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QUARTERLY LETTER
TO OUR CO-INVESTORS

OCTOBER 2023

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Dear co-investor,

This quarter, the management team formed by Alejandro, Miguel and myself is celebrating eleven years working in the complex and fascinating world of investing. A period in which we have remained faithful to the same investment principles and in which we have always managed two strategies: international and Iberian equities. In these eleven years we have delivered cumulative returns of 236% in the international strategy (11.3% annualized) and 185% in the Iberian strategy (10.0%), outperforming their benchmark indices in both cases.[1] These returns are very satisfactory and we will undoubtedly work to maintain this positive trend in the coming years. Of course, the current high upside potential of our funds leads us to believe that we can achieve this.

Taking a shorter-term view, our funds are up 8.7% in 2023 for Horos Value Internacional (versus 10.9% of its benchmark index) and 9.0% for Horos Value Iberia (versus 16.2%). However, these returns do not reflect a number of very important anomalies that are occurring and which make us cautious about the market and, paradoxically, optimistic about our portfolios for the future. I will devote this quarterly letter to explaining this and the main movements of our funds.

Thank you for your confidence.

Yours sincerely,

Javier Ruiz, CFA
Chief Investment Officer
Horos Asset Management

[1] 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.

Executive summary

Before figuring out how you will win the game, figure out which game to play.
— Michael Mauboussin

Human beings are designed to detect patterns. It is an essential attribute for our survival. However, when it comes to investing, it can become our worst enemy. On the one hand, it can lead us into the trap of confusing chance with causality. On the other hand, when there is a clear market pattern, it can trigger a herd behavior that feeds back into the market until it becomes unsustainable. Are we now experiencing a similar situation in equity markets? Indeed, the performance of the technology sector, its valuations compared to other companies, as well as investor sentiment, suggest that this may be the case. The same dynamics, but in the opposite direction, may be occurring in other sectors or geographies. At Horos we will stick to our philosophy of trying to fish in those ponds with many fish and few fishermen, so we will usually invest in those markets that attract very little interest from the investment community. Undoubtedly, our current exposure to Spanish and Asian equities is a clear reflection of this. We will expand on these ideas in this quarterly letter.

As usual, we will also discuss the most significant changes that we have made to our portfolios. Among others, we can highlight that Horos Value Internacional fully divested our positions in the offshore oil rig company **Shelf Drilling**, the technology holding company **Alphabet**, the B shares of the metallurgical coal company **Ramaco Resources** and, already in October, the car dealership company **Pendragon**, taking advantage of the recent battle between several players to acquire this entity. Meanwhile, we invested in the Canadian asset manager **Onex**, the shipping broker **Clarkson**, the Swedish paper producer **Nordic Paper**, the real estate services company **Excellence Commercial Property** and reinvested, a few months after our exit, in the oil and gas producer **Spartan Delta**. As for Horos Value Iberia, we sold our full stake in **Corporación Financiera Alba**.

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The player inside us

Strong chess players realize patterns and can immediately see opportunities.
— Garry Kaspárov

Our brain is a well-oiled machine when it comes to recognizing and processing patterns. In fact, some researchers qualify this capacity as the basis of everything that distinguishes the human brain from that of other species, such as intelligence, imagination or language.[2] This attribute proved essential to our survival and evolution as individuals and as a species, playing a fundamental role in human natural selection itself.[3] Let us realize that our ancestors were more likely to survive if they reacted by hiding at the sound of a breaking branch, regardless of whether the cause came from a predator stepping on it or the wind shaking the top of a tree. The reader will agree that, in this type of situation, the classic confrontation between correlation and causation becomes secondary. However, as has been demonstrated in other fields (such as health), **our brain is still wired to function in a much more hostile environment, where uncertainty could kill you**, than that of a modern society.[4] This leads it to use its survival manual in uncertain situations where it does not need it or, worse, where it does more harm than good. The problem lies in the fact that our brain is not so well designed to detect whether a pattern is correct or not (evolutionarily, as we have seen, this has its *raison d'être*), which can lead us to make decisions based on false beliefs:

> *Our brains are belief engines: evolved **pattern-recognition machines** that connect the dots and create meaning out of the patterns that we think we see in nature. Unfortunately (...) we have no error-detection governor to modulate the pattern-recognition engine.*[5]

A clear example of this can be found in some ancient civilizations, where rituals or even sacrifices were performed when solar eclipses occurred, in an attempt to recover the sun or to placate the gods who were inflicting such a punishment.[6] However, it is not necessary to go so far back in time. A case much closer to home can be found in games of chance, where many gamblers fall into what is known as

[2] Mattson MP. *Superior pattern processing is the essence of the evolved human brain*. Front Neurosci. 2014 Aug 22;8:265. doi: 10.3389/fnins.2014.00265. PMID: 25202234; PMCID: PMC4141622.
[3] Barkman, R. C. (May 19, 2021). Why the Human Brain Is So Good at Detecting Patterns. *Psychology Today*.
[4] Vázquez, M. (November 17, 2018). Diseña tu Entorno para Mejorar tus Hábitos Sin Depender de tu Disciplina. *Fitness Revolucionario*.
[5] Shermer, M. (December 1, 2008). Patternicity: Finding Meaningful Patterns in Meaningless Noise. *Scientific American*. Bold added for emphasis.
[6] Bromwich, J. E. (August 18, 2017). The Demons of Darkness Will Eat Men, and Other Solar Eclipse Myths. *The New York Times*.

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the **gambler's fallacy** or Monte Carlo fallacy, acting on the false belief that past results affect future ones.[7]

> *-You bet it on the zero right now.*
> *-Grandma, the zero has just come out, I said, now it will take a long time to come out again. You're going to lose a lot, wait a little bit.*[8]

This does not mean that our ability to detect patterns and exploit them cannot be an advantage in certain environments. Thus, in other disciplines, such as chess, this neuronal capacity can be crucial, as shown by the story of the Polgár sisters, whose father trained them from a very young age to become the best players in the world.[9] As an anecdote, Judit Polgár would become, at the time, the youngest person to reach the title of International Grandmaster, beating the record held by the prodigious Bobby Fisher, as well as the first woman to beat Garry Kaspárov (the "Baku Ogre"), who has certainly been, with Magnus Carlsen's permission, the best player in the history of the 64-square game.

However, chess is one of the few exceptions to the rule. More commonly, we will face much more random battlefields with changing and incomplete rules and information, where the (often unconscious) search for patterns can lead us down the road to perdition. But why are we paying so much attention to the formation of patterns by our brain? Because, as long as there has been an opportunity for quick profit, human beings have always tried to find shortcuts that allow them to get rich, and this has been especially true (and dangerous) in what many consider to be the biggest casino, the stock market.

> *(The Stock Market) is the biggest casino in the world.*[10]

[7] Picado, B. (December 18, 2022). Apofenia: Ver conexiones ocultas en hechos sin relación entre sí. *Belén Picado Psicología*.
[8] Dostoyevski, F. (2018). *The Gambler*. Read & Co. Classics.
[9] Epstein, D. (2019). *Range. Why Generalists Triumph in a Specialized World*. Riverhead Books.
[10] Thorp, E. O. (2017). *A Man for All Markets: From Las Vegas to Wall Street, How I Beat the Dealer and the Market*. Random House.

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That's NOT what the stock market is all about

My hypothesis: Within the stock market, there is a pattern as well... Right in front of me... hiding behind the numbers. Always has been.
— Max Cohen ("Pi, faith in chaos")

Let me share with you a conversation I had with a physiotherapist this summer, because I think it illustrates very well what I am trying to convey in this letter. Normally, when a stranger hears about my profession, he quickly makes me aware of his interest in the investment world (if he has one, of course). On many occasions, he even shares his portfolio with me to listen to my impressions. This visit to the physiotherapist turned out to be no exception to the rule and he was quick to tell me about some of his profitable (they always are) forays into the financial markets. Sure enough, the "usual suspects" (see **Tesla**, **Nvidia** or **Apple**) quickly made an appearance, to which I reacted by trying to explain to him how I understood that it was best to approach investing. To this end, I asked him if he was the owner of the physical therapy clinic we were at, to which he replied yes. I then used the simplest question you can ask a business owner to get him to understand how he should invest in stocks: "If I wanted to buy your clinic right now, on what basis would you set the selling price?" His answer was quick and accurate: "Well, it will depend on the profits I make each year." At this comment I could only smile, satisfied with how easy the reasoning exercise had been, and I told him that this is exactly how he should invest, thinking about how much he is paying for the profits of listed companies. What ensued, then, knocked me out. The physiotherapist pointed out to me, absolutely convinced of his words, that no, that is not what the stock market was. He then proceeded to tell me how he invested in **Tesla** shares according to a system that worked very well for him: buying every time the share price fell by 10%. At this, I decided it was best to change the subject. However, the phrase **"that's not what the stock market is all about"** stuck in my mind.

Indeed, the popular belief is still that financial markets are a kind of casino where you can make a lot of money and very quickly (the other side of the coin is usually ignored), as long as you manage to see *something* that the rest of investors are overlooking. That something, of course, can be a pattern as simple (and absurd) as the one we have just seen, finding technical figures in some kind of chart (chartism) or relying on some much more elaborate and quantitative tool, such as the hidden model that the disturbed protagonist of that strange movie from the late 90s

called *Pi* was trying to decipher.[11]

We should not think that only the most inexperienced investors use this type of strategy to try to achieve good returns. There are also legendary money managers who have historically exploited patterns as a complement when making an investment decision, the case of George Soros and his theory of reflexivity being particularly paradigmatic.[12] Momentum investing is an example, which is nothing more than an attempt to achieve returns based on the most recent performance of an asset or market. There is nothing wrong with this, as long as one is aware of its risks and limitations or, in other words, no one should make investment decisions solely based on these tools—I take this opportunity to emphasize that at Horos we do not use any kind of predictive strategy to decide where or how we invest.

Indeed, it should serve as a warning that even the most brilliant investors, even when they detect that the market pattern is totally unsustainable and irrational, can end up leaving aside their fundamental analysis and succumb to their worst enemy, i.e., themselves. The one and only Stanley Druckenmiller (one of the greatest investors in history and, precisely, a disciple of George Soros) has told us, on more than one occasion, how he ended up losing three billion dollars in the dotcom bubble at the end of the twentieth century.

> *So, like around March I could feel it coming. I just – I had to play. I couldn't help myself. And three times during the same week I pick up a – don't do it. Don't do it. Anyway, I pick up the phone finally. I think I missed the top by an hour. I bought $6 billion worth of tech stocks… and in six weeks I had left Soros and I had lost $3 billion in that one play. You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to that. I was just an emotional basket case and couldn't help myself. So, maybe I learned not to do it again. But I already knew that.*[13]

In summary, based on what we have discussed so far, we know that our brains are evolutionarily designed to detect patterns and that this can be a problem when investing in financial markets. However, we have also seen that some investors have managed to achieve huge returns, as well as massive losses, by relying on them. But why is all this of particular interest at this time? Because, as we mentioned in our previous quarterly letter (see **here**), there is every indication that we could be entering the final phase of some of these patterns.

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[11] Aronofsky, D. (1998). *Pi, faith in chaos*. Planttain Films, Harvest Filmworks, Truth and Soul Pictures, Protozoa Pictures.
[12] Soros, G. (1987). *The Alchemy of Finance*. Simon and Schuster.
[13] Stanley Druckenmiller's lecture at the Lost Tree Club in 2015.

This IS what the stock market is all about

What about the stock market? The universe of numbers that represents the global economy. Millions of hands at work, billions of minds. A vast network, screaming with life. An organism, a natural organism.
— Max Cohen ("Pi, faith in chaos")

As we had the opportunity to explain on previous occasions, when we described the global stock market crash at the beginning of the coronavirus pandemic (see **here**) or when we compared their dynamics with those of the climate (see **here**), financial markets are **complex adaptive systems** in which the whole is different and greater than the sum of its parts.[14] Or, to put it another way, a complex adaptive system (the financial market) has particular properties that emerge from the interaction of all the units that compose it (investors) and, therefore, its behavior does not depend only on exogenous factors (such as news), but also on endogenous ones. In short, **the market has its own "personality."**[15]

> *If you want to understand an ant colony, don't ask an ant. It doesn't know what's going on. Study the colony.*[16]

Analyzing financial markets as complex adaptive systems allows us to better interpret their evolution and can be useful in investing. We mentioned a moment ago the formation of patterns. Well, although our brain can lead us to identify spurious relationships with apparent validity for investing (such as acquiring shares of a company every time its price drops by a certain amount because it has worked a couple of times in the past), this does not preclude the existence of other patterns that may be more or less sustainable over time. These stock market patterns arise, among others, because of one of the fundamental characteristics of complex adaptive systems: **feedback loops**.[17] Namely, when the result of one iteration becomes the input of the next. In the case at hand: **the past performance of the price of an asset can influence its future evolution**. Therefore, contrary to what is assumed by the classical efficient market hypothesis or the random walk theory, market prices are path dependent and have a **long-term memory** that would be behind some trends or patterns that one can observe in their historical

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[14] To get started in the theory of complexity applied to economics, I recommend Moreno Casas, V. (2022). *Economía de la Complejidad: Breve introducción a un nuevo paradigma*.
[15] Mandelbrot, B. B. and Hudson, R. L. (2008). *The (Mis)Behaviour of Markets: A Fractal View of Risk, Ruin and Reward*. Profile Books.
[16] Mauboussin, M. (2009). *Think Twice: Harnessing the Power of Counterintuition*. Harvard Business Press.
[17] Mauboussin, M. J. (2002), *Revisiting Market Efficiency: The Stock Market as a Complex Adaptive System*. Journal of Applied Corporate Finance, 14: 47-55. https://doi.org/10.1111/j.1745-6622.2002.tb00448.x

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evolution.[18]

But why do these feedback loops occur? Because of what is known as the **herd behavior** of investors. This phenomenon can be explained by a myriad of reasons, such as the risk of losing one's job if the funds managed by a professional experience a period of poor relative performance, how the incentives for the fund manager are designed (for example, not being able to deviate too much from a benchmark index), trying to anticipate what the rest of investors are going to do, by pure social imitation in uncertain environments (running away if everyone else starts to do it, even if you do not know the reason, can save your life) or by a combination of all of them.[19]

> *We are all influenced—subconsciously and to some extent consciously—by what we see others do and approve. Therefore, if everybody's buying something, we think it's better.*[20]

Is a similar situation occurring in the market today? Indeed, the dynamics that are developing in the large companies of the **technology sector** seem to indicate that this is the case. On the one hand, their impressive performance so far this year (60% better than the S&P500 at the end of August) is a perfect breeding ground for the interrelationships of reflexivity and feedback loops that lead to a classic bullish pattern.[21] On the other hand, as a cause and consequence of the above, the sector is getting massive capital inflows since the beginning of the year, especially in those companies linked to the artificial intelligence boom.[22] However, detecting a classic bullish pattern does not tell us anything per se. The important thing is to elucidate whether this pattern is justified and, more specifically, whether it is sustainable. Again, complexity theory can be of great help.

An unsustainable bullish pattern?

There is no future in purity. Purity is in the mix.
— Jarabe de Palo (Spanish music band)

One of the essential characteristics for a complex adaptive system to function properly is the **heterogeneity** of its agents. For example, it seems that a

[18] Mandelbrot, B. B. and Hudson, R. L. (2008). *Idem.*
[19] Kaizoji, Taisei & Sornette, Didier. (2008). *Market bubbles and crashes.* arXiv.org, Quantitative Finance Papers.
[20] Munger, C. (1994). *A Lesson on Elementary Worldy Wisdom.* USC Business School.
[21] (August 2023). Trading the impact of AI adoption. *Goldman Sachs Global Investment Research.*
[22] (September 27, 2023). Cumulative Global Sector Fund Flows. *ISABELNET.*

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heterogeneous habitat helps to preserve biodiversity.[23] The same is true of the stock market. The more different views there are on listed companies, or rather the more varied the investment decisions, the less the market tends to experience any kind of excess. In the most extreme cases, a lack of heterogeneity in the market as a whole can lead to the formation of bubbles and, usually, to subsequent financial crises, as happened in 2008. As Jean-Pierre Landau, former deputy governor of the Bank of France and executive director of the International Monetary Fund and the World Bank, explained at the time, the greater sophistication of financial markets to that point did not translate into greater heterogeneity of their agents, but quite the opposite, with devastating consequences:

> *It has now become apparent that, behind these veils of diverse colors, there was a profound uniformity in the approach to risk, its measurement, its management, as well as in the drivers of risk appetite. This uniformity had very destabilizing consequences. In normal times, it helped and crystallize expectations on overvalued asset prices. In times of stress, it made the adjustment process extremely disorderly.*[24]

Now, the steady **capital inflows** into technology companies, at the same time as money is being withdrawn from the rest of the market, is reducing this heterogeneity. Basically, investors seem to be assuming that it is not an option to be out of this sector. Not only do fund flows seem to be a clear indication of greater homogeneity, but we can contrast this more clearly with other metrics. Thus, technology stocks have not represented such a high percentage in equity fund portfolios since the peak in 2021, just before the sector's downturn with the rapid rise in interest rates and its consequent multiple contraction.[25] This historic **weighting** is three times the percentage of 2017 and nearly double that of 2020.

The evident lack of heterogeneity is causing a series of anomalies that could be described as extraordinary, as we highlighted in our previous quarterly letter. On the one hand, at the end of August, the technology sector accounted for more than 28% of the market value of the S&P500 index. This figure is close to the 29% it reached in 1999, right at the peak of the dotcom bubble. On the other hand, as we just mentioned above, the dynamics that the shares of these companies are experiencing also translate into an outstanding price performance both in absolute

[23] Redondo J.M., García, J.S., Bustamante-Zamudio, C., Pereira, M. F. and Trujillo, H. F. (2022). *Heterogeneity: method and applications for complex systems analysis*. Journal of Physics: Conference Series, Volume 2159, VIII International Conference Days of Applied Mathematics (VIII ICDAM) 20-22 October 2021, San José de Cúcuta, Colombia.
[24] Introductory remarks by Jean-Pierre Landau, Deputy Governor of the Banque de France, at the conference "The macroeconomy and financial systems in normal times and in times of stress", organized by the Bank of France and the Bundesbank, Gouvieux-Chantilly on June 8, 2009.
[25] (August 2023). Tech Share of Equity Sector Fund Assets. *Goldman Sachs Global Investment Research*.

and relative terms. For example, the ratio comparing the Nasdaq-100 (the world's main technology index) with the Russell-2000 (an index of U.S. small-cap companies) has not been at such high levels since (yes, you guessed it) the peak of the dotcom bubble. Another way to contrast this would be to compare the performance of the S&P500 against the same index if all companies were equally weighted. In this case, the outperformance of the former over the latter now reaches heights not seen since, again, the late 1990s. There is literally no record (at least since 1990) of a bullish year for the S&P500 in which just ten companies account for almost all of its performance.[26] Of course, all of this has, unsurprisingly, been accompanied by a very significant expansion in the **valuations** at which these companies are trading. In fact, the eight largest U.S. technology companies trade at much higher multiples than the average of the other companies that make up the S&P500.

Before proceeding further, I would like to make it clear that we have no doubt that this situation is very different from that of the 1990s. This is an industry that has, among its components, companies that operate their businesses with unprecedented global leadership and, therefore, these are high quality companies and ones in which, as you know, we have been shareholders for many years. That said, the current environment does not need to reach bubble levels to make it more uncertain (and risky). Why do I say this? Simply because these anomalies are affecting the rest of the market. The herding behavior and the lack of heterogeneity ends up permeating, for better or worse, all assets and, therefore, stock market indexes. For instance, the ten largest companies in the S&P500 account for 30.5% of its market capitalization, almost 100% of which is attributable to eight technology companies.[27] This is a level of **market concentration** not seen in many decades. As a result, the U.S. stock market as a whole has also seen a multiple expansion and, more importantly, its future performance will be closely linked to the performance of these eight companies.

However, it is not only the S&P500 that is being "distorted" by these dynamics. We are currently seeing other extremes that are worth mentioning. For example, companies with the highest **dividend yields** have one of their worst historical performances relative to lower dividend payers (coincidentally, technology companies often prefer to buy back shares rather than pay their shareholders in the form of dividends). In fact, this worse performance is comparable only to what

[26] Geraci, N. [@NateGeraci] (October 3, 2023). *96.5% of S&P 500 return contribution this yr is from the 10 largest constituents... No other positive performance yr is really even close...* Twitter. https://twitter.com/NateGeraci/status/1709293604269637684
[27] Bilello, C. [@charliebilello] (September 27, 2023). *The top 10 holdings in the S&P 500 now make up 30.5% of the index, the highest concentration we've seen with data going back to 1980*. Twitter. https://twitter.com/charliebilello/status/1707017835736645879

happened in the late 1960s and again in the late 1990s. In both cases, the tide turned sharply in the years that followed.[28] Additionally, although not as directly related, I think it is important to note that the so-called **Equity Risk Premium**, adjusted for inflation, has not been at such unfavorable levels for the U.S. indexes since the end of the last century.[29] There are two reasons for this: a) the strong recovery of the U.S. stock market for the reasons already mentioned; b) the dismal performance of U.S. government bonds (and those of the rest of the world) over the past few years. For example, if nothing changes, the U.S. 10-year treasury bond will record, for the first time in its history, three consecutive years of losses.[30] To make matters worse, it has accumulated the largest correction in a three-year period that it has ever experienced.[31]

We could go on giving more examples, but they all lead to the same conclusion: **the great performance of technology companies has led to a situation that may become unsustainable**. Of course, we do not know if this moment is close to occurring or if it will even happen. However, it is interesting to rely, again, on two other features of complex adaptive systems to understand why this is relevant. Specifically, **nonlinearity** and the **transition phase** or tipping point. The first of these explains that small changes within the system can trigger large impacts on its behavior and, vice versa, large changes can have a very limited effect. The transition phase, on the other hand, is a change in the way a system is organized. To understand this, let us think of the process that water undergoes when we put it in the freezer. It does not freeze gradually, but maintains its liquid state until, suddenly, a small additional drop in temperature turns it into ice. Therefore, **transition phases often imply abrupt and non-linear changes**.

Indeed, in case there is any doubt, the same thing happens in financial markets. When a pattern becomes unsustainable it eventually reaches a tipping point and, when this happens, the turnaround is usually very violent because the previous dynamics are abruptly reversed. The homogeneity of investors means that the market does not find new buyers and the feedback and reflexivity processes, fed by herd behavior, end up causing a cascading correction until heterogeneity is restored:

[28] Weniger, J. [@JeffWeniger] (June 19, 2023). *The 20-year performance gap between High Dividend and Low Dividend stocks is currently at levels seen in 2021 and before that, the late 1990s. Before that, the late 1960s and early 1970s*. Twitter. https://twitter.com/JeffWeniger/status/1670866788513624064
[29] Authers, J. (September 11, 2023). Hitchhiker's Guide to the Equity Risk Premium. *Bloomberg*.
[30] (September 2023). Big Bust: US 10-year government bond annual return since 1787. *BofA Global Investment Strategy*.
[31] Bilello, C. [@charliebilello] (October 1, 2023). *US Bonds are down 15% over the last 3 years, the largest 3-year decline in history*. Twitter. https://twitter.com/charliebilello/status/1708487769452888403

> *During the run up to a crash population diversity falls. Agents begin to use very similar trading strategies as their common good performance begins to self-reinforce (...) The population homogeneity translates into a reduction in market liquidity.*[32]

In short, the current concentration of investors in technology stocks has led them to soar, while at the same time increasing their relevance and impact on the overall market. If, for whatever reason (for example, lower than expected earnings growth in these companies), some investors decide tomorrow to trim their exposure to the sector, this could have a significant impact on their share prices and, given their high weighting, on the world's most important stock market indexes. So, what is the point of this type of analysis and the potential conclusion we have reached? On the one hand, to reinforce our conviction that avoiding these companies is the most appropriate decision—a conclusion to which our company analysis process had already led us. On the other hand, this analysis can help us to identify (and understand) the opposite situations in other markets, where we can find great investment opportunities today.

An unsustainable bearish pattern?

In the mixture of purity. That before it was pure it was a mixture.
— Jarabe de Palo (Spanish music band)

We always say that our geographic and sector exposure is a consequence of the investment opportunities we find at any given time, i.e., we do not invest based on a top-down analysis (choosing a region or sector to invest in), but rather a bottom-up analysis (at the company level) leads to our portfolio structure. This does not mean that we can ignore trying to understand what makes an industry or a market more attractive. For example, for years we have had a significant exposure (now lower but still relevant) to the commodities sector and we have spent time in our annual conferences and quarterly letters explaining the reasons behind the great investment opportunities in this industry (see **here**). Well, today our research leads us to hold a portfolio in which, geographically, the greatest concentration of ideas is in companies listed in the European and Asian markets, with a relative underweight in companies listed in the U.S. market. The fundamental reason? Because these are markets that trade at more attractive valuations. According to some studies, as a result of their poorer performance in recent years, Chinese companies have not traded as cheaply in the last 25 years and European

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[32] Lebaron, B. (2001). *Financial market efficiency in a coevolutionary environment*. Brandeis University.

companies show a clear historical undervaluation.[33]

It is certainly interesting to elucidate what has led to this situation. To do so, we are going to focus on the two individual markets that have the greatest weight in our international portfolio: Spanish equities and Chinese equities (companies listed in Hong Kong and the United States). Specifically, Spanish companies today account for around 23% of the Horos Value Internacional portfolio and Chinese companies for around 19% (some of these companies are listed in Hong Kong, but their business is outside China, although the market does not seem to distinguish this factor). Therefore, between the two geographies, they represent 42% of our international fund. This weighting has not been determined overnight and has varied according to the opportunities we find in these and other geographies, always with the aim of maximizing the upside potential of our portfolios, while reducing the risk incurred. But why are these markets trading at such attractive levels compared to their historical averages? We could give a myriad of fundamental explanations, such as the deterioration in legal certainty in the case of the Spanish market or the economic crisis in China, which we have already explained on several occasions (see here and here).[34] However, in the end, the real reason why assets may trade at a discount is none other than a lack of investor appetite. I am not denying that investor sentiment is not driven by these fundamental causes (every narrative hides a truth). But, as was the case with the bullish pattern of technology companies, **investor herd behavior, with its feedback loops and reflexivity dynamics, plays a very relevant role also in the worst performing markets**: stocks fall or stay cheap because investors sell or ignore the market and vice versa.

The following news about the Chinese stock market can serve as context to what I am saying. For example, this 2023 has seen the highest number of emerging market fund launches with the “ex-China” label.[35] This is reminiscent of the years when all Asian investment funds avoided investing in Japan because no one wanted to know anything about that market. The poor performance of the Chinese stock market, which has accumulated five consecutive quarters of poorer relative performance compared to world indexes, contributes to and feeds back into this negative investor sentiment, which also translates into a slump in the volumes traded on this market.[36] In the end, it all boils down to the following commentary by UBS's global emerging equity strategist:

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[33] JP Morgan Asset Management (September 28, 2023). *Guide to Markets 3Q 2023*.
[34] Sampedro, R. (October 2, 2023). La City mira con recelo a España: "No gusta la amnistía, ni los bandazos contra las empresas". *Vozpopuli*.
[35] Vishnoi, A. (September 7, 2023). China Is Being Left Out by a Record Number of New EM Stock Funds. *Bloomberg*.
[36] Liu, J., Ma, A. and Lu, M. (September 21, 2023). Beijing’s Market-Support Pledges Falling Flat With Traders. *Bloomberg*.

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> *Any way you cut it, Chinese equities are cheap. I think the market is taking it very sceptically: let's see more stuff on the ground that gives us confidence before we start buying.*[37]

For the Spanish case, I will limit myself to share an anecdote that is repeated in many of our meetings and conferences. When we review the performance that Alejandro, Miguel and I have achieved with our Iberian strategy (the highest in the market in the medium and long term), people are always surprised by the low assets of our Horos Value Iberia fund. To which we always respond with the following question: "how much do you have invested in Spanish equity funds?" The answer to this question always solves the initial doubt about our size.

How long can this situation in the Chinese and Spanish equity markets last? Again, we cannot know. What we do know for sure is that the longer it goes on, the more unsustainable it becomes. While it is true that the lack of investor heterogeneity (the entire investment community investing in the same companies) was behind the eventual unsustainability of the bullish pattern in the technology sector, it is no less true that this same lack of investor heterogeneity (the entire investment community ignoring these markets) may end up triggering that transition phase or tipping point that ends up reversing this negative stock market behavior.

In short, at Horos we continue to believe that in order to achieve our goal of generating sustainable and satisfactory returns over the long term, we need to focus our resources on fishing in ponds where there are plenty of fish and few fishermen (Chinese and Spanish stock markets, for example) and avoid those other ponds with very few fish and many fishermen (technology sector). We do not mind waiting patiently for the inevitable tipping point to occur, especially when we go hand in hand with management teams who know how much their companies are really worth and who make the right capital allocation decisions to uncover or generate value for their shareholders (e.g., by aggressively buying back their shares, selling assets above what their market value reflects or distributing the excess cash they accumulate on their balance sheet).

As the legendary investor Peter Cundill used to say:

> *The most important attribute for success in value investing is patience, patience, and more patience.*[38]

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[37] Langley, W. (September 21, 2023). Foreign investors still shunning China despite signs of upturn. *Financial Times*.
[38] Risso-Gill, C. (2011). *There's Always Something to Do: The Peter Cundill Investment Approach*. McGill-Queen's University Press.

Main changes to our portfolios

Over the long run, the crowd is always wrong.
— Seth Klarman

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

HOROS VALUE INTERNACIONAL
Stake decreases & exits:

COMMODITIES (18%)
Holdings discussed: Shelf Drilling (exited) and Ramaco Resources B (exited)

This quarter we exited our historic position in the offshore oil rig company **Shelf Drilling**. Certainly, an investment that leaves us with a bittersweet taste. On the one hand, as our original investment thesis was delayed—the pandemic changed everything. On the other hand, by staying invested in it, due to its relatively better financial position, compared to other alternatives that were also present in our fund (**Valaris** and **Borr Drilling**) and which we decided to divest in 2020, given the unsustainable deterioration of the business and balance sheet that the entire sector experienced at that time.

Over the last few months, **Shelf Drilling**'s management team has been able to carry out value-generating deals for its shareholders. Some examples could be the purchase of oil rigs at very attractive prices, taking advantage of corporate shake-ups in the sector or, more recently, the improvement of its financial profile after an attractive refinancing of its debt. All this, together with a significant recovery of activity in the sector, has allowed **Shelf Drilling**'s share price to multiply more than 30 times in just three years. Following this positive performance, we believe that the risk-return equation is more attractive in other investments that we have included in our portfolio.

In addition, we sold the B shares of **Ramaco Resources** ("Ramaco"), which the company distributed to its shareholders and which simulate the structure of a royalty-bearing entity by paying dividends to its shareholders based on the coal sold, processed and transported by **Ramaco** itself. In our view, the A shares, which give exposure to **Ramaco**'s traditional mining business, are more attractive, hence we chose to divest the B shares and maintain our investment in the A shares.

OTHER

Holdings discussed: Alphabet (exited), Pendragon (exited), Verallia (1.7%) and AmRest (1.3%)

Alphabet exited the portfolio during the quarter, following the strong performance of its share price and its lower upside potential compared to the new companies we added to the fund. It is remarkable how quickly market sentiment can change in such a short period of time. We reinitiated this position in 2022 after the sharp downturn in the tech sector with the rise in interest rates and the inevitable multiple contraction. Soon after, the launch of ChatGPT (supported by **Microsoft**) further weighed on **Alphabet** investor sentiment. Just a few weeks later, the market reacted very positively to the measures taken by the company to counteract the potential impact of this product and maintain Google's leadership as a search engine. All in all, a 50% rally in a very short time that explains our move to fully divest our holdings in this excellent company. We also trimmed our stake in the restaurant company **AmRest** and the glass manufacturer **Verallia**, purely because of their positive price action and their lower relative attractiveness.

The case of the British motor retailer **Pendragon** is even more interesting. To provide some background, it is worth referring back to the lines in which we explained why we reinvested in the stock at the end of 2022: *We exited our position last quarter, following the takeover bid launched by the Swedish group Anders Hedin (led by the former CEO of Pendragon), which already held 27% of the shares. However, in early December they announced that they were withdrawing the takeover bid due to the uncertainty at the time, which triggered a significant correction in Pendragon shares. We think it is possible that, in fact, the reason has more to do with the tightening of the financing conditions of the transaction, so we do not rule out a new attempt in the future. All this, together with the current attractive price at which the company is trading, encouraged us to invest again in this company.*

Now, this past month has seen an unusual takeover bidding war for the company. On September 18, the U.S. company **Lithia Motors** made an offer to buy the company at a price equivalent to 27.4 pence per share (a premium of close to 50% over the previous closing price). The offer had the approval of the **Pendragon** board and consisted of the purchase of the dealership business and the injection of capital into Pinewood, the company's promising software business, which would continue to be listed with the idea of growing it through the **Lithia Motors** car dealership network. At that time, we decided it was best to wait, as it was likely that the Swedish group Hedin (the company's main shareholder, which had already shown interest in taking over **Pendragon**) would make a move. Well, just 4 days

later, this group counterattacked by launching a tentative offer at 28 pence per share and, later, at 32 pence per share (17% above the price offered by **Lithia Motors**). This is not the end of the story. In a turn of events, U.S.-based **AutoNation** entered the fray on September 26, matching Hedin's offer. At that point, with the share price above the offer price, we decided to cut our stake by 50%, while awaiting reactions from both sides. Finally, on October 2, **Lithia Motors** made a move and raised its initial offer to 35.4 pence per share (almost 30% higher than its first offer). So we decided to sell the remainder of our stake in **Pendragon**, as we did not expect any major upgrades to be possible and the price seemed very attractive to us. Just two days later, the Hedin group announced that it was not going to raise its offer for the company, to which the stock price reacted by trading below 33 pence. Certainly, this has been a very profitable investment, in which the analysis of the incentives of the different parties involved has allowed us to maximize our returns.

Stake increases & new stakes:

COMMODITIES (18%)

Holdings discussed: Clarkson (1.8%) and Spartan Delta (1.5%)

This quarter we initiated a new stake in **Clarkson**. The British company provides brokerage and support services to the shipping industry, as well as financial brokerage and investment banking services, among others. **Clarkson** is the world's largest shipbroker, accounting for 80% of its business, which, in essence, allows it to charge a fee for matching a charterer with a shipowner. One of **Clarkson**'s strengths is its sheer scale, servicing the entire shipping industry (bulk carriers, tankers, LNG carriers, vehicle transport, offshore rigs, etc.) as well as being the first or second player by market share in each of these verticals. This scale allows **Clarkson** to provide different services and in different markets to the same customer, in addition to being able to acquire local entities when it makes strategic sense. This investment therefore allows us to have exposure to the shipping industry, but without the classic operational and financial risks of the sector, as its business employs very little capital. In our view, **Clarkson** is a higher quality company with lower cyclicality than the market is valuing, which encouraged us to invest in the name.

As for **Spartan Delta**, we decided to reinvest in the Canadian oil and gas company taking advantage of its current attractiveness. As a reminder, we sold our shares in the company in early 2023, following the realization of our investment thesis with the sale of the Montney area assets to **Crescent Point Energy**. After this move, in

addition to the creation of another entity called **Logan Energy**, **Spartan Delta** owns a portfolio of developed assets focused on gas production in the Deep Basin. The recent natural gas price correction has weighed somewhat on the company's share price. However, we believe that the current situation of very low relative natural gas prices in the United States and Canada is not sustainable and, although we do not assume much higher prices than the current ones in our valuation, there is a clear upside risk in the coming years for these two markets for the following reasons. First, the expected strong demand for natural gas in the European and Asian economies. Second, the start-up of several LNG export terminals in North America in the next few years. Last but not least, **Spartan Delta** has a management team led by Fotis Kalantzis that has already demonstrated its ability to take advantage of corporate opportunities that arise in the sector, generating tremendous value for its shareholders.

HOLDINGS AND ASSET MANAGEMENT (19%)

Holdings discussed: Onex (2.0%)

Onex is an unusual Canadian asset management company, as it initially used its balance sheet to make private equity investments directly, achieving significant returns. While continuing this activity, two decades ago the company began to manage third-party assets through the private equity and credit investment segments, which today account for close to $50 billion in assets under management.

Investing in **Onex** is interesting for two reasons. The first one is that Gerry Schwartz, its founder and CEO for almost 40 years, has just retired, leaving his place to Bobby Le Blanc (formerly, one of the company's senior managing directors). This is relevant in two ways. First, because **Onex** has so far failed to generate recurring profits from its private equity fund management business, which has led Le Blanc and his team to announce cost-cutting measures for the coming years that, at the very least, should enable this division to avoid losing money. In addition, **Onex** expects to grow its credit segment significantly over the next few years. The second reason is that Schwartz, after his retirement, will eventually lose voting control in **Onex**, so the company could be attractive to a third party.

However, all of this is of little relevance to our investment thesis. The most important leg of **Onex'** valuation, and what mainly explains our investment, is the discount at which the company trades against its investments in its own private equity and credit funds, as well as direct investments in companies, real estate and

other assets. This discount was around 40% at the time we initiated our position. A discount that does not seem justified to us and that the company is taking advantage of by aggressively buying back shares (more than 20% repurchased since 2020) and generating significant value for its shareholders.

OTHER

Holdings discussed: Nordic Paper (2.1%) and Excellence Commercial Property (1.4%)

Finally, there were two other new additions to the portfolio during the period: **Nordic Paper** and **Excellence Commercial Property**.

Nordic Paper is a Swedish paper producer, specialized in the production of kraft paper and natural greaseproof paper. The kraft paper produced by **Nordic Paper** is unbleached and is mainly used for packaging in various industries. Natural greaseproof paper is mainly used in the food industry (baking paper, fast food, etc.). The company has more than 800 customers in 70 countries and exports 95% of its production (more than 60% to Europe). An interesting aspect of **Nordic Paper** is that the bulk of its sales are destined for the food sector, which reduces the cyclicality of the business. In addition, within high-quality papers, the company has a dominant position in its respective markets.

The company made its IPO in 2020, when Sutriv Holding placed just over 50% of its shares. Sutriv Holding is controlled by the Chinese company **Shanying International**, an entity that also specializes in paper production and which took over **Nordic Paper** in 2017 (it was previously held by a private equity fund). Obviously, we do not know **Shanying International**'s future intentions regarding its stake in **Nordic Paper**, but we find it hard to see a medium-term fit, as there are no operating synergies and, additionally, the Chinese company's financial situation is not very solid.

In addition, at current prices, assuming a normalization of its operating margins (the company has benefitted from tailwinds due to the sharp rises in the prices of the paper it sells and, to a lesser extent, currency effects), we would be buying **Nordic Paper** at around 6x its free cash flow in three years' time. This is a very attractive valuation and protects us from negative economic scenarios that may occur in the short term.

Excellence Commercial Property ("Excellence") is a company that, like **Kaisa Prosperity** and **Aoyuan Healthy Life** (our other investments in this sector), provides real estate management services to Chinese commercial properties. The company

specializes in the management of office buildings, commercial complexes, corporate buildings or technology parks. In addition, **Excellence** manages public, industrial and residential properties.

As with most of the country's real estate services companies, **Excellence** was founded with the aim of providing services to its parent company, the developer Excellence Group, to grow over the years in its services to third parties. Today more than 80% of its sales comes from entities not related to the group. On the other hand, the shareholder structure is 70% controlled, directly and indirectly, by Li Wa (also owners of Excellence Group) and has distributed in 2021 and 2022 a dividend that would be equivalent today to a yield of more than 10%, which represents, including the dividend declared for 2023, 34% of its current market capitalization.

The country's real estate crisis obviously hampers the future growth of these companies. However, **Excellence**'s business profile (only 12% comes from residential activity), the company's cash generation capacity and a net cash position higher than its market value, encouraged us to invest in this company.

HOROS VALUE IBERIA

Stake decreases & exits:

OTHER

Holdings discussed: Corporación Financiera Alba (exited) and AmRest (2.3%)

This quarter we exited a long-standing position in our Iberian portfolio: **Corporación Financiera Alba**. Although we still believe that this holding company controlled by the March family continues to trade at a steep discount, the lack of interest shown by the company in recent years in trying to reduce this discount led us to fully divest a stake that was becoming increasingly residual in our fund.

On the other hand, as in our Horos Value Internacional fund, we trimmed our stake in **AmRest** following its excellent performance and lower attractiveness compared to other alternatives in our portfolio today.

Stake increases & new stakes:

OTHER

Holdings discussed: Iberpapel (5.5%) and Elecnor (5.5%)

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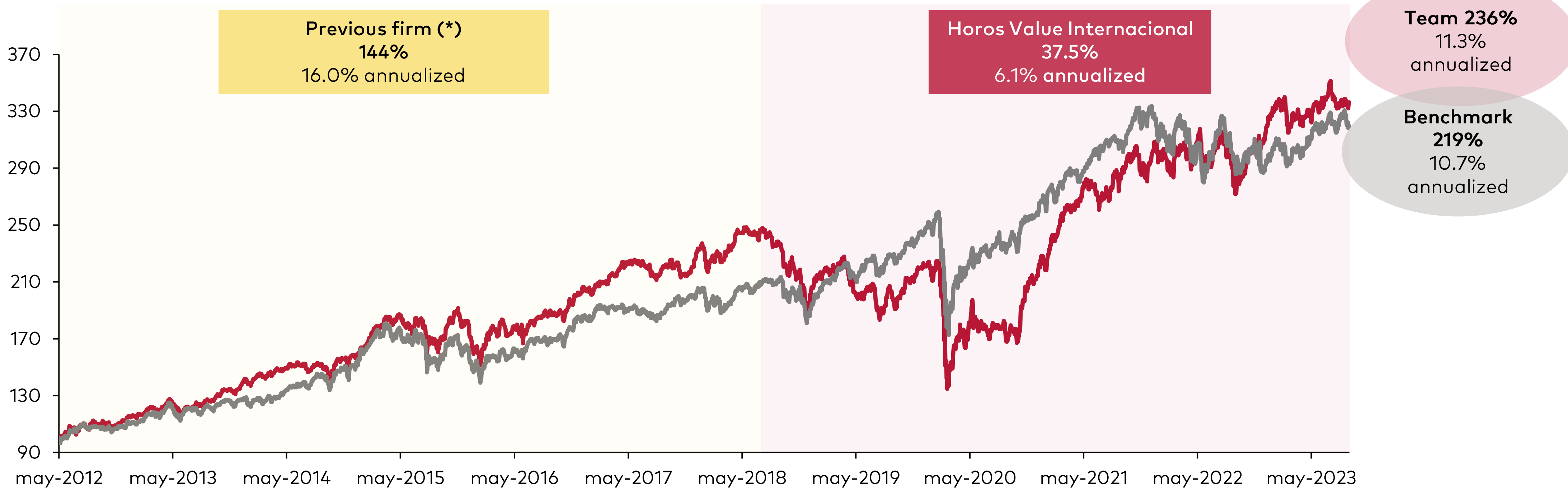
As for **Iberpapel** and **Elecnor**, the increased weight is due to their good relative performance in the period. In both cases, a catalyst is helping to uncover the significant upside potential of both companies. In the case of **Iberpapel**, the company announced at the end of September the sale of its forestry assets in Uruguay for €54 million. This amount compares with a market capitalization, at the time of the announcement, of €175 million and net cash of more than €48 million. Thus, after the transaction, **Iberpapel**'s business is valued at c. €75 million, compared with a normalized cash generation of €20 million.

Regarding **Elecnor**, the company is currently in the process of seeking a financial partner for its subsidiary Enerfín, which would help to uncover **Elecnor**’s true value. Something that had not happened until now and that the market is beginning to correct, as **Elecnor**'s shares have returned more than 55% in the last year. As with **Iberpapel**, we believe that **Elecnor** is still very undervalued, as the market is still not recognizing the full value of the group's engineering division, the concessions subsidiary Celeo and Enerfín itself.

Returns

Historical returns of the management team in the International Strategy



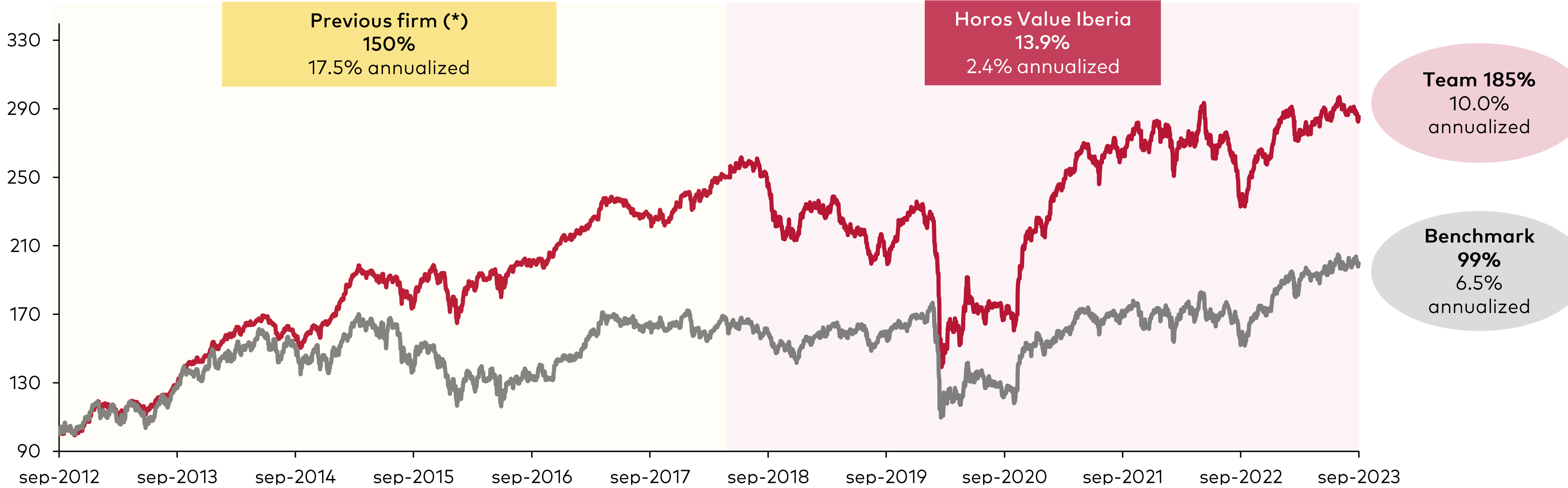
Data cover the period between the 30th May 2012 and 30st September 2023.

*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 30st September 2023.

*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.

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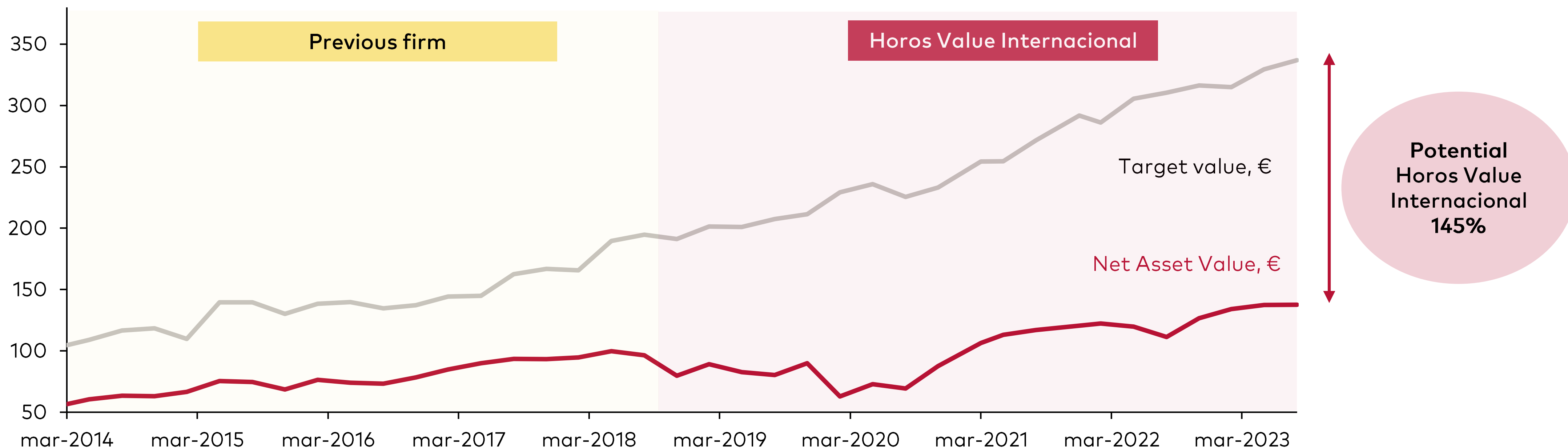
Upside Potential

Target value vs. Net Asset Value of the Management Team



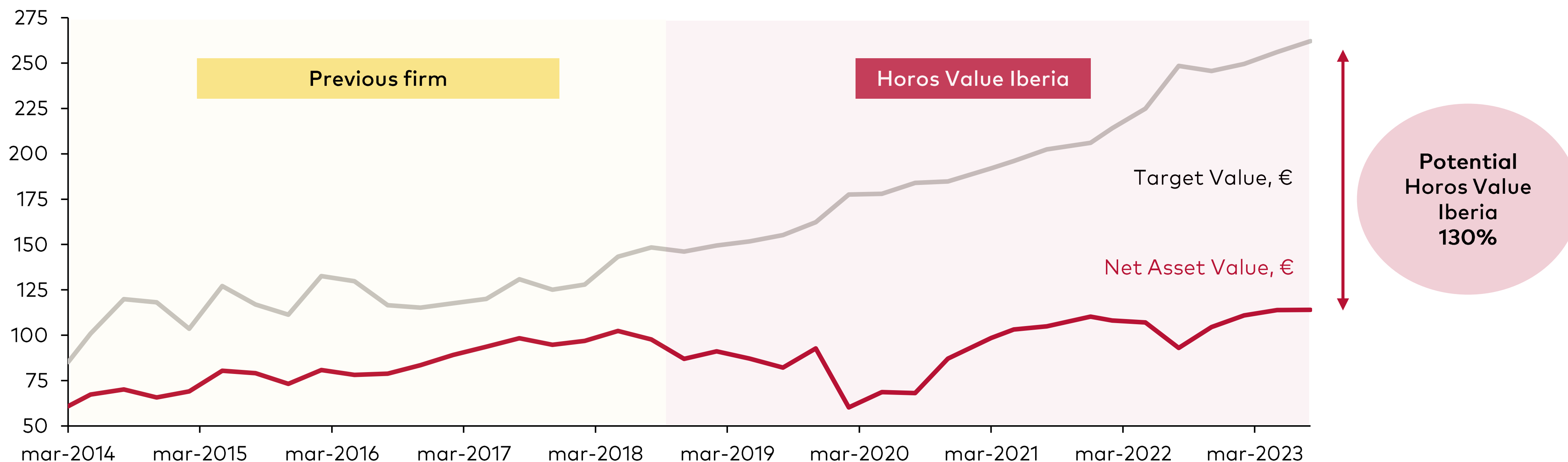
Data cover the period between the 31st March 2014 and the 30st September 2023.

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 30st September 2023.

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
Aercap Holdings	4.6%	Financial
Catalana Occidente	4.2%	Financial
Semapa	3.9%	Holding
Naspers	3.7%	TMT
Fairfax India	3.5%	Holding
Mistras Group	3.4%	Commodities
Talgo	3.4%	Industrial
ALD Automotive	3.4%	Financial
Sung Hung Kai and Co	3.2%	Asia
Gestamp Automocion	2.9%	Industrial

Top 10 Holdings
Horos Value Iberia

Holding	%	Theme
Catalana Occidente	7.0%	Financial
Semapa	6.9%	Holding
Horos Value Internacional	6.1%	Others
Elecnor	5.6%	Engineering
Iberpapel	5.5%	Industrial
Merlin Properties	5.2%	Real estate and construction
Gestamp Automocion	5.0%	Industrial
Talgo	4.5%	Engineering
Aperam	4.3%	Commodities
Atalaya Mining	4.1%	Commodities