2002 SUMMARY: JANUARY 2003 NEWSLETTER

Dear Investors,

- At 31 December 2002, Sextant PEA had €6.5 million of net assets. Thank you for the trust you have given me during the first year of the Fund's existence.
- On the Boursorama website, you can see the Sextant Fund's performance (code 98105). At 31 December 2002, the unit price was €1,147, or a 15% gain since the Fund was launched on 18 January. Sextant PEA has outperformed the CAC 40 by 46% over the same period. After thanking our investors, I would like to extend my thanks to the managers of "Sextant Inc,"1 who, despite their packed schedules, were always able to find the time to answer my questions. They worked hard in 2002 to satisfy their customers, their employees, and of course, their shareholders.

Clouds are gathering and crises are threatening, yet the first days of January still bring a hope of change. In the 1 January edition of Le Monde, Edgar Morin wrote, "The chaos that humanity risks sinking into also carries with it a last chance…. because the approach of danger favours heightened awareness, which can multiply, amplify, and prompt a large policy of world salvation." It's the end of this sentence that we all wish to remember as the new year begins.
Financially, I will do everything I can so that those who put their trust in me are pleased with the growth in their savings… with a bit of luck, in 2003, but certainly over the next 5 to 10 years. For the rest; that is, the most important, I wish you an excellent 2003.

Weak correlation with the indices

Sextant has never been more than 5% invested in CAC 40 companies, although in 2002, an average of about 40% of the Fund's assets were invested in the Nouveau Marché. These index comparisons serve only one real purpose, to show that there is a very weak correlation between their performance and that of the Sextant Fund. Many investors were worried about the Fund's strong position in the Nouveau Marché at the start of the year, because that index had plunged over 80% in less than two years, with no relief in sight. Indeed, they were not entirely misguided, as the index tumbled another 50% in 2002. But I did not invest in the Nouveau Marché, I invested in companies; companies whose stock prices were simply dragged down by the fall in their benchmark. The Nouveau Marché's further drop in 2002 gave Sextant the opportunity to increase these investments at truly remarkable prices, perfectly illustrating our maxim, "He who loses, wins" from the June 2002 newsletter.

Nevertheless, the Fund's relative outperformance is fairly remarkable, and it is difficult to imagine how it could be repeated in 2003. But that is not our goal. We aim for absolute performance, and on this point I am highly optimistic, especially because Sextant has a more powerful, broken-in engine in 2003.

Breaking in the engine, or the positive experience curve effect

[1] Sextant Inc. is the portion of Sextant PEA invested in equity (approximately 92% of the portfolio at the time of writing), which I look at as a holding company.

In all businesses, the experience curve has a steep slope when the business is launched, and then slowly levels off. This is especially true for managing the Sextant Fund, and I will explain why. Imagine that you are an investment genius. Out of a Group of Tracked Stocks that we will call GTS for short, you are able to find the best one to invest in for the next 12 months. Logically, the larger this group is, the better your chances of picking a winner. If, at the start of 2002, you had the choice between France Telecom (-62%) and Vivendi Universal (-75%), your investment performance would have been disastrous no matter how brilliant you may be. But if your choices were expanded to include Passat Industries2 (Nouveau Marché), your portfolio would have gained 200%.
Unfortunately, I am not an investment genius; between Passat and Vivendi, I picked the Vivendi! A huge blunder which I will come back to in a moment.
But if we assume that I can reasonably accurately value companies whose businesses and outlook I understand well, it would logically follow that the more comprehensive my GTS is, the more likely I am to find undervalued companies.
In early 2002, I must admit that my GTS was much too limited. I had gotten into the habit of making large investments in two or three stocks, and found myself required to invest in a minimum of 16 stocks for Sextant. My biggest bets turned out to be winners for the most part, but the investments I made "by default" were generally mediocre. Because the number of companies that I had to select from was too small, I made poor decisions.
This is why I am so optimistic about the future. By broadening my search as time goes on, I should be able to find more treasures, which will in turn let me set more demanding criteria on the quality of the investments.

Engine power, or how to steepen the experience curve
In February, two partners will join me at the helm of Sextant; our GTS will eventually be two to three times bigger. I am a firm believer in teamwork, and in a moment I will discuss the organisational structure we will use to maximize our performance.

Thoughts on fund management methods – An analysis of mistakes made
It is important to mark the end of the year (or as it happens, the beginning) by reflecting a bit on fund management methods. And looking at the mistakes made. Why did a particular investment do well, and why was another disappointing? Is it possible to draw enriching conclusions? Or is everything simply a matter of fate? Can the mistakes made in the past be avoided in the future? And, most of all, are our management methods truly effective?

A largely-proven fund management style
Below are some excerpts from the investor's guide to illustrate my points.

1. Value – Safety margin – Scope of skills
"The Funds' investment decisions are based exclusively on the intrinsic value of a company. Therefore, our key skill lies in being able to appropriately value a company; that is, understand its financial model, which should remain relatively simple. We invest in companies if our

[2] Passat Industries posted an outstanding performance in 2002, but unfortunately, it is a company that I did not understand very well, not in terms of its business, but how it should be valued. A shame, isn't it?

valuation is far from its quoted price, so that the market offers a wide safety margin (between 50% and 100%, depending upon the share's liquidity). Stock market fads, sectoral rotation, economic forecasts, and indices are not investment criteria. We may miss some opportunities and "great bargains" along the way, due to our methodology and discipline, but we will remain within the scope of our skills."

The best performers in 2002 met the above criteria exactly; businesses that were easy to understand (retail, traditional media, unsophisticated IT services, other easy-to-understand business services, online brokers, home hairdressing services, etc.) with low, or even very low, valuations.

- **Value**: The best performances were given by companies whose financial models I understood. For example, women's clothing retail is a difficult business, highly competitive, and one that can be dangerous if inventory is not skilfully controlled. But if a company has excellent management, then it is fairly simple to calculate its value (plus-or-minus 40%, of course). Thanks to Camaïeu's management for its excellence!
- **Safety margin**: At the beginning of 2002, we had a 120% safety margin on Camaïeu. The stock rose 80%. The safety margin is not at all a guarantee of short-term performance, but in the long-term, it's both a safety net on the downside and a potential capital gain.
- **Scope of skills**: Ostensibly, this may seem the simplest concept, because it requires that we only concern ourselves with companies that we understand well. But in reality, it is probably the most difficult to define, and even more so to follow. How can we "define" the level of understanding required? And how can we be sure to thoroughly know all the workings of a company's financial model? Personally, I prefer companies with products and services that consumers like me can easily grasp. Camaïeu, Auféminin.com, and ADLP are all companies whose services you yourself can use regularly.

2. Concentrated portfolios

"The Sextant Fund investments correspond to true convictions. In an environment where fund managers are exposed to more doubts than certainties, establishing a conviction is a rare and difficult exercise. This is why our Funds are concentrated on a limited number of stocks (between 15 and 30)."

The portfolio's concentration proved very beneficial. Last year, three stocks had the maximum weight of 10%: Camaïeu, which gained 70%, Auféminin.com, which surged 60%, and ADLP, which lost 25%. The three other stocks that each represented over 5% of the portfolio rose between 30% and 50%.

These strong performances go a long way to prove the merits of our fund management style. They prove that I was able to pick the most undervalued stocks in my GTS. However, luck did play a role, in that we benefited from good timing. But this is not something I worry too much about, and it has no place in your Fund's management. There is no doubt that Sextant's short-term performance will one day be hit by bad timing. But again, if we do our job well, this would actually give us a boost in the long term by enabling us to strengthen our positions at attractive prices.

In my opinion, the success of the portfolio's concentration is the best proof of the merits of our management style.

Mistakes in 2002: Self-flagellation and lessons learned

Oddly enough, I did not always adhere to these principles, despite their being so simple (not to be confused with "easy"). So why did I stray?

- First of all, as I mentioned above, my GTS was too narrow in scope at the start of the year. I lacked choice, or the time and energy to find more choices. But I did work on this in 2002, so the situation is much better today.
- I lacked self-discipline (or worse, intellectual honesty) by desperately trying to come up with excuses to invest in companies that are extremely overvalued, have highly cyclical business models, or are heavily in debt and therefore too risky. For example, Séché Environnement. It is a splendid company, and I had been wanting to invest in it for a long time. The 40% fall in its stock price in 2001 seemed the perfect opportunity. The only catch was that, according to one of my favourite financial ratios, the stock was three times too high; €72 in January 2002. There was no safety margin. So to get around that, I factored into my calculations excellent results for the next 5 years, and everything came out fine. In January, I invested 4% of Sextant PEA's assets in this company. After a very costly takeover bid was launched on a competitor, I woke up and sold the stock at a 15% loss. When the stock fell to €25 in October, I followed the advice of a future Sextant fund manager and reinvested in the company, which had suddenly become a good buy. But unfortunately, this time I couldn't play my favourite game, "He who loses, wins." Although the stock price doubled two months later, we didn't earn much on this investment. The lessons learned (the hard way) and applied in 2003 will come from both the overall experience and the experience with teamwork. From now on, if we stray from our own principles, we will have to explain to our comrades why (beware of a slap on the wrist)!
- The worst mistake of all was that I went beyond the scope of my skills, without even being aware. It is easy to believe that we understand something if we do not ask the right questions. Fortunately, these mistakes only involved around 5% of the portfolio, but did include a 50% loss on Vivendi Universal. Indeed, this company is worth pointing out. I honestly believe that some analysts and seasoned fund managers can value Vivendi's businesses. I thought I would give it a go; clearly, I was short on discipline, if not out of touch with reality. Perhaps the company was a good long-term buy at €27, and I certainly could have strengthened the position at €8. But at that point, my conviction was much too weak to be able to cash in on the bad news that followed the purchase.

The true Sextant management methods

Don't think that I made only mistakes in 2002. Out of curiosity, I looked at Warren Buffett's performance when he started managing his first Partnership, with $300,000. In 1957, the Dow Jones lost 6%, and Buffett gained 10%. So in an effort to always outperform the master, here are the new methods that I have been using since 1 January:

- Every day, re-read a few pages of Warren Buffett's biography, The Making of an American Capitalist.
- Drink Coca-Cola (according to our Admiral, it's great for digestion)
- Eat grilled steak (preferably at Buffalo Grill, since 8 January)

- Buy my underwear at Vet'Affaires; it's cheaper there, and at any rate, by the time people see it, it's already too late…

SEXTANT PEA, A SPECULATIVE FUND? OR WHY YOU SHOULD BUY SEXTANT

Beware of returns that are too high. Financial theory tells us that to get better returns, you have to take more risk. If earning 2% per year is enough for you, then invest in money market funds. Your risk will be zero. But logically, if you want to earn more, you have to be willing to accept more risk. The same applies to relative performance, i.e., performance compared to a benchmark, which in our case would be the CAC 40. From this perspective, Sextant PEA is a risky fund because its performance will never duplicate the index exactly. Many fund managers see this as an intolerable risk, because their bosses judge them entirely on this criterion for the short-term. But with Sextant, it is the only non-measured risk that we are willing to take, because it is actually not a risk for the Sextant investor.

So should you buy Sextant? Would it be better to invest in mutual funds or buy stock in companies that fell sharply in 2002, and therefore have much greater rebound potential?

- First of all, funds that underperformed in 2002 will not necessarily benefit from a rebound in the stocks they had invested in, because it is highly likely that some of their losses were generated from the sale of this stock, possibly even to Sextant.
- Second, there is no reason why we can't buy stock whose share price dropped in 2002. And if you can explain why a company's value is much higher than its stock price, maybe we will (with your help, at the Amiral Club!). If not, why not play Three Card Monte? Provided, of course, that you are the one handling the cards…

Buying Sextant is an excellent idea, if you have time in front of you, and won't be panicked to see your investment dip between 10% and 20% in the short term. I am always very impressed with the quality of the managers at Sextant Inc. companies, and delighted with the progress in their revenues and earnings. Luckily, their stock prices remain surprisingly low, so we can fully benefit when the market revalues them. Furthermore, the market is still quite nervous, and offers incredible entry points in high-quality companies that are relatively easy to value (such as Buffalo Grill, for example, which at 8 January was valued lower than its property assets).

THE AMIRAL CLUB

Because the Sextant management structure is in the middle of a big (positive!) change, we have decided to postpone our next lunch until the March timeframe.

Once again, Happy New Year to all.

François