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"Most people overestimate what they can do in one year
and underestimate what they can do in ten years"
– Bill Gates

Dear partners and readers,

Our return on capital in 2015 was 35.1%. Currency effects had a positive impact on our returns by roughly 0.5%. Our total assets which are comprised of cash and investments were at yearend worth [xxx] SEK.

Despite a challenging year in the financial markets we managed a great year. OMXS30 returned 2.5% including dividends and the S&P 500 returned 1.4% including dividends. Excluding dividends both indices had negative returns in 2015.

Below are the pre-tax returns since the start of the partnership on Jan 1, 2013. To make the returns a definite "apples to apples" comparison, re-invested dividends are included in the partnership and in the OMXS30 returns.

	Zen Capital Partnership	**Limited Partners** [1]	**OMXS30** [2]	**Difference**	**100 000 SEK** [3]
2013	41.0%	30.8%	25.4%	5.4%	130 800 SEK
2014	45.0%	33.8%	13.6%	20.2%	175 010 SEK
2015	35.1%	26.3%	2.5%	23.8%	221 038 SEK
Overall Gain	176.2%	121.0%	46.0%	75%	121 038 SEK
Compounded Annual Gain	40.3%	30.3%	13.4%	16.9%	

[1] Limited Partners returns are after all fees.
[2] As Avanza Bank now offers Avanza Zero – a fund that mimics OMXS30 returns including dividends and amazingly charges zero fees – the OMXS30 column shows returns after all fees as well.
[3] 100 000 SEK invested in the partnership on Jan 1, 2013.

Compounding

The miracles of compounding are starting to show for us. A hundred thousand invested when the partnership started on Jan 1, 2013 was at yearend worth 221,000 and our accumulated profits since inception have now surpassed [xxx] million. Furthermore, when we started the partnership three years ago a 25% gain amounted to [xxx] while in 2016 a 25% gain would amount to almost [xxx] million. On the flip side is the Toyota Avensis that I and Larisa bought at the end of 2011 for just over 100,000. The implicit cost of that car for us is now in the neighborhood of 275,000 while the value of it most assuredly is not. But yes, we still love it. Of course, additional deposits since we started has played its part and it's important to understand that continuous saving is a vital part in fully partaking in the miracles of compounding and making this snowball of ours bigger over time.

Two years ago and last year I wrote that I believe our advantage versus the OMXS30 index will in general be small in years where it performs very well and greater in years were it does not perform as well. Of course, there will also be years in which we won't outperform the index and years in which our returns will be negative. This year we finally got a first test of whether there was any merit to my expectations. We managed this first tougher year very well with our relative margin versus the index being our largest so far – and I believe managing tough years well is the key to great long-term performance – but I prefer to say 'one down, many more to go' before we draw any conclusions.

While good relative results are definitely nice to report, what I evaluate myself on is not the margin by which we outperform or underperform benchmarks and other money managers – but our absolute returns and the improvement in process and thinking as a business owner compared to where we were one and two years ago. In short time periods good returns should not be taken as proof of a good process. Likewise, a good process should not be counted on to produce good returns every year. Over time, however, it should.

In any area in life when you have a year in which you feel a lot of progress has been made, you also realize how little you knew in previous years. The year I have generated the highest returns so far is 2010 which was accidentally also my first year as an investor. Needless to say, I was a terrible investor then with almost no clue what I was doing. Of course, just like the 18-year old that has just gotten his driver's license, I had no clue I had no clue. In five years, looking back on today, will I say the same thing? Well, what can I say, I hope I do.

Our goals

Howard Marks, which I have discussed in previous letters, wrote a great book in 2011 that I highly recommend. It's called The Most Important Thing. It has 19 chapters and every chapter starts with 'The Most Important Thing is .. '. In 2013, he revised the book and added one more chapter: 'The Most Important Thing is Reasonable Expectations'.

In each of the first three years we have met and exceeded our goals by a wide margin so I want to take the opportunity to remind you of the importance to maintain reasonable expectations regarding our future returns. Remember, our secondary goal – with the first of course being not to lose money – is to earn 15% (pre-tax in SEK) on our capital *on average* per year, not to earn 15% or more *every* year. If you don't find this attractive, the partnership is not for you.

While it would be nice to have very smooth and predictable returns, this is just not how the investing and business world works. Such returns over time are possible only if they are made up. We will leave such tasks to Bernard Madoff, the man behind the largest known Ponzi scheme in the world. Madoff is said to have reported almost exactly 10% returns to his investors every year, even in years when the market crashed, before in his 2009 trial he admitted that he had not bought or sold a single security in the past 20 years.

While I want you to have reasonable expectations, I also want you to be critical if you start hearing me trying to explain away why our goals were not reached year after year. I don't ever want to be the person that throws a handful of darts and when most of them miss, highlights only the few that actually did hit something and explains the others away with some mumbling about current uncertainties in China or some other macro conditions. Our goals are firm and if they were to change, I will let you know before anything else.

Our strategy

Most of you know that our investment strategy is value based as opposed to speculation based. I want to point out that we view growth as a very important component in the value equation and do not at all equate growth investing with speculation. So how is value investing different from speculation?

Speculators buy assets based on what they believe others will pay for those assets in the future, usually in the very near future, without much regard to the value of those assets. Thus, speculators have to rely on luck, or other speculators and uninformed investors in order to make a profit.

Value investors buy assets based on what they believe the assets are worth, usually without a target holding period. Thus, they depend on their estimate of value being roughly correct and that the companies they invest in will perform well or at least as well as they have predicted.

The reason for our choice of strategy is simple: why would anyone ever want to invest in assets where the price paid is higher than the value? And conversely, who would not want to invest in assets where the price paid is lower than the value?

The value of a company

So that all sounds nice, but how then do we go about valuing a company?
The value of a company is the present value of all future cash flows that can be taken out of it from today until the day the company ceases to exist. Depending on interest rates the present value, i.e. the value today of the cash that we as owners will receive in the future, will be different. Future cash flows have a higher present value if interest rates are low and a lower present value if interest rates are high.

To understand why, consider the following: if interest rates were fixed at 0% until the end of time, any future cash flows would have a present value equal to the amount we would receive at any future date. This is because you are not able to earn any risk-free (or at least as close to risk-free as you can get) interest income by investing the cash you have today. When interest rates are above 0%, however, you can invest the cash you have and earn risk-free income on it so in this case it should be clear that x today is worth more than x that we will receive in the future.

As the value of a business is the present value of all *future* cash flows, it follows that what a company has done historically does not determine its value and should only be considered as a clue (albeit often a very valuable clue) as to what might happen in the future. Many market participants tend to overweigh what has happened in the recent past and forget that it is the future that determines the value of a company. Furthermore, what you paid for a company's shares two years ago has absolutely nothing to do with what those shares are worth today.

Surely, an honest, customer-oriented and shareholder-friendly management is likely to stay a good management in the future and a management that has been trying to hide problems and made moves to enrich themselves before customers and shareholders are likely to stay a bad management. But if you would have used historic factors only when trying to determine the value of for example Kodak and Blockbuster or Google and Amazon in the 1990s, your estimates would have been way off. What would have helped you was if you would have made a roughly correct estimate of the future cash flows that those businesses were going to produce. Admittedly, this would not have been very easy.

But let's say we have a good estimate of the future annual cash flows; how do we value them, i.e. what multiple do we assign them?
The short answer is the number of years for which we believe these cash flows can be sustained. If we could somehow know for certain that a company, let's call it Certain AB, would earn one million and pay it all out to its owners every year for 20 years before together with all of its assets and liabilities going up in smoke on Jan 1 on the 21st year, the efficient price for that business today would be 20 million (assuming 0% interest rates).
Thus if the total enterprise value of Certain AB, i.e. the market value of Certain AB plus its debt minus its cash and investments, is below 20 million it would be a good time to buy its shares. And consequently, if it is above 20 million it would be wise to stay away.

Of course, Certain AB does not and will never exist; future cash flows are unknown and vary a lot from year to year. But as is clear from the above, a very important factor to assess is whether the business and its cash flows are sustainable over time. If they are, the value of the company is higher than if they are not. A good rule of thumb is this: the more certain you are about the *sustainability* or *improvement* of a company's cash flows, the higher the multiple on those cash flows should you use in order to estimate the company's intrinsic value.

Our estimate of value

So, how can we possibly estimate what the cash flows of a company will be in 20 or even 10 years? This is very hard, if not impossible to do, at least within any reasonably small range for it to be very useful. Li Lu, the founder of Himalaya Capital that has Charlie Munger as one of its investors and is known for his very meticulous investing approach says: *"If you are good, and spend your entire lifetime studying, across a 50 year career, there will be maybe 5-10 opportunities where you can confidently project the next 10-20 years."*

So what we instead try to do is to estimate what we believe a company will earn on a normalized basis, i.e. what we believe that its earnings will be on average (and in a worst case) over time. In a full business cycle, most businesses will have a couple of bad years, a couple of good years and a couple of average years. A good business will have a higher percentage of good years and vice versa. As bad years are almost certain to come around for any company, we want to be sure that our companies will survive in those bad years as well.

To project future earnings we always consider the industry in which our company is operating. Our focus, however, is on the specific company. We don't try to estimate every year by itself, decide on an appropriate discount rate and then discount all those cash flows back to today to get the present value. Instead, we look into the future in more broad terms. For example, we might have estimated that in two years the company we are looking at will have revenues of at least 500 million based on its number of customers or the number of units we believe it will sell. We then make an estimate of what the profit margins might be under such a scenario based on other similar products and companies or in some cases based on the company at hand. This will give us an estimate of what the earnings might then look like.

Of course, no earnings prediction will ever turn out exactly as predicted. If it does, it will be more luck than anything else. So we never have an exact target price or holding period for any investment. We do however always have a target price range. This price range usually changes over time and sometimes substantially so. This is one of the things that make investing so challenging and fascinating and at the same time much more difficult.

Due to the rapidly and ever-changing world that we live in, we will always stay humble and open-minded about changing our view if new facts come to light that change the fundamental outlook – and thus the value – for the companies that we are part-owners in.
We are very aware of two cognitive biases: 1) Confirmation bias, which is the tendency to search for and interpret information in a way that confirms one's beliefs or hypotheses, while giving disproportionately less consideration to alternative possibilities, and 2) Consistency and commitment bias, which is the tendency to be consistent with what you said in the past and to stay with old conclusions even though there is clear evidence they are wrong.
As Mark Twain warned: *"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."*

In summary, we look to invest in:

1. Companies where we believe that we have a good protection on the downside, i.e. where if times get really bad the company will still survive, and possibly even thrive if some of its competitors go bankrupt during the downturns.
2. Companies where we are very certain that the demand for its products and services will rise in the future or at the very least not fall.
3. Companies where we are paying a good price based on our estimate of normalized earnings.

Striving for easy decisions

"It's tough to make predictions, especially about the future." -- Yogi Berra

As Yogi Berra said in his own special way, making good forecasts about the future is very hard and you will always be dealt surprises. For us it is very important to never run the risk of being totally crushed under any circumstances. The way I handle this for us is to not use any leverage – which is pretty much the only way an investment partnership like ours that invests only in stocks can go bankrupt – and to constantly try to put us in a position where we give ourselves as few and as easy decisions as possible and leave the more difficult ones alone.

This means that we will say no to an investment that looks good on the surface and trades at a low valuation but where I know that there are many unknowns that might come up along the way that would give us very difficult decisions in the future, especially in areas where I know I'm not very comfortable. We will gladly accept lower returns in exchange for fewer and easier decisions. To keep things simple will always be our North Star.

Re-visiting an old favorite: Focus

We always strive to know the companies in our portfolio really well. Very seldom do we invest in a company that I have not followed for a long time, usually many months and sometimes years. If I feel that I need any type of second opinion about a situation, I won't invest. Familiarity really reduces mistakes. Among other things this means reading most reports and news released by the company for the past couple of years. Company released material is the one and only (legal) first-hand source that is available to investors and the one I think is by far the most useful. I spend very little time on other sources.

When you start to know a company really well, it becomes clear why the markets are not always efficient. Most market participants simply don't take the time to really get to know a company. For example, GE has around 5 million shareholders; still their 2013 annual report was downloaded only 800 times in the year following its release. It does take time and it is harder work to go through company reports and filings than to read some random articles and analyses while glancing at the financials of a generic site like Avanza or Yahoo. Most people are usually looking for quick fixes; it's part of our human nature.

It becomes even clearer when you read online articles and opinions about a company you know very well. Sometimes those articles feel like a result of the whisper game; you know the one that you played when you were a kid which starts with someone coming up with a sentence, for example 'In one year my father will be 50 years old' and after being whispered ear to ear around the table ends up becoming 'In five years Superman will be 100 years old'.

As we focus our portfolio around a very small number of companies, I believe we are able to know them much better in the context of constructing our portfolio than some large investment firm that owns those same companies as part of a portfolio with 30 to 50 companies. No matter how many analysts an institution employs and how many companies it can analyze, it still has to assign appropriate weightings to the different companies within the portfolio and continuously re-evaluate them which require comparing them to one another. This is very hard if the different companies have been researched by 10 different analysts.

I believe that in the best managed portfolios one person has sole discretion over the research and ultimately over the decisions. Needless to say, it will be a daunting task for one person if she is working with 50 different companies in her mind. I believe our focus allows us a more intimate knowledge – not only about the specific companies but also about their relative merits – and is something that works greatly to our advantage. Oftentimes less is more.

Our portfolio

We sold quite a few of our holdings during the year. I will follow one of Warren Buffett's mottos: 'praise by name, criticize by category' so I won't name the companies where we sold our shares but will briefly discuss some of our investments.

When I discuss an investment in these letters it should not be viewed as something we will hold indefinitely under all circumstances. No matter how much I like a company, an industry or the qualities and capabilities of the management team, it always comes down to price versus value. The discussions are here to give you a good sense of what types of situations we like to invest in and how I think about them.

In two cases we sold because the stock price reached our estimate of intrinsic value. This is the most pleasant reason to sell. In two other cases, however, I was wrong in my analysis. During the year I realized that I had overestimated the growth prospects of these two companies and thus also their intrinsic value. An in common theme in these two companies was their tendency to always include a measure called EBITDA in their earnings reports. EBITDA stands for Earnings Before Interest, Taxes, Depreciation and Amortization. Some prefer to call it EBAE – Earnings Before All Expenses.

One of these two companies not only reported EBITDA but invented their own definition of it as well; they called it adjusted EBITDA and besides the 'ITDA' they also excluded items such as stock based compensation. It's interesting how you can classify something that has occurred every quarter for the past couple of years – i.e. something that has been *recurring* – as *non-recurring*. Stock based compensation is usually part of employment agreements and thus it is definitely part of the cost of doing business. If the company wouldn't have these stock based compensations in place, would their employees still come to work every day?

This company also did something I have never seen before; in a presentation they labeled their interest costs as non-recurring even though it is clear they are going to be making large interest payments on billions of debt for the coming five years at an absolute minimum. That labeling seems more like reporting a possible long-term vision than reporting reality.

In many cases, if there were no interest costs there would be no business because the company wouldn't have had the cash to come to where it is today nor would it have had enough cash to cover its daily operating expenses.

It is indeed very useful for investors to know about true one-time costs such as for example a litigation settlement charge for a specific court case or a bonus payment that was contingent on and limited to a specific event. In the benign cases you will usually see one of these one-time costs only very rarely. But in companies where the non-recurring costs tend to be there every quarter and there are many of them to boot; the reality is often that they are indeed recurring costs. In general I don’t think it's a bad idea to just skip all companies that always include many adjustments in their financial reports – especially when the adjusted numbers are the ones that are highlighted and touted – when you are looking for good investments.

I should say that in both these cases we were lucky to sell them with a handy profit. But we won't always be so lucky; so I need to be even more diligent in the selection process. You might now have a very reasonable question: "Why on earth did we invest in these companies in the first place?" The plain answer is that I liked the core product of these businesses so much that it made me accept the many warning signs in their financial reporting and to some extent the expensive valuations. It is never pure black and white in investing.

Fortnox
One of our new investments is Fortnox. Fortnox is a small Swedish company that provides cloud services for small and midsized companies in accounting and related services. According to a 2014 SCB report, only 15% of large and 11% of smaller Swedish companies buy cloud based accounting services. In my opinion it should only be a matter of time before these percentages come up. With Fortnox being the market leader in this segment they have a good chance to capture many of the companies that will switch to the cloud in the coming years. Besides the risk of security breaches it is hard to see any disadvantages with having ones accounting data in the cloud; safely backed up and accessible from any device anywhere. The wide accessibility makes it very convenient for the accounting consultants that can just log on to their client accounts from their own offices whenever they need to.

Fortnox also has a nice tailwind from the network effect that its current rapid growth creates. If most of your peers use a certain piece of software for one of these basic services that all companies need, it's very convenient to pick the same one as it will save you time not having to try out all the different options and you will have comfort that it works well and that it can be trusted. The more companies that sign up as customers the more accounting consultants need to learn how to use it. And when new companies contact these consultants requesting accounting help they will likely be recommended it as well. The new companies will in turn mention it to their peers and business friends which complete the virtuous cycle for Fortnox.

These types of basic essential services tend to have very sticky customers. Once you have started to run your accounting in one software and as long as it does what it is supposed to do; the time required and the risk of something going wrong during a switch to another software will usually be much greater than the value your business and, most importantly, your customers get out of it. And, as a small business owner, time is your most valuable resource so there is no way you are going to switch unless the competing software has huge benefits compared to your current one. The annual cost for using an accounting service like this is so small that you will never change based on price alone.

Furthermore, as the service is so basic, the pace of change and innovation is very slow compared to most other Internet services today which greatly reduce the risk of new competitors entering the scene with something that is much better. Finally, the demand should remain robust even when the economy slows; accounting is probably one of the last things a company will give up on as filing regular sales tax reports is required by law.

There are roughly one million companies in Sweden today of which 99% have less than 50 employees which makes Fortnox ideal for them. Fortnox currently has little more than 100,000 customers so I believe they have a long growth runway if they continue to execute well on their software quality and customer service. If they do, with such a scalable business model, their free cash flow should go up a lot faster than their revenues.

Fiat Chrysler Automobiles

The savvy of Fiat CEO Sergio Marchionne's moves during the financial crisis is now becoming clearer. After negotiations with the Obama assigned auto crisis team, Marchionne in 2009 agreed to take on and run the then troubled and bankrupt Chrysler in exchange for a 40% stake without making any cash outlay. The stake was subsequently increased until the remaining outstanding shares were finally acquired in early 2014. In total Fiat paid around $4 billion for all of Chrysler. This subunit of Fiat is now on its way to generate about $4 billion in free cash flow in 2015 alone. Warren Buffett's advice from 1951 when he was teaching a class at Columbia University at the age of 21 held through nicely 58 years later as well: *"Be fearful when others are greedy, and be greedy only when others are fearful."*

Ferrari, another subunit of Fiat, was spun off from Fiat in the first days of 2016. We just received our part of Ferrari shares – we received one Ferrari share for every 10 Fiat shares that we owned. We do however see much greater value in the Fiat shares at current prices.

Closing thoughts

After three years in which our compounded annual gain has been very high it would be easy to become overconfident. I can assure you I won't; now more than ever do I understand how difficult it is to achieve these returns. I thought about that at the end of the first year, I thought about it last year and I have the same thought as I am writing this.

The key to our successful start, I believe, has been that we never chased high returns but have kept the focus on the downside. When we were down for the year (which has happened two times so far) I haven't searched for quick fixes or started to take chances to maintain our high average but our strategy has remained exactly the same as when we were up 20%. We have just been doing what I believed to be the most sensible thing to do at all times; with no consideration to any index, to our previous returns or to anyone else's. You can count on this to be the case in the future as well.

When I started out, I figured that 50% a year was a reasonable goal even though every book I read and every smart investor I listened to talked about being very happy with 15%. I could have done some very simple math and then easily realized the absurdity in such a goal. If you start with $1 million and compound it at 50% for 30 years you will end up with $192 billion. For some perspective, that would land you the 16th spot on the S&P 500 list just below Wal-Mart and just above Visa and Coca-Cola. Don't ask me what I was smoking at the time.

Besides that this year produced some excellent results for us, we also gained a lot of new knowledge about some new industries and also a handful of new companies. While we haven't invested in most of them, I believe the added knowledge will pay great dividends for us over time. For example, two years ago I did a lot of research into the American for-profit education industry. Early this year, the industry was hit with the revelation of some bad actors that had engaged in highly unethical and even fraudulent activities. This bad press dragged down the whole industry and the babies were thrown out with the bath water. My research had yielded one clear favorite in this industry which we were now able to invest in at a very good price. This has actually been a recurring theme for us. Companies I read about but don't invest in – for either fundamental reasons or a too high price at the time – have had a good habit of becoming big winners for us later on.

I have made mistakes during the year and new ones are bound to happen in the future as well. In the most nagging cases I knew enough to invest and the opportunities were right in our sweet spot of knowledge but I still did nothing. And in some cases I made mistakes when estimating the intrinsic value. But the majority of decisions have worked out fairly well so far. The overall big picture is all that I – and what you partners should – really care about.

Eighteen-time Olympic swimming champion Michael Phelps advices: *"Make a million mistakes but never make the same one twice"*. I do follow his advice and given the amount of mistakes I have made in the six years since I started investing, our mistake universe has now at least been vastly reduced.

Thank you for letting me manage your assets. I love doing it and I look forward to expand the structure of this partnership from the current family office so that more people can partake in the future. I vastly underestimated what is required to make that possible but a lot of progress has been made here during the year and I am now working with a lawyer to set it up.

I wish all of you a happy year with positive developments in the areas that are the most fun and meaningful to you.

Daniel Glaser   Uppsala 2016-01-14

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