Dear fellow shareholder,

Mistakes

Since we suffered a rather poor fourth quarter, it might be a good time to consider mistakes. Of course, in investing one doesn't really know how definitive mistakes are until it is too late, and perhaps this is like other parts of life – childhood, parenthood, periods of happiness – the errors (and pleasures) are more obvious later than at the time.

You may remember a book and film, both called *Searching for Bobby Fischer*. The subject was the chess career of a boy called Josh Waitzkin. He became one of the world's top ranked chess players, retired when he was about 24 (!), took up a new sport, Tai Chi Chuan, and became its World Champion. Last summer I read his book *The Art of Learning*, which I recommend. It starts with this quotation from an 11th century Chinese author, Er Cheng Yishu:

"One has to investigate the principle in one thing or one event exhaustively…Things and the self are governed by the same principle. If you understand one, you understand the other, for the truth within and the truth without are identical."

A striking thought, similar to one of the precepts of Marcus Aurelius, the Roman Emperor, this idea has often come to me as I read into the deeps of individual companies. One has to look at that one business in itself. You are bringing a lifetime of experience, parallel situations and mental models, all of which are useful and certainly speed up the process of seeing this new business and this new opportunity for investment. But what matters is the individual company and what it may be doing better and differently than all the others.

The book is full of deep insights into the learning process and, even though Tai Chi Chuan is a fast game, it is replete with application to investment. I was struck by Waitzkin's expression that one needs to "invest in loss", meaning that you should not be afraid of loss in a game, as that is one of the sources of learning. (The world class investor Tom Russo says he likes to invest in businesses with the capacity for loss). Much of the book is about how to study, how to relax in times of stress, how to get into the flow state, and above all slowing down time, which comes with study and knowledge. Deep learning allows a player to slow down action and Waitzkin shows how it is possible to trigger this useful skill, arriving at a place where your unconscious mind takes over.

My favourite anecdote in the book relates to another player, who tells Waitzkin that his ultimate aim is to slow the mistake down so much that he doesn't make it. Well, if only. Is it possible to be so advanced in your learning that you undo the mistakes before you make them? I thought I'd have a look at the biggest mistakes I've made over the life of the fund and whether they were avoidable in advance. I am excluding mistakes of omission as it is impossible to own the highest performing shares one after another. Omission is important, impossible to measure and so for the purpose of this exercise we shall look only at mistakes of commission, starting with bad purchases.

For simplicity's sake, I am going to present results from the UK fund only, as it is the bigger fund but I don't doubt we would find similar results in our European fund. Realised gains in the UK fund have (thankfully) outpaced realised losses by a factor of over two to one, and unrealised gains also

outpace unrealised losses – which is why the fund is in profit over its lifetime. Zeroing in on the realised losses, I divided them into "large" and "small", the latter defined as over 1% of the fund's current value. There were in fact only three large realised losses, from Bonmarché Holdings plc, Eastern European Property Fund Limited and St Peter Port Capital Limited, and together these equated to about one-quarter of the total. The first conclusion is that losses were spread mainly across a large number of small losses. Anything else? Several of the largest losses (numbers 1, 2, 4, 5 and 6 in ranked order) suffered shocks to their businesses that more than overwhelmed the apparent margin of safety we thought we had built into our purchases. The largest loss by value, for example, was Bonmarché. It had a niche supplying outsized women's clothing. It was unable to survive the increasingly cutthroat retail landscape of the late 2010s and went into administration (although we managed to sell our holding for a small sum a few months before that). The other two large losses had a common factor – they were funds. A large discount to the stated NAV was not enough to compensate for devaluations. Weak businesses, like Bonmarche and St Peter Port, are clear candidates for mistakes we might have avoided. Even though there is a danger in labelling companies as weak in retrospect, I think this is reasonable in these cases.

The second sin of commission is selling too soon. Inevitably, a number of shares we sold have risen since then, especially since we are talking about nearly a decade of sales. Some like Melrose and Cranswick have done pretty well, although in fairness a number of shares we sold have gone down, so we avoided loss in those cases. However, I wanted especially to look at the case of Impax, our biggest realised gain but also our biggest gain foregone. This was a particularly cheap stock (roughly six times earnings, after deducting its owned cash and investments) that turned into a company of very high quality. This does happen from time to time (Flutter, Ryanair and Domino's are other examples) and the gains are high as both earnings and the earnings multiple compound. Impax went from 54 pence when we first bought to around £2.92 when we finished selling (we had also sold some shares on the way up as the holding had become too big for the fund). This was a realised gain in the millions. What is the problem? The share price today is £11. Why did I decide to sell the remaining holding at what has turned out to be such a low price? It was at the time of the first lockdown in early 2020. Impax was selling at nearly thirty times earnings by then and we had the opportunity to buy peer businesses, such as Miton, for less than 25% of that price.

The decision to sell Impax has been the biggest mistake objectively in the history of the fund, costing us more millions on top of the realised ones. A full accounting allows two mitigants: first, the stocks we bought with the proceeds (Miton and others) have themselves as a class done pretty well (gains also in the millions); and secondly, later on in the year we bought back a portion of our Impax shares, which are now up 40%. Why? Changing your mind is one of the prizes of working independently. Several of our largest profits have stemmed from buying back shares we previously owned. Sometimes this happens because of a pure change in mind (as with Impax, and LVMH in the European fund) – I decide the sale was a mistake. Sometimes it is because the share price sells off considerably and it is possible to make a fresh purchase at a newly advantageous price (this happened with Flutter and S & U). But I still regret the Impax sale…The lesson is well known to value managers: an apparently high price does not a bad company make, especially when it has a proven capacity to grow. (Impax's earnings per share have grown a further three times in the past three years).

Overall, selling too soon has been far more costly to the fund than the realised losses we discussed earlier. So while it is clearly crucial to slow down the purchase decision it is even more important to slow down the selling decision.

Those are my most expensive mistakes, but not my most embarrassing one. Buy me a drink some time and I'll tell you about the stock tip I gave Warren Buffett in the middle of the Lehman crisis.

Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

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