INDIVIDUAL PORTFOLIO MANAGEMENT SINCE 1979

August 15, 2018

Dear Valued Client,

We spent a lot of time thinking about pharmacies when we were analyzing McKesson and other drug distributors. We have struggled with a question: How will the retail pharmaceutical industry look in the future? Or more precisely, how will Amazon's eventual entrance into retail pharmacy change the landscape of this industry?

Our inability to answer this question kept us away from retail pharmacies. And then we had a small but an important insight that shifted our thinking on Walgreens (WBA): The preponderance of drugs in the US is consumed by the older population, whose habits change very slowly or 'not at all. Thus if – actually more like when – Amazon opens an online pharmacy, the impact on the existing drug industry will not be significant.

Americans spend $450 billion a year on drugs. Walmart is the fourth largest pharmacy in the US with sales of $21 billion, or 4.6% of total sales. Let's say that over the next five years Amazon gets to Walmart's sales level of $21 billion. If the US pharmaceutical industry grows 2% a year over that time, total drug sales will have increased by $45 billion, or two Walmarts (we are ignoring compounding here), to $495 billion; and companies like Walgreens, with its pharmacy selling about $70 billion, will barely notice Amazon's presence.

Today everyone is paranoid about Amazon. This sort of paranoia is healthy for the long-term wellbeing of our portfolio, as it is creating interesting buying opportunities. We've made this point in the past, but it is important to repeat: Ten years ago Amazon was not taken too seriously. Giants like Google and Microsoft ignored its entry into cloud hosting, thinking "What does a bookseller know about the cloud?" – and they have regretted it ever since. But today everyone is taking Amazon too seriously, bestowing on Jeff Bezos walk-on-water-like superpowers. Boardrooms today are filled to overflowing with chatter about Amazon. There is a lot we and the rest of the corporate world can learn from Jeff Bezos (for instance, about ignoring short-term profitability), but he is not superhuman and Amazon cannot bend the laws of economic gravity.

Walgreens' US business, which is about 75% of its total sales, is awesome. A single standalone store produces revenues of about $10 million a year, $7 million in the pharmacy and

$3 million in front-end sales (milk, candy bars, T-shirts etc.) A single store fills about 121,000 scripts a year (up from 97,000 four years ago). Walgreens has one of the highest sales per square foot numbers in the retail industry, at around $1,000 per square foot (compared to Walmart's $450, Kroger's $550, and Target's $300). (We'd like to note that Tesco's UK stores have sales per square foot of $1,100 – this is why we like that UK grocery business more than ones in the US).

Walgreens has an underutilized asset: the front end of the store. Think about it: The pharmacy takes up 20% of the floor space but generates 70% of revenue. In other words 80% of the store (the front end) brings in only 30% of revenue. Walgreens is experimenting with different ways to optimize its underutilized asset – it's opening medical clinics and bringing LabCorp into its stores, for instance.

In 2018 Walgreens bought 1,900 stores from Rite Aid, bringing its total US store count up to around 10,000. We think its store-count growth days are behind Walgreens. However, the scripts per store growth will continue, since Baby Boomers are not getting any younger; thus total sales growth will continue at a level of at least 2-3% a year. When retailers mature and cannot open new stores, their free cash flows explode. Which brings the question, what will the company do with its cash flows?

Walgreens is taking a very different approach than its largest counterpart, CVS. CVS already owns one of the largest pharmacy benefit management (PBM) companies (a business that has a lot of political risk, as it's ridden with conflicts of interest), and it is doubling down on complexity and buying Aetna, a health insurance company. CVS is trying to become an integrated healthcare provider. We don't know if CVS will be successful in this endeavor, but the historical odds of success with acquisitions of this complexity clearly do not favor CVS.

Walgreens is run by Stefano Pessina, who owns 13% of the company; and thus 13 cents of each dollar spent is his. Walgreens has therefore been deleveraging its business, buying back stock, and paying a dividend. Walgreens is expected to earn $6 a share in 2018. We estimate that its earnings, helped by the Rite Aid acquisition, same-store sales growth, and share buybacks (WBA bought 8% of its shares in 2018 and has an authorization to buy another 13%), will exceed $8 in 2021. If the stock is trading at 13x earnings in three years, then the upside is about 70%; if it trades at 15 then it's a double (FYI, Walmart is trading today at 18x, and Target is at 15x 2018 earnings). We bought WBA at a little over 10x 2018 earnings. We think Walgreens is a better business than Target and at least as good a business as Walmart. At this WBA valuation, heads we win, tails we win – the only question is how much.

Walgreens is yet another healthcare-related company in our portfolio, which already has a lot of healthcare exposure. This is by design.

We don't trust the fundamentals of the global economy – that's not new news to you. We look around us and see debt growing globally and governments running huge deficits while interest rates are still at incredibly low levels.

We also don't like stock market valuations: Looking at almost any metric, stock markets were only more expensive once in the last hundred years – just before the dotcom bubble burst. And then there is another risk that we put into a category of its own: China.

Bloomberg had a very good piece on the extent of the Chinese real estate bubble, and this is a paragraph that jumped out at us:

From June 2015 through the end of last year, the 100 City Price Index, published by SouFun Holdings Ltd., rose 31 percent to nearly $202 per square foot. That's 38 percent higher than the median price per square foot in the U.S., where per-capita income is more than 700 percent higher than in China.

This story gets more interesting. Most of these apartments are sitting empty because they are purchased as investments. Rental yields in China are 1.5%, while the cost of borrowing (mortgage cost) is around 5-6%. Chinese consumer debt-to-GDP is much greater than it was in the US during the financial crisis.

Since household real estate lending is 22% of Chinese banks' assets, if you are the almighty Chinese government, you have a decision to make: Do you let real estate prices normalize (decline) and then suddenly discover that your financial institutions are bankrupt, or do you allow (and actually support) the inflation of housing prices? Predictably, as Bloomberg writes,

China is simply ramping up development. New starts and land purchases have grown strongly through the first five months of 2018. Investment in residential real estate is up 14 percent and development loans are up 21 percent. Far from reducing leverage, banks are jumping back into the speculative bubble: Mortgage growth is now at 20 percent.

In one of my all-time favorite books, *Margin of Safety*, by investing legend Seth Klarman, he writes:

> There is the old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller said, "You don't understand. These are not eating sardines, they are trading sardines.

In a normal economy an apartment is a place to live in. When it becomes an unoccupied asset whose sole purpose to be used as a investment or speculative vehicle (okay, and temporarily keep people employed while it's being built), it turns into a trading sardine. Its price will rise until… nobody knows when; but at some point someone will metaphorically open that trading can and Chinese real estate prices will collapse, bringing the banking system and the whole economy down with them. Simply put, things that cannot go on forever don't – it just feels like they'll go on forever while you're waiting for them to stop.

We are going to sound like a broken record – this is what prolonged market euphoria does to our voice – but we look at today's environment as a game of musical chairs. Investors are up and marching along because the music is playing, and they're hoping they'll be able to grab a chair when the music stops (few will do so). We on the other hand assume that we are stone deaf and have no idea when the music will stop, and so we invest as if the music might stop any second.

Over the last ten years it did not pay to be cautious. Low interest rates drove prices of almost all assets higher. Pricier assets made people feel wealthier and thus magically created economic growth… not great growth but growth nevertheless. Low interest rates also pushed people into riskier assets, thus creating a mismatch between the assets people hold and their true risk affordability and appetite.

But so far this hasn't mattered – the more risk you took, the more money you made. It will matter when the risk truly rears its ugly head, because investor reaction to it will be more irrational than usual – this is why we hedged our portfolios through put options.

The problem with an economy that has been propped up by artificially appreciated assets is that this pendulum swings both ways. At some point assets will decline – hard to believe, but these things do happen. We don't know what will cause the decline – maybe higher interest rates, maybe a tweet by you know who, maybe the implosion of the Chinese economy, or maybe just because trees don't grow to the skies, nor do stock markets (or real estate). Or it could be triggered by something we completely fail to see today.

However it happens, as asset prices decline they'll cause the economic decline or will be an accelerator of ongoing decline. Since interest rates are low and global economies are as leveraged as they've been in recent memory, central banks and governments will not have as much power to help. Today, our global economic system is built on quicksand.

And that is why you see a lot of healthcare in your portfolios. These companies have great balance sheets; their business, though it occasionally paints newspaper headlines, is not cyclical (the demand for its products doesn't fluctuate with the whims of the global economy); and there is still a huge tailwind behind their backs in the form of the aging global population. Oh, and we can buy these stocks at very attractive valuations.

Sale of Virgin Money. When we bought Virgin Money we hoped to own it for decades. In addition to its attractive valuation, it had a huge growth runway, a unique brand, and awesome management. Unfortunately, Virgin Money is being bought by another bank, and the management of the new bank will continue to run the combined entity.

Management is very important with all the companies we own, but it is paramount for financial institutions, which deal with a much greater time disconnect between decisions made and their consequences. As they lend money they at first show profits, almost no matter how good or bad their lending decisions are – the losses show up years later. The change in management at Virgin Money was such a significant departure from our purchase thesis that we felt compelled to sell the stock. We made a very good return on Virgin Money over a very short period.

We sold all short-term bond ETFs and bought US Treasury bills instead, and bought US Treasury bills where we held above a small percentage of cash. The core motive for this decision was not to pick up a few basis points of extra yield, though that's a nice bonus. We made the decision because we were concerned about the very-low-probability but still possible risk mismatch in liquidity between the ETF and the securities it holds, in the event of a (not-low-probability) panic sell-off in the market.

Let us explain this move by first defining a term that lies at the core of the problem: liquidity. Liquidity is measured on two dimensions, time and price – it is the degree to which an asset can be bought or sold without impacting its price. For instance, a house is not a very liquid asset. If you want to sell it fast you might have to lower the price significantly to find buyers. On the other hand, stocks of large companies (think Proctor & Gamble or Johnson & Johnson) and US Treasury bills are incredibly liquid.

However, this definition of liquidity is not complete. Liquidity of an asset may or may not be constant – it can change from one environment to another. Today, in a benign economic and market environment, many assets provide a false sense of liquidity. But this may change on a dime when this artificially created calm environment gets roiled.

Short-term corporate bonds are fairly liquid assets, but they may prove to be less liquid than the ETFs that buy them. During a market scare, if investors were to sell ETFs at several times daily volume, the ETFs in turn would be forced to go out and sell bonds they hold. Supply might temporarily exceed demand, and thus the prices of bonds would drop. This would cause (a) price of ETFs to decline – creating losses for exiting (selling) ETF holders (b) permanent losses for remaining ETF holders, or (c) both a and b. Something similar happened during the financial crisis to action rate securities – they were very liquid until they were not. It took investors years to get their money back.

We don't know if a, b, c, or none of the above will happen. But we used high-quality bond ETFs as a cash substitute and thus relied on their continuous liquidity, which might or might not have been there when we needed it most. And finally, since our cash position is very high today, we cannot afford to put it at risk of even low-probability events. Treasury bills are the safest securities in existence today, and they are yielding 2%, so we gain safety and increase yield at the same time.

As a side note, since we are on the topic of ETFs, today's investors look at ETFs as a panacea and a way to get around active management. They feel secure holding them because they feel diversified. But as investors who owned VIX ETFs recently discovered when they declined 80% in a few days and never came back, not all ETFs are created equal. Investors in all those "diversified" index funds (be it ETFs or just plain-vanilla funds) may discover that when you own a diversified basket of assets that are uniformly overvalued, as today's market is, the diversification is not actually there to protect them.

Junk bonds were all the rave in 1980s, and then they became a dirty word. Technology and dotcom were all the rage in the late 90s, and you know how that story played out. ETFs are likely going down that road as well – as Seneca put it, "Time will discover the truth."

Soul in the Game

From Vitaliy:

We (both Mike and Vitaliy) have been reading *Skin in the Game* by one of our favorite authors, Nassim Taleb. The point of the book can be summed up in one sentence: You want to associate with people who will share not only upsides with you but also downsides. When someone is getting paid to sell you a product but captures no downside in the transaction (this describes the bulk of Wall Street transactions), that person doesn't have skin in the game, and his/her advice may or may not be in your best interest.

We have designed IMA so that we have skin in the game. Our business grows and shrinks with our clients' success. But our skin in the game doesn't stop there. We feel that if a stock is good for our clients it should be good for us (including our significant others and our kids). Thus we and our families are clients of IMA, just like you, and our wealth goes up and down in tandem with yours.

However, in reading *Skin in the Game* we have discovered that we can intimately relate to the concept Taleb calls "soul in the game." He calls people like us "artisans."

Artisans, says Taleb, do things for existential reasons first and for financial and commercial ones later. Their decision making is never fully financial, but it remains financial.

Warren Buffett says that he tap-dances to work. He goes to work not because he cannot wait to earn another billion – he is giving the bulk of his money away; he works because he loves investing. We can relate to this sentiment, investing is an incredible intellectual riddle that we have the privilege of attempting to solve every day. It is a never-ending journey of self-improvement. Neither Mike nor I have Buffett's wealth, nor do we aspire to have it; but we feel exactly the same way about tap-dancing to work (though at times I ride a bike or drive a car to work).

I dated a lot of majors when I was I was getting my undergraduate degree, but when I went on my first date with investing it was love at first sight. At first unintentionally and later intentionally, I sculpted the perfect job.

If I won a $100 million lottery, my daily life wouldn't change a bit – I'd just have to work harder to make sure my kids didn't get spoiled. I cannot see myself doing anything else with my life.

Thinking about investing and portfolios doesn't just start when I come to work and stop when I go home. It always follows me around. It's a bit unhealthy, and there's always a tug of war between work life and family, but I still wouldn't change a thing.

We are not trying to build the largest financial firm; we are trying to build the best one, a firm we'd want to be the clients of (since we already are). We'll stop growing the firm (accepting new clients) if and when we feel growth is becoming detrimental to this goal and thus to our existing clients.

Artisans also incorporate some type of "art" in their profession; they stay away from most aspects of industrialization; they combine art and business.

Investing is located at a quaint intersection of art and science. We strive to be both process-driven, disciplined investors and creative at the same time. My first two books focused on the investment process, the "sciency" part of investing. My next book centers on the importance of creativity, the "artsy" part of investing, which will become even more important in the future, as we'll be competing against computers, not ETFs (not to insult them, but most ETFs have the IQ of a potato).

Artisans put some soul into their work: They won't sell something defective or even of questionable quality, because that would hurt their most deeply felt values.

Mike and I built IMA not for altruistic reasons. We wanted a business that would provide for our families while we did not have to do any heavy lifting, we wanted to be comfortable in an air-conditioned office with lots of coffee. But importantly, we wanted to wake up in the morning, look in the mirror, and feel good about ourselves.

We are acutely aware that many other professions, like nursing and firefighting, are more noble than investing other people's money. But we are given an incredible responsibility to invest our clients' life savings so they can afford to pay for their kids' education and weddings and their own retirements. We don't save lives, but what we do has an enormous impact on our clients' lives. Therefore our approach to investing doesn't follow the traditional Wall Street (institutional) playbook, which brings us to Taleb's last point.

Finally, artisans have sacred taboos, things they will not do, even if they markedly increase profitability.

Over the years, with the advent of computers and consultants, an elegant but flawed theoretical framework, Modern Portfolio Theory, scientized and institutionalized investing. Large pension funds and foundations employ an army of consultants that slice and dice manager performance data (this where computers become very handy). Inflows and outflows in a manager's fund are completely driven by his short-term performance, how he compares against his peers and benchmarks. This is not an abstract concept to a money manager, because his bonuses and employment itself are tied to the success of the assets he manages. He – it's usually he – has a wife, kids, and bills to pay. These incentives are very powerful and turn institutional investing into the Wall Street version of the Hunger Games, where winning and staying in the game is often more important than what is right for the client.

The concept of long-term doesn't exist in this game: If you're fired in the short term, who cares about the long term. Managers start emulating benchmarks – if you stray far from the benchmark "You are not doing what you were hired to do." If you're a large-cap growth manager, God forbid you find a stock that a consultant categorizes as value. What your peers own becomes more important in your buying and selling decision making than what will generate attractive long-term risk-adjusted returns (risk in this case being not volatility but permanent loss of capital).

There is a welcome unintended consequence to managing separate accounts: We actually get to meet or at least talk on the phone to every client. When a client turns their life savings over to you and you know your decisions will have direct consequences for their life, playing Hunger Games never even enters into the equation.

This is why our portfolio has a lot of cash. When the market is incredibly expensive and the foundation of the global economy is very shaky, the number of stocks that will provide good risk-adjusted returns declines. If we were playing Hunger Games we'd be buying stocks that we hated the least. The risk/reward of a particular company might not be attractive, but we could justify it by saying that out of the universe of bad investments this one is less bad. We don't do this.

There's an old saying: Companies get the shareholders they deserve. It's true of investment firms as well: We get the investors we deserve. We are lucky to have attracted clients who share our values. Our growth as a firm may have been slower than some on Wall Street, but growth for the sake of growth has never been our priority.

From Mike:

Many years ago I interviewed a young Russian immigrant who wanted a job as a securities analyst. He had no credentials, no experience. He was obviously very intelligent, but it was his passion to learn that convinced me. I challenged him to finish his education and complete the CFA program.

He became not only the best analyst I have known but also a portfolio manager who understands the responsibility that comes with people entrusting us with much of their financial future. Vitaliy's concept of "soul in the game" is a vital part of that responsibility, and I would like to think I helped him get there.

Best regards, and please call if you have any questions.

Enjoy and Prosper,

Vitaliy N. Katsenelson, CFA
Chief Executive Officer

And

Michael L. Conn, CFA
Chairman