

To the partners :

### Partnership vs S&P 500 Performance

Year	ANNUAL PERCENTAGE CHANGE*		
	In per share market value of partnership (1)	In S&P 500 including dividends (2)	Relative Results (1)-(2)
2013 *in USD	16.1	32.8	-16.7
Compounded Annual Gain - 2013-2014:			16.1%
Overall Gain:			16.1%

2013 was a rich year in terms of opportunities. The American banking industry had fallen into distress, which to us was temporary. At the same time, the construction industry in United States was also having problems. Among other situations of distress (in other words other situations which constitute opportunities for us) we can count the education and health industries (in America) that were subjected to legal changes; the Greek shipping companies which were in recovery from the 2008 crisis, the indices of many companies like Ireland whose performance deteriorated the most since the crisis, The Tokyo Electric Power Plant which was devastated by the earthquake and tsunami, the accounting scandals relating to Netflix, and Green Mountain Coffee Roasters; and (to give some local bad news) the crises the Turkish football clubs such as Galatasaray and Fenerbahçe was going under.

Among all of these opportunities, our attention was particularly grabbed by the situation of the banking and construction sector in US. In these two sectors, there were “golden” companies which had long and successful histories (Some of them were 100+ years old). After asking questions such as: Which sector would we like to be in over the next 50 years? Which companies do we think, in these sectors, are more likely to grow faster, are less risky to invest in, and give us higher gains? Which of these crisis situations are non-permanent? we came up with 4 good to great companies in the 2 sectors: Goldman Sachs, JP Morgan, and Wells Fargo Company in banking; and D.R. Horton in construction.

Our Method of Operation

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We are working under the principles of “Value Investing” (please refer to *The Intelligent Investor*; Benjamin Graham, *Security Analysis*; Benjamin Graham, *Common Stocks and Uncommon Profits*; Philip Fisher, *Annual Letters Berkshire Hathaway 1965-2012*; Warren Buffett). Our motto is “reasonable returns with safety of capital”. We invest in high quality, durable businesses when their price is “cheap” (when they are undervalued). We look at the investment business, as being a partner to a small portion of wonderful businesses. We are not playing the stock market game, but rather we partner with successful companies for the long term buying their stocks. In this sense we also look for businesses that we can buy as a whole.

Attaining compounded returns of 15-20% over periods of 20-30 years, is an ideal, yet very hard to attain target in the stock market investing business (doubling the money every 3.7 years). This rate of return is close to the growth rate of highly successful companies such as Coca-Cola, Microsoft, and Starbucks, when they were spreading their products throughout the world during the 80s and 90s. Also, this rate of return is about twice of the general return of the S&P 500 index when the last 100 years is taken into account (which is around 10%<sup>1</sup> including dividends). It is three times of the return one can achieve by investing in inflation protecting assets such as a house (7% on the long run including rental income<sup>2</sup>). It is twice what large investment companies such as Goldman Sachs, Merrill Lynch, and JP Morgan brought in to their investors, during the last 50 years of their history. We are not chasing 100% a year returns, knowing the associated risks of doing so. We head for 20% consistent annual returns, but would be delighted to attain a straight 15% for the next 20-30 years.

The Miracle of Compounding  
100 USD compounded by 5%, 15%, and 25% for 10 consecutive years<sup>3</sup>

	5%	15%	25%
Year 1	100.0	100.0	100.0
Year 2	105.0	115.0	125.0
Year 3	110.3	132.3	156.3
Year 4	115.8	152.1	195.3
Year 5	121.6	174.9	244.1
Year 6	127.6	201.1	305.2
Year 7	134.0	231.3	381.5
Year 8	140.7	266.0	476.8
Year 9	147.7	305.9	596.0
Year 10	155.1	351.8	745.1

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<sup>1</sup> 9.95% between 1913-2013 to be exact

<sup>2</sup> 6.9% including rental income, based on a US study that covers 1952-2005

<sup>3</sup> In 10 years our money amounts to 7 times of initial investment with 25% annual return, yet only 1.5 times with 5% return.

So, what are we NOT involved in? We do not invest in an expensive company, even if it is an excellent business. Again, if we can not (to a large extent) see where a company is headed in 10-20 years time, we do not take any risks. We prefer those business with high predictability, and those which are greatly managed. In addition to quantitative criteria (i.e. those companies that double their net income in the last 5 years), we also pay attention to qualitative criteria (i.e. brand value, managerial talent).

What else are we NOT doing? We do not try to forecast where the US dollar is headed next year. We do not buy a stock merely because a professional advised us to do so, without looking deep into its revenues, net incomes, or operating margins in the last 10 years. We do not go and buy gold, because all of our neighbors have been piling on it. We do not try to time the market, nor are we heavily preoccupied with market movements. Our daily endeavour is to search for, locate and invest in high quality, undervalued businesses.

We know for a fact, that the price of a business, might at times be quite different from the intrinsic value of the business. Following this fact, we pay attention to not being influenced by the “madnesses” of the market, but rather use its “fears” for good buying opportunities.<sup>4</sup>

*High Quality.* What we mean by a high quality company is, pretty much a company like Coca Cola; a company in a preferably consolidated sector like the Coca Cola’s soft drink sector which is dominated by one or two major companies; one with high net operating margins/one that has “pricing flexibility”; one that has been increasing its revenues and income consistently (so consistently that it may be labeled boring), in the last 5-10 or even 20 years at compounded rates we target for; one that will, with a high likelihood, increase its revenues in 20-30 or even 50 years from now; one that is built on simple ideas; one that does not like debt; and one that is good or greatly managed. We want the company that we invest in, to have what value investors call a “moat” around its business model. We know two major issues for a company are deadly: (1) competition, (2) debt<sup>5</sup>.

*Safe.* One of our most important rules is “Never lose money”, the second is “Never forget the rule that says never lose money”. We target for companies that has at least 10 years of operating history, and that are very likely to be around in 10-20 or even 50 years from now. Take, again, Coca Cola as an example. It is a 120+ year old company that has seen 2 world wars; there is no other company than Pepsi in its core business that it competes with, and because it is able to shield itself from competition and debt, it is very likely to be around in 50 years from now.

*Cheap.* We also pay close attention to jump in and purchase these companies, when their stocks are cheap. We like to invest in perfect businesses when they are in a temporary crisis (or when they are at the operating table as Warren Buffett suggests). We identify “value” looking at ratios such as “Price/Earnings” and “Price/Book Value”. Even if a company is an excellent candidate for us to invest in, we do not invest in it unless it is fairly or undervalued. Again to cite an example, rather than buying the Coca Cola stock back in the beginnings of 2000s at valuations of about 60-80 times of its yearly earnings, we wait for moments like the 2008 crisis and buy the stock at price earnings ratios of about 10-15.

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<sup>4</sup> Please kindly see Graham’s “Mr Market” analogy

<sup>5</sup> One good example to such a business: Owning the only toilette business in a mall.

Sometimes we purchase an index like the Russian stock market index at crisis levels of the 1990s and wait for 10 years before selling it. "Patience" comes into play during such trades. In the investing business it is much easier to see "what" will happen (ie the price of a depressed stock will increase), yet hard/impossible to see "when" things will happen. We focus on the "what", and let the "when" to take care of itself on its own.

Our ideal holding period is "eternity". We do not sell and get out of a good business if we think that it will generate the returns that we aim for in the near and far future, or until it loses its competitive power. Especially in those businesses that we like and hold a large stake of, we prefer not to move whatever the price the market throws at us. Whenever a one in a lifetime opportunity knocks our door (I should say one in a decade), we might sell assets to buy others that will guarantee higher returns. Other than that, we buy to hold.

## 2013 Results

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We previously said that two of the ideas we had in 2013 were in banking and construction. We made significant gains in a matter of months in all of our investments under these two areas. Of course S&P (breaking a 16 year record) performed much better than us in this time interval. The good thing about focusing on cheap stocks, is that, the market value of our portfolio goes down slightly lower, when S&P performs poorly, yet it does not go up as much as S&P when the general market heads higher. Still (as many other value investors) we hold our thesis, that we can beat the S&P in the long run (10-20 year span), through a strategy that focuses on high quality, safe, and cheap stocks. We hope to attain a higher performance, than the 10% historical return of the S&P on the long run.

This is both good and bad news. You are not going to be wealthy in a matter of months if you decide to stay with us. However, in 20-30 or 50 years time, you will be the partner of many safely growing businesses, that you can even leave to your children.

Some of our notable realized/unrealized; gains/losses in 2013 are listed below.

Banking. 14.1% JP Morgan, 7.8% Goldman Sachs, 14.8% Wells Fargo Company

Construction. -9.8% D.R. Horton

Stock	(First) Purchase	Now (January 2014)	Notes
JP Morgan	48.1	58.5	Sold and exited on profit. It will go up in the coming years, however we decided to invest the money in other opportunities.
Goldman Sachs	145.1	178.2	Goldman Sachs recovered very well from the crisis, and is still undervalued at a P/E ratio of 11. It will continue to go up.

Wells Fargo Company	37.1	45.9	Sold and exited "to a large extent".Based on criteria such as growth, debt, and ROE it stands as the best large banking business in US.
D.R. Horton	24.1	21.8	Started a position in the beginning of the year. It is not sold yet. Depending on the recovery of the housing sector, it will go up further.

If you think these results are good, think again. If we had bought the above stocks on 1st January 2012 and held them 24 months until 1st January 2014, we would attain a much higher "annual" gain. By the end of 2014, we exited most of the above positions, and purchased stakes in other 4-5 new, high quality, safe, and under-to-fair valued businesses that we think would give us higher returns in the next 5-10 years. We will disclose these investments in our next letter.

We made one other small operation in 2013. We became a partner to two other companies that were about to go bankrupt, using a very small portion of our net worth. One of these companies is Nokia, a technology giant with tens of thousands of workers, which happened to lead the cell phone industry until recently, yet which was quite battered by the ongoing competitive changes in the sector; and the other is Thomas Cook Group, a 150 years old (founded in 1841) British tourism firm, with 25 thousand employees. We found the probability of these two companies to default, much lower than the probability of them being around in 5-10 years in a better condition.

The stock price of Thomas Cook Group has risen from 40 pounds to 180 in the last 12 months (over 300% appreciation), and the stock price of Nokia has risen from around 3 dollars to 7 dollars (over 100% appreciation) after the news that Microsoft will buy out Nokia's cell phone segment. During the 3-4 months we stayed in these investments we scored close to 60% on Thomas Cook, and 30% on Nokia.

Despite the fun we have in such games called "turnaround plays, these plays do not make up the backbone of our investment philosophy. Whenever we find the risk meaningful, we will perform similar trades using a small portion of our net worth. However, we will make the majority of our profits, by focusing on buying high quality businesses at good prices.

E. Olmez