



Dear Investor Friends,

Your Sextant funds rebounded strongly in 2009, and on a relative performance basis we are looking well again. Sextant PEA, for example, has beaten the CAC40 over 1, 3 and 5 years, and of course since the fund's creation in January 2002. So it is now eight years since the little Sextant adventure began. On the time scale of the long-term investor, we have not yet celebrated our first anniversary. I think you need about ten years to draw the first conclusions and blow out a first candle. Following the terrible year of 2008, we could simply say that we are not dead, which in itself is not too bad. We could also say that we have beaten the leading stockmarket indices seven years out of eight, and that our first fund has been multiplied by three when the CAC 40 has done less than zero. But there are also major problem areas. Our clients, the brave and patient holders of Sextant fund units, can enter and exit our funds each day. Therefore some entered at the peak two years ago and are still sitting on a loss of more than 30% of their stake. From a long-term perspective, it's not dramatic. But we're not here to make you lose money, and of course we shall work hard to get back on our feet.

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### Scientific economic outlook

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I have a childhood friend called Laurent Saloff-Coste. At school, he was very good at skiing and maths. He is now a Professor at Cornell University in the United States (there is no ski slope in Cornell, so he teaches maths). Although he was always far superior to everyone in gymnastics and nearly every discipline, he was very humble and never boasted. That is why I believed him without hesitancy when he spoke to me about his work last time I saw him, and told me that only about a dozen people in the world could really understand the results of his latest research. One or two Indians, a Chinese, a Russian, ..... To exchange ideas over a drink he is obliged to travel the world! Here is the introduction to his latest article, published in July 2009, it's very amusing and poetic:

We discussed problems posed by the quantitative study of time inhomogeneous Markov chains. The two main notions for our purpose are merging and stability. Merging (also called weak ergodicity) occurs when the chain asymptotically forgets where it started. It is a loss of memory property. Stability relates to the question of whether or not, despite temporal variations, there is a rough shape describing the long time behavior of the chain. For instance, we will discuss an example where the long time behavior is roughly described by a binomial, with temporal variations.<sup>1</sup>

Laurent explained to me that he did not really know what could be the use of his research, but that one day his work would be understood by a wider audience and that a physicist or another mathematician would find practical applications for it. And I'm sure that he's right.

The works of Professor Saloff-Coste will probably never have any spin-offs in the field that interests us, investment, and probably no spin-offs in any field before a very long time. The same thing could undoubtedly be said about most work by economists. The difference is that mathematicians have a poetic sense that makes them prepared to work in complete abstraction, whereas economists are convinced that they always work in what is tangible. They are mistaken, of course. Conclusion: the economic outlook for our country and our planet is hard to predict in the present state of science.

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<sup>1</sup> This study was also presented in Berlin before 300 people. But did they all really understand?



In other words, economics is a very complex subject, and most people (including yours truly) should not talk about it. Or at least they should avoid taking decisions based on thinking or opinions concerning this discipline. When I was a young broker, about twenty years ago, I was very embarrassed when I had to comment on economic indicators about which I understood nothing. For example, I had to speak about the Lombard rate, and explain why Carrefour lost 2% because this rate - which didn't even come from Italy - rose by a quarter of a percentage point. There was also the M1 money supply and the Fed. I thought I was the only one who didn't understand, until I read Peter Lynch, in his excellent book "One up on Wall Street":

*When I was in the army M-1 was a rifle and I understood it. Suddenly M-1 was this critical digit on which the entire future of Wall Street depended, and I couldn't tell you what it was...What better reason to sell stocks than that "the M-1 is rising" - even if you weren't sure what the M-1 was. Then suddenly we heard nothing further about the dreaded rise in the M-1 money supply, and our attention was diverted to the discount rate that the Fed charges member banks. How many people know what this is? You can count me out once again. How many people know what the Fed does? William Miller, once Fed chairman, said that 23 percent of the US population thought the Federal Reserve was an Indian reservation, 26 percent thought it was a wildlife preserve, and 51 percent thought it was a brand of whiskey...*

Since this book was written more than 15 years ago, if I have given up trying to distinguish between an assault rifle and a formless money supply, I have a slightly better understanding of the Fed. I now know that it prints (a lot of) bank notes.

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### **Economic Outlook for the Sextant Investor**

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The best attitude for the investor is to foresee the worst. Knowing that the worst is not the end of the world. And yet the end of the world exists (communism for example), but if you see it coming you buy diamonds and flee somewhere or other. It so happens that at present it is not very hard to write a very gloomy scenario for Europe and the United States.

One of the only things that is foreseeable over the next 20 years is the demographic structure of our planet. We don't know how many children will be born in 2010 (in any case already two since the start of the year at Amiral Gestion, Raphaël Komilikis and Paul Badelon!), but we already know precisely the number of French citizens who will be aged 30, 50 or 65 in 2020 or 2030. Without going into detail, it can be said that we have gone from a very favourable situation in the 1990s and 2000s to a very unfavourable trend for the next twenty years. Few retirees (the children of the 1930s and 1940s) but a lot of experienced workers and big consumers (the baby boomers from 1946 to 1965) until 2010. A growing number of retirees and fewer and fewer worker-consumers from 2010 on. You work better and spend more at age 45 than at age 25 or 70. A pity for the economic growth of Spain, Italy, Austria, Germany and Japan. But also for France and the United States. Add to this the fact that on the whole these countries are already heavily indebted, and it is hard to see how they will be able to meet their commitments to their creditors and their ageing populations. They will have to pay more interest on their debt, and spend more on pensions and healthcare. All this with fewer contributors and fewer taxpayers. It may seem rather scary.

Each day, our life expectancy increases by five hours. It's basically good news to accompany little Paul and Raphaël a long way in life. But in the end, everything tends to change for the worse, doesn't



it? Until the 1960s, Americans ended their days in their homes at the age of about 70. At present, in the United States, people no longer die at home, but after spending on average 80 days in hospital in the last year of their lives, around age 78. After the age of 90, I promise you to start doing free-fall parachuting and bare-handed shark hunting again to improve the statistics, but that will not be sufficient to plug the hole in the social security system.

What must be clearly understood is the amazing demographic event that took place in Europe and the United States from 1945 on until the 1960s. The birth rate suddenly increased by more than 40% in one year, and continued at the same pace for more than 20 years. In the 1990s, the result was a dramatic increase in the 45-55 age group, i.e. in the number of experienced workers and good consumers. This category will now decrease year after year, while the number of retirements is currently exploding, and the age pyramid is increasingly widening at the top. In Spain, people aged 70 outnumber one-year-old babies! Who could say that this will not have negative consequences for economic growth in the next 15 years?

In 1994, I read an incredible book, recommended on the outside back cover by Michel Rocard himself: "*The Great Boom Ahead*", by a certain Harry Dent. This book, written in 1992, in the midst of an economic recession, explained that from 1994 on, and until 2007, the economy would experience a fantastic upturn, the Dow Jones would reach 10000 points (a wild prediction at that time), the US budget deficit would become a surplus again, productivity gains would be persistently better than expected, and inflation would fall sharply. He also predicted that the stock exchange would collapse in 2008.... This book made a big impression on me, because for the first time in my life I felt that I understood the economy. Everything became simple: the more consumers there are, the more consumption there is; the more experienced workers there are, the more productivity gains there are. The fewer pensioners there are, the easier it is to manipulate pension systems, and the more pensioners there are, the more these systems will become bankrupt. It was very perspicacious, but since there was no mathematical formula in the book and because Harry Dent profited from his success to sell rather harebrained short-term forecasts, he did not get the Nobel Prize. And yet I know nobody who had such a precise and accurate view of the future, with such simple reasoning. But what conclusions can be drawn from all this for our Sextant investments?

In 1994, I drew only one conclusion from this book and the 1945 baby boom. People become longsighted at age 45 on average. First-time buyers of expensive glasses generating high margins for the distributors and glass manufacturers would suddenly increase by 40%. So I went down from my office to visit the opticians on the Champs-Élysées. I saw shops that were dull and old-fashioned. And then I came across Grand Optical, which by good fortune (call it serendipity, if you like), made an initial public offering a few months later. A Buy, then. Thank you Mr Dent. In 2008, I drew no conclusion from his book and we all lost a lot of money. Today, I draw the following simple conclusion: just as economists were always surprised in the 1990s by the productivity gains and the robustness of growth in the United States, now they will often be disappointed by the sluggishness of western economies.

The Sextant investor will therefore be very cautious and not punt on a rebound in growth over the next few years (if it does occur, so much the better). He will be interested in companies that are very resilient to a general economic slowdown, and in regions with positive demographics, such as Brazil, China and India, for example. At the same time he will refuse to pay for overvalued assets. The Sextant investor is also prepared for market conditions that will be far less easy over the period 2010-2030 than over the period 1994-2007. Finally, as always, the Sextant investor recognizes that he doesn't really know what the future reserves for him insofar as regards the economic situation, and that it is best to be prepared at least for sluggishness.



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### **Gloomy on the economy, yet heavily invested in equities**

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The stock market does not reflect the state of our economy, but the players' expectations regarding the economic situation (the famous M-1 of Peter Lynch) and corporate earnings. So nothing is simple. As the stock market has already collapsed, it could rise without an economic recovery in 2010. Or else the opposite. In this widespread confusion, the best thing is to focus on what we have most chance of understanding: companies. That is why we can be rather gloomy about the economy (but are there really any optimists?) and yet heavily invested in equities.

#### **Boiron and Pharmagest, health at a low price**

Crisis or not, you will get healthcare treatment in 2010. And then in 2011, you will be one year older and your consumption of medicines will increase. Gradually, your pharmacy will become your favourite shop. For my part, it's already been the case, for a long time now. I hate doing shopping, but I love pharmacies, my only hope of a younger skin, plentiful hair, and a fresh breath when I wake up. I don't know why, but I find that my anti-aging pills work better if I buy them at a higher price from a health specialist wearing a white coat rather than from the checkout operators (although they're very pleasant) at a Monoprix supermarket. I should also add that, crisis or not, in 2010, in 2011 and each year until the fatal shark hunt I shall buy a tube of Homeoplasmine. A fantastic product to put in every nostril to counter the adverse effects of air conditioning, too cold or too dry. That is why we greatly admire the companies Boiron and Pharmagest.

Boiron is the world leader in homeopathy. This form of medicine has existed since the start of the 19th century and its development has been constantly accelerating for many years now in countries such as the United States and Brazil.

Pharmagest is the French leader in IT equipment for our favourite dispensaries. It allows pharmacies to manage their stocks, communicate via Internet with the social security organizations and your mutual insurance company, and provides them with heaps of other very useful services.

These two companies are full of cash and development plans. Their earnings grew in 2008 and 2009. The valuation ratios are moderate. And we have admired their managers for almost ten years now. We were shareholders of these two companies in the past, and we took advantage of very interesting entry points in 2009 to reinvest in the shares.

#### **Google, the best of the Net**

Google has changed our lives, and allows millions of entrepreneurs to make themselves known every day. On Google, there is the most efficient and hence the most useful advertising we know. This share is very volatile, and we regularly buy more in market dips. The valuation ratios are high but reasonable for one of the finest companies in the world.

Hongguo: In China, there are a lot of feet to provide shoes for! We have counted about 2,667,225,936. Hongguo is the third largest manufacturer of women's shoes. When we began to take an interest in it last June the company had a PE of 5X current earnings and its stocks of shoes covered two-thirds of its market capitalization. The future is bound to be bright. Management thinks so too, and recently proposed delisting its company from the Singapore stock market. We would gladly have accompanied them longer.

Other investment ideas



Generally, our companies are financially sound, often with a lot of cash at the bank. Sucrière de Pithiviers, for instance. 85% of its market capitalization is covered by its cash position. The market is not interested in this company because of the low liquidity of its shares. And yet, in the past year the company's net profit doubled, and 2010 should be even better due to an exceptional French harvest combined with record international sugar prices. Alongside us is one of the best value investors in the world and, like him, we are prepared to be very patient, while receiving comfortable dividends each year.

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### News of Peak Oil

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Last November, the IEA radically changed position. Representing the interests of the OECD countries, i.e. the buyers, the International Energy Agency had always refused to seriously consider the Peak Oil hypothesis. It has now done so, since its chief economist, Fatih Birol, has put the date at 2020. In an interview given to The Guardian, that you can view on Internet thanks to Google, Mr Birol explains that the IEA is now far more cautious regarding global oil resources. The overall depletion rate, formerly estimated at 3.7%, was raised to 6.7% in the latest World Energy Report. The violence of the phenomenon is impressive. In plain English, depletion means that the oil fields currently in operation experience a drop in production each year, namely by 6.7%. Since global production is about 80 million barrels per day, this means that, in order to maintain the same level, the industry must bring into production each year new fields producing the trifling amount of 5.5 million barrels per day, i.e. 80% of US production, or again half the production capacity of Saudi Arabia. Quite a challenge! And it's not a foregone conclusion, especially if the oil price falls. To embark on huge investment programmes, with oil increasingly complicated to extract, the companies need good visibility on prices. It is rather unpleasant to embark on a project that is profitable at \$60 per barrel if the price is only \$70. The margin of safety is rather small.

As we have seen in the past two years, anything can happen in the oil market. Including a sharp rise in prices, which could prove to be the only way to adjust supply and demand in the event of a shortfall in production capacity.

At the current price level, in any case, there are still a large number of very interesting oil companies. We are also looking at the renewable energies sector and, after a brief incursion last year, we pulled out again frightened by very high valuation ratios and technological challenges that we do not always understand very well. We continue to work on this sector.

We think that it is still very worthwhile to have a few Sextant Peak Oil units in a portfolio for the long term. Because there are good companies in this sector that will earn a very good living with an oil price of between \$60 and \$90 per barrel. But also because a price above \$100 again is perfectly conceivable.

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### News of the Crew

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Two babies since the start of the year, and a new recruit, Victor Benavides, a young Chilean who will help us look for good ideas in South America. We shall continue to invest in our management team, the earth is vast.

See you soon

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