Sextant Newsletter – September 2004

Dear Investor Friends,

Today, we manage €63 million. Your Funds have performed outstandingly well for the 1-year, 2-year, and soon to be 3-year return for Sextant PEA, as well as since the start of the year. However, we have all lost some money since April (6% off its high, not yet a crash). Slightly bothersome for those who joined us just beforehand, but weak markets are always appreciated by your fund managers; who can complain about lower prices?

Sextant Fund Performance: your fund managers' *savoir-faire* and lucky star

The Sextant PEA Fund is the world champion with regards to 2-year performance. With a return of over 100%, it outstrips Thai and Chinese funds, sectoral funds (tech, non-tech, value, growth, indexed, surtaxed, etc.), specialised funds (small-cap, large-cap, mid-cap, etc.), and so on. Fantastic, isn't it? After feeling quite proud of ourselves and our extraordinary intellectual capacity, reading *Bull!* by Maggie Mahar put us back in our place. Dear Maggie, whose book was recommended by Mr. Buffett himself, explains in Chapter 10 that our performance is no reflection of our talent whatsoever. World champions, yes; lucky, most certainly; talented, not necessarily. Perhaps it is best if you read Ms. Mahar's devastating words for yourself.

> Yet history suggests that a fund's returns over three- and five-year periods offer little insight into how k is likely to perform going forward. In fact, fund's one-year performance might serve as a better short-term indicator, observed Mark Hulbert: "Funds that own a given year's top performing stocks have a good chance of outperforming the next year too. h has nothing to do with the manager's ability. It's the momentum effect—the wind at your back," Hulbert explained. "If you had a bunch of monkeys running the funds, the ones that did best for the previous 6 or 12 months would be likely to outperform the next year. But the effect is short-lived; in the third year they would do no better than the average fund. Investing based on a fund's one-year performance works only if you're a short-term player."28 And of course, when a bull market ends, momentum goes into reverse: the funds that owned the top technology stocks of 1999 were doomed to plunge in 2000.
> "At the other end of the performance spectrum, long-term performance can tel1 you something about a fund manager's ability," Hulbert explained. Just how long a track record is needed to predict future performance? [...]Mark Carhart, head of quantitative research at Goldman Sachs, has done extensive research on mutual fund performance, and his work shows that "for your average fund manager, in order to get results that are statistically significant—results that allow you to say with some certainty that his active management has added value to the returns you would have gotten in an index fund—you might need 64 years of data. On the other hand, a 10-year record might be enough for you to say 'I can't project statistically that he's a star, but I feel pretty confident that he's a star. I think I'll give him some of my money.' The problem with past performance," Carhart added, "is that there is always so much noise in it.".
> What seems clear is that a three-year record, by itself, is virtually worthless: "It's too long: to capture the momentum effect, and too short to capture the manager's ability", said Hulbert

It's a pity, because on its third birthday, Sextant PEA will probably be one of the best-performing funds in the world over this horizon. In any case, our Funds have delivered excellent 1-year returns. If nothing else, you can at least benefit from the momentum until 2005….

Sextant Funds: more than a track record!

We have been lucky, indeed, very lucky, but will inevitably face difficult times ahead in the short-term; it's mathematically certain. But an attentive reader of our newsletters and website can easily distinguish between a simple track record and true *savoir-faire*.

A bit of probability in our *savoir-faire*

In the 1970's, the greatest minds of modern finance (Nobel prize winners, etc.) swore by the efficient market theory. This theory states that the market values every listed company at its fair value at time T, incorporating all the information available at time T. Therefore, a company's stock price should only reasonably fluctuate in response to new information, be it economic, political, or about a particular company (earnings releases, new products, etc.). This theory is still taught in our universities, so in essence we are teaching our young people, as they go out into the world of finance, that there is no need to think because the market does it for us. The market values all quoted assets accurately, completely on its own. So the only way to make money in the stock market is to follow the indices, unless you are an insider, or unless, like the Sextant Fund managers, you are very lucky. Sounds good on paper, but there is something that doesn't quite fit: why is it that every Buffett and Graham disciple seems to have been "lucky"?

In 1984, our teacher Warren gave a speech at Columbia University called "The Superinvestors of Graham-and-Doddsville." He asked students to imagine a nationwide heads-or-tails game, in which every American (225 million at the time) played heads-or-tails at dawn. The winners (those who bet heads, or statistically 50% of the players) would play again the next morning, and so on. After 20 days, 215 gifted players would remain who managed to bet successfully 20 times in a row. New heroes. Except that a group of orangutans could have had the same outcome! This is how the great minds behind the efficient market theory explain successful investors; they are lucky orangutans. But Buffett commented on what those scientists would say if, out of those 215 winners, 40 came from the Omaha, Nebraska zoo. "I think you will find that a disproportionate number of successful coin-flippers in the investment world came from a very small intellectual village that could be called Graham-and-Doddsville. A concentration of winners that simply cannot be explained by chance can be traced to this particular intellectual village."

We don't think that we have yet found Buffettville. We may be searching for it for the rest of our days! But for you, our search is a guarantee, a true safety. And for us as well, because Buffett's followers are statistically quite successful over the long-term. A few years ago, when I was a broker, one of my customers borrowed my Berkshire Hathaway annual reports, announcing "I am going to start an asset management company, and we are going to use Buffett's strategy." This former customer never returned my annual reports, although today he is with one of the best-performing asset management firms in Paris, Pastel & Associés. So is Mr. Pastel an excellent fund manager, or a lucky orangutan like us? If it's the latter, we should share the same cage.

A lucky star and volatility

Volatility. What is it exactly? Put simply, we say a stock is volatile if it experiences sharp fluctuations, and volatility is the historical measure of these fluctuations. For example, a money market fund is not volatile; it increases approximately 0.2% per month. On the other hand, France Telecom stock is extremely volatile. It was floated in 1997 at €28.5, soared to over €200 in 2000, collapsed to €8 in 2002, and clawed back up to €19 a few days ago. Professional wealth managers are obsessed with volatility. They seek low-volatility investments that generate solid returns, which we can all understand. Because volatility can lead to uncomfortable situations, stress, and errors of judgement. Our friend Mr. Market despises volatility. He panics when markets decline, loses sleep, and ends up selling low. When markets go up, he gets stressed, wishes he had joined in earlier, and ends up buying high.

In reality, volatility is a speculator's enemy and an investor's friend. A speculator bets on things he is not fully certain of, and when markets drop, he panics. Professional speculators unwind their positions very quickly when things head south. They know when to cut their losses. But an investor has convictions; he believes in his ideas. He is happy during soft markets, and buys. An investor plays "He who loses, wins" (see our June 2002 newsletter). A speculator follows market fads and trends. When the markets fall, he has nothing to guide him. He can only sell, or pray that things improve.

The volatility of Sextant Funds

"I would rather get a 14% annual return with high volatility than a 13% return with low volatility." (Warren Buffett). Me too! In fact, you should be aware that at Amiral Gestion, we are not at all concerned about the volatility of our Funds. We don't even measure it (although it is apparently rather remarkable). Some fund managers do the opposite; they spend more time managing volatility than seeking good returns. In theory, your Funds should be relatively volatile because they are highly concentrated. Logical, isn't it? If you have 10% of your portfolio invested in a stock that loses 40% before soaring 10X, you are very likely to have a volatile portfolio. In June 2002, I promised you happy stories, fruitful "He who loses, wins" experiences. I had no idea how right I was. I recently invested 10% of your Fund in Auféminin.com. Four months later, the stock tumbled 40%, but your Fund was not volatile! Simply because we were lucky. Lucky because while Auféminin.com plunged, Camaïeu and Gifi rose sharply. Then while Camaïeu and Gifi experienced setbacks, Auféminin.com rebounded, etc., etc.

Our lucky star

So this is our bit of the luck, our Funds' low volatility for over 2 years. If all our stock had dropped simultaneously in October 2002, Sextant PEA would have lost between 40% and 60%, rather than 20%. Not that we did much better than monkeys, because there really wasn't much that could be done; we do not in any way manage the short-term price movements in our portfolios' stocks. By the same token, we are lucky to have generated such outstanding performance for more than 2 years, as our investments have climbed very rapidly. Camaïeu immediately jumped in January 2002 (up 50% in one year), while it had not moved much over the 2 previous years.

With Toupargel (up 600% since January 2002), we were lucky to have bought it so low, and to have been able to watch as Mr. Roland Tchénio and his brilliant employees executed a fantastic

acquisition just a few months later (a never-before-seen in the memory of Badelon-Crestin-Lepage). Mr. Tchénio didn't ask our advice, neither us nor the monkeys at the Vincennes Zoo. We had luck on our side…. sort of…... thanks to the influence of Warren Buffett and Didier Le Menestrel (a bit less wealthy, but still an outstanding fund manager), we "invented" a new stock market theorem, "with good managers you always get good surprises." Yes, it is simple, a monkey could understand it, but it has nothing to do with luck.

The life of your Funds

- Sextant Grand Large benefited from the declines in some of its internet and traditional retail stocks to strengthen its equity holdings, which now comprise almost 60% of the portfolio. Grand Large is now a proud Camaïeu shareholder, bought at €66 per share.
- Sextant PEA is 93% invested in equity.
- In June, we sold all our holdings in Ad Pepper, a German online advertising company, with a 100% capital gain. This investment represented 10% of the assets of your two Funds. We bought Ad Pepper because it was overflowing with cash (€3 per share), and managed to earn a profit after 3 years of losses. But we decided to sell it because its safety margin had become a bit low, and because we do not have complete confidence in its management, which have granted themselves a few too many stock options to be perfectly honest.
- Toupargel, LDLC, Auféminin.com, Camaïeu, Artprice, and ADLP all announced excellent revenues for the first half.
- We saw less-good news from Gifi, Vet'Affaires, and Hubwoo; a profit warning from Gifi and weak revenues at Vet'Affaires. 10% of the portfolio was invested in Vet'Affaires at the beginning of 2003. Today that level is much lower (less than 2%), and the company's stock price has returned to fantastically low levels. Gifi is also trading at a very attractive price, as is Hubwoo, which plunged 50% following the release of poor quarterly sales results!
- Our fifth stock in the PEA portfolio is a Franco-Japanese automobile company, Renault. We make a very good living thanks to the incredible managers, Mr. Schweitzer and Mr. Ghosn. Proof that the CAC 40 is always hiding little treasures. Even when it falls.

We estimate that today, the true value of our equity investments is an average of 60% above the stock price. So there is still amazing potential. When will this true value materialise? In one month, or in three years? We haven't a clue, and to be perfectly honest, we aren't even trying to find out. We are waiting patiently, like gorillas in the mist…

Talk to you again soon,

François Badelon