

## Learning From Francisco Garcia Paramés: Quotations and References

*We are pleased to share the following resource for investors looking to learn from Francisco García Paramés, one of the most successful value investors of our time. This piece is authored by MOI Global research associate Alex Gilchrist through extensive collaboration with the team at Cobas Asset Management.*

*Please note: Unattributed quotations in the following text are taken from [Investing for the Long Term](#), a highly acclaimed book by Francisco Garcia Paramés (Wiley, 2018).*

Francisco Garcia Paramés was born in 1963 in El Ferrol, a city located at the top of Spain's North Western Coast, in the region of Galicia. He read Economics at the Complutense University of Madrid before working as a graduate for the Spanish retailer, El Corte Inglés, and going on to complete an MBA from IESE Business School. Thereafter, he joined Bestinver. From the time that Francisco started managing money in 1989 until he left in 2014, AUM grew from the equivalent of around €1 million to over €6 billion. Over this period he achieved a 30x return or a cumulative annual return of 15.7% for his investors, earning him the nickname of the "Spanish Warren Buffett."

### **Finding his path (1963-1991)**

Francisco grew up in a large family of five children. His father was a professor in the Naval Engineering School, while his mother spent her time entirely devoted to their family. His parents were good role models, leaving him with "this inexplicable belief in the need to do the right thing" and "to pass on my mother's folk wisdom to my own children, even though I used to laugh about it." Francisco was not drawn to either Physics or Engineering: "Perhaps my aversion to physics was a premonition. One of the gravest errors of a cross-section of economic theory - as we will see - is applying natural science techniques, specifically physics, to social sciences, including economics, treating human behaviour as if it were an equation to be solved."

At 16, he developed a love for reading fiction, "especially the great Spanish and French classics: Galdós, Cervantes, the 1898 generation, Stendhal, Victor Hugo." This passion for reading has stayed with him to become "a core personality trait and a key constant in my life." Although he later "drifted away from fiction to non-fiction...these days I am more relaxed and have come to appreciate it again."

Not having yet found his calling, he pursued a broad degree: "At 17 years of age I was pretty clueless, like most people at that age, and the best thing I could do was delay the important decisions for as long as possible. I did what I think is sensible in such cases: embarking on a diverse degree covering law, history, mathematics, accounting, business management, etc."

He combined his studies at the Complutense University of Madrid with learning English, French and German; in addition to completing military service: "In my group of ten sailors who shared a room together, there were two people who were illiterate, and only four of us out of the squad of 100 had a university education." During 1985, his final year of study at Complutense, "arising from my love of

sport,” he picked up a copy of *Business Week*, having been drawn to a cover story about basketball player, Patrick Ewing. From that moment on, he became an avid reader of *Business Week*, through which he “began to gain an interest in the business world.”

For 15 months prior to starting his MBA at IESE, Francisco worked as a graduate for the Spanish retailer, El Corte Inglés. Feeling relatively uninspired “and lacking clear professional ideas. I ticked all the boxes for doing an MBA.” Francisco was impressed by his fellow students: At IESE, “I discovered that some of my colleagues were brighter than me or, at least, were able to concentrate better.”

This pushed Francisco towards introspection: “I think this ultimately helps me to focus on the future, knowing that I had to follow my own path, knowing that there will always be better and worse people than me, professional speaking (and personally as well). [...] The clearest and most decisive conclusion from those two years in Barcelona was that analytical activities suited my personality. I was lucky to be able to apply the classic and essential ‘know yourself’ refrain. Others never find themselves, despite frantically searching. For me it was clear. I was not somebody suited to sales, or leadership, rather study, reflection and reading: in one word, analysis.”

Upon graduating from the IESE in 1989, Francisco joined Bestinver, “to help analyse the groups potential diversification investments.” At the time Bestinver had three divisions: diversification, a stock brokerage service and a “tiny” portfolio management business. However, the job description was unclear, and he initially spent some time finding private companies that might be interested in “being listed on the stock exchange. [...] However, I didn’t like the commercial part of the work one bit, essentially cold calling.”

Francisco took it upon himself to find work that interested him, “helping the three brokerage agents and the small equity analysis team which fed them information.” In 1990, through a book review in *Business Week*, Francisco picked up a copy of Peter Lynch’s, *One Up on Wall Street*. He followed up on this, by learning about the other “investment maestros: Graham, Buffett, Fisher, Templeton, etc.” and by obtaining a copy of Warren Buffett’s letter to shareholders after writing to Omaha. “I had found the type of work that suited my keep personality traits – analytical capacity and patience.” In February 1990, Francisco made his first personal investment in shares, purchasing 50 shares in Banco Santander.

### **Bestinver (1989-2014)**

The small equity analysis section at the time was headed by Santos Martínez-Conde, who was a good early mentor to Francisco. “Although at that point he was unfamiliar with the American maestros, he applied fundamental valuation to all investment opportunities.” When Santos left Bestinver in 1991, Francisco asked to fill his role as Head of Analysis and Portfolio Management. “I mustered the nerve to ask the two co-directors whether I could take over responsibility for managing the Bestinver portfolios.”

Having spent a year gaining familiarity with all the stocks on the Spanish stock market, although just 27 years old with a single year of experience under his belt, Francisco felt “capable of rising to the challenge” to manage the 2-3 million euros that was the Bestinver portfolio at the time. His life as an asset manager began. Bestinver launched two funds in quick succession: Bestinver Renta in 1991 and Bestinverfond in 1992, that went from being a “family fund” to attracting “external clients over time thanks to the returns it achieved” as one of the highest performing European funds.

This was an opportune time to invest. “[T]he Spanish stock market found itself at the same level in December 1992 as it had been in December 1987, 35% below the 1989 peak.” In 1993, the Spanish stock market rose by 46%, “supported by a sharp cut in interest rates in Spain.” Even while holding

liquidity of almost 50% for most of the year, Bestinfond returned 44%. “Continual price rises over the course of the year made it impossible to fully invest.”

In 1994, while the IGBM (Madrid’s Stock Exchange General Index) fell by 11.7%, Bestinfond rose by 5.28%. “These two years cemented trust among our client base, especially the most important ones – the Entrecanales family – forming a solid base with which to weather the events that were to come our way over the next 20 years.” In the background of liberalisation policies and cuts in interest rates, the IGBM more than tripled over the next three years. At the end of 1997, the “biggest bull market of the twentieth century” started to show signs that it was coming to an end. As the Spanish market had yet to catch up, the IGBM gained another 40%.

Francisco used this opportunity to unwind some of its large positions including Banco Santander and Repsol, ending Q1 1998 with liquidity of 32%. Between “the beginning of July and the start of September, the Spanish index (which had risen by 50% from January) fell by around 40%, while our funds retreated by 10%. This afforded us the opportunity to reinvest the bulk of our liquidity at much more attractive prices. [...] We ended the year with liquidity of 10%. We obtained overall returns in 1998 of 30%, below the market returns of 37%, but a respectable difference given that the volatility and the risk level of our investments had been much lower. This is crucial and bears repeating: we took on much less risk. [...] With the benefit of hindsight, I believe those years were probably the most important of my professional career. It’s no simple undertaking managing to survive at the end of the longest bull market in the twentieth century, managing to post a reasonable return while being conscious of the dangers on the cards for the following years.”

In 1998, the Bestinver Internacional fund was launched. “Up to that point Bestinver had only invested in Spain. [...] Our equity position at the end of the cycle was designed to make the most of low prices in Asian markets and commodities (I’m struck by a certain déjà vu as I write this in late 2015!). Investment in Asian stocks through funds or structured products accounted for more than 20% of the portfolio; exposure to oil and other commodities another 20% (oil was trading at \$15 dollars per barrel); and finally, less than 10% was invested in a limited group of shares in small European companies. [...] Hampered by a further decline in crude oil from \$15 to below 10, and by a lack of recovery in Asian markets, the year ended with a 14% loss. A great start to the fund’s life! Especially bearing in mind that global indexes rose by 10% per year.”

“[I]n March 2000 the tables turned and the market set off on a downward path that lasted for three years, with an accumulated loss of 40%. [...] How did we manage to obtain a 49% return in a market losing 40%? The starting point was crucial. At the beginning of 2000 the biggest market divergence in history was taking place; within an expensive market a whole series of stocks were trading at ridiculous prices. [...] Outside of Spain our portfolio was invested almost entirely in equities, our strong suit, with European companies making up 50% of the portfolio and American companies another 30%, with now only around 10% of the portfolio in Japanese funds. [...] Over 10 years, from 1993 to 2002, we obtained a return of 570.65% on our Spanish investments compared with 289.39% achieved by the IGBM. [...] Over five years of international activity, from 1998 to 2002, we posted a 28.03% return compared with a decline in the benchmark MSCI index of 10.2%.”

By December 2002, AUM for both funds stood at 160 million euros. In 2003, Francisco promoted Mario Serna, who had been supporting him as an analyst for two years, to the position of investment manager. However, Mario, decided to leave: “I was after an established asset manager; somebody still young, but who already have some experience under their belt. And as I was used to making my own decisions, with a system that works for the clients and myself, it was a challenge to transition to a more consensual approach. However, it was becoming a necessity to have support from somebody else – particularly in the international area – to help improve decision-making and reduce client risk. [...] It was too much for one person to be on top of the details of the 150 companies in the portfolio, plus the

30-40 companies in the Spanish portfolio, and the hundreds of potential candidates under consideration."

Francisco was introduced to Álvaro Guzmán de Lázaro through a mutual friend ex-colleague. Álvaro was a passionate value investor who had already proven himself by managing a family fund. 2003 saw both strong outperformance of the indexes (32.7% rise for the international fund compared to 8.83% increase in the index) and growth in AUM: "2003 saw a continual increase in our assets under management, reaching 225 million euros in the Spanish funds and 47 million in the international fund by the end of the year. We had finally earned the necessary confidence of potential investors after 10 years of hard work and results."

In 2004, Francisco already saw the first signs of the Spanish real estate bubble: "It was logical with funding at 2% and real estate assets inflation of 10% that all economic agents wanted a piece of the 'free for all.' Furthermore, banks were prepared to lend up to 100% of investment rarity in normal times." Over the next years, Bestinver mainly invested in European mid-caps, outperforming the indexes significantly. By 2006, AUM had grown to six billion euros. "Returning to 2007, while we were clear about the (grim) prospects ahead for Spain, having set out a very defensive portfolio - in fact, we had broadened our sights to Portugal to try to limit the exposure to Spain - we were not as well prepared for a global crisis, despite having no explicit exposure to the financial crisis."

2008 saw losses of 35.16% for the Spanish portfolio and 44.71% for the global fund. "By the end of 2008 the Spanish portfolio was trading at a P/E ratio of six and the global portfolio was at 3.4. These were obviously the lowest prices we had ever encountered, and wouldn't be repeated for a long time. The potential upside was enormous, 150% and 340%, respectively. [...] The clearest indication that we were at the low point came from my own inner circle. For the first time my wife queried whether her mother's modest investment in the funds, whose returns helped cover her expenses, might not be better placed in a lot less volatile fund. This took place in February in our kitchen at home, and I distinctly remember thinking that if even my wife - who had been and is a firm believer in what we do - was wavering, then the end of the crisis could not be far off."

By March 2009, AUM had fallen to two billion euros. Since Bestinver was structured so conservatively and given the support of its parent company, Acciona, the Bestinver team calculated that they could "endure additional market falls of 75-80% before the company's future was in jeopardy."

However, by the end of 2009, Bestinver registered a strong recovery, with a 71% increase for the year. Having anticipated for some time the troubles facing the real estate sector in Spain, "from 2010 to 2012, our Iberian portfolio went up slightly in value while the Spanish index retreated another 30%." The Global portfolio too, weathered the European Debt Crisis well, suffering "significant losses in summer 2011, thereafter gradually recovering them. All of our top picks, to which we added Exor - the holding company for the Agnelli family - performed well, especially our beloved BMW."

From 1989-2013, Francisco earned a world class track record returning 15.7% annually, delivering 30x returns to shareholders and growing Bestinver's AUM by 1000x. "Despite the later success and growth in assets, the terms of my remuneration remained essentially unchanged from then on [the moment he became Head of Analysis and Portfolio Management], despite being well below the market average."

Over time, Francisco outgrew his initial role: "After mulling it over in summer 2013, I decided that in our business, which is almost a craft, being a manager must mean being able to manage the company and not just investments." Initially Francisco discussed various alternatives to create a new role for himself at Bestinver, however: "The process was extremely slow, as logically the other party wasn't much interested in changing the statu quo, and after 15 months without finding any common ground,

tiredness and frustration got the better of me and I announced my departure.”

Following his contract with Bestinver to the letter, including a two-year non-compete clause, “fitted my character and strong aversion to confrontation.” Francisco spent the next two years on ‘gardening leave’ in London, thus providing his family with “the experience of living outside of Spain and exposing our children to an English-language education.”

During those two years, Francisco, “followed the markets on a daily basis,” travelled to countries that he “wanted to get to know better, such as India and UAE.” Additionally, he wrote the book, *Investing For the Long Term* (Wiley, 2018), where he set out to both fill a gap in the Spanish value investing literature and generously shared his knowledge: “I tried to cover everything I know, and I hope I have achieved it.” (MOI Latticework, 2018)

### **Cobas (since 2016)**

Francisco decided to start his new venture in Spain: “I don’t consider myself a rampant patriot, but I’m fond of my country and would like my countrymen to have a good future. I am making my small contribution by returning to Spain, creating a company along with a good group of professionals, giving a service to clients like our way of working, and contributing as best I can to promote my city and country. [...] On 30 December 2016, CNMV, Spain’s securities market regulator, gave the preliminary green light for the formation of Cobas Asset Management, a firm to be headed by Francisco García Paramés.” (Cobas website)

Several members of Francisco’s team from Bestinver moved across to Cobas: “We have a magnificent team of analysts and managers comprising a select team of professionals. John Barden, Vicente Martín, Andrés Allende and Peter Smith. I have known nearly all of them for some time and so it was not a hard decision for all of us to make. Some of them are fully familiar with our investment process, since we have worked together for many years: Iván Chvedine, Carmen Pérez Baguena, Mingkun Chan, Juan Huerta de Soto and Juan Cantus.” (Cobas Asset Management, letter to investors, 2017)

### **Relationship and communication with clients**

“The trust among our client base, especially the most important ones – the Entrecanales family – forming a solid basis with which to weather the events that would come our way over the next 20 years.” Essential to this trust is transparency in communication: “Transparency has always been an essential part of our relationship with clients. It’s true that there have to be some limits – the competition is always peering over our shoulder – but within these limits we try to be as helpful as possible. This enables our clients to better understand our work, which helps us. As a consequence, over the crisis as a whole, from summer 2007 to spring 2009, redemptions amounted to a little over 20% of assets under management.”

At the start of the financial crisis, in 2008, Francisco was quick to communicate and re-assure clients: “Our investors are a sensible bunch, and we were already talking about falls of over 25% from 1 January, such that the desire to sell began to dissipate. Throughout the year we went to great lengths to communicate and be transparent. We held telephone conferences, we started publishing the target values for our funds, and we broadened the information set out in our quarterly reports and other client communications. On 30 September we sent another letter to clients, along similar lines to that of December 2000. In this new letter we stressed that our portfolios were extremely conservative and that the American housing market adjustment was now quite well advanced.”

On Bestinver’s Investor Day on the 5<sup>th</sup> of March 2009: “When we arrived in Barcelona, the international funds NAV was at nine euros per share, down 62% on a high of €23.6 in July 2007 – just

18 months earlier. Never in my worst nightmares did I think a portfolio managed by us would suffer losses of 25 to 30% in value, let alone 62%... We didn't quite know how our clients were going to react. We had done a good job explaining our approach over the years, and we had redoubled our efforts in 2008, but were talking about enormous losses. We gave an extremely exhaustive presentation, going into more detail than ever and disaggregating the portfolio to the level of granularity rarely seen in the market. For example, we spoke of our two biggest investments: BMW, which was being given away at €11 (it's now trading at €70) and Ferrovial, trading at three euros (it's now priced at 20 euros)."

At these investor meetings, what Charlie Munger has referred to as "the deserved trust" that had been gained over the years was evident: "We were applauded. This might well be the most extraordinary thing to have happened to me in all my years as an investor. People who had seen 60% of their savings wiped out (only temporarily, mind you, as we insisted) applauding the people 'responsible' for these losses. Three days later the applause was repeated in Madrid, and this surprising show of confidence gave us renewed strength to continue fighting the falls."

Francisco's funds, both at Bestinver and Cobas, have tried to avoid clients with a short-term mindset: "Thirdly, we have never gone out of our way to actively attract the clients who knock on our door. It requires a certain initiative and interest on their part, meaning that they tend to be people who are very attractive, both on a professional and a personal level. [...] Until recently any amount was enough, but we have just put in place a minimum of 1 million pesetas (6000 euros) and a 3% redemption fee for the first year. This is because the new law, which allows the switching between funds, could see people start to use them like a current account. And we don't advertise, nor are we particularly concerned about growing, so if somebody invests with us we want them to be in it for the long term. [...] Short term redemption fees are intended to send a clear message: think carefully about where you are investing to avoid rapidly repenting."

Francisco has continued to give equal importance to building a relationship with clients since founding Cobas: "This personal message marks the start of a long process of dialogue and communication with investors who believe in our way of doing things. (Cobas Letter to Investors, 2017) "As part of our objective of greater transparency in reporting, we have begun a cycle of conferences in several cities throughout Spain with a view to getting closer to our investors and tracking the performance of our funds not only more personally but also more frequently. This cycle entails an open-question format with the Cobas team." (CAM, 2018 Q2 comments)

These tours around Spain, should also help to disintermediate the classical financial product distribution model: "In his opinion, the financial product distribution model in Spain, which relies exclusively on banks, is often predicated on many of the mistakes made when investing, because to sell funds, banks reward managers based solely on the volume of assets managed, and not on the returns obtained." (CAM newsletter, 2017)

### Circle of competence

"Many of us go by the title of value investors, but none of us are doing exactly the same thing. [...] We look in the graveyard and in places no one is willing to go. Otherwise, you get a 6% return." (MOI Latticework, 2018)

Bestinver's initial portfolio at the end of 1992 was comprised of 70% of large caps, including "Telefónica, Bilbao-Vizcaya, Banco Santander, Bankinter and Iberdrola." The attractive prices of large caps at the time as well as their being easier to explain to clients than comparable small caps made them especially attractive at the time. As these large caps made significant gains, by 1997 Bestinver unwinded these positions in order "to focus on medium caps which had been left behind." Being aware



that the bull market could not go on *ad perpetuam*, Bestinver increased their “positions in ERZ and Enher, very defensive electricity stocks.”

For the first seven years as an asset manager, Francisco had only invested in Spain. With the creation of Bestinver Internacional in 1998, Francisco started investing internationally. The European markets were the logical starting point: “The geographical proximity of European markets, which also tend to be less efficient relative to the American markets, makes it easier and more natural to invest in Europe.”

Francisco has frequently invested in European companies with significant family ownership. He insists that they should be good businesses with high barriers to entry and high returns on capital involved. They should only have family involvement in the day-to-day running of the business if that involvement is supported by a “good track record.” While the market often discounts family ownership and in Europe “they have been neglected by the financial sector,” Francisco often values family firms at a premium. He has found that in Europe, “families are the active investors. All their worth is usually involved with the business. (MOI, 2018) On the other hand, Francisco is cautious of non-family firms “run by executives” in Europe. He believes that there is a poor alignment of incentives and little activism to provide a remedy. (MOI, 2018)

Given the more sophisticated competition in the US, Francisco is especially cautious when approaching this market: “After having had some bad experiences there, nowadays, whenever I find a stock that looks to be trading at an attractive price, I always ask myself what I’m seeing that the Americans aren’t.” However, he found a niche and “Cobas has had success with “insurance brokers, with a cyclical issue.” In early 2018, 10% of the portfolio was invested in the US. (MOI, 2018)

Francisco recommends prudence as the investor attempts to expand their circle of competence: “At the beginning we have to try to gradually and very prudently expand our circle until we reach a point where it is established and thereafter fully respect it. [...] But we needed to apply the same process we had used in Spain – where our error rate was extremely low – to the selection of global companies, making it an imperative to devote more resources to an analysis in this area. [...] We focused mainly on European mid caps, which proved to be pretty rewarding, despite simply duds such as Escada itself, Boewe Systec, Smoby, Schlott, Regent Inns, Alexon, Clinton Cards, and some others whose names are painful to remember.”

Francisco tries to avoid activism, placing value on the opportunity cost of the time lost in such endeavours: “Either way, I only get involved in ‘activism’ when I have a significant stake; when my investment is small, I let larger shareholders lead the way. At the end of the day it’s about making efficient use of my most scarce resource, which is my time.”

Over time, Francisco has moved from the spectrum of fair companies at wonderful prices to wonderful companies at fair prices. “That is the only big change we have done over the years.” (MOI, 2018) “Indeed, the crisis confirmed that high-quality companies at reasonable prices perform better over the long-term than companies which straight cheap. [...] Joel Greenblatt, *The Little Book That Beats The Market*, which provides statistical confirmation that quality is worthwhile. After reflecting on our portfolio – which was of moderate quality – and given our desire for greater resilience in the future, we began to move more deliberately down this path.”

Francisco explains how being “agnostic about company size” and “solely interested in their business and valuation” is more conducive to high returns than specialism: “Sectoral and regional specialists suffer from a basic problem of being limited to the specific market in which they are able to operate. They have to buy something and they end up doing so regardless of whether it’s attractive.”

Juan Huerta de Soto explains how this approach is applied at Cobas today: "We do not limit ourselves to a particular investment style, which quite frequently happens nowadays. In other words, we are not one hundred percent deep value, nor do we belong exclusively to the school of Buffett and Munger (quality companies at reasonable prices). Instead, we invest where we think value exists and the market is inefficient. For instance, right now the US stock market is high, as is part of the European market. They are close to their highest levels in the last twenty years, so we have no problem looking for opportunities in other parts of the world, such as in Asia, where a substantial portion of our portfolio is currently invested." (Juan Huerta de Soto, MOI 2018)

Francisco confirmed this flexible approach: "You always make exceptions. For instance, we always manage a Spanish portfolio, and some of the holdings are extremely commoditized businesses, and we try to buy low-cost producers. We're focused on the other businesses, but in the last couple of years, we have made exceptions, and we are invested in commodity-oriented stocks. Sometimes, this is a short-term play, less than three or four years, which is certainly a short-term play for us." (MOI Latticework, 2018) "We are struggling to find sufficient quality companies at attractive prices in our natural environment of Europe, meaning that our position in non-European companies is higher than normal." (CAM, 2017 Q2 Comments)

Value investors have to look to areas where capital is flowing out: "If you want to do something special, you obviously have to do special situations, and that's what we do. I mean, we are in the UK - 15% of the fund is in the UK. Why? Because I read that this month is the most pessimistic for the UK retail investor since the Winter of Discontent with Margaret Thatcher in 1980." (MOI Latticework, 2018)

Mingkun Chan, who has worked with Francisco since 2008 and currently heads Cobas's Asian office in Taipei, Taiwan, provides a timely example of how Cobas is expanding its circle of competence in Asia: "For example, we used to invest in Schindler (a European elevator company), so I studied the competitive landscape in China (the largest global market for elevators). In the process, we identified a very good competitor listed in Taiwan. We invested in the company before its revenues began to increase and the sell-side analysts began to carry out an initial coverage of the company. The result was that we profit handsomely from that investment." (Post from Japan, Cobas Website)

Recently, Cobas has made use of the analysis it has undertaken in its equity investments by selectively purchasing corporate bonds in the same holdings: "Additionally, it is now possible to invest up to 10% of the total exposure in fixed-income assets with low credit rating (less than BBB-) or no rating. This type of investment will be very occasional, when we detect investment opportunities in corporate bonds of companies that we have previously analysed for equity portfolios. An example of this kind of investment is the position in Teekay Corp. bonds in the Cobas Renta portfolio." (CAM Newsletter, 01.04.2017)

### **Austrian School of Economics**

Having witnessed as an investor "the regular ups and downs" of markets, six to seven years into the profession, Francisco sought "a theoretical framework" that could help explain them. Picking up Hayek's, "*The Road to Serfdom*", spurred me to dedicate five years of reading to economics books, particularly the 'Austrian' School. [...] I had finally come very close to finding the truth that I sought, and studying these thinkers helped me develop a deeper understanding of my environment from then on. [...] And without mathematical formulas to befuddle the understanding."

Ludwig von Mises, who "systematised Austrian School thinking," put forward "the premise that nobody is capable of accumulating perfect knowledge and information on everything that is being created in a dynamic economy at a given point in time." A central planner therefore has less



information than the market as a whole and through intervention distorts the clearing function of prices. In order to centrally plan, the government bases its actions on statistics.

The Austrian school is critical of GDP as an either good or necessary gauge of economic welfare: "This economy and its economists will not tell us how much GDP will grow by next year nor what inflation will do, but it can alert us to what might happen in a country or particular sector over time based on how different economic actors are currently behaving. A warning of where the dangers might lurk and where it's safe to swim."

The Austrian School emphasizes savings and not consumption as a source of future wealth generation in an economy: "Although some misled people warn of a supposed one-off savings glut, an excess of savings is never bad news; it always contributes to financing projects which improve the productive structure. If an excess of savings results in very low returns and savings cannot be put to good use over a reasonable period of time, they will end up being consumed in products and services."

At Latticework London, Francisco provided a poignant example: "For instance, it was clear to me all along that China was growing in a sustainable way although I heard at some conferences and from some value investors it was going to collapse. But if you went there and applied common sense, you could see the country's growth was based on savings, on hard work, on things which create wealth over the long term, so this is a particular positive case. In Spain, it was obvious there was a real estate bubble as early as 2000, so we just didn't invest at all in any banks. [...] I was in China in 2006 and 2007, and credit was growing. It was growing by 15% and the economy by 10%, so that was fine. Then I came back to Spain, and I found credit growing by 15%, 16%, 17% but the economy by 2% or 3%. That's for six or seven years. At the top, we were building 800,000 houses in Spain compared to 1.5 million in the US. It was completely obvious. All the banks were over-exposed. It was a disaster." (MOI Latticework, 2018)

Francisco noted ten key points from the Austrian school of Economics that have informed his investment style:

*"Markets work, by definition."* Since the knowledge of the market is greater than the knowledge of individual actors, Francisco sees intervention as more likely to reflect the interests of the interventionists than of the overall market. He cites the example of Brazil, where: "Companies demand tariff protection and they are granted it; workers demand protections which cannot be sustained by their productivity and they also get their own way. [...] Fiat employs 1000 people just to present multiple tax declarations." On the other hand, China, "despite supposedly being a socialist economic system," intervention "is largely absent from a broad spectrum of the economy, unleashing such fierce competition that the economy has been able to grow rapidly without inflation." Along with greater uncertainty, intervention adds a cost on firms, rendering them less innovative and thus competitive.

*"Markets are never in equilibrium."* In their efforts to gain profits, entrepreneurs constantly innovate, resulting in creative destruction. "As such, there are very few companies able to maintain a durable competitive advantage, and such advantages tend only to be time-limited, because knowledge developments inevitably provoke unpredictable changes. The flipside is that this also implies that nothing lasts forever. Sectors in crisis with an excess of capital will sooner or later experience capital outflows, improving the situation for those left behind."

*"Economic growth is fundamentally based on increases in productivity resulting from division of labour, financed by savings."* Savings reflect organic growth in the economy, while growth as a result of intervention, finances unsustainable projects, leaving in their failure, a future burden of debt. "[A]fter having carefully analysed the type of growth being experienced by one country or a group of countries, it is crucial to determine whether such growth is solid – based on savings and productivity –

or unstable – built on credit and plunder. [...] Until 2009, Chinese growth was supported by strong increases in productivity, overseeing the inclusion of millions of people in the market and with very high savings rates. [...] The polar opposite has happened in Spain. In the first decade of the 21<sup>st</sup> century growth was fuelled by massive indebtedness. [...] When the economy grows by two and real estate lending by 20, a bubble is being inflated... we have a typical supply-side crisis resulting from interest rates which are too low for the economy... this is one of the reasons why we don't have a single bank share." (From *Futuro*, May 2003)

*"Time is an essential aspect of the Austrian explanation of the productive process, which is about making an immediate sacrifice for the development of greater future productive capacity and an increase in productivity."* Giving up savings today to invest, means deferring consumption to a date in the future. Following the Austrian School, reinforces a mentality of deferred gratification. "Sacrifice is a crucial Element of the process, but ... it runs contrary to our nature; we are not wired that way."

*"A particular type of intervention in the money market is especially important: currency manipulation through the control of interest rates by central banks."* "Central bankers do not possess exceptional knowledge enabling them to accurately determine monetary conditions and to set the right interest-rate: the only advantage is having access to relevant information 15 days before other operators. [...] Real-world application: investors should steer clear of economies whose growth is based on credit creation under the auspices of low interest rates established by central banks. This was how we avoided permanent capital losses touring the 2006-2007 financial bubble. We had practically no exposure to the real-estate and financial sectors."

*"The economy's natural state is deflationary, when there is no artificial boosting of the amount of money in circulation."* "Productivity increases enable more goods to be produced for the same amount of money." Deflation arguable puts more pressure on firms to be innovative and competitive. "The strongest growth in the American economy's history took place from the end of the civil war up to the completion of the nineteenth century. These 30 glorious years were characterized by pronounced deflation. [...] In truth, deflation is not a cause of stagnation but rather a symptom and part of the solution to the problem. In Spain, it was clear that labour and real estate costs had risen beyond fair value and the economy did not recover until they returned to market levels. [...] So why is there so much fuss about deflation? These warnings are mainly sounded by governments, who are generally indebted and stand to lose from deflation. The weight of is debt increases with deflation."

*"The absence of a currency linked to gold – or a similar commodity free from political decision – means that the currency will permanently depreciate in relation to real assets."* "Real world applications: once again, it is best to only invest in real assets, aside from the occasional liquidity needs. I repeat, always."

*"Product prices – which depend on consumers' willingness to pay – determine costs and not the reverse as many people think."* Example based on crude oil: "marginal costs – associated with the final and most expensive producer – are constantly changing in line with the scale of demand. If the demand for oil is 80 million barrels a day and barrel number 80 million costs \$100 to produce, then the market price will be 100 dollars and everyone who is able, will produce at a cost below \$100. If the demand falls to 50 million barrels, the marginal price will also fall, and so, if the marginal producer who produces barrel number 50 million does so at a price of 40 dollars/barrel, the market price will be 40 dollars and it will only be produced by those who do so below 40 dollars. If the demand falls to 0 barrels, the cost will be 0 dollars and nobody will produce. It seems obvious, but not to everyone. Investors should not forget the order: first, demand is calculated, then, the costs necessary to meet that demand."

*"Production costs are subjective, meaning that any production structure is liable to vary depending on*

*the circumstances.*” When a sector is rising and capital is flowing into it, competition for resources in that industry push their prices up “Costs continually vary in accordance with changing market conditions or technological developments.” However, when the cycle turns, there is a fall in the competition for those resources that are factors of production. “A lot of engineers have found themselves out of work following the decline in oil prices in 2014 and 2015, reducing their options and meaning that they are willing to work for less money, reducing mining costs.” It is for this reason that this applies the most to “commodity or cyclical companies, or companies with novel products.”

*“Economic models are - to all intents and purposes - useless.”* “Real-world application: avoid falling into the trap of thinking that we can precisely forecast what will happen. This is particularly true for economic forecasts, which are subject to changes that are not only probable, but certain and impossible to predict.”

### **Equities as the most preferable form of investment**

#### *Real assets protect against inflation*

Like Milton Friedman, Francisco perceives inflation as a tax by government on holding currency. For this reason, Francisco tries to avoid holding cash as much as possible, preferring to keep a set of highly liquid stocks in order to be able to meet liquidity needs.

Francisco is suspicious of the role of the “political class.” By increasing spending without proportionately increasing taxes, the only way to finance expenditure is through the issuance of debt. Consumers can also be made to be felt better off by reducing interest rates or by relaxing liquidity ratios for commercial banks. The effect of both of these is to increase the amount of money in circulation: “This is where the political class comes into play. After having exhausted the possibilities of increasing taxes, given that there is always the limit that the public is unwilling to cross, and after having also reached a limit on public debt issue, investors too run out of patience (‘The limit is the point at which promises to pay stop being credible’) – the political class then have to find other funding mechanisms. And the most suitable mechanism for their interests is to issue paper money – especially after the abolition of the gold standard, which supported currency issue with something tangible, robust, and real – currently under control of the central banks, administered by the political class.”

Friedman declared inflation to be an exclusively “monetary phenomenon.” By increasing the amount of currency in circulation without proportionately increasing production, the prices of goods in the currency will automatically rise. Equivalently, the currency will lose its purchasing power over time. In fact, Francisco thinks that the most evident change in his portfolios as a result of following the Austrian School has been a desire to avoid high cash levels: “Probably the main effect is we are always fully invested. I find it surprising when I hear, ‘I’m in cash because I think the US economy is going to collapse because this experiment they are doing with TARP or whatever is going to depreciate the currency.’ I feel an inconsistency there. Of course, if you don’t find any stock trading at a reasonable price, I could understand. That’s what happened to us in 1998, but interest rates were at 8%, so the alternative was not that bad. Now, I just don’t see it.” (MOI Latticework, 2018)

#### *Equities versus fixed income*

“The wind is against you if you are a creditor to someone. In a worst-case scenario, you are much better defended as an asset owner than as a creditor. Personally, I am always fully invested in the stocks, and the funds we manage are 96%, 98%, or 99% invested all the time.” (MOI Latticework, 2018) Bonds as a form of monetary assets are vulnerable to the currency in which they are denominated losing its value: “Specifically, the loss of value of the promise to pay as a result of the

loss in value of the currency in which the contract is denominated or referenced. This problem is less obvious and as such much more dangerous for the saver, because it can be hidden or suppressed over many years behind a façade of apparent stability.”

Since the debut of fiat money, governments have been able to discreetly overspend, leading to a decline in the return on fixed income: “The abandonment of the gold standard and subsequent increase in inflation have led to a decline in returns on fixed income over the last 80 years compared with the previous period, putting more recent returns below this 3.6%.” Real non-monetary assets are, however, more attractive, as they provide a defence against the inflation tax: “The main upshot of owning an asset which fulfils the service demanded by society is that it will sustain its purchasing power reasonably well in any economic environment, so long as society retains an interest in it. Returns on real assets will vary according to numerous factors, but their ability to retain purchasing power reasonably well is irrefutable and crucial.”

Non-monetary and monetary assets have very different characteristics, even though the markets often treat them as comparable: “On the one side, we are talking about payment rights deriving from ownership of an asset which interests the public (real assets), while on the other we are talking about a promise to pay backed up by paper money (monetary assets). The only reason that financial markets typically compare shares and bonds – the clearest embodiments of both asset types – is for ease.” As a point in case: “Today, over 15 years later, Argentinian public debt has lost 70% of its value, while the Merval, the Argentinian stock exchange, has multiplied in value by 20 – compensating the loss in value of the Argentinian peso, which is now at 1/15 against the dollar.”

The higher return achieved on equities compared to fixed income is commonly attributed to ‘a risk premium’ due to their higher short term volatility. However: “Equities are subject to greater short-term volatility, but not over the long term. The longer the timeframe we analyse, the more this volatility progressively diminishes.”

Francisco investigated longer-time frames. He found that: “[T]here is no period over a 20-year tenure where equities lose purchasing power; the worst period saw a return of 1% above inflation. The same thing happens over 30 years: the worst period generated a real return of 2.6%. By contrast, the worst 20- and 30-year periods for bonds are very negative. [...] From all this we reached the surprising conclusion that for all long-term investors, equities not only offer greater returns, but do so taking on less volatility. [...] The conclusion is unequivocal: the bulk of our savings should be invested long-term and in equities. We only need hold positions in monetary assets to cover occasional cash needs.”

#### *On real estate and personal investment*

“The real-estate sector is very much entrenched in our lives; until recently we didn’t know about other forms of investment. Our forefathers did not have access to the infinite possibilities currently on offer, and they felt secure with their own property.” However, Francisco sees many disadvantages with owning real estate: “In addition to being an easily replicable commodity with limited real increases in value, there are also maintenance costs to consider, which we know can be very high; transaction costs, which vary by country but are far from negligible; and management costs, which can be very uncomfortable or expensive for the owner. There are some specific exceptions in the centre of large cities, due to space restrictions. But these are replicable over time, and their overall performance cannot change all that much from the rest of the real-estate sector. Even a city centre can change with time. For example, in Madrid the centre of gravity has shifted northward, with a subsequent loss in value of certain buildings in the old ‘centre.’ We can conclude that houses are like gold: they avoid the worst, but add little compared with equities.”

Real estate and commodities may however be purchased if they are available at opportunistic prices.

All moats disappear over time but good businesses have the longest shelf life: "As for things like real estate and commodities, they're fine at certain moments in time, but we tend to prefer high return on capital businesses because they are more difficult to replicate. In the end, all businesses are going to be replicated." (MOI Latticework, 2018) "All my savings are in Bestinvest stock funds, and the critical moment for me is when my savings get into the financial system. Once we're investing in companies that I know, and trust, I can relax much more than if I was investing in fixed income securities, which basically means going into partnership with a Government whose only interest is in being voted in at the next election; they have no 10-15 year vision." (ESADE, 6.11.2009)

Furthermore, publicly listed firms are generally preferable to private firms, since there is less information asymmetry between buyer and seller: "When somebody sells their company on the private market they are fully aware of its future potential. The same is not true for public stock, where investors are either unwilling to stray from the pack or lack sufficient knowledge."

### **Investment philosophy**

#### *The subject and social value of investing*

Francisco sees investment as a study of people who are grouped into "consumers, entrepreneurs, workers, politicians, and everything that surrounds us." For it is the interactions between those groups that will determine how well an enterprise and its investors do. "Indeed, the focus of our analysis is mankind itself. The businesses that we analyse are created and developed by people, who sell their products and services to other people. We're not analysing strange beings or mythical or legendary markets, we are analysing people. Some people manage to create and develop exceptional businesses, which are difficult to reproduce. Others are unmitigated failures. The former are of more interest to us for potential investment, especially when circumstances mean they can be acquired at accessible prices. These are the businesses that should be the focus of our time; analysing their competitive position and resilience to future developments."

Both the primary and the secondary investor add value to society through the provision of liquidity: "[A] strong financial system, enabling new projects to be taken on and providing liquidity to those who finance these projects with their savings. These ingredients create a developed capital market, which, over the long term, reflects the positive performance of the economy, allowing good returns to be obtained by not just initial investors in business projects, but also investors providing liquidity to these projects through share purchases of listed companies at a later stage in their development." In relation to his own firm: "Another 'social' function is increasing market liquidity, acting as a counterparty: we buy what nobody else wants and sell what everyone is after."

#### *Investment style*

While Francisco does not believe in setting "targets for returns," he believes that they will achieve a good return for clients by "seek[ing] out solid and undervalued companies, as they will certainly outperform the market regardless of its performance." (*Hedgeweek*, October 23, 2006) While Francisco is agnostic to size or industry: "We are not subjected to the limitations of investing by following a benchmark. Nor are we restricted with regard to the sectors in which we invest: we may invest in any security, regardless of its liquidity. Decisions are taken directly by the managers without the need for investment committees." (Ibid.) However: "We are very disciplined when it comes to making investments and we employ the same strict analysis process to each and every one of the companies that we analyse." (Ibid.)

Francisco espouses a culture of extreme patience in investing: "We have sometimes spent years buying shares in the same company and this requires a great deal of patience." (Ibid.) He believes that

enjoying the work involved in investing is essential to success: "Our work is part of our lives. We enjoy our work. Management is not just a job but a constant challenge that requires many hours of reading and constant attention to all the factors that can affect the valuation of companies." (Ibid.) While at Bestinver, Francisco perceived the competitive advantages he had built up in the firm as being: "Competitive advantage. It would be best defined by: (i) adhering to a military-style discipline with regards to our required IRR; (ii) valuation skills; (iii) fund managers' firm commitment to their investment management role." (Ibid.)

### *Pricing*

"It is all about buying a flow of earnings at an acceptable price; the pace of earnings growth is a second-order issue. [...] When I am asked whether equities are expensive, I always get the same response: there are cheap and expensive stocks. [...] There is no such thing as a crystal ball for markets, but when most stocks are expensive, the market will deliver mediocre returns at best. [...] Buying things below what we think they are worth. You end up with companies with a low P/E ratio and a high dividend yield; the average for us is 4%. Double what Treasury bills are paying. And sustainable dividends, because our portfolio is pretty defensive; companies that are unencumbered by debt and aren't affected by the cycle. No banks, construction, real estate... The companies which everyone is talking about, following, and analysing are pretty well priced."

Juan Huerta de Soto, an analyst at Cobas, confirmed in a recent interview the approach of looking for opportunities in sectors that do not receive as much coverage: "Consequently, in our opinion, at the present time, good companies, as I have defined them, are quite expensive in general, while certain sectors, such as the maritime transport of raw materials, and oil and gas, among others, are close to their lowest levels in the last ten years. If one knows how to search well and is willing to carry out a comprehensive analysis of such sectors, it is possible to find good companies, with good management teams, little debt, and great potential for appreciation." (Juan Huerta de Soto, MOI 2018)

Francisco does not generally ascribe to the use of Discounted Cash Flow models, unless if the company has extremely predictable cash flows: "Analysing does not involve building complicated mathematical models with discounted cash flows (and, for example, with forecast for annual earnings over the next 15 years). Discounted cash flows is a neat stylistic exercise, but adds little to the valuation. I would use it only very occasionally for extremely stable and predictable businesses - motorways, gas or electricity networks etc., where by their very nature the likelihood of erring is very low - but in other cases it adds practically no value, since the chances of correctly predicting earnings in - say - year seven are minimal. It doesn't tell us enough to warrant the time spent performing the calculation."

Instead, once the business has been thoroughly researched and analysed, it should be possible to arrive at a range for normalised earnings. Following this, a multiple can be applied: "Although I personally have not done it for 18 years", he said, "what we do is apply a reasonable multiple to an estimated average profit standardised by the economic cycle". The example he gave was: with the average PER of the New York Stock Exchange at PER 15, if it is a slightly better than average company, we give it PER 17, if it's slightly worse, a PER 13." (ESADE, 2009 Dinner Discussion)

"The multiple to apply to these normalised earnings will depend on the quality of the business. A very reasonable - and probably the most suitable - approach is to use the stock market average for the last 200 years. This average is 15, which is equivalent to an 'earning yield' of 6.6% ( $1 \times 100/15$ ), in line with the long-term real return on equities. Setting this as the target return seems pretty sensible. For some outstanding businesses we could apply a somewhat higher margin of between 15 and 20; while for more mediocre businesses, with limited barriers to entry, we should push it down to between 10 and 15. For most businesses, 15 is an appropriate multiple."



Francisco has remained disciplined over time with the price he believes makes sense paying for an investment: "In short, there have always been, and will likely always be, enough securities to reach full portfolio investment, even though, as a general rule, we are not willing to pay more than 12 years of earnings (P/E of 12x)." (CAM newsletter, 01.03.2018)

Cobas is on the lookout for events that can create favourable pricing opportunities: "Typically, we are looking for temporary problems which lower their share price to accessible levels. For example, an unfavourable currency movement which temporarily disrupt exports (four example, BMW or Thales were affected by a strong euro). Or digital migration, which can camouflage underlying business growth (Wolters Kluwer)."

Share buybacks provide an indication that management agrees that their shares are currently underpriced: "Under normal conditions I limit myself to insisting on the virtues of share buybacks, since if I invest in the company it's because I think the market is undervaluing its assets. So, reducing the number of shares at this market price makes economic sense."

### Risk

Francisco does not perceive risk being captured by volatility, but rather the risk of capital loss. The latter risk is dependent on the competitive position of the firm: FP//AM: "For us, risk is not measured by volatility but by the real possibility of losing money. Volatility is not necessarily a problem: the more a market falls, the more opportunities there are to find undervalued stocks. The most important means of managing risk is to assess the competitive advantage of the companies in which we invest. If we think they have competitive advantage, and it turns out they do not, then the risk becomes ours. Therefore, the only factor we 'measure' is the possibility of a permanent impairment of value in any of the stocks." (*Hedgeweek*, 2006) Francisco writes: "As Fernandez observes, the CAPM is an absurd model because it is based on absurd hypotheses. Obviously, these conditions are not fulfilled in real life. [...] As Buffett says: "Half of the attendees at the Berkshire Hathaway annual general meeting don't know what Beta is, the other half couldn't care less."

Francisco notes nine main sources of business risk that can lead to loss of capital:

1) *Companies with an excessive growth focus*: "The obsession - because that's what it is - with high-growth targets is extremely dangerous. The goal should be for the largest number of clients possible to enjoy the product on offer but without exploiting loopholes or taking shortcuts."

2) *Companies which are constantly acquiring other companies*: "Growth can also bring with it two other problems: first, more complex accounting can more easily conceal problems; and second, each acquisition ends up becoming bigger than the last, increasing the price and therefore the level or risk."

3) *Initial public offerings*: Tend to offer lower returns, due to "clear asymmetries in the information available to the seller and what we know as purchasers."

4) *Businesses which are still in their infancy*: "Old age is an asset: the longer the company has been going, the longer it will last in the future. [...] It takes a certain amount of time for a business to get on a stable footing, depending on the level of demand and competition. Until this happens, we are exposed to the high volatility inherent in any new business, with an uncertain final outcome."

5) *Businesses with opaque accounting*: "Whenever there's significant potential for flexible accounting, being able to trust in the honesty of the managers and/or owners is essential."

6) *Companies with key employees*: "These are companies where the employees effectively control the

business, but without being shareholders (the latter could even be positive). For example, many service companies reportedly have very high returns on capital, but only because capital isn't necessary: investment banks, law firms, some fund managers, consultancy companies, head-hunters, etc. The creation of value in these businesses benefits from these key employees, while the opportunities for external shareholders to earn attractive returns are limited, despite supposedly high returns on capital employed."

7) *Highly indebted companies*: "Excess debt is one of the main reasons why investments lose value."

8) *Sectors which are stagnant or experiencing falling sales*: "[F]alling sales can be very negative. Quite often these companies can cross our radar because of the low prices at which they are trading, but over the long term, time is not on our side with them. Sometimes, sales will recover, but mostly the opportunity cost is too high, given that the situation can persist for some time. I have encountered my fair share of these: Debenhams, printing companies, etc."

9) *Expensive stocks*: "I don't think I have ever tried to buy a stock valued by the market at over 15x earnings."

#### *Investment idea sourcing*

"How do you find this 30%-35% return on capital businesses at 8x earnings, which is, for instance, the case now in our fund? The average is something like 30% return on capital, good quality businesses, and the price/earnings ratio is 8x. Usually, these high-quality businesses tend to trade at 13x to 15x earnings, but we need a way to find businesses at a much lower multiple." (MOI Latticework, 2018)

On the other side, Francisco lists a set nine attributes that often lead to the market undervaluing firms:

1) *Shareholding structure*: Companies that contain a reference shareholder often a family that controls more than 25% of the share capital, which favours a good alignment of incentives. They tend "to pay less attention to the market" with "underdeveloped public or investor relations departments. [...] They generally prefer conservative balance sheets, with little debt and a lot of cash."

2) *Organisation of assets*: The holding of unrelated assets, "which can sometimes lack coherence and can deter investors. Very few of them trade at their intrinsic value, not even Berkshire Hathaway - the clearest example of a conglomerate."

3) *Geography*: Companies where a significant part of its business is generated in foreign countries. "Companies which are listed in Europe, but have an important part of their business in the United States - like Ahold or Wolters Kluwer - are an example of this."

4) *Small companies*: "It stands to reason that the investment community pays less attention to small companies, providing us with the opportunity to uncover some great little gems. The main problem is a lack of liquidity, which can also apply to family companies, conglomerates, preference shares, etc."

5) *Cyclical companies*: "We are never going to know exactly when the low point will come [in the cycle]; we will always end up jumping the gun. The crucial thing is to keep buying throughout the fall, since the best results are obtained from the last investments that are made." However, "the company needs to be inefficient producer and able to operate under low prices; and it shouldn't be holding much debt. Failure to meet these two conditions can put our investment at risk, as the company may not make it out to the other side of the cycle."

6) *Share types*: "I have come across discounts in European and Asian preference shares. These types

of shares forego voting rights in return for the right to a bigger part of the dividends than common stock. Since we are normally investing in family businesses, losing the voting rights shouldn't be a big deal, and the discounts on common stock can sometimes amount to 30 - 40%.

7) *Long-term projects*: "Patience is undoubtedly an investor's biggest asset, more so than intelligence or any other ability."

8) *Spin-offs or asset separations*: "[F]irstly, with spin-offs the incentives change and executives are financially and professionally motivated to do a better job in managing the new company (perhaps they even managed it before, but the new incentives improve results); secondly, there may be a lack of detailed information on the new business, since we are not talking about a stock market launch (IPO) but rather a placement among existing shareholders; thirdly, the company's existing shareholders may not want to have a position in the spin-off, meaning they will immediately offload their shares, providing an opportunity.

9) *Free lunches*: "Free lunches appear when a stable business - which justifies its share price - comes into possession of a tangible asset or an early stage project with potential to mature and which is not well priced by the market."

There are many potential sources of investment ideas, however the investor must be weary of how they distribute their time to analysing each idea: specialist financial press, other non-specialist reading material, brokers' reports, conversations with company managers, conversations with rival companies, visits from the company itself, conversations with other value managers, and research by analysis houses. "A large number of our ideas come from the knowledge we have accumulated over time about certain specific sectors, so experience and passing years provide an added value." (Juan Huerta de Soto, MOI 2018)

## Analysis

"It is not enough to find a high ROCE and low P/E ratio. I have to understand where the profits are coming from and, above all, where they are headed. This is the essence of my work and what I spend most of my time doing. The possible purchase price can be readily found in the daily newspaper or in real time on Bloomberg, but analysing a specific sector and the company's competitive position is what enables us to determine the intrinsic value, which is neither as obvious nor as easy to identify. In fact, it's the great enigma of investment. However, there is a way to begin deciphering it."

Francisco details three stages in analysing the financial statements of a potential investment:

*Stage 1: Ascertain whether the financials provide a true reflection of a company*

(a) *Cash flow analysis*: "it's no use if the company is supposedly obtaining good results but this isn't reflected in cash at the end of the financial year... The ideal company in this analysis will generate more cash than implied by its P&L account. This is a sign of very conservative accounting and that earnings are being 'stashed'."

(b) *Credibility of the income statement*: beware of (i) aggressive accounting "in regard to income or expenses, reporting income for a year that still hasn't materialised and failing to recognise outlays that have taken place"; (ii) "provisioning, which can be too low given the company's situation"; (iii) the company's policy on fixed asset depreciation, which may not reflect real asset depreciation; and, finally, excessive capitalisation of expenses"; (iv) however, there are some very conservative companies that conceal part of their earnings capacity, perhaps to hide the underlying attractiveness of the business, or to benefit from a more favourable tax treatment."

(c) *The balance sheet:* (i) search for “hidden or off-balance-sheet liabilities. These could be pensions liabilities, costs associated with closing down factories, mines, etc., or any erroneous calculation of some type on provisioning for possible future losses”; (ii) “an unexplained increase in certain current headings, such a stocks or account receivables, could suggest that the reality is more challenging than the income statement makes out”; (iii) however, there can also be “hidden assets making the company more attractive, such as real-estate assets not used in the business or subsidiaries not related to the main business, the brand or other intellectual property which increases in value over time, etc.”

#### *Stage 2: Calculate normalised earnings*

“The company may be going through an unusual situation influenced by temporary factors which obscure its real capacity to generate earnings. We need to delve into this.”

(a) Economic cycles: There are various different methods that we can use to adjust earnings in the face of this difficulty: taking the average results over the last 10 years, adjusting for inflation; taking maximum and minimum earnings over the last 10 years and using the mid-point; or any other common sense criteria.

(b) “Disruption to supply or demand can bring about exceptional situations, and we know that investors tend to extrapolate the current situation to the future. It’s a huge error since economic agents will react to such problems, and they will gradually be resolved.”

(c) “The company in question might still be in its infancy. [...] It’s important to consider the potential to generate earnings in the future, which have not yet materialised.”

(d) “The previous issues could affect a part of the company, tainting the overall evaluation of the rest of the business. A normalisation will need to be applied to these ‘loss’-making businesses, otherwise we will be damaging the whole company. In the worst-case scenario, we can value the division at zero, taking account of the costs involved in a possible wind-up.”

#### *Stage 3: Indebtedness*

“Debt improves the return on capital, but the increased volatility from interest payments can become impossible to bear.” The analyst should be very aware of the “capacity to pay back debt: size, term, restrictions, etc. [...] Debt requires us to be more precise with our predictions than is desirable.” This make it more suitable when there is “an easy to predict outlook (motorway toll road, electricity networks, etc.) Additionally, Francisco examines “the incentive system for executives,” [h]ow competitors view its executives and “[t]he historic positions of the regulator if it is a regulated business.” He is generally keen to talk to or meet company management. (*Hedgeweek*, 2006) Francisco is concerned with the increase in shareholder value rather than cash being immediately returned to shareholders: “The dividend is not a focus in our investment process. If the company has a good use for the free cash flow, we accept it can reinvest it.” (MOI Latticework, 2018)

Five key catalysts that can lead to value being unlocked: (1) New managers. (2) The end of circumstances “which cloud the ability to generate results” can change. Currencies, technological changes, or any other event which may have concealed a business’s advantages can drop out.” (3) “The economic cycle can change. Nothing lasts for ever and we should be mindful of that.” (4) Market efficiency: “Experience tells us that for one reason or another, the market always ends up recognising a company’s ability to generate earnings.” (5) Share buybacks: “When we come across an undervalued company which repurchases its shares, we are looking at the only catalyst under the influence of the company and its shareholders.”

## Portfolio weighting

On diversification: “As such, our portfolio should be prepared to withstand any situation, be it a market collapse or a boom, inflation or deflation, for all possibilities. It must be resilient against any eventuality. [...] Having at least 10 stocks gives us a reasonable amount of diversification. If we are managing on behalf of others it can be helpful to hold a few more, creating a portfolio of some 20-30 stocks. [...] We must be sure of our investment if we’re going to assign it a high weight in our fund, never doing so if the company is indebted.”

Early on in his career, between 1990 and 1991, Francisco had invested 40% of his portfolio in Nissan’s Spanish subsidiary, Nissan Motor Ibérica: “I learnt an important lesson from the excessive focus of my portfolio on Nissan: even when we are totally convinced of our convictions we can get it wrong, making it vital to diversify our investments.”

At Q3 2018 in Cobas’s four largest funds, there was a mean of 50 holdings, equating to an expected 2% for every holding in the portfolio. However, each of the top ten holdings in these four funds, had an average share of 4.5% of the total fund value. The positions were not equally sized: “The size of positions should follow Eugenio D’Ors’ maxim: “Experiments should be made with lemonade and not champagne.” The stocks with the highest weight, over 5%, should command our total confidence to avoid the risk of serious damage. The riskiest bet should be kept up to a prudent size, never more than 1-2%.”

While individual investments rarely represent more than 5% of AUM, different themes do. Indicatively in Q1 2018, there were five main blocks that accounted for 78% of exposure: Shipping (25%), Commodities (11%), UK Companies (16%), Automotive Sector (11%) and Asia (15%). The average P/E ratio in Asia was 6x in addition to Net Cash. (CAM, 2018 Q1 Comments) *The Value Investor* had also highlighted there being certain “prominent industries” in the portfolio, at the time of their writing: “maritime transport, automobile manufacturing, fertilisers and baking products.”

In their Q1 2017 newsletter, Cobas too had referred to “Transport, Consumer Goods, Chemicals, Food, and Distribution” as making “the lion’s share of the portfolio. [...] Funds should be allocated to the opportunities providing the greatest discounts relative to their “target valuation.” Quality and confidence will help us decide the appropriate weight for each stock in the portfolio. [...] I am constantly tweaking the weights of my stocks according to their performance. If I have positions in two stocks and one goes up by 20% and the other falls by 20%, I almost automatically sell positions in the first to allow me to reinvest in the second.” Given as a result of the analysis, “we tend to know the companies very well” and “markets tend to over-react,” it is possible to take advantage of the volatility. “A 40% change in position, you have to play that.” (MOI, 2018)

## Investment examples

*Anglo American (sum of the parts, deep value, cyclical)*

“This situation caused oil and commodity prices to plummet in the latter half of the year, creating in the process the biggest opportunity in the financial markets since 2000 or perhaps 2009. While I attended numerous conferences and events related to the world of commodities during the autumn of 2015, my clearest recollection is of 7 December 2015, when I attended Investor Day at Anglo American, one of the biggest companies operating within the mining sector. It caught my attention because their shares were priced at 270 pence, having fallen 90%, and its main asset is De Beers, the world’s largest diamond company. The atmosphere was so negative in the City of London that it was hard not to feel sorry for its CEO. It struck me as an extraordinary opportunity and the company is currently priced at around 1,400 pence, five times its initial value.” (CAM Letter to Investors,

2017) “However, when launching Cobas in 2017 he noted that he had seen (and presumably acted on) an “extraordinary opportunity” in miner Anglo American in late 2015, when the shares were trading at roughly 270p. By March 2017, they had recovered to 1,400.” (*Moneyweek*, 2018)

#### *International Seaways (cyclical, deep value)*

“We have a significant investment (almost 10% of the International Portfolio) in the oil shipping business, in which International Seaways is one of our favourite companies. The current situation, which is the lowest point of the last 30 years, encourages investment in favour of the recovery of the cycle of maritime transport, in particular of crude oil. Several factors contribute to the current weakness, and we can gradually see how each and every one of them is returning to normal (inventories of crude oil, demolition of the fleet, and the drop in orders for new ships, among others). This means that supply and demand are being adjusted as is shown by the daily freight rates and the price of new ships. With International Seaways we moved into position for this recovery through a company with moderate levels of debt and with revaluation potential, even if the company should be liquidated today before the recovery of the cycle.” (CAM, 2018 Q3 Comments)

#### *Investing in Asia*

“In a recent example, with the help of a friend (a value investor) and taking advantage of the experience we had obtained by investing in a Spanish refrigerator company in the past, we began to investigate the Japanese refrigeration sector a year ago. We compared similar businesses on a global scale and confirmed that the business offers high quality (return on capital employed, (ROCE)) with entry barriers. We came to Japan to meet the main players in the sector and found out what the locals thought of them. The more we learn about the industry and the companies, the more convinced we are to add two Japanese refrigerator companies to our portfolio. Both have a net cash position and are controlled by families.” (CAM Newsletter, 01.01.2018)

#### *Israel Chemicals (quality business, cyclical)*

Low cost producer of 30% of world bromine, sixth greatest producer of potash, main provider of phosphoric asset. Key uses include as fertilisers, pharmaceutical component, food additives and to increase energy efficiency. Competitive advantages: privileged access to high quality, low cost minerals in the Dead Sea; vertical integration, from minerals to end products; geographical location; leadership position in the industry. Reason for underpricing: fall in the price of fertilisers. Margin of safety: generates cash in a stable manner; added-value business (processed minerals) more resilient than unprocessed minerals. Catalysts: strong capital management and optimisation of the debt structure, considerably reducing its net debt to EBITDA ratio; potential growth of additives business; eventual reversion to mean of potash prices.

“We’d like to place Israel Chemicals under the spotlight; this Israeli company’s history dates back to the start of the 20th century, with the first efforts to extract minerals from the Dead Sea, in southern Israel. Currently, it is one of the biggest manufacturers of fertilizers and specialist derivatives worldwide. The clear majority shareholder in ICL is Israel Corp. (TASE: ILCO), which controls around 45% of shares in circulation. The company produces approximately one third of the world’s bromine and is the sixth greatest producer of potash; it is also the main provider of pure phosphoric acid, although its main benefit resides in the fact that it is a producer at the lower end of the cost curve, making it more competitive.” (CAM, Newsletter October 2018)

#### *Quabit (cyclical, deep value)*

“We are also positive with the real estate sector and increase exposure to the cycle through Quabit. It



is a company with a reference shareholder that is quoted at a discount on the value of its assets, since part of them do not include the price increase that has occurred in the big cities. In December we went to the capital increase due to the discount with which the operation was made.” (Cobas, Comments on Q4 2017)

*Smurfit Kappa (event-driven, leveraged, catalyst)*

Bestinvest investment from 2007, completely exited previous to 2013. Gary McGann who was CEO of Smurfit Kappa is currently CEO of Aryzta, which is a current Cobas holding. From 2007-2008 Smurfit Kappa's share price fell 93% from €16.5 to €1 as EBITDA fell from €1,000 million in 2007 to €740 million in 2009, and debt of €3 billion. Gary McGann avoided a capital increase. As of 2018, the share price had risen to €34. Smurfit Kappa provides an example of the cumulative benefits derived from the knowledge of businesses and people gained through experience.

“We need only to look back at the cases of Smurfit Kappa and Thales to get a glimpse of what we can expect from Aryzta. The cardboard packaging company Smurfit Kappa was listed at 16.50 euros per share by mid-March 2007 after an IPO. From then on, the listing price began a downward spiral of 93% to hit a record low of 1 euro per share by the end of October 2008. We began building the position in 2007 and continued buying even at less than 1 euro. At this moment, the company had 237 million outstanding shares, resulting in a market cap of nearly 250 million euros compared with the 3.9 billion that it had on the date of the IPO. This share price descent was the result of an EBITDA that had fallen from 1,000 million euros at the end of 2007 to 740 million in 2009 and a debt in balance of approximately 3 billion euros. During such a delicate juncture for Smurfit Kappa, the company's CEO Gary McGann maintained his resolve to defend the interests of the shareholders and not to destroy value by avoiding a capital increase at all costs. Today, 10 years later and after having weathered the worst financial crisis in the past 50 years, the company still has the same number of shares outstanding, which are listed above 34 euros, thus entailing an upside of over 3,000% since the record low in 2008 and capitalising over 8 billion euros. We sold our last shares at 8 euros per share. Aryzta's current chairman is Gary McGann.” (CAM, 2018 Q2 Comments)

*Thales (event-driven, catalyst)*

Developer of information systems and services for aerospace, defence and security markets. Share price fell from €45 to €30 as margins fell to 2% compared to 10-12% margins of competitor, General Dynamics. Margin of safety: high barriers to entry, likely high switching costs. Catalysts: acquiring by Dassault Aviation of 25% of the share capital, the latter enjoys an excellent reputation for project. Improvements of margins. Result: margins at 11%, share price up 4x from 2011-18. Francisco continued to acquire shares as the price fell to €22 per share, while margins had already improved to 6%.

“The French electronics company Thales develops information systems and services for the aerospace, defence and security markets. Midway through 2007, its stock was listed at around 45 euros and company was posting margins of 7%. However, deficient project management caused its shares to trade below 30 euros for most of 2010, with very low margins of approximately 2% for that period. We thus took this as an opportunity to build most of our position and continued buying until the share hit the minimum lows in December 2011 (below 22 euros/shares), when Thales reported margins of 6% in the shadows of the 10-12% that its competitors such as General Dynamics were reporting. Such a visible difference in the margins made us ask ourselves why Thales wouldn't also be able to generate such margins doing things the right way. The entry of Dassault Aviation (whose shares we also held at this moment) in the middle of 2009, which bought over 25% of the share capital, was also a key factor in our investment assumption, since it would help Thales develop projects thanks to Dassault Aviation's already solid reputation for excellent project management. Hardly more than 8 years later,

the company has posted its first-quarter earnings for 2018 and forecast for the next 3 years that entail a turnover increase from 3% to 5% and margins standing at approximately 11%. With a share price surpassing 110 euros in 2018, the upside since 2011 has exceeded 400%.” (CAM, 2018 Q2 Comments)

*Aryzta (event driven, leveraged, catalyst)*

Swiss company in the pre-frozen bread sector, reminiscent of Smurfit Kappa and Thales. Share price fell 65% due to high debt levels, and 50% fall in EBITDA. Margin of safety: Stable and cash-generating business. Catalyst: improvement of margins; CEO Gary McGann who was CEO at Smurfit Kappa; strong growth prospects; reduction of debt; improvement of margins from current 8% to industry standard 10-15%. Despite a rights' issue deemed unnecessary by Cobas, Francisco remained positive on Aryzta. “It is a robust, stable and traditional company. Its production facilities are well located from a strategic perspective, and it has an extensive sales network. Both factors represent two of its biggest competitive advantages. Nevertheless, its share price has dropped 65% since the highs of 2014, closing May at 30.6 CHF/share.” (CAM Newsletter, June 2017)

“Our past investments in Smurfit Kappa and Thales are two successful examples with similar key aspects to what Aryzta is currently going through. “With Aryzta, we now have a company with an elevated debt level (1.8 billion euros, excluding the value of its subsidiary Picard) and an EBITDA that has shrunk from 600 million euros to 300 million euros expected, with the share price falling by over 84% from the maximum levels hit midway through 2014, nearly 90 Swiss francs per share, to bottom out this year under 15 Swiss francs per share. Similar to Smurfit Kappa, this stable and cash-generating business will gradually reduce its debt despite a financial situation that is hardly simple. Aryzta is also reminiscent of the case of Thales, further proof of our resolve that going against the grain is an essential character of our investment process.” (See Thales Section Earlier)

“We are asking ourselves the same questions about Aryzta: How could it be possible for the sector's leader to have EBITDA margins around 8% while its competition is posting margins between 10% and 15%? We believe that there are no sufficient reasons to think that this European and American leader couldn't improve on its present margins and achieve figures more in line with its competition. We have therefore taken advantage of a steep downturn to buy more shares with a view to increasing the potential upside of the position. Even in the possible worst-case scenario of a capital increase, this potential still remains greatly elevated.” (Cobas, Comments on Q2 2018)

“In the case of Aryzta, I cannot comment much because there are some ongoing situations, but mainly, one of our people brought up the name, we did our due diligence, and met some competitors. This is a better business than you'd think. It's a big business -you need the manufacturing side, you need the distribution because you have to provide a service everywhere every day, and there are health and safety issues. The returns are better than what people think -something like 20%-25% on capital - and the company has a pretty good management. That's why we jumped in, and that was the process.” (FGP, MOI Latticework, 2018)

*Atalaya Mining (cyclical)*

Copper miner, underfollowed due to small market cap and headquarters in Cyprus while it is traded in London. Expansion of the annual production of the Rio Tinto mine; good prospects for copper prices. Margin of safety: future world copper needs cannot be met by current copper production. “Atalaya Mining is a copper mining company with two assets: an open-pit mine in Huelva (Rio Tinto) and mining project in Galicia (Touro). We believe that the share price does not reflect the intrinsic value of the company for several reasons. Firstly, the company is not well known in the marketplace because, while its assets are in Spain, the company has its headquarters in Cyprus and is traded in London. Moreover, with a market cap of only 360 million euros, the company does not attract many market

followers. Another reason is the company's administrative body, whom we've known for some years now, who will expand the annual production of the Rio Tinto mine, thus increasing the value of the mine with hardly any additional investments. When optimisation occurs, the results will improve and it is therefore reasonable to think that this will affect Atalaya's listing. By investing in Atalaya Mining we are investing in copper in a more profitable way. At a global level, we believe that the copper price has good prospects, since we estimate that the future world copper needs cannot be met with the mines that are currently operating and the available copper stocks. Consequently, we believe that the price of copper should rise to encourage the development of new mines. When it rises, we will benefit from the higher margins of Atalaya." (CAM, 2018 Q2 Comments)

#### *Teva Pharma (event driven, catalyst)*

Leader in generic drugs; poor management and capital allocation; loss of patent of most important medicine (Copaxone); and net debt to EBITDA of nearly 5x led to share price falls from \$70 in 2015 to \$11 in 2017. Margin of safety: growth of ageing population and penetration of medicines in emerging markets. Catalyst: new CEO, Kåre Schultz. "Teva is the world leader in generic drugs, with a global share of 8%, and also has an important presence in innovative products related to neurodegenerative, respiratory and oncology diseases. A poor management of the existing business, together with an aggressive acquisitions policy at the wrong time, caused the company to lose focus in the business at a crucial time for the sector (clients were consolidating, together with greater public pressure on the product prices), which generated more pressure (than normal) in the prices of generic products. Furthermore, its most important innovative medicine (Copaxone) lost its patent in 2017. All these difficulties led to expectations deteriorating and showing a weak balance with a Net Debt ratio to EBITDA (close to 5 times). This caused shares to fall from a maximum of \$70 in 2015 to \$11 in November 2017. We, as usual, started buying too soon, but we took advantage of the drop to strongly increase our position. Convinced that the sector has a future, because it is a sector that grows, due to the growth of the population, its ageing, and also due to the greater diagnosis and penetration of medicines in emerging markets, although with lower prices, together with the references of the new CEO, Kåre Schultz, which are extraordinary. As the COO of Novo Nordisk, the Chairman of the board of Royal Unibrew, and CEO of Lundbeck, the results show that he did a very effective job (just to mention the last case, his stage in Lundbeck, shares multiplied by 3 times from May 2015 to September 2017). Based on this generated credibility, we are confident that he can carry out the announced restructuring without the need for dilutive capital increases, which makes the valuation of Teva, which is trading at a 6.25x P/E ratio at 31 December, very attractive." (CAM, 2017 Q4 Comments)

#### *Daiwa Industries (Japan)*

Japanese family business, manufacturer of industrial refrigeration equipment. High barriers to entry and high returns on capital. Re-use of investing experience in Europe, through the expansion of Cobas's circle of competence in Asia. "One of the companies we visited during our trip to Japan was Daiwa Industries. Its weight on 31 December at Cobas Selección FI was 1.68%. We have already visited them twice in Osaka. It is a family business, with 42% of the capital in the hands of the Ozaki family, whose business consists of manufacturing industrial refrigeration equipment, which it sells to restaurants, hospitals, retail shops, etc. The four main competitors in Japan have consolidated their market share in recent years and accumulate around 75% of that quota. It is a good business with a ROCE of more than 50% and stable sales growth of around 3-4% per year. It is a business with high entry barriers given the customisation required by kitchens and the wide portfolio of products to be offered in order to be competitive. It is necessary to have a good and fast pre-sales and after-sales service (24 hours a day, 365 days a year) since, being cold machines, customers cannot wait due to the type of products they keep. For more than 20 years, we had an investment experience in Spain in the sector, specifically in Ibérica del Frio (Koxka), one of the sector leaders in Spain. In the case of Daiwa,

it is a company with a net cash / market capitalisation percentage of approximately 64%. It is trading at a P/E ratio of 5x, while its biggest competitor (Hoshizaki) trades at 20 times profit.” (CAM, 2017 Q4 Comments)

## Lessons and advice

### *Personal approach*

On his daily routine: Francisco believes “consistency, combined with a long-term passion for what I do, underpins the achievement of optimal results over time. [...] The same basic routine, come what may.” Each day for the last twenty years, he has read *Expansión* and the *Financial Times*, with particular attention to the Lex Column, that “analyses companies briefly but in sufficient depth to add value.” The “core” of his weekly reading consists of *Baron’s*, *The Economist*, and *Value Investor Insight*. After “demolishing the press,” he reads “company or sectoral reports” and participates in company visits and “contacts with sector experts or people familiar with companies of interest to us. [...] Nobody can spend their life studying for 50 years – which is what we do – if they don’t enjoy it. He doesn’t “follow the markets until they close” and “swear[s] by the need to sleep on decisions” in order to “fend off unnecessary haste.”

Study is more than just a means to an end, it is an end unto itself: “Our work is part of our lives. We enjoy it. Asset management isn’t just a job, but a permanent challenge that requires many hours of reading and constant attention to all the factors that could affect a company’s valuation”. FGM (CAM newsletter, 2017) The investor must seek to develop multiple mental models: “Understanding what motivates others to act and how they do it, and our own rationale for what we do, is the essence of prudent and successful investment” (CAM newsletter, 2018) Being a learning machine is important: “What you learn at 20 years of age is not as important as lifelong education – preferably when it is self-taught.”

Since starting at Bestinver and carving out his own role, Francisco placed great emphasis on one’s own initiative: “It’s probably because of this that later in life I have put a lot of emphasis on my own initiative, free from guidance. This is my approach to management, when I have had to work with colleagues. If we wait for somebody to solve our problems by giving clear instructions, it is more likely that Godot will show up first.” Francisco draws a clear distinction between his personal beliefs and the goals of the fund: “In my funds I make sure to clearly define that the main goal of the fund is obtaining the best return possible while meeting the letter of the law. I find it uncomfortable imposing my conscience on clients; which is why it is preferable that the returns achieved by the funds enable each of us to act in accordance with our own conscience.”

### *Advice for becoming a professional investor*

Small investors should be willing to commit the time and effort: “The funny thing about the public market is that most of the people are retail investors and the majority of them don’t have much of an idea why they invest in Telefónica, for instance. Then you have the institutions with all the problems they have. In the public market, you may have a chance to make a consistently higher return than average.” (MOI Latticework, 2018)

The aspiring investor today is fortunate to have a wealth of learning tools available to them. However, the focus must be on applying the framework in practice to build one’s own portfolio: “When young people ask me how to get started with investing, I always say that they have to start right now. There are two options. The first is that some charitable soul in the markets will come along and offer you a work opportunity related to investment analysis or management. This makes life easier, provided that bad habits are not picked up, which can later prove hard to shake. The second, more likely, option is

that you have to self-teach, working in other jobs to support yourself while learning about investing correctly in your spare time. Fortunately, there are a lot of resources out there these days to help you. I was lucky enough to spend a year midway between the two, I was paid by somebody but I was allowed to choose how I spent my analytical time. Either way, the crucial thing is to create your own portfolio from the outset. The amount that we invest is irrelevant, the key is organising an effective process, which suits us and, if possible, actually works."

Learning through doing is an essential part of building an investment process and being able to communicate this to potential clients: "Indeed, my cases even starker than Álvaro's, I started with just 50 shares in Banco Santander. The key thing is to learn the process, survive the emotional ups and downs, and build confidence in your ability to invest effectively and convey that confidence to others. Believing that we can invest and being able to prove it, even with small sums is a crucial first step." Even superinvestors cannot outperform the market all of the time: "If the market is behaving rationally, it's difficult to outperform and our returns will be broadly similar. It's much better therefore for volatility to be very elevated, provoking a degree of irrationality, which opens up opportunities that wouldn't emerge in a more stable environment."

Patience is necessary even for established managers waiting to get more traction: "Nothing to be sniffed at, but when other asset managers complain about a lack of growth and difficulties in attracting money, I explain to them that it took years for us to gain investors' approval. For better or worse, time is the only way to tell who's right or wrong, and clients need to be confident in their decisions. At some point a sparkle will come along and ignite the fuse, and you will be carried away by a wave of exuberance. This is what happened to us from 2003 onwards."

Increasing AUM makes it harder to achieve the same returns: "Although we want to allow as many people as possible to take part in a management approach we consider attractive, it is also true that finding value becomes increasingly difficult the more assets we have under management." (Cobas Letter to Investors, 17.03.2017)

### *Defeating biases*

The institutional pressures increase the investors vulnerability to human biases: "The problem is the pressure of the people in an institution. Your job is at stake every morning, so it's an issue. Then, there are your colleagues. You go into a room, eight people are saying something, you say no and share something different. It's not that easy. You have to use some tricks to avoid that. The main thing here, with all the psychological biases we have, is to be aware of them, to be aware of behavior that is sometimes difficult to understand and find solutions by regressing to the mean." (MOI Latticework, 2018)

The investor should be weary of overconfidence: "It's extremely dangerous to think that we are more capable than our competitors and we are going to get it right all the time. Dangerous but all too common. We must fight to remain within our small circle of competence, as Buffett says."

Mistakes should be used as a tool for learning: "The key to not repeating one's errors is owning up to them. We are all responsible for our own errors and learning from them. He who doesn't learn from them faces a bigger problem than the error itself. I made some mistakes, which I hope have taught me an abiding lesson."

It is hard to distinguish skill from luck in investing: "Who knows whether what we are attributing to skill is no more than chance? As Taleb observes, we tend to confuse judgment with luck." A dangerous consequence of confusing skill for luck, is taking on too much risk: "This bull market is confused with a capacity or ability to invest, leading us to excessively increase the risk of our investments."

Falling into the false belief that the market will always play out in line with our expectations: "A particularly disastrous illusion of control arises when we think that we can predict something: the economic or market outlook, or certain short-term market prices."

Sometimes it is easier to change our view of reality than to admit to our errors: "We humans have a very strong tendency to change our understanding of the facts as they develop. If there's a strong fall, we will acknowledge that it was obvious and we'll forget that we had previously thought differently, and this applies across the board." The risk of this bias is not recognising when it is necessary to correct course: "This becomes more of an issue when it concerns an investment error, since our attachment makes it hard to recognize the error and sell the stock, which probably requires us to accept some losses. [...] The third factor is the point of reference. We have a tendency to immediately take the current price as our point of reference. If Telefónica is trading at 12 euros, we find it hard to think that it's worth 30 or five euros." Using this point of reference is akin to moving with the herd: "The main one is that we all want to go with the herd because we feel much more comfortable among it, and it has been a successful path over the years. We try to extrapolate the past into the future." (MOI Latticework, 2018)

Too much information can lead to poorer decisions: "When facing information overload, in countless situations it has been proven that better decisions are made with less information, since in reality we are making the same error as when we are looking at market movements too frequently, which drives us to act when we shouldn't." Checking a Bloomberg terminal too often makes it harder to pursue independent analysis: "I don't have a Bloomberg terminal in my office; we have a shared one for the whole office."

The loss of independent analysis is also a danger of investment committees: "Furthermore, in investment committees, group thinking (group feeling as Tuckett calls it) also comes into play, which increases our dependency on others – with a strong tendency to conform to the group and avoid confrontation. [...] One way to reduce the risk is for each committee member to write down their opinion before anyone speaks. An alternative is to set incentives based on group results, which is the system that we have always applied."

Patience and a focus on the right investment process are the best defences against these biases: "Patience is the key to the investment process, helping us to master more myopic impulses. As such, anything that helps strengthen it is welcome. [...] In fact, the result itself is not what matters, but rather that it's been accompanied by the right process. If the process is right and we can differentiate it from luck, then we will be able to replicate the success without making unnecessary errors." A good process will be followed by good results over time: "But what we do know is that we have a good management process in place and that income and profits will naturally follow." Attributes of the ideal investor: somebody who is patient, invests over the long term, enjoying the journey and focusing less on the results, who doesn't get carried away by emotions, with strong convictions but willing to learn.

## Concluding Items

Francisco is an optimist: "One thing I've noticed is that in the last 50 years, there has been no year whatsoever with negative GDP growth on a global basis, on PPP (purchasing power parity). Only on five occasions has the growth been below 2% (between 0% and 2%), the last time being in 2008. You don't have to think the world is going to collapse because it's not. We will have some hiccups here and there." (MOI Latticework, 2018)

In the tradition of Milton Friedman, personal goals should remain distinct from business objectives: "In my funds I make sure to clearly define that the main goal of the fund is obtaining the best return possible while meeting the letter of the law. I find it uncomfortable imposing my conscience on clients;



which is why it is preferable that the returns achieved by the funds enable each of us to act in accordance with our own conscience.”

In 2007, Francisco launched the Africa Support Fund in collaboration with José María Márquez and África Directo: “The fund “finances hospitals, schools, medicine, water treatment systems, treatment for albino children, etc. A large number of projects across more than 20 countries, with a total investment of around 3,500,000 euros.”

Francisco is not considering retiring any time soon. He is motivated by the nature of investing work which suits his personality; the valuable service it provides to clients “because the returns come with a degree of trust and composure, which enables them to feel that they have this part of their life under control;” the financial compensation which reinforces independence and the “social role,” providing employment and liquidity to the market.

In 2017, Francisco together with his wife, María Ángeles, founded Value School. Value School is an organisation devoted to providing free of charge investing and economics instruction to the general public. It delivers this through weekly lectures, seminars, courses as well as the translation and publication of investment classics into Spanish.

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