we have lived through a terrible period for

[33] Greenlight Capital (April 24, 2024).
[34] Rosenberg, A. (August 24, 2016). Passive investing is 'worse than Marxism,' Bernstein strategist claims. *CNBC*.

value investing (arguably the most active style of investing or separate from stock market indexes), thanks to a constant flow of money into large and growth companies to the detriment of smaller companies and more cyclical businesses. This flow has made the former more and more expensive and the latter cheaper, feeding back what we baptized at the time as the great evasion. It is therefore a totally hostile environment for active management, very reminiscent of the dotcom bubble.

In fact, as was the case at the time, many active managers, under pressure from the risk of losing their jobs (money outflows and underperformance) have given up and sought to reinvent themselves by changing their investment style. As the Standard & Poor's study itself proves, in the last ten years 6 out of 10 actively managed funds have survived and less than half have managed to stay true to their original investment philosophy. What is more, how many of these active funds are truly active? Obviously, under such adverse circumstances, too much differentiation can be an insurmountable toll for a manager. Bill Nygren, the renowned manager of the Oakmark funds, estimates that the true active share of the average large fund in the United States is 60%:

> *The average large-cap fund has an active share of 60%, meaning that 40% of the fund could be replaced by a no-cost index fund.*[35]

Does all this prove that active management does not add value or, rather, that active management is very difficult to implement sustainably? I am clearly leaning towards the latter. That is why I will never tire of repeating why it is so important that the ownership of the asset management company is fully aligned with the investment style of the portfolio management team (as is the case at Horos) and that its clients understand and share its investment process (as we hope is also the case at Horos).

The second relevant aspect relates to index funds. Specifically, it remains to be clarified how sustainable are the returns expected from these products and, more specifically, from the main indexes of the U.S. stock market (where the bulk of their assets are concentrated). More than a few voices have warned about the risks of these (and other) dynamics that we have highlighted in this letter. Legendary investors such as Peter Lynch, Seth Klarman or Michael Burry (the one from The Big Short movie) have shared their fears on several occasions.[36] In fact, Burry went

[35] Nygren, B. (December 31, 2023). Active vs. passive: did funds meet the mark in 2023? | U.S. equity market commentary 4Q23. *Oakmark Funds*.
[36] Mohamed, T. (December 9, 2021). Legendary stock picker Peter Lynch warns against passive investing after the 'Big Short' investor Michael Burry called it a dangerous bubble. *Business Insider*.

so far in 2019 as to call passive investing a bubble, by continually making large U.S. companies more expensive and smaller companies cheaper.[37]

For our part, we already emphasized in our last annual conference the risks we saw in the U.S. stock market (see **here**), where the relentless rise of mega-cap tech has led to an unprecedented index concentration in recent decades (10 companies account for 33.5% of the value of the S&P 500 index and almost 20% of the global MSCI ACWI index). To make matters worse, the bulk of active managers are also invested in these companies.[38] Although various studies have been warning for years about the risk of higher future volatility in an inelastic market dominated by index funds, I am convinced that this concentration in so few names and the lack of investor heterogeneity (see **here** on the importance of this factor in a complex adaptive system such as the stock market) will further exacerbate the probability of major future stock market shocks.[39]

One might think that these alerts are self-serving, as they all come (including Horos) from active fund managers. However, surprising as it may seem, even Bogle warned, a couple of years before he passed away, about the dangers of the unstoppable rise of index funds, which has benefited **Vanguard** so much:

> *If everybody indexed, the only word you could use is chaos, catastrophe. The markets would fail.*[40]

Have we answered with this letter the question at the beginning of why invest in an actively managed fund, if index or passively managed funds obtain higher returns with lower risk? I am aware that not entirely. In the markets, as in almost everything else in life, we operate more within a spectrum of gray shades rather than in stark black and white. That said, I think it is clear that markets do exhibit varying degrees of efficiency, which creates ongoing investment opportunities. Also, that index funds seem to be distorting market behavior and that this trend may not be sustainable. Finally, it is not easy to be an active fund manager in the current environment, but I believe that our performance as a portfolio management team over the last twelve years shows that it is possible to create value (inevitably, with better and worse periods in the interim), assuming less risk than investing without criteria (in terms of valuation) in a stock market index. Let

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[37] Kim, H. and Cho, M. (August 28, 2019). The Big Short's Michael Burry Sees a Bubble in Passive Investing. *Bloomberg*.
[38] Bahnsen, D. L. (May 3, 2024). The Month of May is Here to Stay. *The Bahnsen Group*; Cobas Asset Management (May 8, 2024).
[39] Soni, A. (November 29, 2023). The flood of money investors are putting in ETFs is distorting stock prices and worsening volatility, study says. *Business Insider*.
[40] Udland, M. (May 6, 2017). Jack Bogle envisions 'chaos, catastrophe' in markets if everyone were to index. *Yahoo! Finance*.

us not forget that, **for a market to aspire to be efficient, there will always be a need for active managers who contribute to closing its inefficiencies, obtaining an excess return for this work**:

> *When active investing is dismissed totally and all active efforts cease, passive investing will become imprudent and opportunities for superior returns from active investing will reemerge.*[41]

Main changes to our portfolios

Investment success does not require glamour stocks or bull markets.
— John Neff

The following is a summary of the most significant changes to our funds' portfolios:

HOROS VALUE INTERNACIONAL
Stake decreases & exits:

FINANCIALS (16%) & HOLDINGS AND ASSET MANAGEMENT (18%)
Holdings discussed: Fairfax India (2.8%) y AerCap (2.7%)

This quarter we cut our exposure to some companies in the financial sector, such as **Fairfax India** or **AerCap**, due to their lower relative attractiveness compared to other alternatives in the portfolio or other investments that we added during the period.

COMMODITIES (19%)
Holdings discussed: Mistras Group (1.5%)

In addition, we significantly trimmed our stake in the U.S. company **Mistras Group**, which specializes in non-destructive testing and inspection services, following the excellent performance of its share price and after lowering our future cash flow estimates. Although the management team seems to be making the right decisions in terms of business restructuring, generating significant cost savings and improving the company's revenue outlook, we prefer to be conservative with our numbers and wait for confirmation of these positive changes in the coming quarters.

[41] Marks, H. (June 18, 2018). *Ídem*.

OTHER
Holdings discussed: Renta Corporación (0.1%)

Finally, this quarter we cut our position (fully divested in April) in **Renta Corporación**. This is undoubtedly a historical investment that has been a source of much disappointment. The results of 2023 and the changes in the management team were the straw that broke the camel's back and led us to sell our entire position. The reasons? The significant deterioration of some assets on the balance sheet (which has led to the sale of properties at a significant loss to keep the debt low), an increasingly opaque communication policy and, especially, the continuous "promises" of improved results that have never materialized.

Stake increases & new stakes:

COMMODITIES (19%)
Holdings discussed: TGS (3.6%) and Acerinox (2.2%)

The first new stake to highlight in the quarter is **Acerinox**. This stainless steel company, present in our Horos Value Iberia fund, has been penalized along with the rest of the sector by the weakness in demand in its European business for several quarters, both due to the fall in real demand, as well as that derived from the accumulation of inventories by its customers to cover the bottlenecks that have persisted in recent times. However, the situation seems to be coming to an end and we should at least anticipate a market bottom and a gradual recovery. Meanwhile, **Acerinox** has an enviable competitive position in the United States, where the dynamics are much more favorable for the company. Additionally, the company's robust financial health has enabled it to make value-accretive acquisitions in higher value-added segments. For example, in 2020 Acerinox acquired **VDM Metals** (a German manufacturer of high-performance alloy products and solutions) and, more recently, announced an agreement to purchase the U.S. company **Haynes International** (still pending approval by the various regulators). All these factors, combined with a very attractive valuation, led us to add the company to our international portfolio.

As in the previous quarter, the persistent weakness in the performance of **TGS** led us to further increase our exposure to this data services company for the oil and gas industry. The delay in the realization of certain investments by its clients has provided an excuse for a correction, which we believe is unjustified.

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FINANCIALS (16%)

Holdings discussed: Catalana Occidente (5.0%)

The strong earnings performance of the Spanish insurer **Catalana Occidente**, especially in the automobile business (the company consistently makes money in an environment in which the rest of the Spanish listed companies are suffering losses), as well as the potential synergies from the acquisition of Mémora, the growing accumulation of excess capital on the balance sheet, the cost savings that the group will achieve with the early retirement of a large part of the workforce and, all this, combined with a share price that has remained virtually unchanged in recent years, led us to increase our stake in this company. As always, we would like to see more decisiveness from **Catalana Occidente**'s management team in unlocking the massive upside potential that the market does not seem to perceive (a share buyback would certainly be the best decision). However, it seems that we will have to continue to hope for the long-awaited corporate deal to put to work the more than one billion euros "idle" that the company has been accumulating on its balance sheet for some time and that, possibly, will help to unlock part of this value.

OTHER

Holdings discussed: Naspers (4.4%), Nordic Paper (2.0%), LNA Santé (1.8%) and Aubay (1.4%)

This quarter, we also added the French companies **LNA Santé** and **Aubay** to our fund. The former is an entity founded in 1990 that manages nursing homes, rehabilitation and health centers, psychiatric clinics and home health care. **LNA Santé** manages 49 nursing homes in France (mostly) and Belgium, as well as 24 health clinics and 10 hospital care at home structures. It has also recently entered the Polish market with the acquisition of two rehabilitation centers. In total, the company has around 9,400 beds and 85 centers. The investment opportunity arises because the healthcare sector has experienced a succession of unprecedented problems, such as the coronavirus pandemic, malpractice scandals (which have not involved **LNA Santé**, but other companies such as **Orpea**) and significant cost inflation that they have not been able to counteract with price increases (many prices are set by regulation). All this, together with the historically high debt of companies operating in this industry due to their presumed stability, has led to bankruptcies and major stock market collapses.

Nevertheless, **LNA Santé**'s more conservative balance sheet management, as well as better practices in the management of its centers, have enabled it to weather this sector downturn with solid results, while taking advantage of the situation to pursue inorganic growth. Meanwhile, as in many other countries, the demographic dynamics in France are a structural tailwind for this business. Finally, it is important to note that the company is just over 60% controlled by the founding families and employees, which ensures a good alignment of interests with the rest of shareholders. All these factors, coupled with its sharp market correction in recent times, convinced us to invest in this company.

Aubay is a family-owned French IT services company founded in 1997 and present in 7 European countries. The company generates just over half its turnover in France, with the remainder spread across other countries. Like **LNA Santé**, approximately 60% of **Aubay** is controlled by its founding families, ensuring alignment between management and shareholder interests. The company operates in various sectors, but has a strong exposure to the financial sector (60% of revenues), with clients such as **BNP Paribas**, **Crédit Agricole** and **Banco Santander**. **Aubay**'s type of service, where reputation and certain switching costs play an important role, means that it has a very low client turnover. On the other hand, it is a business with limited capital employed and, therefore, high returns on invested capital, which has experienced a structural tailwind derived from the continuous digitization of processes and the drive for greater productivity across all industries. In the case of **Aubay**, the investment opportunity originates from the margin pressure that the sector is experiencing due to the halt in investments by some of its customers because of economic uncertainty. We believe that, at our acquisition prices, the market is discounting a permanent decline in the business's operating margins, as well as zero sales growth. In our opinion, **Aubay**'s quality and positioning should allow it to recover its historical profitability and return to growth, which is why we decided to initiate this new position in the fund.

We also increased our position in the technology platform holding company **Naspers** and in the kraft and greaseproof paper producer **Nordic Paper**. Regarding **Naspers**, the depressed market sentiment towards Chinese companies has also affected its share price (reminder: **Naspers** has a 43% economic interest in **Prosus**, which in turn holds a c.25% stake in the Chinese technology giant **Tencent**). Given the positive outlook for **Tencent**'s business over the next few years, **Naspers'** attractive valuation and its superb capital allocation over the past two years (selling **Prosus** shares while at the same time selling **Tencent** shares to buy back **Naspers** shares at a discount), we increased our exposure to this great company.

As for **Nordic Paper**, the company announced the initiation of a process to explore potential interest in its sale, following an announcement by its main shareholder, **Shanying International Holdings**, of its intention to divest its 48.16% stake. Although not a particularly relevant part of our investment thesis (see here), we have always commented that this move would make perfect sense, as the Chinese company's investment in **Nordic Paper** ended up being merely financial, without bringing any synergies to its business. This announcement, combined with a better business performance than we expected, led us to slightly increase our stake in the Nordic company.

HOROS VALUE IBERIA
Stake decreases & exits:

REAL ESTATE/REAL ASSETS (10%):
Holdings discussed: Renta Corporación (0.3%)

During the month of April we exited this investment for the reasons already explained above in Horos Value Internacional.

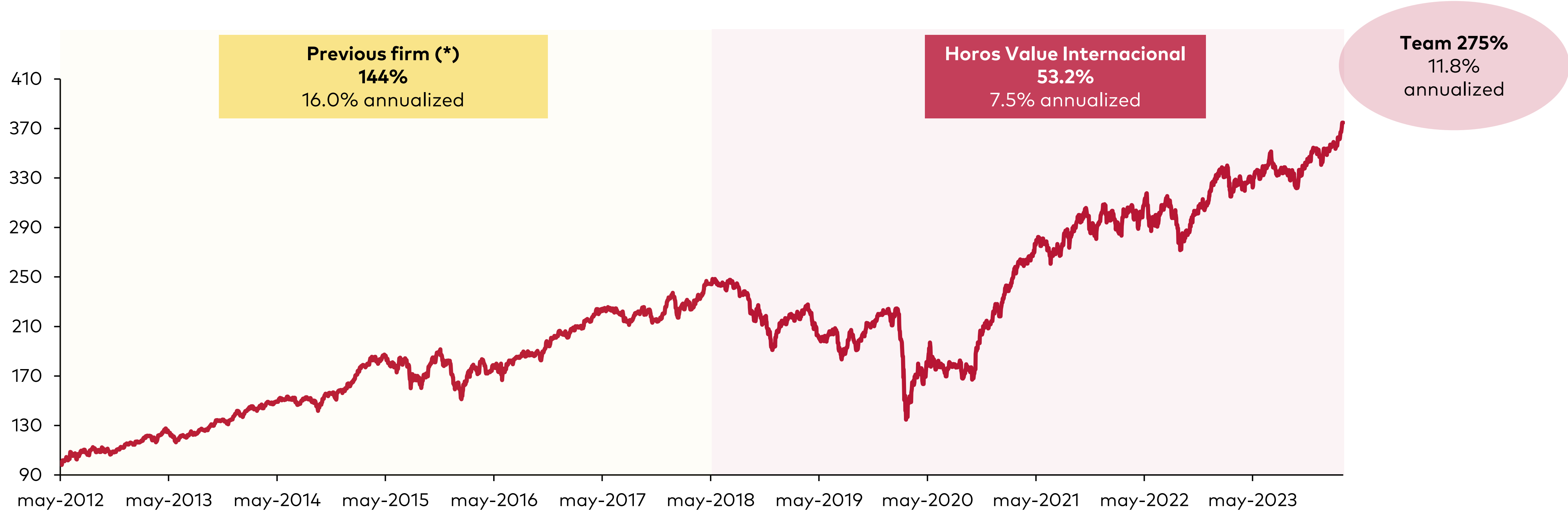
Stake increases & new stakes:

OTHER
Holdings discussed: Catalana Occidente (7.2%) and Meliá Hotels International (4.3%)

This quarter, the two companies whose positions in the fund increased the most were **Catalana Occidente** and **Meliá Hotels International**. Although we did not purchase additional shares of these companies, their outperformance contributed to this greater weight. The strong results published by these companies and their excellent prospects for the coming years led us to raise our valuation and, consequently, our allocation to both companies.

Returns

Historical returns of the management team in the International Strategy



Data cover the period between the 30th May 2012 and 31st March 2024.

*Previous firm returns correspond to the management team performance achieved in their previous profesional stage, where they worked for a different asset management firm. This "previous stage" corresponds to the period between the 30th May 2012 and 22nd May 2018.

Past performance is no guarantee of future performance. The Fund's investments are subject to market fluctuations and other risks inherent to investing in securities, so the acquisition of the Fund and the returns obtained may vary both upwards and downwards and an investor may not recoup the amount initially invested. Decisions to invest or divest in the Fund must be made by the investor in accordance with the legal documents at all times, and in particular on the basis of the Regulations and the Fundamental Data for the Investor (DFI) of each Fund, accompanied, where appropriate, by the Annual Report and the last quarterly Report. All this information, and any others, will be available to you at the headquarters of the Manager and through the website: www.horosam.com

Returns

Historical returns of the management team in the Iberian Strategy

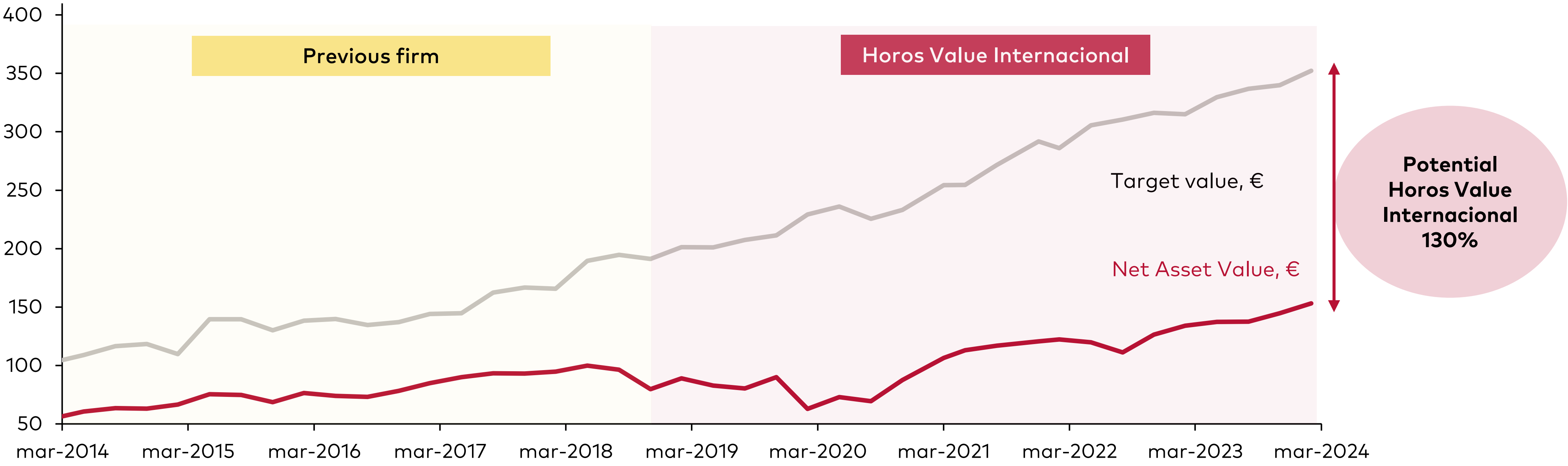
Data cover the period between the 30th September 2012 and 31st March 2024.

*Previous firm returns correspond to the management team performance achieved in their previous professional stage, where they worked for a different asset management firm. This "previous stage" corresponds to the period between the 30th September 2012 and 22nd May 2018.

Past performance is no guarantee of future performance. The Fund's investments are subject to market fluctuations and other risks inherent to investing in securities, so the acquisition of the Fund and the returns obtained may vary both upwards and downwards and an investor may not recoup the amount initially invested. Decisions to invest or divest in the Fund must be made by the investor in accordance with the legal documents at all times, and in particular on the basis of the Regulations and the Fundamental Data for the Investor (DFI) of each Fund, accompanied, where appropriate, by the Annual Report and the last quarterly Report. All this information, and any others, will be available to you at the headquarters of the Manager and through the website: www.horosam.com

Upside Potential

Target value vs. Net Asset Value of the Management Team



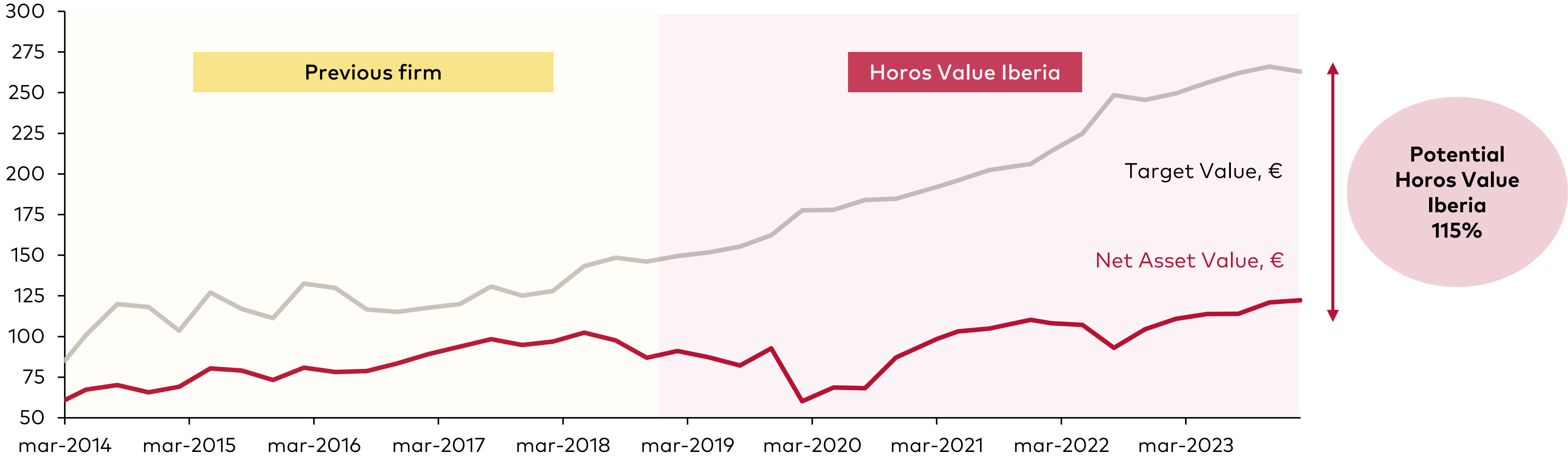
Data cover the period between the 31st March 2014 and the 31st March 2024.

Previous firm data correspond to the period when the management team worked for a different asset management firm. For the NAV calculation, this previous firm performance has been used, and as a base for retrieving the simulated NAV within this period, the NAV of Horos Value Internacional at 23rd May 2018, the day when the management team joins the project.

For the target value calculation, we perform an individual assessment of each Investment included in the portfolio. Specifically, we make a three-year estimate of the value of each company in which we invest. To do this we calculate, in a conservative way, the future cash flows we think the business will generate over the next three years in order to estimate the company future value (understood as market capitalization adjusted for net financial position). Subsequently, with this data we estimate the EV/FCF multiple (future value of the company divided by its normalised free cash flow, adjusting the latter for extraordinary items) at which each company would be priced. Finally, as a result of the qualitative analysis we do on each company, we assign an exit multiple to each investment (how much we think each business is worth trading at) and compare it with the previous figure to estimate the potential or attractiveness of the investment. Occasionally, given the nature of the investments, other generally accepted valuation methods would be used such as sum of parts, discounted cash flow or price to book value multiples.

Upside Potential

Target value vs. Net Asset Value of the Management Team



Data cover the period between the 31st March 2014 and the 31st March 2024.

Previous firm data correspond to the period when the management team worked for a different asset management firm. For the NAV calculation, this previous firm performance has been used, and as a base for retrieving the simulated NAV within this period, the NAV of Horos Value Iberia at 23rd May 2018, the day when the management team joins the project.

For the target value calculation, we perform an individual assessment of each Investment included in the portfolio. Specifically, we make a three-year estimate of the value of each company in which we invest. To do this we calculate, in a conservative way, the future cash flows we think the business will generate over the next three years in order to estimate the company future value (understood as market capitalization adjusted for net financial position). Subsequently, with this data we estimate the EV/FCF multiple (future value of the company divided by its normalised free cash flow, adjusting the latter for extraordinary items) at which each company would be priced. Finally, as a result of the qualitative analysis we do on each company, we assign an exit multiple to each investment (how much we think each business is worth trading at) and compare it with the previous figure to estimate the potential or attractiveness of the investment. Occasionally, given the nature of the investments, other generally accepted valuation methods would be used such as sum of parts, discounted cash flow or price to book value multiples.

Top 10 Holdings
Horos Value Internacional

Holding	%	Theme
Catalana Occidente	5.0%	Financial
Naspers	4.4%	TMT
ALD Automotive	3.9%	Financial
Talgo	3.7%	Industrial
TGS Nopec	3.6%	Commodities
Semapa	3.6%	Holding
Atalaya Mining	3.2%	Commodities
Spartan Delta Corp	3.2%	Commodities
Fairfax India	2.8%	Holding
Gestamp Automocion	2.7%	Industrial

Top 10 Holdings
Horos Value Iberia

Holding	%	Theme
Catalana Occidente	7.3%	Financial
Semapa	6.8%	Holding
Horos Value Internacional	6.1%	Others
Alantra Partners	6.0%	Financial
Iberpapel	5.9%	Industrial
Talgo	5.1%	Engineering
Meliá Hoteles	4.3%	Consumer cyclicals
Atalaya Mining	4.3%	Commodities
Gestamp Automocion	4.2%	Industrial
Aperam	4.2%	Commodities