Investing with Insight

Full Year Investment Report 2021

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REQ CAPITAL

INVESTING WITH INSIGHT

Investing with Insight

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Dear fellow investors

We launched the REQ Global Compounders fund on June 15th. It is a concentrated portfolio of the very best serial acquirers we can find around the world. As the name suggests, the fund invests globally in serial acquirers that reinvest and compound capital and generate strong returns over decades. We have a generational perspective on our investments.

It's been a great start for the fund. The fund has returned 20% since inception[1], which was above our expectations. The fund also has share classes in USD, EUR, GBP, CHF and SEK. We invest completely independent of benchmarks. We do not measure ourselves on an annual basis. Warren Buffett says it best:

"*Our investments are simply not aware that it takes 365 days for the earth to make it around the sun*"

For investors who still want to benchmark, the most relevant alternative investment is the MSCI All Country World Index, which gained 12% over the same period.

We have made few changes to the portfolio since inception. The hurdle for new companies to enter the fund is high, and we do not sell companies that work perfectly. As the famous investor Charlie Munger said, "The first rule of compounding is: Never interrupt it unnecessarily". We will not do that.

We invest in companies that will grow and thrive over the long term, regardless of market conditions. Ultimately, the value created by these companies will be reflected in stock prices. As owners of these companies, we can sleep very well at night. The companies in which we have invested are in the best position to deliver profitable growth in the years ahead. They share some common characteristics. Our companies are led by management teams that have excellent capital allocation skills. They are strong investors. They tend to organize themselves in a very decentralized manner to unleash entrepreneurial energy. And last but not least, just like us, management teams own a lot of stock. Incentives matter.

In this letter, we will provide some insight into the REQ Global Compounders portfolio and later share some insights into themes that we believe will be of interest to our investors.

Thank you for your trust and support. We will ensure that we deliver on our promise to find the best compounders and create significant value for our investors in the decades to come.

[1] In NOK, as of 31.12.2021, "A" class after 100bps management fee.

REQ Nordic Compounders: An introduction

We are very excited to launch REQ Nordic Compounders in January 2022. The fund will follow the same investment philosophy as REQ Global Compounders, being a long-only fund constituting the best serial acquirers in the Nordics.

The fund will invest in high-quality companies that grow profitably over time through organic growth and through acquiring quality companies at below-market multiples. The focus of the fund will be companies with decentralized business models with high-quality management and perpetual ownership horizon on subsidiaries. The fund will have a unique collection of companies with strong reinvestment opportunities at high returns on capital. The fund will primarily invest in companies where the founders and senior management have high ownership stakes, ensuring aligned incentives.

There are many companies in the Nordic countries with the serial acquirer business model, and the business model is well established, especially in Sweden. Several renowned serial compounders are Swedish, and there are a large number of prospective investment opportunities with this business model in the Nordic market.

Nordic companies also have many of the characteristics we look for when identifying new investment opportunities. Corporate governance is high on the agenda and the Nordic countries are pioneers in

integrating sustainability into business decisions. Proximity to companies is also a positive, as we are able to engage with them more frequently. REQ Global Compounders and REQ Nordic Compounders are Article 8 funds, promoting environmental and social characteristics. Sustainability is integrated in all investment decisions.

REQ Nordic Compounders will not follow a benchmark. The fund will follow a bottom-up investment process and have a high active share, with 25-30 long positions. There will be a long-term investment horizon, with a high hurdle for adding new companies to the portfolio. There will be no short-term stock market cases, turnaround stories, or companies with any balance sheet risk.

REQ Nordic Compounders has many of the same characteristics as REQ Global Compounders, but has a higher proportion of small and medium-sized companies. This results from the fact that the investment universe includes, on average, companies with a smaller market capitalization. For serial compounders, size does matter. It is easier to grow a company in the early stages because additional growth is cheap. As the company gets bigger, a higher frequency of, and larger, transactions are required to drive growth. There is a clear relationship between size and returns on invested capital. Therefore, we believe that a fund specializing in the Nordic market offers a very good exposure to the serial compounder strategy.

The best shareholder letters

We spend a lot of time reading shareholder letters and have drawn inspiration from the best of them when writing our investor reports.

The best shareholder letters should give you, the investor, a good insight into the company's culture. Unfortunately, most shareholder letters do not provide insight into the company or management's thinking. But the best shareholder letters share many similar characteristics. We will try to summarize the most interesting ones below which is a summary of both our own experiences as investors and some takeaways from the book “Dear Shareholder” by Lawrence A. Cunningham.

Trust

The best shareholder letters instill confidence. They are not written by the investor relations department, but by the CEO. The best shareholder letters establish management accountability. The best CEOs talk openly about underperforming investments and failed product launches. They seem almost proud to describe failures. They are personal. They do not try to cover up challenges. They are honest and convey a message based on trust.

“*One of the analysts who covers Constellation recently changed his perennial "sell" recommendation to a "buy". We lost one of our few critics. Analysts who worry about the quality of earnings and reversion to the mean and the impossibility of trees growing to the sky are valuable*”
(CEO Mark Leonard, Constellation Software, Shareholder Letter 2017)

Culture

The best shareholder letters provide a deep insight into a company's culture. Over time, employees self-select into or out of a culture. So, it is with investors. Companies often get the shareholders they

deserve. A company that takes a long-term view and does not focus on quarterly numbers will attract investors who value those aspects. If the company spends a lot of time talking about short-term results and quarterly numbers, it will attract speculators. Long-term communication attracts long-term investors, which is a great competitive advantage for any company.

Conservatism and frugality

The best shareholder letters convey a story of conservatism, but also of rationality and boldness. The best shareholder letters convey a culture of frugality. The message sends a strong signal to the company about how best to spend its hard-earned money. CEOs themselves lead by example and do not spend money on expensive hotels or airline tickets in front of the curtain. Employees are adapting to the frugal mentality.

Ownership and compensation

The best shareholder letters are written by CEOs who act like owners. They treat the company as if it were their own. These companies often have a dual stock structure where the original founders or CEO control the voting stock of the company. These companies are big fans of internal stock ownership among all employees and often supplement employee 401(k) plans with company stock. In cases where the company grants stock to employees, the vesting period lasts for many years.

Long termism

The best shareholder letters provide a long-term vision. The CEOs who write these letters do not provide earnings forecasts and use the shareholder letter as their primary medium to communicate information about the company. Many of these CEOs aim for low share turnover, which is a sign that many long-term shareholders are on board. They use the shareholder letter to explain the company's strategy and often take the time to explain the company's history and how it got to where it is today. The best letters address the importance of long-term shareholders.

"Our approach to ownership is perpetual"

(CEO Per Waldemarson, Lifco, 2020 Annual Report)

Principles

The best shareholder letters contain ideas that relate to the business and management principles on which the company is built. These principles serve both to build the company's culture and to manage investor expectations. Management principles are often about how people in the company treat each other, and they focus on processes rather than goals. These CEOs know what they are influencing. By making the culture process-oriented, they increase the chances of achieving their goals.

Succession planning

The best shareholder letters clearly set out the company's succession plan. Therefore, there are no surprises for employees or shareholders when the CEO decides to leave the company. Often, internal candidates are promoted to CEO, which reduces the risk of changes in corporate culture and strategy.

Capital allocation

The best shareholder letters emphasize the important aspect of capital allocation. The letters explain how the company will allocate its capital and what its priorities will be in terms of dividends, share

buybacks, investments, acquisitions, and leverage. Some of the CEOs have very clear ideas about dividends and share buybacks. Most CEOs who write good shareholder letters are aware of the need to reinvest in the company at high returns on capital to create shareholder value.

Performance measurement

The best shareholder letters describe how shareholders should evaluate the company's performance. The best letters include different types of performance metrics, but the common denominator is some type of economic value creation (EVA). The performance metrics that the CEO presents do not alter from year to year. The CEO does not cherry- pick the metrics based on what looks good in the current year. The best letters often explain and argue why the metric is used.

Accounting

The best shareholder letters frequently discuss accounting and the limitations of accounting in measuring true economic profit. They explain to investors the subjective nature of accounting and its drawbacks. These letters take time to explain to investors what they should look for in financial statements. They try to guide investors.

For example, Larry Page and Sergey Brin wrote in their first investor letter on Google's IPO, *"We won't 'smooth' quarterly or annual results: If earnings figures are lumpy when they reach headquarters, they will be lumpy when they reach you."*

Conclusion

The best shareholder letters stand out from the rest. These letters are based on trust and go to great lengths to attract the right shareholders. They have a long-term focus and often cover the same topics such as ownership, principles, capital allocation, and how best to value the company.

When you invest in companies that can clearly articulate the fundamentals of their corporate culture, you increase your chances of excellent long-term returns. At REQ Capital, we call it "Investing with Insight".

REQ Global Compounders

REQ Global Compounders is based on an investment philosophy of investing in value creators and more specifically a strategy of investing in serial compounders, a group of publicly traded companies that specialize in sourcing, acquiring, and supporting a range of private companies. Serial compounders acquire private companies at below-market multiples with a perpetual view on ownership. Our interest and growing fascination with these high performing serial acquirers stems from our experience that these companies have some very good elements of risk mitigation due to diversification. They are fundamentally low-risk business models.

The fund invests globally, with a focus on developed markets. Over the years, we have developed a list of companies that meet our investment criteria. The fund is focused on companies that are run by great capital allocators, decentralized organizations, and management teams with skin in the game who act like owners. We believe these are the long-term determinants of investment success and that the majority of our long-term returns will come from these three core investment principles. The rest is noise.

Our three investment principles are powerful sources of long-term returns. Investing is a reductionist art, and those who can boil things down to the essentials will generate strong long-term returns. Great companies are the ones you like more the longer you own them. Some of these we will describe in this report.

Capital allocation is at the core of our investment strategy. The companies we have invested in have an extensive network of relationships with private sellers and buy companies at a large discount to market valuations. We believe the CEOs of our portfolio companies are excellent investors. Return on capital employed (ROCE) is high and because our companies reinvest large amounts of free cash flow each year, we enjoy strong and profitable earnings growth. The serial compounder business model as such provides a high degree of diversification while offering high returns and therefore has excellent risk mitigating characteristics.

In financial theory, one would assume that these lower risk businesses should also have lower expected returns. In the years we have been investing in these business models, we have not seen that. They offer some very interesting return characteristics.

The risk reduction approach

Our acquisition-driven companies are highly diversified in terms of products and services, customers, and geographic markets. By investing indirectly in hundreds of small private companies through their publicly traded parent companies, we largely avoid exposure to major events that can have a significant impact on earnings.

We do not invest in companies that sell only one product to one group of customers in one market. Experience has taught us that negative changes in the attractiveness of a single product or service, a change in the bargaining power of customers, or a change in the market outlook can have dramatic consequences for the company in question. Dependence on a single product, customer or market also carries a high degree of regulatory risk.

Of course, there are companies with very concentrated exposure that are very successful in their business, but our experience is that many of these companies carry unattractive binary risk characteristics that make them vulnerable.

From this risk mitigation perspective, and with the goal of avoiding financial meltdowns, we have built a portfolio of a special group of publicly traded serial acquirers. A big part of winning big is losing small. As we will explain, the return prospects of our companies are very promising.

The return enhancing approach

With our risk reduction approach at the heart of our investment philosophy, it is interesting to meet investors - mostly private - who are invested in the same companies as we are. Many of these investors have come to the same conclusion as we have, but from a very different perspective - from the perspective of high returns.

During 2021 we have been talking to US investor Chris Mayer, author of the book "100 Baggers: Stocks that Return 100-to-1 and How to Find Them". We highly recommend his book, which talks about the ingredients you need in stocks to find the ones that will yield 100 times your money. He has identified many of the same companies as us, but from a very different angle - the return angle.

If you disregard the "lottery tickets" in the stock market - the companies that carry a lot of binary risk (think biotech, mining, etc.) - Chris Mayer says there are five ingredients you need in order to find a potential "100-bagger.":

1) **Size:** Small to medium sized companies
2) **Quality:** High return on capital
3) **Growth:** In all dimensions: sales, margins, multiples
4) **Growth path:** Decades of durability
5) **Valuation**: It helps to buy at reasonable prices

If you look at the portfolio of REQ Global Compounders, many of our portfolio holdings share these characteristics.

“I study great stocks, great businesses and great leaders – hundreds of them. I put in the reps to develop pattern recognition and then go find them when they are small. Great companies always trade at a premium because there is a scarcity of them”

(Peter Lynch, “One up on wall street”)

Our fund holdings consist primarily of companies with small to mid-sized market capitalizations. The average market capitalization of the Fund is approximately $13 billion.

The quality aspect of the portfolio is solid - the fund's return on equity in 2021 is approximately 20%.

Growth is underpinned by two growth engines, both organic and acquisitions. In December, our companies collectively announced 26 private acquisitions, bringing the year-to-date total to 316[2]. Just think about that for a moment. In order to close such a high number of transactions with private sellers month after month and year after year, several conditions must be met. The growth path is secured as management of these companies has a high degree of skill in allocating capital and has an incentive to deploy excess capital in a way that creates, not destroys, shareholder value. The deals must be sourced (normally off-market without M&A brokers), negotiated (multiples paid are in general lower than those paid by private equity GPs) and funded (usually through free cash flow). Basically, these portfolio companies have developed a very effective internal M&A capability.

Furthermore, we sleep well at night knowing that the management teams of our portfolio companies have a lot of skin in the game through their equity ownership. On average, the management or families behind our companies own 6% of the stock.

Finally, the estimates and valuations of our portfolio companies tend to underestimate future growth. It is very difficult to estimate such a high pace of future acquisitions, even though this is an essential part of the companies' business model. It follows that analyst forecasts for the serial acquirers in our portfolio tend to significantly underestimate the long-term growth potential of the listed parent company.

Durability of growth is provided by very diverse markets and generally low market shares. Our companies continually buy private companies at multiples far below public market multiples. The reasons for this are that the companies bought are generally too small for private equity firms or the founder does not want to sell to private equity.

"*The biggest mistake an investor can make is to sell a stock that goes on to rise ten-fold. It is not from owning something into bankruptcy. But that is what everyone thinks, at least judging by the questions we get from clients*"

(Quote Nick Sleep, from tweet of MastersInvest.com on Sept.10th 2021)

We believe REQ Global Compounders has some unique risk and return characteristics. We believe we can combine low-risk business models with high return prospects.

From a risk reduction perspective, these companies are highly diversified and comprise hundreds of small private entrepreneurs. From a return perspective, the right ingredients are in place for these companies to continue to create tremendous shareholder value.

Portfolio changes

Our hurdle rate for adding new positions is high. We have included one company in the fund during the second half of the year, US insurance broker Brown & Brown. The company is an acquisition-driven compounder, and a consolidator in the highly fragmented insurance broker market in the US. Since 1993 the company has acquired 565 businesses and had an average earnings growth of 16.3% annually.

[2] As of 31.12.2021. Internal estimates comprising announced transactions and transactions reported in interim reports. Transactions completed but not reported are not included.

Brown & Brown runs a highly decentralized business model, with a disciplined focus on acquiring businesses that fit its existing sales and service culture. In 2020 the company acquired 25 businesses, and year to date it has announced 14 acquisitions.

The company is owned by the Brown family. Chairman J. Hyatt Brown owns 14.9% of the company. Since almost 60% of all employees are shareholders the total ownership by insiders is almost 25%. The vesting period for stock incentive grants is 7 years. Consequently, B&B is more focused on the long term rather than quarter-to-quarter results. 94% of employees say that B&B is a Great Place to Work®.

The market opportunity for the company to continue to consolidate is promising. There are tens of thousands of small brokers in the US that are attractive acquisition opportunities for B&B over the coming years.

Sustainability – A Source for Long Term Value Creation?

All REQ Capital funds are Article 8 funds as defined by the EU taxonomy, promoting environmental and social characteristics. Sustainability and the integration of ESG (environmental, social and governance) criteria into investment analysis have probably been the most discussed topic in financial markets in recent years. After receiving little attention in the years leading up to the Paris Agreement in 2015, it now seems to be at the top of every asset manager's agenda.

At REQ Capital, we view sustainability as a requirement that must be met in order to create value for shareholders, not just an opportunistic investment opportunity. Our investment philosophy is to only invest in companies that we believe will create long-term value over time, as measured by consistent profitable earnings growth and free cash flow generation. For a company to do this over decades, the management of these companies must thoroughly evaluate all relevant aspects of the business model that may impact future growth. Sustainability is an important component of this.

When we analyze sustainability, we put the most emphasis on governance. This is not because we do not care about social and environmental issues, but because we believe that a well-governed company also incorporates social and environmental factors into its business model. We also analyze social and environmental metrics, but mostly from a risk mitigation perspective. There are a growing number of companies promoting ESG characteristics, and several of these companies do not currently have tangible businesses or cash earnings. We believe it is too risky to base an investment decision on opportunistic ESG characteristics alone.

A company's growth prospects and cost of capital are two important factors in investment analysis. Failure to fully incorporate sustainability into the analysis can negatively impact returns. Below we will outline how we believe sustainability impacts a company's value creation and how we incorporate this into our investment process.

Sustainability and growth

Sustainability has a major impact on a company's growth prospects. Regulatory risks are the biggest threat, closely followed by reputational risks and political risks. Companies operating in controversial

industries with high regulatory risk, such as coal mining, fossil fuels, or weapons manufacturing, run the risk of new regulations limiting their growth opportunities. Companies operating in industries with high reputational risk, such as tobacco or gambling, face significant risk of lower growth prospects as regulators restrict sales and marketing practices and customer behavior and sentiment changes. Companies operating in high political risk countries such as Iran, North Korea, and disputed territories such as Western Sahara also face significant risk as political sanctions can suddenly close the end market.

It's not just the big sustainability factors that can affect a company's growth, but important social factors can also have a major impact on a company's growth prospects. Unsustainable material sourcing or not developing human capital are examples of major social factors that can limit a company's growth. Companies that do not have a sustainable supply chain run the risk of disruptions or increased costs for inputs. Companies that do not develop and invest in their human capital may not be able to attract the best employees and have high sick leave or turnover.

At REQ Capital, we always analyze a wide range of social and environmental factors that can influence growth as part of our investment analysis. Sustainable growth is at the heart of our investment philosophy and is therefore an integral part of our investment process. This is also one of the reasons why we invest in serial compounders. Serial compounders own several small portfolio companies, each operating on a stand-alone basis. Typically, no subsidiary accounts for a significant portion of the parent company's total revenue, and the subsidiaries operate in different geographies and/or industries. The parent company makes high-level strategic decisions and acquires companies that fit the company's strategy, including sustainability attributes. This business model ensures that sustainability is embedded throughout the organization.

Sustainability and the cost of capital

There is no doubt that sustainability also affects a company's cost of capital, through higher costs of equity and debt. If a company does not take sustainability into account, it risks lower growth prospects, which increases the cost of capital.

The allocation of capital also has a major impact on a company's cost of capital. The introduction of the EU taxonomy in Europe and several initiatives by investors around the world have led to an increasing number of investors excluding certain industries or certain companies that do not meet certain sustainability criteria. This means that investors are withdrawing capital from companies that do not meet sustainability requirements. Companies that operate in such industries or do not meet certain sustainability requirements run the risk of having access to a smaller pool of capital, which increases the overall cost of equity.

The above two factors also apply to the cost of debt, as companies with lower growth prospects face a higher risk of not being able to repay their debt. In addition, lower access to equity financing increases the risk for lenders. Moreover, the number of potential lenders is lower, as many lenders apply the same sustainability criteria. Consequently, the cost of debt also increases for companies that do not incorporate sustainability into their business model.

At REQ Capital, we invest in companies that grow profitably over time. Given our long-term investment horizon, we place great emphasis on a company's long-term growth and return prospects.

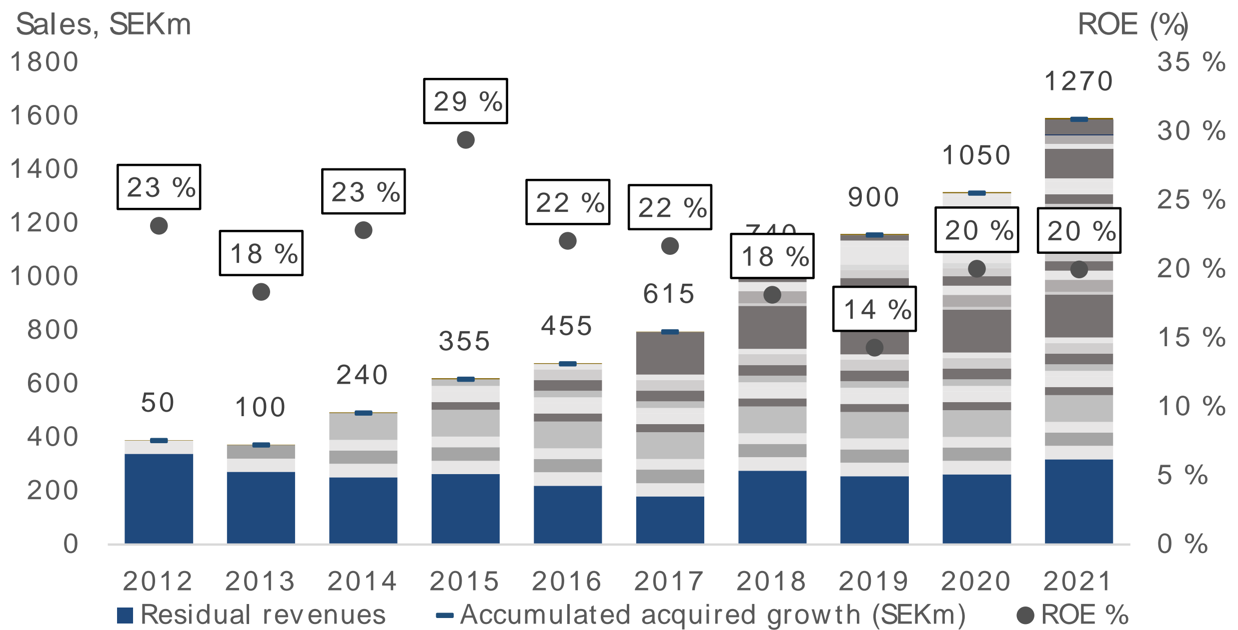
Conclusion

Sustainability is becoming an increasingly important topic in financial markets. It can be measured and analyzed in many ways, and investors place varying degrees of importance on governance, social and environmental characteristics. While many investors today often focus on environmental characteristics, we believe it is equally important to include social and governance factors in investment analysis. A company that focuses on only one of the three sustainability metrics is at risk of lower growth and higher cost of capital. Therefore, regardless of which sustainability criteria are most important to you, you should always ensure that a company incorporates all criteria into its business model.

Serial acquirers: Which to avoid?

We invest in serial acquirers, a group of companies that follow a specialized business model where they acquire companies through a programmatic M&A strategy. Programmatic M&A is a high-frequent pace of small-to-moderate sized deals, as opposed to the traditional, larger, and more infrequent mergers and acquisitions. The companies we invest in grow organically in a profitable way, but programmatic deals create an extra engine of growth.

The chart below shows the annual revenue and return on equity of Swedish software company Vitec. The grey bars represent the acquired companies' revenues per year, assuming that all acquired companies maintain their revenues at the level at the time of acquisition and that all acquisitions take place on January 1 of each year. Vitec has acquired over 30 software companies in the last ten years, each averaging ~3% of annual revenue. Residual revenues are understated in the chart below due to the assumed timing of revenue recognition of acquired growth, but it is still quite interesting to see that the company has experienced a 17% CAGR in total revenues over the last several years, while ROE has averaged 21% over the same period.



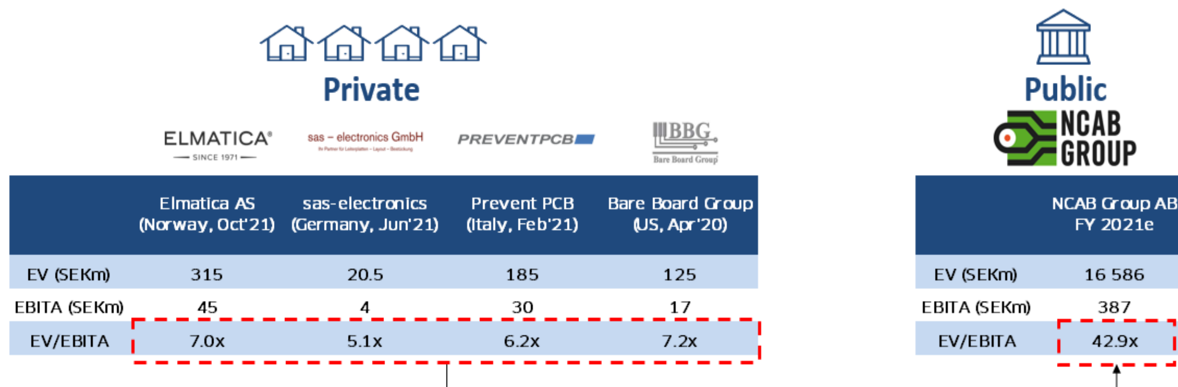
The best serial compounders tend to use internal cash flow to fund acquisitions, which is possible as each deal on average only equals 1-2% of the holding company's annual sales. Combined with pricing discipline the deals are earnings enhancing and increase shareholder value.

The best serial compounders acquire private companies at a discount to their own public prices. Acquisition targets are often privately held and too small to attract the interest of private equity firms. Many owners sell for personal reasons due to estate planning, poor health, or other commitments. They prefer to sell their businesses to serial compounders because they have decentralized business models and an open-ended ownership profile, and because they know the acquiring company will not restructure the business and sell it after a few years.

Below is an example of Swedish printed circuit board manufacturer NCAB Group. The company is listed on Nasdaq Stockholm. NCAB Group's growth strategy is based on both organic growth and acquisitions. The company has acquired eight PCB companies since its IPO in 2018, each at very favorable multiples, as you can see in the table below. The market for printed circuit board manufacturers is highly fragmented and a volume play. This allows the company to leverage its size and relationships to obtain favorable terms when acquiring new companies.

"NCAB often collaborates with more advanced factories that are not available to smaller trading companies, which means we can offer the acquired company's customers a broader product portfolio and thereby increase sales"

(Anders Forsén, CFO NCAB Group, 2020 annual report)



	Elmatica AS (Norway, Oct'21)	sas-electronics (Germany, Jun'21)	Prevent PCB (Italy, Feb'21)	Bare Board Group (US, Apr'20)
EV (SEKm)	315	20.5	185	125
EBITA (SEKm)	45	4	30	17
EV/EBITA	7.0x	5.1x	6.2x	7.2x

	NCAB Group AB FY 2021e
EV (SEKm)	16 586
EBITA (SEKm)	387
EV/EBITA	42.9x

When we analyze serial acquirers, we are selective about the type of companies we invest in. We have identified several characteristics that we believe create value and some that we believe destroy value:

Capital allocation

Acquisition-driven business models, which we generally consider unattractive, make extensive use of equity or debt to fund acquisitions. Some very early-stage companies use equity as a means of financing, but we generally prefer the use of free cash flow. We want growth with high incremental return on capital. Declining return on capital is a sign that the company is paying too much for acquisitions. The companies we own buy companies with high returns on capital. Turnarounds rarely succeed.

Synergies

Our companies generally do not expect synergies from acquisitions. Acquisition decisions are based on stand-alone valuations and should be accretive to earnings without restructuring or synergies. We avoid investing in companies that justify acquisitions by realizing revenue or cost synergies.

Ownership

We prefer family-owned or management-owned companies to those that are purely institutionally owned. The CEO should hold a significant stake in the company to align interests with those of shareholders. Companies that are purely institutionally owned are often run at the sole discretion of management, who in many cases do not even own shares. We avoid investing in such companies because the interests are not aligned.

Management

Management in the companies we are invested in tend not to guide the market on short term earnings expectations. We do not like the earnings expectations game where companies play with sell side analysts and "beat" consensus expectations with a cent every quarter due to earnings (mis)management. We also avoid investing in companies where the CEOs spends too much time attending financial conferences and investor events, as we believe the CEO should prioritize his or her time on running the company and focusing on his employees, customers, and suppliers. If these stakeholders are happy, shareholders will benefit.

Acquisition targets

Since we prefer "programmatic" serial acquirers the acquisition candidates are small private companies. We do not like companies that undertake few and large deals. Larger deals are more complex to carry out, and the due diligence process and integration takes longer. These deals typically carry higher risk. Larger deals also come with higher valuations. Our companies focus on "active sourcing" of deals. Active is when our companies contact private companies directly themselves. Passive is when companies work mainly through M&A advisors who have a mandate to sell a company. Active sourcing leads to better prices for buyers.

Use of M&A consultants

Companies that specialize in programmatic acquisitions develop an in-house skillset for acquisitions. Very few of these companies utilize external advisors when sourcing and acquiring new companies. Not only does this lower transaction costs, but it also speeds up and improves the strategic sourcing of new deals, deal execution, and integration of the acquired companies. We prefer companies that do the financial due diligence of private companies themselves instead of outsourcing the activity to "The Big 4".

Business models

We prefer investing in serial compounders that have decentralized business models. This enables the portfolio companies to focus on running the businesses, rather than on integration processes post acquisition. Senior management in the companies we invest in delegate responsibility to local managers, who know and understand the business, customers, and employees of the local portfolio companies. The decentralized models make our companies more agile and responsive to change.

Conclusion

We strongly believe our strategy of investing in strong programmatic acquirers will serve us well over the coming decades. These companies have an extra engine of growth and carry out acquisitions in a profitable, low risk, manner. We have identified a set of characteristics that we believe differentiates the best serial compounders, and invest in companies that share these traits.

We look forward to being perpetuity owners of these excellent businesses.

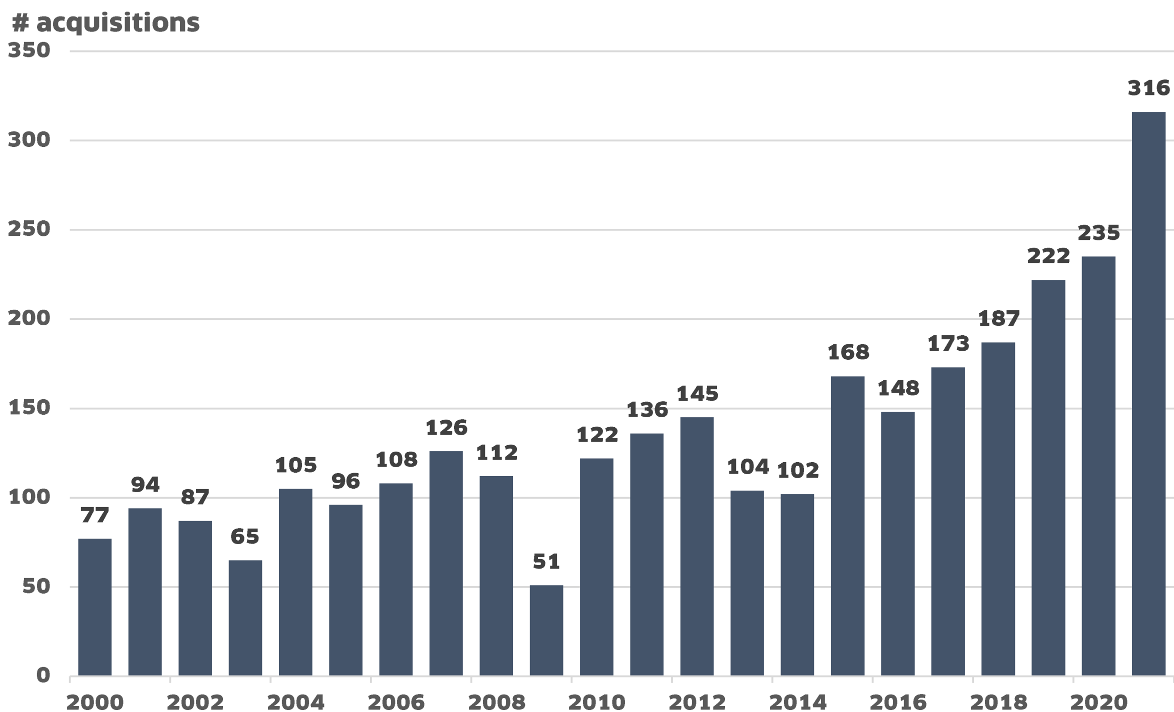
Attractive	Unattractive
Free cash flow to fund acquisitions	Heavy use of equity to fund acquisitions
Strong incremental return on capital	Weak incremental return on capital
No synergies expected	Expects synergies
Avoids guidance to the market	Guiding market
Buys demonstrated track records	Buys turnarounds
Prefers to buy private companies	Tend to buy listed companies
Small, frequent tactical acquisitions	Few, large deals
Inhouse M&A team	Frequent use of "M&A consultants"
Founder operators or family owned	Purely institutionally owned

Record high acquisition pace in 2021

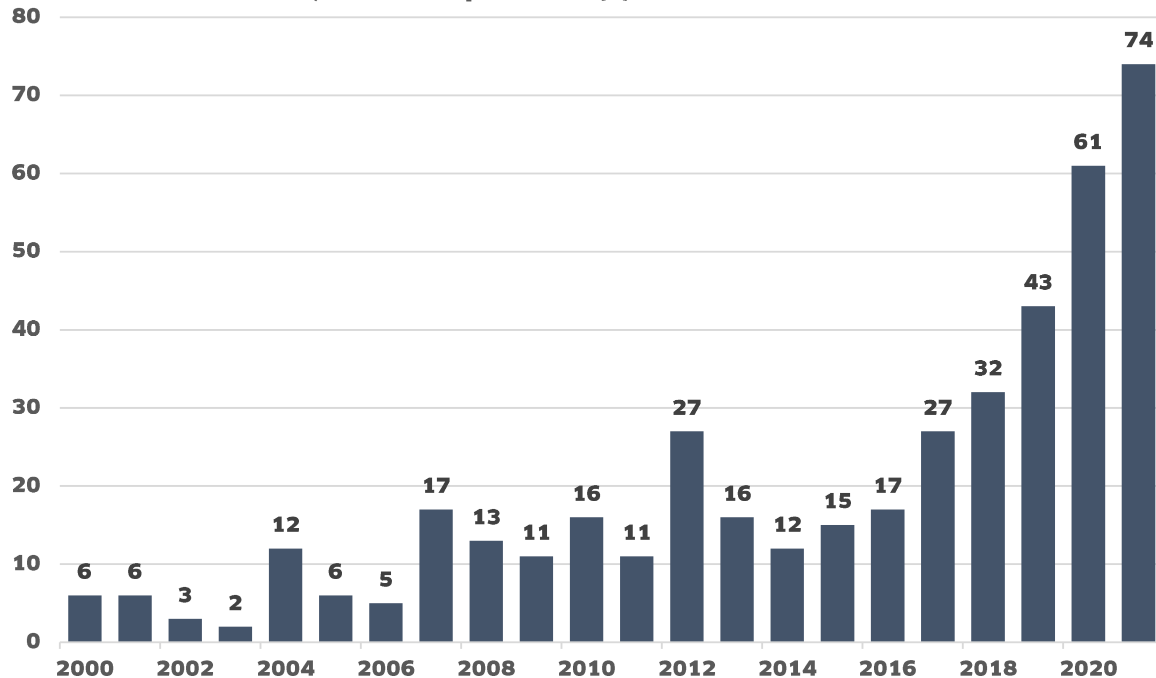
The pace of acquisitions by our portfolio companies in REQ Global Compounders was high in 2021. In total, 316 small private deals were completed by the companies we own during the year.

The pandemic has provided a significant increase in deal flow. There are many reasons why we are seeing the increase in deal flow. Some of the companies we talk to point to the fact that many private companies usually come up for sale after or during crises. When you are a business owner going through a crisis, you are often more willing to sell your business, or at least a significant portion of it. Because our portfolio companies have spent years building relationships with private sellers, we observe that our companies are in a great position when assets are up for sale.

The average transaction size represents approximately 1.4% of consolidated revenue. Acquisitions are generally high-margin, growth-oriented private companies that continue to be run by existing management with part ownership.



The most active acquirer of the year was Constellation Software, which made 74 acquisitions of vertical market software companies during the year. We are not surprised by the sharp increase in deal flow at Constellation Software. The company announced a few years ago that it would significantly increase the number of people working on acquisitions. What we are seeing today is the impact of steps the company took a few years ago.



We continue to expect strong deal flow through 2022, with acquisitions providing strong double bottom-line profitable growth for our businesses, ultimately leading to strong returns for our investors.

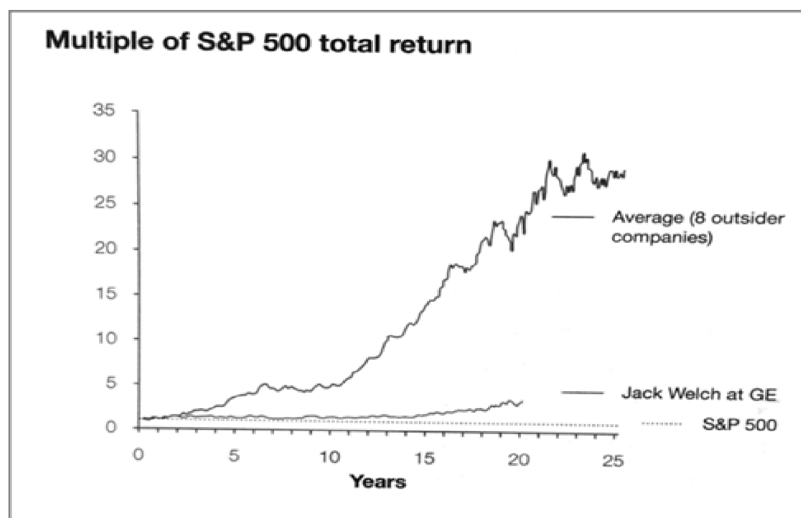
Extraordinary CEOs

As an investor you entrust senior management in an organization with your capital. Finding exceptional management teams is perhaps the most important aspect of an investor's job, but it's not an easy task; it's more of an art than a science. Warren Buffett put it this way:

> *"It is almost impossible to overpay for the truly extraordinary CEO…but the species is rare"*
> (Warren Buffett quote, from "The Outsiders", 2012)

William N. Thorndike has written a brilliant book about exceptional CEOs. When we combine the insights from the book with our own experiences as investors, we find some commonalities among CEOs who achieve extraordinary results.

The eight truly exceptional CEOs featured in The Outsiders share many common characteristics. What is extraordinary about these CEOs is that they have led their respective companies for decades, not years, while delivering total shareholder returns that truly stand out from the crowd. The chart below compares the average stock performance of the companies led by these individuals relative to the S&P 500 and that of "rock star" CEO Jack Welch at GE over a 25-year period.



Source: "The Outsiders" (William Thorndike)

Over time, many of the stocks of companies run by the "outsiders" became so-called "100-baggers" - stocks that multiplied the original investment by 100 times. Aside from Warren Buffett, one of the eight CEOs featured in this book, these individuals are less well known to the public. We should study these very successful CEOs like we study very successful athletes. As investors, we like to learn about their similarities and use these traits in our search for new outstanding investments.
A great example of an extraordinary CEO is Henry Singelton, who founded Teledyne in the early 1960s, and generated a 20.4% annual return on Teledyne stock during his 30-year tenure as CEO. He may be one of the best CEOs in American corporate history, but he is less known than Warren Buffett. $1 invested in Teledyne when Singelton took the helm had grown to $180 by the end of 30 years. The same dollar invested in the S&P 500 index would have grown to $15. Investing that same dollar in Teledyne's "peer" companies, mostly conglomerates, would have returned $27. All in all, an extraordinary performance.

What is the measure of a CEO's success? It's not the size of the company, the number of employees, or the number of headlines in the business press. The role of the CEO is to manage people and capital in a way that gets the most out of these two vital resources.

For us as shareholders, the most important criterion for judging a CEO is the total return of the stock over very long periods of time, and comparing those returns to those of the overall market, and the returns of a relevant peer group. If the leadership team has been in place for many years and has delivered total shareholder returns that far exceed the market index and peer group, you know the leadership team has done something right and maximized value per share. So, looking for commonalities between exceptional CEOs is not only interesting, but could also increase the chances of finding new exceptional investments where the right kind of top management is in play.

It's easy to be intrigued by an outgoing and well-articulated CEO who constantly shows up at stock conferences and trade shows and speaks with great conviction about strategy and market opportunities. Busy CEOs who are constantly on their private jets talking to journalists and analysts seem to be the norm for many. Wall Street loves these CEOs.

The extraordinary "outsiders" in Thorndike's book could not be more different. They are not fixated on Wall Street. They see Wall Street as a distraction. For them, customers and employees are their top priority. If customers and employees are happy, shareholders will be happy. These outstanding CEOs plan for the long term, and let their performance speak for itself. Of course, they know that as a publicly traded company, they are exposed to a lot of short-term noise, but they choose not to pay attention to it. They build dominant companies with enduring cultures.

Thorndike draws on Jack Welch as an example of a charismatic and outgoing CEO who has long been considered the perfect blueprint for a CEO. Welch was CEO of GE from 1981 to 2001, and during his tenure, the stock achieved a CAGR of 20.9%. That's a very impressive return, even during one of the longest bull markets in history. But the truly exceptional CEOs in Thorndike's book have achieved even higher returns over longer periods of time.

Exceptional CEOs differ from other CEOs in three different ways.

1) They are masters at capital allocation
2) They run very decentralized organizations
3) They are independent-minded and humble

Truly extraordinary CEOs do most things differently than their peers, which helps explain their performance.

"It is impossible to produce superior performance unless you do something different"
(Sir John Templeton, Investment Maxims)

Capital allocation

The truly exceptional CEOs choose capital allocation as their most important job. These CEOs are investors rather than managers.

Every CEO has a toolbox when it comes to capital allocation. There are three sources of capital and five ways a CEO can allocate capital, as shown below. Exceptional CEOs are masters at using the right source of capital at the right time and investing capital where it will produce the best returns for shareholders.

Sources of cash	Uses of cash
Free cash flow	Acquisitions
Debt	Capex
Equity	Dividends
	Share buybacks
	Debt reduction

Most senior managers in a company are promoted to CEO because of their strong performance over many years in functions such as operations or marketing. Many managers are promoted to the role of CEO because they are successful in corporate politics. On your first day as CEO, you have sole

responsibility for allocating the company's capital. This is a skill that very few people have experience with before becoming CEO.

Most of the CEOs in Thorndike's book made large stock buybacks during their time as CEO. Sometimes the best investment opportunity is your own stock. We are not talking about ordinary stock buyback programs that most companies do. Outsider CEOs undertook large buyback offers when the stock price was undervalued and used stock as payment in acquisitions when the stock was highly valued. Many bought back as much as 90% of outstanding shares during their tenure as CEO. Most companies today announce stock buyback programs for a set amount and run them over several years. This is not the outsiders' approach.

These CEOs very rarely paid dividends, even at times when dividends were "popular" with investors. Instead, they focused on maximizing cash flow per share rather than earnings per share.

Many of these very successful CEOs acquired many private companies during their tenure. The acquisitions were often made through direct contact with the sellers. By avoiding auctions, they were able to secure assets at attractive prices. They showed patience and occasionally acted boldly.

Organization

All outsider CEOs ran extremely decentralized organizations. They were not afraid to delegate responsibility downwards in the organization. Top management's primary focus was capital allocation. They were masters of delegation. By taking a decentralized approach, they were able to unleash entrepreneurial energy in the organization. It's also a good way to keep costs down. They avoided "office politics" by paying for performance.

They often combined this decentralized approach with good incentive systems that focused on maximizing cash flow per share. One criticism of this type of company is that lower-level managers who perform well are handsomely rewarded.

They all set up small headquarters and clearly understood that headquarters did not have the answers to solve customers' problems. These CEOs hired the best people and left those people alone. They had a deep understanding of human behavior and motivation.

These exceptional CEOs had no time for investor relations. They owned part of the companies and acted as owners, not agents. Henry Singelton owned 13% of Teledyne.

Personalities

The outsider CEOs were devoted to their families and often left work to attend school events. They did not attend conferences. They set their own agendas. These were not the CEOs who wrote books of management advice after they retired. They were not the rock stars of the business world, but people who preferred to operate in the background. They were not out for fame. All these CEOs were new to the industries and companies they led. Humility and independence were the salient characteristics of these CEOs. They shunned bankers, consultants, and advisors.

All eight outsider CEOs were new to the CEO role. That may be one of the reasons they were successful. They looked at the companies and industries they were in with new eyes. They were very rational and used new perspectives that led to great performance.

Most CEOs are unable to resist the "teenage pressure" to be like everyone else. The "Outsider” CEOs did not care about conventional wisdom. They relied on rationality and avoided peer pressure in the corporate world.

The bottom line

We can learn a lot from exceptional CEOs who perform well over many decades. As investors, we can use these blueprints for success in our search for future exceptional investments. If we can find investments with high integrity and top managers who focus primarily on capital allocation, are decentralized, and share many of the personality traits mentioned above, we may have found something very special. These potential investments can give us returns that far exceed those of the overall market.

Mark Leonard (Constellation Software Inc.) – An Extraordinary CEO

The longer we have been invested, the more we have realized the importance of leaving our capital to the masters of capital allocation. Management teams that are excellent investors will always find a way to create value for us as shareholders.

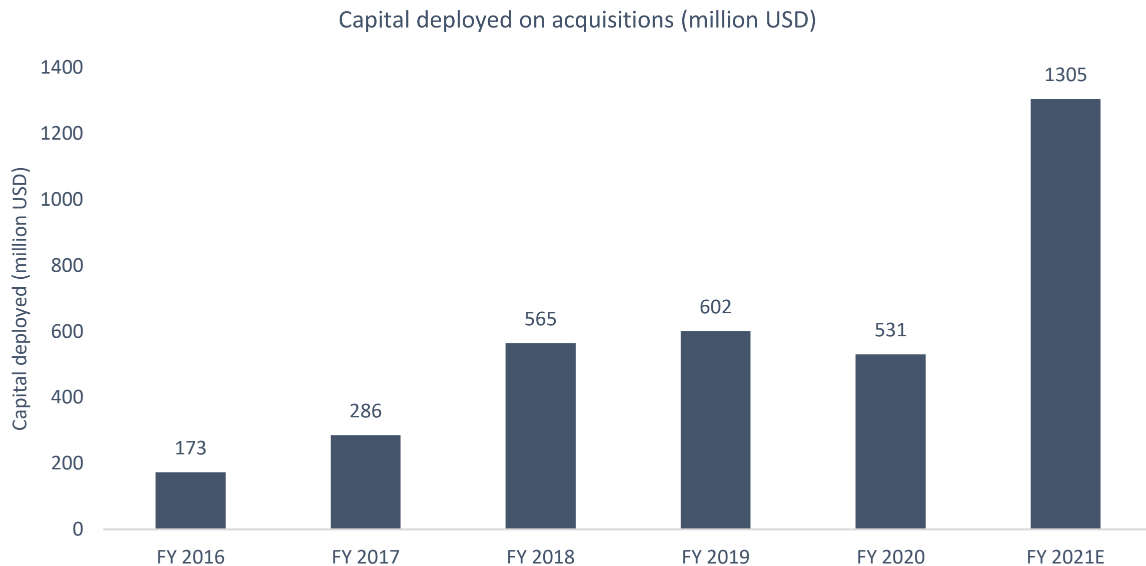
One of the very best CEOs we have come across worldwide is the CEO of Constellation Software, Mark Leonard. His capital allocation skills and approach to decentralization is unique. He is the blueprint for an extraordinary CEO and deserves to be studied along the lines of Warren Buffett.

Mark Leonard built Constellation Software (CSI) with a simple strategy based on his background as a software venture capitalist. The company uses strong, recurring free cash flow to acquire multiples of small, niche software companies.

Capital allocation

Mark Leonard understands the creation of shareholder value. The KPI used at Constellation Software to measure company performance is "ROIC + organic growth." As communicated in Leonard's annual letters, ROIC is the cash return from the acquisitions that CSI makes. ROIC + organic growth" combined is the increase in value of CSI. The company's communication clearly shows that capital allocation is key. As an investor, you also see the result of this strategy in the financials.

The key aspect of the investment thesis in Constellation Software is the company's ability to allocate capital to new acquisitions. Over the past few years, Mr. Leonard and his team have significantly increased the number of employees doing acquisitions. This has resulted in capital invested in M&A more than doubling. The company currently spends 88% of its operating free cash flow on acquisitions. Unlike many other acquisition-driven models where capital allocation is the responsibility of top management, CSI has a decentralized capital allocation policy. Most acquisitions are made by portfolio managers. The model is therefore highly scalable.



The company continues to pay a $1 quarterly dividend which we would gladly forgo. We would rather see the company reinvest that capital at its current 56% return on equity.

Decentralization

Decentralization is the hallmark of Constellation Software. For a decentralized structure to work, it takes a lot of trust and a long-term investment horizon. As Mark Leonard described in CSI's annual shareholder letter in 2015:

"*We continue to believe that autonomy and responsibility attract and motivate the best managers and employees*"

Authority is delegated to individuals. As stated on Constellation Software's homepage:

"*CSI will not take over the day-to-day management of its businesses. We continue to rely on the managers and employees of our subsidiaries to run their businesses well. Managers who are excited at the prospect of creating an exceptional company and who are willing to embrace new ideas tend to flourish at CSI*".

A mindblowing statistic regarding decentralization is well described by Roi Lipovetzky in his writeup "Constellation Software: A capital allocator's culture"

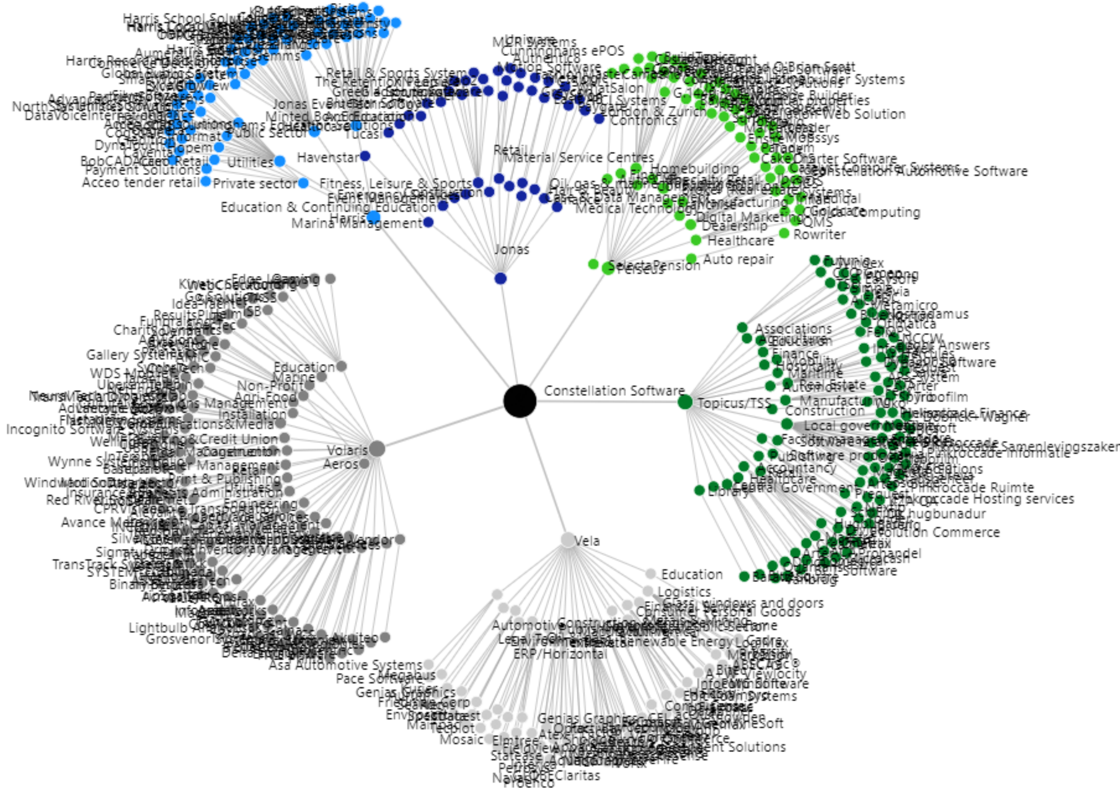
"If someone is looking for evidence for decentralized culture, he should probably look for the number of employees in the headquarters compared to the total company. In Constellation software, a company with approximately 25,000 employees, only ten people sit in the headquarters at Toronto (a ratio of 1:2,500)"

As part of the decentralized structure, Leonard and his team creates the right incentives. Manager compensation is closely aligned with that of shareholders. Mark Leonard is the 5th largest shareholder of the company. The bonus plan for employees requires those who exceed a certain level of

compensation must invest in shares with at least four-years vesting period. According to Leonard, the average holding period for employees is much longer.

The visualization we have created below shows the structure of Constellation Software. CSI is basically a collection of 434 niche software companies spread across six divisions and dozens of different verticals. A “vertical” might be software for “Library Management” or “People Transportation”. The software companies that CSI owns are mission critical software systems for customers and very sticky products.

As can be seen from the figure CSI is highly diversified across divisions and verticals. Software products offered by the individual companies varies from software that test and debug chips and circuit boards (Asset InterTech) to software technology solutions for public libraries (EnvisionWare). A rare Norwegian example is also found in the CSI portfolio. The software company DataGrafikk is one of 15 companies under the "People Transportation" vertical in Volaris. DataGrafikk is a company that delivers software for bus and public transport companies across Norway.



The six divisions could each easily be independent, publicly traded companies. One of them became a publicly traded company earlier this year when Topicus.com was spun off and taken public. CSI is still the main shareholder in this division, with a 50.1% stake.

Of the other businesses, Volaris is known for transportation, financial services, and communications and media. Harris is primarily in utilities and healthcare. Jonas is known mostly for hospitality, clubs and resorts and Vela is more into manufacturing. Perseus Group operates in a variety of industries, including housing, real estate, pharmaceutical manufacturing, and pulp and paper.

There is a clear incentive structure in CSI, based on the ability to deploy capital. According to a former director, "owner operators" are the largest source of acquisitions, accounting for 70% of transactions. 10% of acquisitions are "carve-outs" from large companies and only 3% are from private equity funds or venture capital firms. Constellation accounts for only 3% of total software acquisitions worldwide.

Management characteristics

Leonard's comments are always modest and as a person he avoids publicity. In his 2017 annual letter he shares his very simple management philosophy:

"Our senior managers consistently generate rates of return in excess of 25% on the capital that they deploy. As investors you will know that this is wildly difficult to achieve. How do we keep these multi-talented managers? Hopefully we provide an environment that is fulfilling, colleagues that are both challenging and entertaining and work that is meaningful. We also pay them well"

It is important to emphasize that Mark Leonard has not been alone in building Constellation Software. The years of tenure in the company of the CEO, CFO, COO and CIO is 26, 18, 26 and 26 years respectively. Together they have built a culture from the top that embrace frugality, honesty and prudent risk-taking.

The frugality is best described by Mark Leonard in his 2007 shareholder letter:

I recently flew to the UK for business using an economy ticket. For those of you who have seen me (I'm 6'5", and tip the non-metric scale at 280 lbs.) you know that this is a bit of a hardship. I can personally afford to fly business class, and I could probably justify having Constellation buy me a business class ticket, but I nearly always fly economy. I do this because there are several hundred Constellation employees flying every week, and we expect them to fly economy when they are spending Constellation's money. The implication that I hope you are drawing, is that the standard we use when we spend our shareholders' money is even more stringent than that which we use when we are spending our own.

(Mark Leonard, annual shareholder letter 2007)

You very seldom experience CEOs who are willing to "talk down" the share price. In the annual letter from 2010 Leonard shares his insight regarding the importance of the share price moving in tandem with the growth in intrinsic value:

"I used to maintain that if we concentrated on fundamentals, then our stock price would take care of itself. The events of the last year have forced me to re-think that contention. I am coming around to the belief that if our stock price strays too far (either high or low) from intrinsic value, then the business may suffer: Too low, and we may end up with the barbarians at the gate; too high, and we may lose previously loyal shareholders and shareholder-employees to more attractive opportunities"

(Mark Leonard, annual shareholder letter 2010)

In the annual report of 2011 Mark Leonard actually argued that the share price increased too much ahead of intrinsic value by stating:

“Unfortunately, our stock price has increased at over twice that rate (of intrinsic value) during the last year, a differential that would seem difficult to be sustain in future years”

(Mark Leonard, annual letter 2011)

The stock

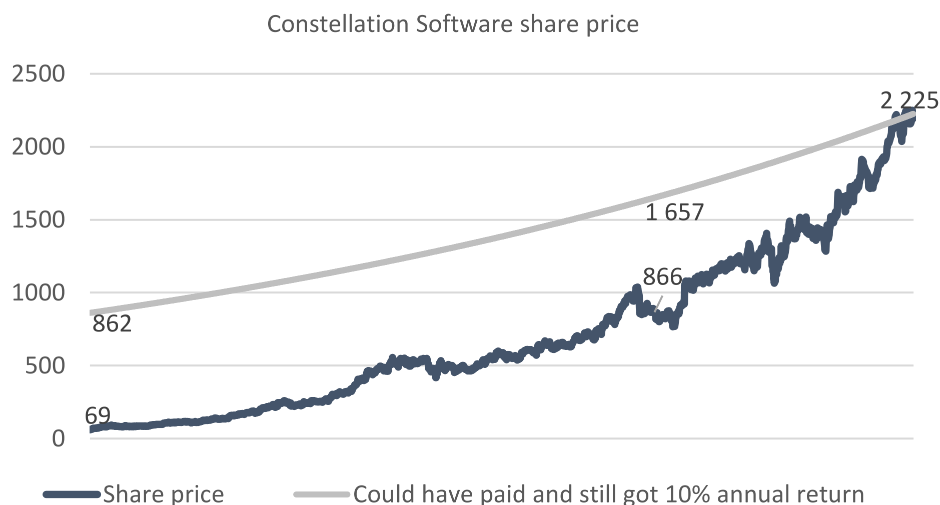
Constellation Software trades at 30x last 12 months free cash flow per share. We still believe the runway of growth opportunities globally for CSI is large. Currently CSI owns almost 500 companies. The total addressable market is about 40,000 targets. Therefore, CSI has about 1% global market share with lots of room to grow. We think CSI can continue to grow strongly for many years into the future. In Mark Leonard’s own words:

“A very special case of value investing, is the example of a company that is growing quickly, that the market expects to stop growing within the next 5-7 years, but that actually keeps growing quickly for much longer. If you can spot one of those, it may appear expensive on a P/E basis, but may actually be an attractive long-term investment on a “value investing” basis. Spotting this kind of investment requires the ability to foretell the distant future…which is extremely difficult to do with consistency”

In addition to the specific niche of vertical market software, Mark Leonard appears to be open to other acquisition-related growth opportunities in other sectors. We find it very interesting to see Constellation Software enter new sectors as this will create even more growth opportunities for the future.

The chart below shows Constellation Software's share price over the last ten years, excluding smaller dividends and the extraordinary dividend in 2019. The share price has grown 41% per year over this period, driven by very strong profitable earnings growth of over 30% per year. The grey line shows what share price you could have paid at any point in time and still received a 10% annual return.

This shows that CSI was grossly undervalued at all times and, as we will show below, is still grossly undervalued. If you had paid 862 CAD per share 10 years ago when the stock was trading at 69 CAD, you would have received a 10% annual return to date. If you had paid 1,657 CAD per share 3 years ago when the stock was trading at 866 CAD, you would still be earning a 10% annual return.



The question today is what earnings growth to expect for the next ten years. If it turns out that CSI can continue to grow earnings at the same impressive rate (30% CAGR) for the next ten years, the stock is strongly undervalued today. In that historical case you can justify paying 13 776 CAD per share for the stock today and still get a 10% annual return over the next ten years. In 2020 the company grew earnings 31%. Even with a much slower rate of earnings growth of 15% you can justify paying 3 624 CAD, well above the current market price.

We strongly believe the right ingredients of reinvestment opportunities, scalability, and optionality (new verticals or even completely new business areas outside of software) are in place to continue a very strong path of profitable earnings growth over the next ten years. That is the reason why CSI is a core holding in the portfolio.

A special interest – in finance

We are always surprised at the variety of special interests in which people are enthusiastic. Some are very interested in ancient Egyptian pharaohs, while others are passionate about researching tanks used in World War II. Kyoto University in Japan offers a doctoral programme in "manga," comic books that originated in Japan.

In finance, there is one topic that we find particularly interesting and that we believe explains in large part why stocks are valued the way they are. This highly interesting topic is "hyperbolic discounting." It sounds like an academic theory - but it's not.

Cash flows in the dividend discounting model are discounted using what is known as "exponential discounting". This discounting method is the standard method for discounting cash flows. We all know it by heart from our business school exams. All investors use it because most have probably only heard of this discounting model. But what does this way of discounting cash flows actually mean, and is it the right way to discount cash flows?

The traditional way of discounting, exponential discounting, is "time insensitive," meaning that the discount factor always decreases at the same rate over time. This is the rational way to look at economics. Consequently, cash flows that are far in the future are not worth much under exponential discounting.

Hyperbolic discounting

Behavioral studies of humans show that we do not behave the way traditional economic theory claims. We are not rational. Our human way of discounting is "time dependent." In other words, we use different discount rates depending on how long it takes to receive a payoff. Consider the following two examples.

1) You can choose between receiving $100 today or $110 in one year. In experiments, people have a strong tendency to choose $100 today to get the instant gratification.

2) You can choose between receiving $100 in ten years or $110 in 11 years. In this situation people tend to be willing to wait an extra year to get $110. Since the instant gratification is not there anyway,

we act more rationally and think we can just wait one more year until year 11 instead of receiving the payout in year 10. It is so far into the future anyway.

The challenge in example 2, in which you decided to wait 11 years, is that when you approach year 10, you would rather get the instant gratification of $100 than wait another year. In other words, people avoid waiting the closer they get to the end of the waiting period.

In the short term, people are irrational, but in the longer term, they choose the rational option.

The basis for the hyperbolic discounting model is human behavior. The pattern that emerges from the way people choose as time goes on follows what is called a "hyperbola". People do not appear to use a constant discount rate as exponential discounting purports to do. In economics, hyperbolic discounting is a time-inconsistent model of discounting. People make decisions that are more similar to hyperbolic discounting than exponential discounting.

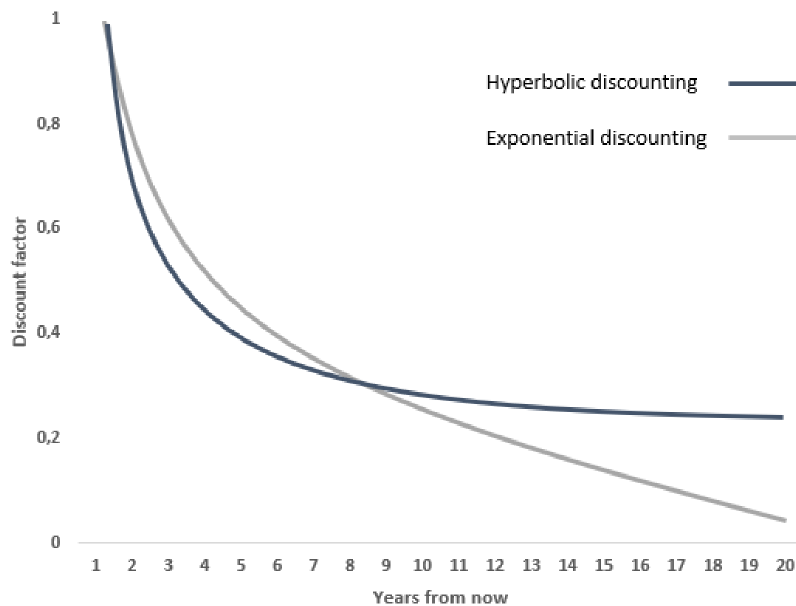
In hyperbolic discounting, valuations fall very quickly for periods close to the present because we want instant gratification, but they then fall slowly for longer periods that are deferred. The hyperbolic model discounts more than the exponential model at the beginning and less than the exponential model for very long term events.

Hyperbolic discounting states that discount rates are greater in the short term than in the long term. What does all this have to do with finance and the valuation of companies?

Hyperbolic discounting in finance

In the hyperbolic formula, the present value of short-term cash flows is lower than in the exponential model, but the present value of longer-term cash flows is higher than in the exponential model. Consequently, the terminal value in hyperbolic discounting for companies with durable competitive advantages, will be higher than in the model we know from business school.

There are various kinds of mathematical expressions for the hyperbolic formula. I will not go into them, but will try to simplify the hyperbolic function using an example of a 20-year cash flow where the discount factor is decreasing over time. The falling discount factor reflects the way experiments point to how we as humans make tradeoffs, represented by the hyperbola. The resulting figure shows the discount rates using the exponential function and a hyperbolic assumption:



You will notice that by discounting the cash flows with a hyperbolic function, the present value of the firm is higher than with exponential discounting for companies with long term competitive advantages. In the example illustrated above the present value of the cash flow using the hyperbolic function is almost 40% higher than using the exponential function!

We are not advocating that you should flip all your DCF models and start using hyperbolic discounting. The reason why we find the topic very interesting is that hyperbolic discounting might be one reason why very strong companies with highly predictable cash flows long into the future deserve to be priced much higher than other companies in the stock market. We think that market participants, in aggregate, price these stocks by discounting their cash flows with a discounting mechanism that is closer to the hyperbolic discounting method than the exponential discounting method.

By using traditional exponential discounting to value very long-term cash flows you might actually undervalue these strong long-term compounders that we invest in significantly.

The most important lessons learned

If we were evaluating a fund manager, the first and most important question we would ask him or her is this: "What are your biggest mistakes and what have you learned from them?" The fund manager's answer to that question would be paramount to our evaluation of whether we should put money behind that manager.

Learning from your mistakes is an important part of investing. We all make mistakes and investors who learn from their mistakes will ultimately be successful. If you are not able to see a pattern in the mistakes you have made as an investor, just keep looking. Below we discuss some of the mistakes we have made over the years, which have shaped the way we invest today.

“*If you are extremely confident in yourself, taking a loss does not bother you*”
(Stanley Druckenmiller, The New Market Wizards)

Confidence and humility

One of the great challenges of investing is balancing confidence and humility. You need confidence to make an investment. At the same time, you need to be aware that you could be wrong. If you are overconfident, you will never be able to admit a mistake, and your results will suffer. If you constantly think you are wrong, you will not be able to make an investment decision. This is the reason why some of the very best long-term investors are often humble. They have made many mistakes, but have become better investors in the process.

"*Poor investors often disguise inexperience with arrogance. Rich investors disguise experience with humility. The richest person in the room is usually the quietest one in the room. The poorest person in the room is usually the loudest one in the room*"

(Ian Cassel, Tweet on June 8th 2021)

Learn from losses

To grow and develop as an investor, you should try to learn as much as you can from your mistakes. Over time, the mistakes you make will come to form a set of principles that will guide you through your investing career. You will learn the hard way where your strengths and weaknesses lie. Keep learning and refining your principles. Try to write your mistakes down and keep them in a journal. Over time, you will notice that some of your mistakes have something in common, situations that you should avoid in the future, because your diary and experience show that these situations are not your strengths. The best tool is to learn from your own mistakes.

Not willing to sell losers

One costly mistake we have made time and time again is not being able or willing to sell companies that have not performed according to expectations. If your investment thesis changes, you should re-evaluate the investment. Weaker than expected fundamental performance is always accompanied by a falling share price and seemingly more attractive pricing of the stock. It is better to admit you were wrong and sell the stock than to try to find a new reason to own the stock at a lower price point. We would rather average up and buy more shares at a higher price point in companies where the underlying fundamental performance is better than expected.

"*It is remarkable how much long term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent*"

(Charlie Munger, The Complete Investor, 2017)

Selling too early

A common mistake we have made is selling stocks far too early, just because the price has risen sharply in the short term. Unfortunately, these exits have involved companies that have performed well over the long term and continue to do well. Buying the stock back at a higher price is a difficult mental exercise.

We have become very hesitant to sell shares of companies that are performing perfectly. Sometimes the shares of these companies run ahead of the underlying performance of the companies. The lesson for us is that we should not let a temporarily high price of a stock scare us out of the company. To

quote the legendary investor Charlie Munger, "The first rule of compound interest: Never interrupt it unnecessarily."

We have come to three reasons to sell a stock:

1) The first is when we identify that our decision to invest in a company was flawed. The company may not be as strong as we originally thought, or we may have underestimated the cyclicality of the industry or company. In such circumstances we take the consequences and sell.

2) We also sell when we no longer trust management. Perhaps management is beginning to convey a message we do not understand, or they are using language we do not like, or we have lost confidence that they are managing our capital well. We have made several misjudgments in the past when evaluating management teams. Through these mistakes, we have developed a set of principles that we apply when forming an opinion about management's capabilities.

3) The final reason we sell a stock is if its price is far above what we think is reasonable. We believe this is the most difficult reason to sell, and we are very cautious about selling a stock based on price considerations alone. There are often very good reasons why a stock is trading at a high multiple.

Buying too much too early

One mistake we have made several times is buying a large position too early. It takes time to learn about a company, and the best way to deepen your understanding is to become a shareholder. Sometimes owning a stock causes you to see the company through different eyes.

Based on past experiences, we start with a smaller position when we first invest in a company. After following the company as a shareholder for some time, our conviction grows and we buy more. Sometimes this means that the average cost of our position increases, but we are happy to pay a higher price for the stock of a company where management is executing according to plan. If the stock price has risen after we bought the first position, the company is usually doing something right.

Over-analysis

Some of our worst investments have been in companies where we spent too much time analyzing complex opportunities. That experience has led us to be much less interested in complicated business models. We like simplicity. We like to read quarterly or annual reports and quickly decide if the company is moving in the right direction or not. Too much information about a company often leads to decision fatigue. With complex business models, you are unable to form an opinion about the direction of the company because there are too many conflicting signals about the way forward. Simplicity often wins out over complexity when it comes to investing.

Charmed by management

Some investors avoid contact with management, while others find conversations with management helpful. It is easy to be charmed by charismatic management. In our experience, it is best to avoid overly charismatic managers. It's helpful to consider how the company's employees feel about the CEO sitting in front of you. Is the company a "one-man show" or is the CEO able to see and acknowledge the company's employees? What kind of culture does the CEO bring to the company?

Company culture starts at the top. It is the CEO's values that are passed down through the organization. It's been our experience that CEOs who spend too much time talking about themselves and not the company they lead are a clear red flag. It only takes a few management meetings to understand that you should not necessarily invest in the most charismatic and outgoing CEO in town. We like CEOs who are down to earth, pragmatic, and able to delegate a lot of responsibility to employees. You want to invest in companies that are run by CEOs who you think are very good role models in the company. If you doubt that the CEO is a good role model, you should not invest.

Too much focus on numbers

At the beginning of our investment journey, we focused mainly on the quantitative aspects of potential investments. Our biggest investment mistakes resulted from investing in the wrong kind of management, the wrong kind of ownership structures, and dysfunctional corporate cultures. In contrast, our most successful investments have been characterized by excellent management teams and ownership structures that increase the chances of creating shareholder value. As a result, we pay more and more attention to qualitative factors.

We are increasingly interested in "owner operators" and companies that are management-led rather than board-led and wholly owned by institutions. Because management is part owner, they treat the business as their own. When you rent a car, you rarely, if ever, spend time and money cleaning and maintaining the car. We try to find management teams that are down to earth, pragmatic and understand value creation. We have also concluded that management teams that do not give investors short-term financial guidance to investors and stand by their mistakes in conference calls tend to be more interesting investment opportunities than the opposite. These are all non-financial aspects that are more difficult to evaluate than financial numbers. But these qualitative assessments increase the chances of good shareholder returns.

To sum up

Learning from our mistakes and avoiding the same mistakes in the future is an important success factor for future performance. We have made a number of mistakes and believe that we have become better investors as a result.

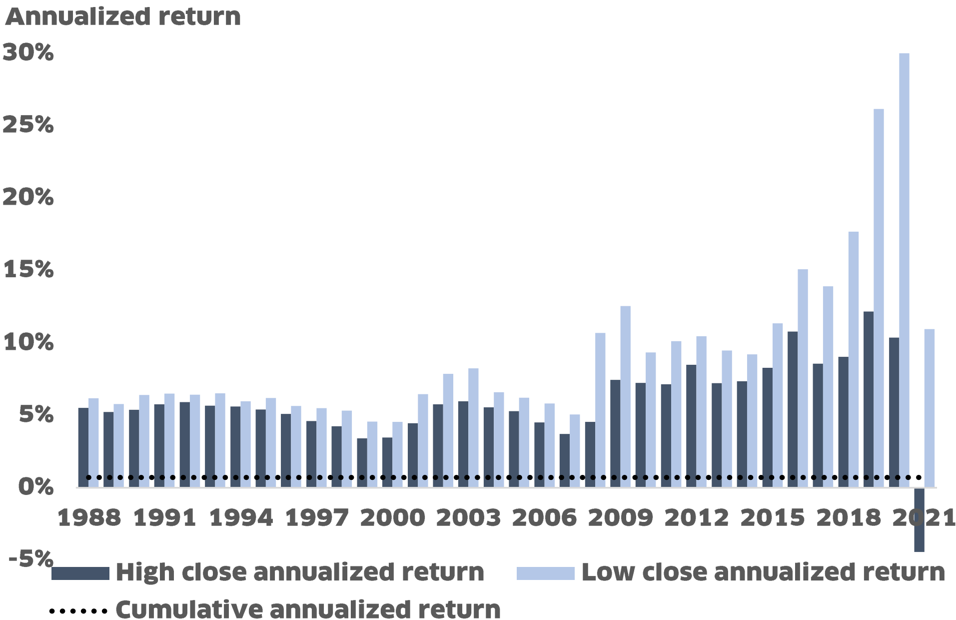
Is timing the market everything?

Global stock markets are trading at historically high levels, and many investors are wondering if this is the right time to invest in the stock market. Wall Street fund manager Peter Lynch is known for saying that it does not matter if you time the market perfectly, and that investors have lost more money trying to avoid or prepare for corrections than in the actual correction itself.

Trying to time the market over the long term makes little sense because the overall effect of market timing for long-term investors is limited. As we will show, the difference between perfect and imperfect market timing is negligible in annual returns over time.

We can illustrate this with an exercise similar to Lynch's by imagining two investors who both invest $100 each year in the MSCI AC World Index since its inception in 1987 and up to the present. We simplify things a bit and ignore inflation, interest on uninvested cash, tax refunds on losses, or fees. One of the investors would time the trades perfectly and invest at the bottom of the market each year, while the other investor would be unlucky and invest at the top of the market each year.

The difference in annualized return for each year is relatively small, as you can see in the chart below. This shows that the effect of market timing for a given year is offset over time by compounding. The exception to this is years with high volatility and therefore large differences in entry price levels, such as the 2008 financial crisis and Covid-19 in 2020. In these years, it takes longer for the effect of compounding to mitigate the effect of market timing, but in the longer term it should even out over the entire period. The annualized difference is 0.7%, showing that market timing has little impact in the long run.

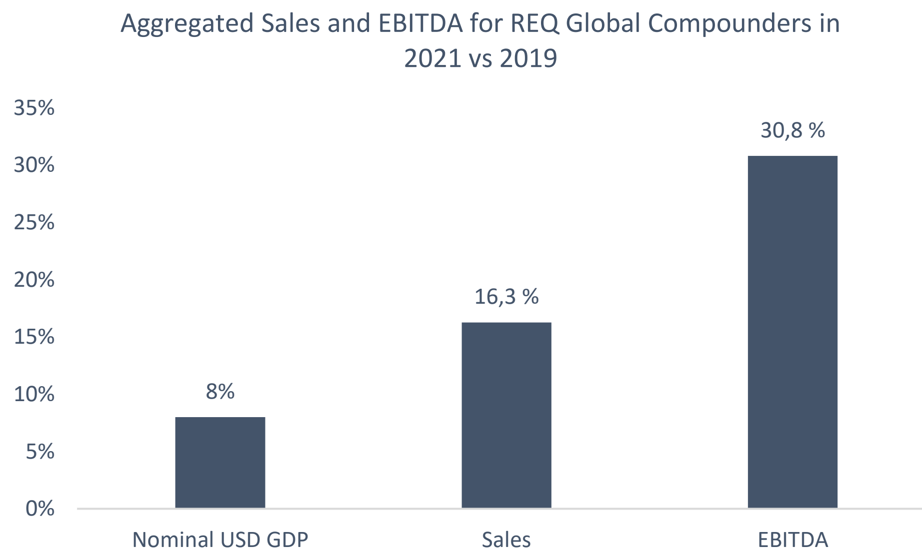


As illustrated, trying to time the market makes little sense for a long-term investor because compound interest mitigates the effects of market timing. If you are a long-term investor, you should not spend too much time worrying about the market, but rather analyzing the companies in which you are invested. Well run companies that grow profitably over long periods of time create more value for an investor than market timing.

Some investors have asked us what we think of the current market climate as stock prices continue to reach new highs. The above argument suggests that long-term investors should not worry too much.

We are not surprised that stock prices of our holdings have reached record highs. This is because the underlying revenues, earnings, and cash flows of the companies we own continue to grow at an

impressive pace. Below you can see the level of aggregated revenues and EBITDA of the Global Compounders portfolio compared to pre-pandemic levels. Sales and EBITDA are both well above pre-pandemic levels.



Research project: The REQ Cultural Index Model

We are pleased to announce that REQ Capital, together with partners, received NOK 10,7 million from the Norwegian Research Council on December 16 for the development of the "REQ Cultural Index Model".

Our investment experience has shown us that in order to identify companies that perform well over time, we need to find organizations with outstanding people, great management and a corporate culture where people thrive. When we have failed with our investment thesis, it has rarely been because we failed to find financial accounting irregularities or had less sophisticated cash flow models than the market in general. We made mistakes because we invested in the wrong kind of management, in the wrong ownership structures, and in corporate cultures that worked against us as shareholders rather than for us. In contrast, when we have made excellent investment decisions, we have found that capital allocation, decentralization, and corporate culture worked in our favor.

A growing body of literature suggests that corporate culture is directly correlated with firm performance, as culture can indicate characteristics such as innovation orientation, agility, and employee engagement.

Simply put, corporate culture is "the way we do things around here," and in recent years we have seen companies go down the tubes due to scandals caused by poor corporate culture. The Volkswagen emissions scandal, the Wells Fargo account fraud, and the collapse of Enron are prime examples of the scale of destruction that the wrong kind of corporate cultures can result in.

The continued focus on financials that many asset managers display today is therefore a paradox, as this approach, taken in isolation, does not offer crucial insights into one of the most important performance drivers - corporate culture.

Our goal with this project is to develop a platform that leverages the latest advances in computational linguistics, advanced analytics, and artificial intelligence (AI) to provide automated, in-depth insights into corporate culture. To identify and quantify various culture factors, we aim to create a unique database that combines multiple open data sources with quantitative and qualitative data. We also want to create an intelligent linguistic model that reveals correlations between key cultural factors and performance.

The REQ Cultural Index model will not be a substitute for how we manage capital and make investment decisions. However, we believe it can provide better insights, a deeper cultural understanding, and be a unique tool to create value for our investors.

Fund details: REQ Global Compounders

For clients

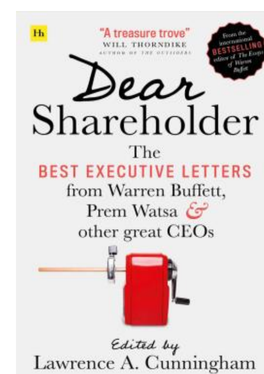
Suggested reading material

The following books will not only make you a better investor, they are also very inspiring and great for discussing with friends. They also have the potential to make you pause and think about life in general. Some of the books listed below are purely investment related, others are more appropriate for dinner conversation.

We believe that the best filter while reading a book or article is to pause and ask yourself the following question, "Will I still care about this a year from now?" For the following books, the answer is clearly "YES!".

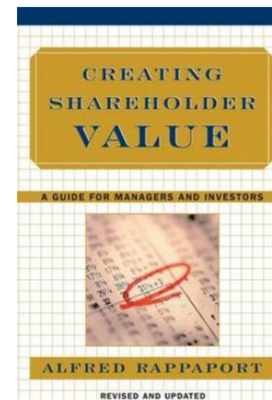
The REQ Capital Team

Dear Shareholder by Lawrence A. Cunningham



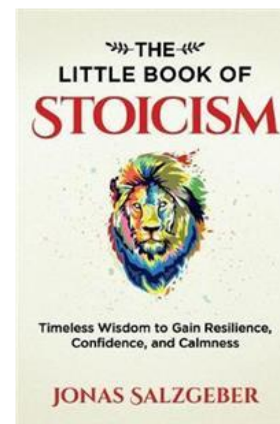
Mr. Cunningham's book examines the best shareholder letters and the commonalities between them. The best letters unfold much like a good book. The best letters speak of quality and rationality and emphasise trust and convervatism. They analyse rather than lecture, and examine failures and challenges rather than praise triumphs or best cases. The best letters attract Quality Shareholders - shareholders who are in it for the long haul with big positions. Cunningham has also shown that companies with Quality Shareholders tend to outperform other companies over time.

Creating Shareholder Value by Alfred Rappaport



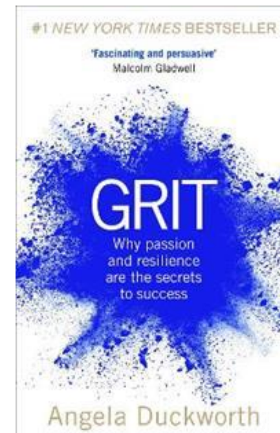
Creating Shareholder Value stands out from many other valuation books because of its simplicity and clear message. The book gives the reader a very good insight into the value drivers of companies through revenue growth, margins, capital intensity and cost of capital. It should be read not only by investors but also by management teams and analysts.

The little book of stoicism by Jonas Salzgeber



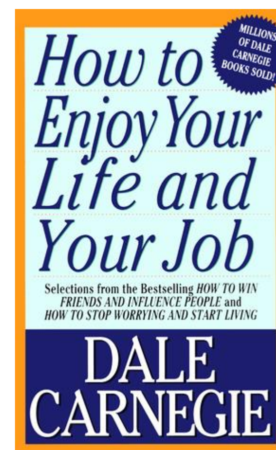
The goal of Stoicism is not to get overwhelmed by emotions. The ancient Stoics wanted to minimize the impact that strong emotions have on our lives. It is not the events that make us happy or unhappy, but our interpretation of those events. The central teaching of Epictetus was that there are things which are up to us and things which are not. The cornerstone of Stoic philosophy is to know the difference. The Stoics advised to focus on what we can control and let the rest happen as it comes. Focus on what you can control, set the bar high for yourself, and take responsibility.

Grit – why passion and resilience are the secrets to success by Angela Duckworth



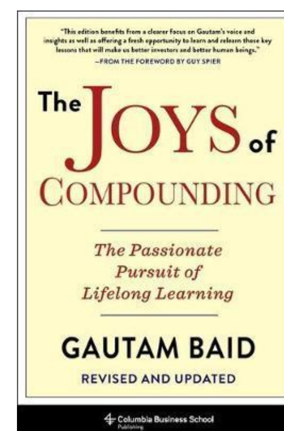
Angela Duckworth argues that talent is overrated and the attitude of "never giving up" is undervalued. It is the combination of passion and perseverance that makes high achievers in any field special. They have "grit." The author argues that many give up on what they start too early - "eighty percent of success in life is showing up." It comes down to waking up the next day and the day after that, ready to get on the treadmill and keep going.

How to enjoy your life and work by Dale Carnegie



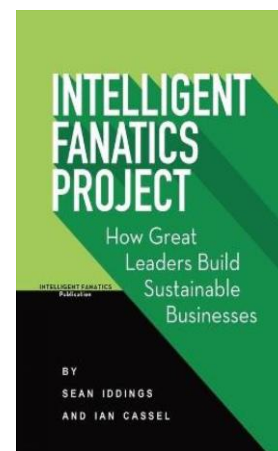
Another book by Dale Carnegie for those who have already read his classic "How to win friends and influence people". Have you ever thought that a dog is the only animal that does not have to work for a living? A hen has to lay eggs, a cow has to give milk, and a canary has to sing. But a dog makes his living by giving you nothing but love. The deepest principle of human nature is the craving to be appreciated. "Talk to people about themselves and they will listen for hours".

The joys of compounding by Gautam Baid



This book contains a lot of investment wisdom from Mark Twain to Munger and Buffett. The book contains many great insights and quotes from these outstanding investors and provides several links to great investing classics. An easy to read book that will resonate well with those who believe that big money tends to be made by investors who are right on qualitative decisions.

The Intelligent Fanatics Project – How Great Leaders Build Sustainable Businesses by Sean Iddings and Ian Cassel



Investing in companies managed by "Intelligent fanatics" is a powerful concept. In the book "Intelligent Fanatics Project - How great leaders build sustainable businesses," the authors describe the characteristics of exceptional leaders who have led companies to extraordinary returns. As a company evolves from a small business to a large enterprise, Intelligent Fanatics are able to maintain the "small business feel" without bureaucracy. They preserve the entrepreneurial spirit and prudent risk-taking. We should study these companies like we study successful athletes.

Investing in Value Creators by Oddbjørn Dybvad

Our own investment philosophy and strategy. Investing in Value Creators presents some basic principles and fundamental reasons why some stocks significantly outperform other stocks over the long term. By investing in Value Creators, you increase your chances of earning high stock returns over the long term.