Dear Investor Friends,

Since our June letter, the capital markets have revived, oil prices have peaked and then collapsed by over 25%, a war has broken out, lost by the winners, or vice versa… There is only one thing that hasn't changed too much since June: the performance of your Sextant mutual funds has been generally flat, or even downright mediocre for several months now.

Since 1st January, Sextant PEA is up 9.84%, Grand Large 6.47%, Autour du Monde 15.07%, nothing to boast about when the CAC 40 Index, for its part, has advanced 14%. I would have preferred to tell you about my last holidays in Morocco, but I haven't been there for many years now. Instead, I'm going to have to explain to you why our recent performance is disappointing. In the end, maybe that's what you're interested in, no? But first of all, a few words on a real portfolio manager…

Thanks a million, Mr Bill

When I was a (bad) student at ESCP, I sometimes copied on my friends, because I had not learned (and often not understood) my lessons. It wasn't very nice, and not very smart. The problem is that at over forty years old I still copy… Our management approach, the Sextant newsletters…. I'm almost ashamed. I still look over the shoulder of guys like Warren Buffett, Charlie Munger, Bill Gross, Benjamin Graham, Whitney Tilson and Didier Le Menestrel (but since he threw me out of his office three years ago, I find it much harder…). The difference this time is that I learn my lessons. And I copy on the teachers, which is basically the right idea, isn't it?

Bill Miller, for example, is a wonderful guy. In the United States, they call him "*the man who beats the S&P*"[1]. We read attentively everything that he writes and everything that is written about him. It's always extremely interesting. I believe we have only one stock in common, Google (for which we paid three times as much as he did, but it was a bargain all the same...). We even disagree completely on oil companies, for example[2]. But his management approach suits us entirely, Bill teaches us to think, and that's what interests us. Miller defines himself as a "Value" investor, in the sense that he buys shares on the basis of their intrinsic value. The aim is not to find companies with a low P/E, or a high yield. Even though we love big dividends and P/Es of 3.5.

But let's rather listen to the master[3]:

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1 Since 1990, year after year, the Legg Mason Value Trust fund has beaten the US Standard & Poors Index. Nobody before him had achieved such a performance for more than 15 years. 2006 has got off to a bad start, Bill is lagging far behind, it's probably the right time to buy his fund!

2 Is it a good idea to disagree with Mr Bill? It may seem scary. What matters to us is to be right in about ten years' time. See you in 2016, Mr Miller.
3 I found these quotes from Bill Miller in Janet Lowe's excellent book entitled "The Man Who Beats the S&P".

> "Our definition of value comes directly from the finance textbooks, which define value for investment as the present value of the future free cash flows of that investment. You will not find value defined in terms of low P/E [price-to-earnings] or low price-to-cash flow in the finance literature."

Yes, dear Doctor Miller, but how do you determine those future free cash flows?

> "We do a scenario analysis of the business. We project cash flows out anywhere from five to ten years under a variety of scenarios. One scenario would be where the current growth rate continues. Another is where the company does a lot worse. Another is where it does better. We then try to figure out what we call the "central tendency of business value". Each scenario analysis gives us a different number and then we see how those numbers cluster. If they all cluster around the same thing, then we have a pretty high confidence in the particular valuation range."

Interesting, isn't it? Frankly, I can't tell you that we do precisely the same thing at Amiral Gestion. But we have always examined several scenarios. My favourite scenario is to imagine that everything goes wrong. The doomsday scenario. If everything goes wrong and you still have a margin of safety in terms of value, it's really great. For example, recently we bought shares in *Leguide.com*. It's a price comparator, like *Kelkoo*. Except that it's far better. The cyber merchants (in any case 100% of those that we questioned) consider that *Kelkoo's* practices are not always very loyal toward them. From personal experience, I find chiefly that their service is not very transparent for cybernauts, to put it politely. *Leguide*, on the other hand, is a real community site which offers a very good service both to e-tailers (the cyber merchants) and cybernauts. *Leguide* wants to expand in Europe, and is going to spend a lot of money to do so. So we imagined that they were going to spend a great deal of money on this project over three years, that it wouldn't work, and that in 2009 they would stop everything: zero expenditure and zero turnover. Frankly, it's not very credible! I am counting on this company's super managers to do much better, and succeed in penetrating markets where there is not yet any firmly established leader. But even with this scenario, the stock is not expensive and offers a 25% margin of safety. It's not much, but if you prefer to listen to the management and adopt its scenario, the upside potential is 130%[4]…

When Bill Miller is convinced of a company's high growth potential, he is prepared to buy it on relatively high multiples (P/E, etc.). There must be good reasons for this, an asset, expertise, leadership, a high-growth market, something on which to base strong conviction. Strong conviction, but never any certainty. In any case, at Amiral Gestion, we are never sure of anything. Except in atypical periods: in 2002 there were profitable companies, in high-growth markets, which were valued at half their cash. (Let's not dream, we'll probably never see that again). But let's hear Mr Miller again:

> "Estimates of business value are subject to substantial uncertainty arising from, but not limited to, the availability of accurate information, economic growth, changes in competitive conditions,

4 Relative to the current price of 13 euros; we bought in at 10.2 euros.

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technological change, changes in government policy or geopolitical dynamics, and so forth. We attempt to minimize the potentially unfavorable consequences of errors in the estimation of business value by building in a margin of safety between our estimates and the price we are willing to pay for a security."

It's beautiful, isn't it? Clear, easy to understand, not easy to apply, but all the same we thank Bill Miller for his investment lessons.

Still more Mistakes and why we shall continue to make them

The famous margin of safety, a simple concept explained by Benjamin Graham, should make it possible to avoid, not making mistakes, but losing money. In short, I make mistakes but I have left myself such room for manoeuvre that I lose nothing. I think that Miller too accepts more radical bets: betting with a very positive expectancy of winning but where the probability of losing a lot of money is not zero. In any case, this is the kind of bet that we accept. Frankly, I don't like losing money outright, by taking a loss. But it's inevitable, unless you have an IQ of 140, your first name is Warren and your best buddy is called Charlie.

On Hubwoo, for example, we lost a lot of money. Hubwoo is a marketplace for large firms. This marketplace allows the firm's non-essential procurements to be centralised on the Web, placing each employee in direct relation with suppliers. The benefits for those using the marketplace are great, of course: centrally managed procurements are negotiated better, they are tracked better (you always know precisely who bought what, and when). But we paid far too much for this company whose business model was not clearly defined. In fact, even the management didn't know exactly how they were going to earn money. I worked hard on this investment, interviewed quite a lot of people and spent (too much) time doing a variety of research. There were many alarm signals, but I didn't listen to them. I sincerely believe that there was a way to avoid making this big mistake. Bill Miller wouldn't have made it (but Bill Miller is the best manager in the world, he's been in this business for more than 25 years and he has 20 billion dollars under management. We have room to progress). I think, too, that it was hard to believe in the Internet, to make such extraordinary investments in Aufeminin.com, Business Interactif and Boursorama without letting oneself be carried away by this project which was very promising. As Julien Lepage says, to reassure me: *"I'd rather have been in Aufeminin and Hubwoo than in neither of them."* Perhaps. But Julien bought Aufeminin and never bought Hubwoo. Which is why his sub-portfolio has performed far better than mine over the past two years. In the future, we shall try not to invest in companies whose business model has not been validated. Either by the company accounts, or by our personal experience, or by a similar model already existing. I wish Hubwoo the best possible future. It is a company with very good managers, and active shareholders of high quality. But this corporate story will go on without us.

We always spend time analysing our mistakes. Unfortunately we shall continue to make some. A great way to progress. One thing we learned with Hubwoo is that it is good ideas that do the most harm. The marketplace was a very good idea. The customers and users confirmed this to us. You can get carried away by a good idea, not a bad one. It's rather paradoxical, isn't it? To get a better understanding, let's rather listen to the inevitable Charlie Munger:

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> "It's not the bad ideas that do you in, it's the good ideas. And you may say, 'That can't be so. That's paradoxical.' What he [Graham] meant was that if a thing is a bad idea, it's hard to overdo. But where there is a good idea with a core of essential and important truth, you can't ignore it. And then it's so easy to overdo it. So the good ideas are a wonderful way to suffer terribly if you overdo them."5

Steve Forbes, Terrorism and Oil

Much turbulence in the oil markets for some months now. Our stocks peaked in March/April and have declined constantly since then. At the peak we lightened our position on Statoil, but kept most of our investments in this sector. Which partly explains our poor performance for several months now. It is always very hard to make quick trades on long-term convictions. In fact the oil companies are valued based on market expectations concerning the oil price, or even more subtly on the mere perception of the trend. Which generates even more volatility. After a sharp decline, the market is becoming nervous, and anticipating ever lower oil prices. Our investments in companies with relatively high production costs (a cost price of $20 to $25 per barrel) are therefore logically punished. But we regain a very fine margin of safety, because the market is now anticipating a price lower (about $40 to $45) than it is in reality ($55-$65).

Oil stocks will always be very volatile, because they anticipate and sometimes accentuate oil price fluctuations. Now, in the near future, the oil price could fluctuate sharply. Consider, for example, the view of Steve Forbes, the highly influential owner and chief editor of Forbes magazine in the United States. He thinks that for the good of America and the free world, to stop the war, save lives and fight against terrorism, the oil price must fall. "*Imagine the setbacks the bad guys* (Iran, Venezuela and other countries) *would suffer if oil went back to a price range of $30 to $35 a barrel."* But he thinks that the Federal Reserve will not adopt a brilliant recipe to bring down the oil price[6]: "*Instead, we will for a while longer subsidize terrorists with billions of dollars, thereby prolonging the war and unnecessarily giving up innocent lives."* And Steve Forbes is quite right: $30 oil would hurt the OPEC members very badly. That is precisely why these good people don't have the slightest wish to sell it to us so cheaply. And when you control 30% of production in a tight market, you can control prices, can't you? Moreover, insulting the OPEC members by calling them terrorists, I don't know whether that's the best strategy to bring down the cost of filling your scooter tank, dear Mr Forbes.

In any case, you can read anything about oil, it's rather amusing. For 2007 and 2008, the price projections range from $20 to $100. Interesting. We still think that energy supplies are one of the greatest challenges faced by our planet over the next 20 years. Which is why we calmly

5 Charlie Munger in Poor Charlie's Almanack.
6 Back to the gold standard. In fact, Forbes' reasoning is almost a Catch-22: if we went back to the gold standard, the oil price would decline in US dollar terms, while the dollar would rise in value, being directly convertible into gold. The terrorists (all those guys who have an oil well in their garden) could then buy themselves pilot training by paying with Swiss ingots. Is this really a good idea?

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hold on to our investments in companies that have large reserves and excellent management to exploit them well. We have ideas for the next 50 years. The price to be paid for this is high volatility.

Not very pleased

So we haven't performed very well. Most of you suffer in silence our mediocrity, which I hope will be temporary. Others complain, and they have the right to do so! Holders of Sextant fund units, unite and protest! Here is the latest e-mail from one of our investors, dissatisfied but I hope still loyal:

Gender:M
Name:X
First name :Y
Comment: François Badelon, a former broker on the "best performing European managers" list in the magazine Funds No. 2 of September 2006
Comparison of SEXTANT PEA with investment funds of the same category:
/1° January Rank: 337/381
1 month: 395/396 last
3 months: 392/394 last
6 months: 384/388 last
1 year: 326/361 virtually last.
As for Sextant Grand Large, it's worse.
It's becoming a joke (and that's an understatement)
Has F. Badelon left with the money for the Bahamas?
Above all don't answer me by speaking of the past; that would be cynical.

I sincerely thank this co-investor who gave me permission to publish his letter. Here is an open reply:

Let us consider a very high-performing manager, that we shall call Mr Charlie M. By definition, Mr M does much better than the index (because he is very high-performing). In other words, his performance deviates sharply from the index.
Now take a mediocre manager, that we shall call Mr François B. Mr B, by definition, does much less well than the index (because he is mediocre). In other words, his performance deviates sharply from the index.

So, by definition, Messrs M and B deviate from the index. Now, most funds are benchmarked, in other words their managers have explicit instructions not to deviate from the index. One could therefore imagine that Mr M is always first in the rankings and that Mr B is always last. In fact, this won't be at all the case, and it's fairly logical. Let's forget Mr B for a moment, leaving him in the agony of underperformance, and let's focus on Mister M.

Mr M is very high-performing. He beats the indices. If he beat the index each minute, he would very soon be the richest man in the world. He could borrow money and make it fructify at the speed of light, and he would become master of the universe. The game's really no fun, it's rather like cheating at Monopoly. So Mr M sometimes underperforms for a few moments.

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A few moments, but are these minutes, hours, days or even years? How long a period of underperformance are people prepared to tolerate from someone regarded as a very high-performing manager? How long, and how intense?

Let's unmask Mr M. He's not a very high-performing investor: he's one of the greatest and most respected of them, the immense and brilliant Charlie Munger, partner and friend of Warren, the man who gives away billions. Between 1962 and 1975, he managed an investment partnership which returned 500% to his clients, or five times more than the rise of the Dow Jones (100%). But here more precisely is Charlie's performance from 1972 to 1974:

	Munger	Dow Jones
1972	+8.3%	+18.2%
1973	-31.9%	-13.1%
1974	-31.5%	-23.1%

In two other years, 1965 and 1970, the partnership underperformed the Dow Jones by about 8%. Munger therefore underperformed the Dow Jones in 5 out of 14 years, and very steeply (by 11% on average). In reply to our dissatisfied co-investor, I would say to him that at the end of 1974 Charlie Munger was probably last in the rankings over **one month, three months, six months, one year, two years and three years**. Which didn't prevent him from becoming one of the richest men in the world.

Out of charity, we shall not unveil Mr B's name.

After "Loser Wins", another fundamental truth of portfolio management at last revealed[7]

Once more[7], I consider I deserve the Nobel Prize in Economics for the following fantastic discovery: The more high-performing a portfolio manager is, the more he will underperform his benchmark index, and the more chance he has of coming last in the Boursorama rankings (the reference to Boursorama may be irrelevant for the Swedish jury). Demonstration: Imagine that 99% of managers more or less track the index (the pros speak of tracking error, i.e. a manager has the right to deviate from the index by only a certain percentage), then the remaining 1% would systematically be first or last. QED[8].

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7 See our newsletters of June and September 2002*, "He who loses wins"* and "*The internet bandwagon"*

8 Read in Value Investor Insight, an interview with Joe Feshbach, head of Joe Feshbach Partners *"Chris Browne of Tweedy, Browne (note: one of the best value management companies in the world) has studied the long-term performance of seven of the greatest value investors in history and found that they underperformed the market between 28% and 40% of the time - sometimes with hair-raising declines in their assets - whereas they beat the indices hands down over the long term."*

My partners pointed out to me that others had already discussed this subject at length and that I had discovered nothing. I'm rather disappointed by their attitude. Perhaps there's not enough respect for senior management at Amiral Gestion. I believe that no-one has ever invented anything completely new. The stone is merely pushed a little bit further. I consider that I have formalised this truth better than others, and deserve academic or university recognition, or better still, a cash prize. If it comes to it, I'm prepared to share my prize with Chris Browne:

"Chris Browne of Tweedy, Browne (note: one of the best value management companies in the world) has studied the long-term performance of seven of the greatest value investors in history and found that they underperformed the market between 28% and 40% of the time - sometimes with hair-raising declines in their assets – whereas they beat the indices hands down over the long term."

See you soon and *Mille Mercis* for your trust.

Your devoted Manager

François Badelon

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