April 18, 2024

Dear Investor,

For the first quarter of 2024, the fund was hit hard by a negative ruling from the judge in the proposed merger between Spirit and Jet Blue. We had invested in Spirit in anticipation of a positive ruling, based on our extensive research of the facts and the specific legal case. We believe the risk/reward ratio was very strong, with a triple or more on the upside if the merger would go through. Based on the facts, we had estimated an 80% chance likelihood of the merger being approved in court, cognizant of the fact that ultimately it comes down to one man's opinion. Unfortunately, that man, Judge Young, ultimately ruled against the merger, in an opinion that we believe twisted the facts and basic law beyond recognition. We believe that he got the law very wrong, but that does not save our position. We do continue to believe, however, that the position was a good risk/reward position for the fund to take, and we do not regret making the investment.

On to the quarterly numbers. The fund experienced a −16.9% loss for the fund for the quarter, which compares unfavorably with the S&P 500, which returned +10.6% for the quarter. This is primarily due to the sharp loss on Spirit, mitigated somewhat by positive improvements in the rest of our portfolio. We continue to see Burford, Silicon Motion, and Kingsgate as substantially undervalued, and we continue to expect substantial appreciation in their value in the future.

In recent months, AI has taken center stage in the tech scene and has begun to break into the general consciousness as well. This has led to many wondering how to approach AI from an investment perspective, and you can read our thinking in the attached Strategy Paper. We hope you enjoy reading it, and we welcome all comments.

As always, we continue to welcome any questions you may have about our investment philosophy, our positions, or the markets. We continue to believe that by being willing to endure some short-term volatility, we thereby enable steady long-term gains.

Sincerely,
Mordechai Yavneh
Mordechai Yavneh
Focus Capital Advisers, LLC

The AI Revolution: The Real Deal for Investors or Just FOMO?

April 18, 2024

Artificial Intelligence is all the rage lately, and many investors are wondering whether AI is The Next Big Thing™. Will AI dramatically change the world as we know it or is this just another case of herd behavior unwisely pouring money into the latest buzzword. Like many such dichotomies, the answer is both. We believe that even if AI is indeed the wave of the future and will come to massively affect all aspects of our lives (full disclosure: we do indeed believe this to be true), that does not mean that investing in AI companies is a wise allocation of capital, and such an investment strategy is rife with elevated risk.

Investing in Revolutions — Risk vs. Reward

Valuation Matters

One book which has had a formative effect on my way of thinking about investing is Jeremy Siegel's deservedly classic *Stocks for the Long Run*, a book which I highly recommend. The main thesis of the book is that investing is stocks is more lucrative long-term than investing in bonds or in the classic 60-40 stock/bond portfolio and that more investors, even retirees, should be heavily if not entirely invested in stocks, as long as they have a reasonably long-term time horizon.

However, a secondary thesis of the book is how value outperforms growth, *even when the growth indeed materializes*. He illustrates this with his discussion of different industry sectors. The sectors which significantly grew to be much larger portions of the economy and market did not correlate with which sectors did well for investors. (How did the sector become a larger section of the market if its market cap did not grow, you ask? The answer is that the market cap of the sector did grow, but not by increased returns to shareholders, rather by an increased number of companies in the sector.)

Siegel again illustrates the folly of chasing growth in Chapter 13 of his book, by comparing and contrasting market returns from different countries. He lines up 34 different countries and shows how the faster and stronger a country's growth, the worse were the stock market returns for that country over the long term. Again, stock market returns were *anti-correlated* with growth. And China, which had the largest annual real GDP growth per capita by far over the period studied, also had the worst returns by far — quite a bit into the negative, in fact. The reason, as Siegel explains it, is simple. Growth economies, like growth sectors, have high starting valuations. In investing, valuation matters. Valuation always matters. And the prospects of juicy growth cause investors to place eye-popping multiples on the favored countries, sectors, and companies, to the point that investors would do better by purchasing the more moribund countries, sectors, and companies available with undemanding valuations.

We have written in the past about what we view as a false dichotomy of value vs. growth. Quoting from our Strategy Paper Deep-Value Investing (2019 Q1):

> It is common to divide fundamental investing into value investing and growth investing. We believe this to be a false dichotomy which misses the point. The point of fundamental investing is to analyze companies and invest in those companies which are undervalued. This can be because it's a "value" stock which has an unjustifiably low P/E despite stable or improving prospects. This can be because it's a slowly dying company whose depressed P/E is even more pessimistic than duly warranted. Or this can be because it's a "growth" stock with an elevated P/E, but *which is still too cheap compared to its future prospects and underlying intrinsic*

> *value*. In our view, that is 100% *value* investing. Obviously, paying pie-in-the-sky valuations for sketchy future growth is not value investing. But that isn't growth investing either. That is just stupid investing (investing being a borrowed term for this endeavor). If it's not worth it, it's not worth it. If, after taking all possibilities and valuation into account, it is worth it, if you are purchasing the company for a price that is less than its analyzed value, then that is value investing.

We stand by what we wrote then about "growth" stocks being eligible for value investing, but that does not detract in any way from Siegel's point. In general and on average, those areas with heightened expectations for future growth tend to be poorer investments. Even though they do indeed grow faster, the valuations they are prospectively awarded tend to overcompensate for their future growth on average and leave investors worse off. Valuation always matters.

Applying this to investing in the AI space, one is forced to wonder whether paying a P/E of 70-80 for Nvidia is not such an example of overpaying for prospective growth. Admittedly, Nvidia has a very strong position in the AI space and a real moat. But valuation still matters. And Micron, which is making headlines as a provider of memory for Nvidia chip systems? Is that really a good enough reason to raise its valuation beyond its peers for what remains essentially a commodity product with multiple competitors? Micron is coming off cyclical lows, so its valuation may not be too stretched yet, but valuation always matters.

Picking Winners and Losers

Another reason to avoid investing even in legitimate growth revolutions is the difficulty of distinguishing in advance who will emerge as the winners and who will end up as the losers within the space. Take, for example, the internet. No one will deny that the internet massively changed the world as we know it and affects every aspect of our lives as we know it. Does that mean we could have known in advance which companies would ultimately be the internet winners? For every Google which was massively successful, there is the forgotten AltaVista and AOL. For every Cisco, there was a Nortel, Lucent Technologies, and Worldcom. Is anyone going to claim it was reasonably predictable in advance that the winner of internet retail (and cloud computing) would be an internet bookstore?

So yes, if you can correctly divine the revolution's winners, you may well make a lot of money despite initial high valuations. But that involves forgetting all the investments made in their forgotten competitors, also at sky-high valuations. Counting up the gains and the losses, investors as a whole do not come out ahead.

Can we correctly divine the winners and losers? It's certainly far from easy. As we see time and time again, the race is not to the swiftest. The winners are not necessarily the first to enter the space (remember Blackberry?) nor necessarily the biggest to enter the space. And if you predict the winners wrong, the downside risk is massive, due to the aforementioned sky-high starting valuations across the board. We do not see this as an attractive hunting ground for investments.

So yes, we do believe that AI may come to rival the internet in terms of its effect in every area of business and human endeavor. But who will emerge the winner in this brave new world? Will it be Open AI, the present leader? Will it be Google — already a close runner-up — with its massive resources and data? Will it be Microsoft, Meta? Or perhaps it will be some hitherto unknown company with some technical innovation in training algorithms? Will Nvidia, the market leader in chips with a formidable moat, ultimately defend and

expand its position to justify its eye-popping P/E of ~75? These are not easy questions to answer, and the downside of getting the answers wrong is massive.

How to Invest Due to The AI Revolution

Focus on Downside

Absolutely, an investor needs to be thinking about the coming AI revolution when it comes to choosing stocks to invest in. But not to try to choose winners. Instead, an investor has to strive to avoid losers. As an obvious example, investors in Google need to ask themselves whether AI will destroy Google's hitherto unassailable moat in search. As LLMs improve and GPT-5 or -6 or -7 can correctly and effortlessly answer nearly any question posed to them, will legacy search decline? Will Google succeed in catching up to the present market leader in AI? Even if they do, will this cannibalize their bread-and-butter business?

But don't confine your thinking to pure AI companies. You have to think about every industry and business and ask yourself if the coming AI revolution will upend the entire industry or business model. For an obvious example, will Shutterstock and Getty Images really be able to sell stock photos in a world where you can just craft any image you want to order? Already, you are increasingly seeing AI images being used in places where stock photos would have previously been used and even in places such as game art that would previously be using bespoke custom art. Today's image AIs are more than capable of generating stock photo quality artwork and they are getting better and better at a very rapid rate. Looking at Shutterstock's and Getty Images' valuation in the stock market, one does not get the impression that the market is paying attention to the very real risk that their entire business may likely (probably? certainly?) fall off the cliff in the coming years.

Don't just stop there. Already we are seeing the beginnings of capable video and audio generative AIs. It's nowhere near ready to take on Hollywood yet, but I believe it will relatively soon be capable of providing the graphics and video needed for video games, maybe even offering the possibility of dynamic graphics and gameplay that changes for each user. I don't think this will harm game studios per se; on the contrary, this will be another tool to bring down the cost of production. But I definitely pity the company whose business revolves around special effects or crafting short bursts of video.

What exactly does it mean to be a coder in a world where an LLM can take your natural language prompt and craft perfect code? Or even make a whole program for you from scratch, with frontend and backend, all from the specifications you provide? Does that mean the whole software field becomes obsolete? I doubt it. Does that mean that companies like Wipro which provide cheap outsourced programming labor may start feeling the pinch? I think that's quite likely.

For each company you have to ask yourself, is the essential product or service that the company is offering going to be co-opted by AI offering it to customers directly. Maybe not quite as well to begin with, but cheaper and easier? Or is AI's place going to be as a tool that makes the company more efficient, similar to how the internet is for pretty much every company today? The former scenario is likely a death sentence for the company, while the latter scenario is not. And the answer will be different for each company and business model.

Companies that deal with physical goods are the least likely to be negatively impacted. I doubt that an electric utility, a mining operation, or a consumer product company will find the core of their business

hollowed out by the AI revolution. Yes, AI will likely integrate itself into every part of the chain, similar to the internet today. But that just becomes part and parcel of life and does not threaten the essence of the business. Similar to how no one really differentiates between consumer product companies on the basis of the internet.

Conclusion

Buzzwords and fads come and go, but I do believe that AI is real and here to stay. For anyone following the leading edge of the technology and the astonishingly rapid pace that progress is being made, it appears obvious that AI will change everything, akin to the mobile revolution at least, if not the internet itself. An investor has to analyze companies in the light of this changing future, but that does not mean that chasing AI-adjacent companies is the wise or rewarding approach. Because valuation and risk/reward always matter.