BrightGateCapital
INVESTMENT~INTELLIGENCE

Annual letter to the co-investors of the BrightGate Focus fund

January 3rd, 2024, Madrid

"A 'sound' banker, alas! is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can really blame him."

J. M. Keynes, Essays in Persuasion.

Dear co-investors,

We hope you had a happy holiday season and wish you all the best for the year ahead.

The Fund closed on 31 December with a NAV (institutional class) of 1,549, representing a return of 35.4% for the year, compared with 26.3% for the S&P500, 23.8% for the MSCI World and 13.5% for the BofA US High Yield Index (all including reinvestment of dividends or coupons, but excluding the cost of currency hedging). Although the Fund does not have a benchmark, I consider the three indices above to be a representative group of the asset universe (equities, high yield, and preferred bonds) in which the strategy invests.

The Fund's philosophy is to build a concentrated portfolio of international securities with low turnover. In equities, the investment philosophy seeks companies that operate in predictable industries (generally with an oligopolistic structure), without debt, and trading at reasonable valuations – that can capitalize our investments at rates of at least 7-9% (*compounders*). Finally, the required return on fixed income investments is 8-10%, after currency hedging costs.

As I have mentioned in previous letters, annual results should be interpreted with caution. While I believe that over the long term the performance of the Fund will be in line with the objectives set at inception, short-term movements in NAV, both up and down, may be largely irrelevant.

The Fund has outperformed the comparable indices over the year, although as I mentioned in my letter six months ago, *the gains have not come from the exuberance in which technology companies are involved, nor from those companies with weak business models,* which fell sharply in 2022 and which, surprisingly, have recovered dramatically over the past year, although, for the most part, their respective business models remain, in my view, as fragile as ever.

In this year's closing letter, I would like to explore two very different themes. First, I want to share my thoughts on a book I read this year called *What I Learned About Investing from Darwin*, written by the successful Indian investment manager Pulak Prasad. Secondly, I will give a brief overview of our recent exposure to financial companies. I hope to make it clear that this group of companies is far from homogeneous and that each company has its own particular long-term dynamics – *in other words, each of these institutions has different sensitivities to both interest rate changes and the economic cycle.*

Finally, in keeping with the tradition of previous years' letters, I will summarise our top holdings on the compounders side, as these are usually the stocks that will make up the bulk of our portfolio. These summaries can be found in Appendix I to this letter.

What I learned about investing from… Pulak Prasad

Without a doubt, one of the most interesting reads this year was *What I Learned About Investing From Darwin*, written by Pulak Prasad, manager of Nalanda Capital, an asset manager specialising in investing in Indian companies with an excellent track record.

I have to admit that I started reading the book with a certain dose of scepticism. The world of investing is rife with superficial knowledge, where giving one or two glimpses of a subject to demonstrate knowledge is the rule rather than the exception, so a book with such a title immediately raises the question of whether the author is abusing the parallels between the world of evolutionary biology and the world of investing. Moreover, I have always been of the opinion that most investment books (especially those written by reputable managers) are dispensable and just tell little stories, explaining why this or that stock did what it did, but without looking for schemes that help us to think in a slightly more universal way.

Prasad's book suffers from neither. The parallels he draws between evolutionary biology (drawing not only on Darwin's work but all the science that has been proposed since) and investing are fascinating. Moreover, the book is superbly structured around the idea that in the world of investing, fantastic long-term results can be achieved through a sensible, repeatable, and simple process.

The book is divided into three sections, each covering one aspect of Nalanda's investment process. Its three pillars are: avoiding significant risks, buying only good companies at fair prices and, finally, holding them forever – in other words, low portfolio turnover. Given the length of the book and the brevity of these letters, I will only comment on the aspects that I found most striking, although any other reader could easily have selected other ideas.

The first part deals with what should be the number one factor in any investment process, minimising unnecessary risk. The emphasis at this stage of the analysis is similar to Buffett's two famous rules for investing ("rule number one, don't lose money; rule number two, don't forget the first rule"). The risk mitigation aspects are both qualitative and quantitative. For Prasad, the primary qualitative aspects that determine whether a potential investment idea will ultimately be considered are: i) that the company has no financial leverage, ii) avoid companies run by dishonest management teams, iii) avoid turnarounds, iv) avoid companies with an addiction to inorganic growth and v) avoid investing in industries undergoing rapid technological change where the competitive structure is not yet defined.

Prasad uses several examples from the animal kingdom (both predators, preys, and plants) to show how the successful long-term survival of a species ultimately depends on minimising errors of commission (what he calls, in statistical jargon, “type 1" errors), which are the ones that can end up being fatal (not running away from a potential predator that ends up being a lion), as opposed to errors of omission ("type 2" errors), which are often much more benign (running away from a predator when it really wasn't one). Investors should approach their work in the same way, avoiding opportunities that are lucrative but have a high probability of total loss of capital. *A good investor is, first and foremost, a good "rejector" of potential investment ideas*, an insight always championed (and embodied) by Charlie Munger.

On the quantitative side, the most important financial variable for Prasad is the return on the company's capital. Using as an analogy the experiment conducted over several decades with wild foxes in Siberia (in which breeders, by simply selecting for one trait, tameness, were able, after several generations of crossbreeding among the tamest foxes, to "select" for other traits, such as soft ears, mottled colouring or a shorter snout), Prasad explains how a company's return on capital is also a "trait" that can help to determine other desirable but harder to identify traits, such as being run by an excellent management team, having certain competitive advantages, or allocating capital efficiently.

One of the most fascinating chapters in the book is the fifth, entitled "Darwin ate my DCF". In it, Prasad explains that *the discipline of investing should be practised in a similar way to evolutionary biology, not by trying to make predictions about the future as, say, physicists do, but by rigorously analysing the past*. An evolutionary biologist, for example, does not ask what will happen to humans, but how our ape ancestors evolved into a bipedal organism. Darwin himself formulated his own theory of natural selection with the facts that were already available to everyone, but with the crucial and then differential idea that the present is simply the result of the accumulated changes in the past. Nalanda does not waste a minute in making business projections and spends this time in understanding the evolution over time of the business and its sector. Although not mentioned in the book, this "directional" way of understanding a company is similar to the question that Todd Combs and Charlie Munger used to ask themselves, which was to try to estimate the percentage of S&P500 companies whose business would be better off in five years' time.

In investing, the main reason why projections are unhelpful most of the time is that any projection involves a large number of variables. As Prasad shows, a projection of the main financial magnitudes for the coming year can involve estimating (at least) ten variables, which even if we assume that we are really good at estimating them with 90% accuracy (which is simply unrealistic), the probability of getting them all right is only 35% (0.9^{10}). And this is only for a one-year forecast: the probability of being right continues to fall rapidly as the time horizon (and therefore the number of variables) increases.

Focusing on the persistence of a company's past performance has two main disadvantages. First, it causes us to miss lucrative investments when a business turns around, for we continue to assume that its future will be as bad as its past, when in fact it will not. For Prasad, we have to live with such errors of omission because no investment method is perfect. The second pitfall, however, is more worrying, as it concerns the errors of commission that can be made by assuming that a good business will continue to be good in the future, when in fact it will not. Although the book offers evidence as to why businesses tend to be more stable than is usually assumed (likening it to the stability of organisms according to palaeontologist Stephen J. Gould's famous theory of punctuated equilibrium), this is a problem to which there are no simple answers and will always ultimately require the judgement of the analyst.

Such judgement, as behavioural finance teaches us, is prone to biases and is also influenced by social elements (in the previous letter I showed the fairly conclusive evidence that financial bubbles can form even under laboratory conditions). Two of the most effective tools that behavioural finance proposes to improve our decision making are pattern recognition and the outside view. Both have a close equivalent in the world of evolutionary biology, which is the principle of convergence. This principle states that different organisms in different geographical areas and at different times end up with similar solutions to similar problems – for example, there are eighteen different plant species that have evolved red, the preferred colour of hummingbirds, because it is the bird that pollinates them. In the case of companies, as in the biological world, both successful and unsuccessful companies share similar traits, so that the study of each investment is not unique and discrete, but part of a larger universe of successes or failures that can be interpreted by analysts with more developed pattern recognition skills.

The last chapter of the book teaches us how honeybees build their hives and concludes that a simple and on average correct process can yield extraordinary long-term results if repeated enough times. Honeybees, which have survived countless dangers for 13 million years, make the important decision of where to build their next hive through a simple process (through a kind of communal dance, and I am not kidding!) that, although it does not always choose the optimal place to build their home, on average it works. As Prasad explains, Nalanda's process (eliminate significant risks, buy good businesses at reasonable prices, and hold them forever), like that of the honeybees, is simple and repeatable, and has worked wonderfully since they launched the fund.

As I hope I have shown, the book contains teachings on multiple levels. Some of these insights, such as not making predictions, focusing on return on capital, avoiding turnaround situations, or avoiding excessive leverage, are not foreign to me and I feel fully identified with them, as I hope I have shown in previous letters. However, the selling discipline that he proposes is more difficult for me to implement, and it is undoubtedly an aspect that needs to be improved of my current investing style. I am confident that further reading will lead me to improve this aspect of my investment process in the years to come.

BrightGate Focus Financials?

Given that the Fund's exposure to financials has gone from zero at the beginning of the year to around a third of the portfolio, I thought it appropriate to devote an entire section to explaining the rationale behind this investment. European investors have suffered an absolutely bloody decade in terms of returns when investing in banks, so the first reaction to the idea of a Spanish manager investing in the sector is naturally one of horror.

As I hope to make clear in the following paragraphs, *the financial businesses in our portfolio bear no resemblance to the "ordinary variety" (to use a botanical metaphor) that has swamped the main European stock indices over the last decade*. The companies we have acquired have high returns on equity under "normal" conditions, operate in niche sectors where universal banks have little or no presence, do not need interest rate rises to make up their poor returns and, of course, are led by competent managers who have been with the same institution for many years, who defend a stable corporate culture and for whom capital allocation decisions are a priority.

Without considering the bonds of financial companies, which I will explain in a later section, our equity portfolio currently consists of four banks. Since it is impossible to give a detailed overview of each of them, I think it is more instructive to show the diversification they offer between all of them.

Of the four banks, two of them operate in Europe (and in very different geographies, Italy and the United Kingdom) and another two in the United States (I explain one of them, Northeast Bank, in detail in the appendix to this letter), so their end markets are very different geographically. Not only do they operate in different geographies, but their businesses are also different: the Italian bank specialises exclusively in discounting invoices for the public sector, the British bank exclusively specialised in mortgages for the professional landlord market, one of the US banks is the leader in student lending, while the other operates mainly in the secondary market buying commercial real estate loans.

To gauge the sensitivity that this disparate set of banks could have throughout the economic cycle, it is interesting to consider a couple of alternative scenarios.

In a first scenario of economic slowdown, this slowdown would undoubtedly affect the results of our UK bank through higher credit losses on its mortgage portfolio, but on the other hand it would be an ideal environment for our Italian bank (the delay in payment by public administrations would be higher, increasing the amount of late payment interest) and for the US bank operating in the secondary market (greater opportunities to acquire loan portfolios at a discount).

In a second interest rate rise scenario, this rise would benefit all banks in the long term, although the UK bank could suffer in the short term due to a lower volume of mortgages and how it makes certain accounting adjustments to its mortgage portfolio as a result of a rate rise, as seen in its results six months ago.

From this admittedly simplistic analysis it is important to point out two things. The first is that I am fairly confident about how the businesses of these banks would react if the above scenarios were to materialise, although I have no idea how their share prices would react. The second is that these banks have weathered economic cycles in different circumstances in the past and in all cases their returns on equity (ROEs) have been phenomenal.

To give you an idea, the average ROEs of these banks from 2017 to 2022 have been 29% in the case of the Italian bank, 18% in the case of the UK bank, 29% in the case of the bank that lends to students (the same as the Italian bank, pure coincidence) and 17% in the case of the bank that buys in the secondary market. It is important to note that although the credit cycle has been benign so far, benefiting the credit losses of all these institutions, interest rates have been at the lowest levels in history, depressing the interest margin they earn. All in all, I would not say it has been a particularly favourable environment for banks (as evidenced by the poor returns of their peers), and yet all these banks have generated phenomenal returns on equity.

Obviously, and as it could not be otherwise, these fantastic returns on equities have translated into fantastic returns for their shareholders. Without considering dividends (which, as we shall see in the case of the British bank, are usually a fundamental factor in the shareholder remuneration policy of these companies), over the last five years the share prices of the Italian bank have multiplied by two and those of the two American banks by two and a half times and two, respectively. Only in the case of the British bank has the return been poorer, 20% in total. Even in this case, where a large part of the loss has come from a sharp correction in the valuation multiple and not to poor business performance (and which does not take into account a further 16% of dividends paid out by the company since then relative to its current market capitalization), shareholders can show something in return for their patience.

An equally weighted portfolio of these 4 banks would have easily beaten the S&P500 over these five years, and without the need for the Magnificent 7!

In short, *in the long term there are no "value traps", just bad investment decisions, whether in banking or any other industry*. These examples show that banks do not necessarily fall into this category per se, and that even generalist investors who focus on institutions with profitable businesses and competent management can be reasonably successful over time.

Significant divestments during the year

In line with the Fund's low turnover philosophy, we have made few overall exits during the year, although given the sharp rises in some of these stocks, portfolio turnover has been slightly higher than I would have liked.

The main disposals in the first half were North Media, Naspers and LGI Homes. The reasons for their sale were explained in the previous letter and, in order not to go into too much detail, I will not repeat them here.

In the second half of the year the main divestments were THOR Industries, CarMax and the companies of the NICE group (both NICE Holdings and NICE D&B). In the case of both THOR Industries and CarMax, the reasons for the sale were that the expected future annual returns were below the double-digit threshold after the price increases of both stocks, and that the proceeds from both sales could be reinvested in other more attractive opportunities. In the case of THOR, we continue to have exposure to the RV industry through our investment in Patrick Industries, while in the case of CarMax, we continue to have exposure to automotive distribution through Asbury and Lithia.

Furthermore, we closed our position in both NICE shares, having suffered significant losses since our initial investment in 2021, despite the fact that both companies have continued to do well operationally speaking as originally planned. So, what happened? Simply put, the management team's capital allocation decisions have been terrible. As well as continuing to destroy value in the holding company by investing in capital intensive and highly competitive businesses (such as the nascent auto parts or semiconductor businesses), the cash on the balance sheets of the subsidiaries (particularly in NICE D&B and NICE Information) has continued to accumulate for no apparent reason, since credit bureaus are businesses with minimal capital needs. This simple accumulation of cash has penalised the return on equity of these businesses and prevented shareholders from benefiting from their good operating performance.

It will be a long time before I invest again in Korea or similar countries where capital allocation is far from optimal and seems to be the last concern of management. Investing is difficult enough under normal conditions, as we managers always make sure we have a sufficient amount of "errors of commission." There is no need to have disappointing results if you get the thesis on a company right, which is what happened with NICE. In my experience, the latter does not usually happen in the US, while it is almost the norm elsewhere.

Structure of the portfolio

Turning to the main metrics of the portfolio, as of December 31 the Fund held 8.3% in cash, with the remainder invested as follows: equities 61.8%, high yield 18.9%, special situations 8.7%, and preferred shares 2.1%. Geographically, our largest exposure is to North America (64%), followed by Europe (18.2%), the Middle East (5.8%) and Asia (3.7%). All of the companies in our portfolio have a long and proven track record of profitability (measured through the return on net operating assets), and the incremental investments they are making are in most cases in excess of our cost of capital. I believe that the current combination of liquidity, attractive companies at reasonable prices and bonds with double-digit yields will allow us to be better positioned than the indices and our competitors in the event of a correction in valuations, giving us the flexibility to take advantage of investment opportunities as they arise.

The fixed income portfolio has grown significantly over the past twelve months, from a single bond at the beginning of the year to five securities representing 18.9% of the Fund. This percentage has risen throughout the year because I believe that relative to the opportunities in equities, this basket of credits will allow us to generate positive returns even in an environment of a severe stock market correction. The main aggregate variables of this basket of credits are a yield to maturity (in euros) of 8.9% and a duration of 2.4.

I am sometimes asked what is the best protection you can have in the fixed income world, and I always say that one of them is to have high coupons. The high yield to maturity of our bond portfolio means that, in the absence of defaults, the prices of these bonds would have to fall sharply before we would suffer short-term losses.

Apart from the perpetual bond we hold in General Motors, the other four bonds are from financial companies, three of which are based in the US (Discover Financial Services, Genworth Financial and American Coastal Insurance) and one in Spain (Bankinter).

As you know, the equity part of the portfolio is generally not currency hedged, while the fixed income part is. However, given the high exposure we have been accumulating during the year to US companies with only local operations, I felt it prudent to partially hedge the currency. Over the long term, currency movements should be neutral for the Fund, and this was the case in 2023, where currency movements played a secondary role. Although I believe that the dollar will appreciate structurally against the euro, these macroeconomic considerations are irrelevant when constructing the portfolio, which is based solely on my conviction in each security, not in the currency in which they are denominated.

I remain at your complete disposal to answer any questions you may have or to go into detail on any of the stocks in our portfolio.

Nullius in verba,

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Appendix I. Summary of our main long-term equity positions

Asbury Automotive (ABG:US)

Asbury Automotive is our largest long-term equity investment because I believe that of all the companies we have in our portfolio, it best combines an attractive valuation, a good business, an excellent management team and a dream list of investors.

Traditionally, dealerships have been a profitable business in the US, aided by legal barriers to entry that regulate distribution at the state level (franchise laws), making regional competition between different dealers difficult. Additionally, the sector is highly fragmented, providing future growth opportunities for large dealer networks such as Asbury. Finally, although the margins on the sale of new and used vehicles are low, the repair and maintenance business, on the one hand, and the sale of financial products, on the other, are high-margin businesses that require little capital to operate and are stable over the economic cycle, making the return on capital for operating a dealership attractive and much more predictable than for the rest of the companies operating in the automotive value chain.

Despite these positives, there are several reasons why both Asbury and its peers are trading at very depressed valuations. Firstly, the dealership business was one of the big beneficiaries of Covid (although sales volumes were lower, margins per vehicle more than compensated for these declines) and the market is now discounting a return to normality with sharply lower profits for all these companies. Second, there is concern that the transition to electric vehicles will have a major impact on the most profitable part of the business, repair and maintenance. Electric vehicles have fewer parts and therefore require fewer replacements and repairs. Finally, new OEMs (such as Tesla) have been able to establish a direct-to-customer distribution model, bypassing traditional dealerships, raising the question of what the role of these distributors will be if this trend becomes more widespread in the future.

While all of these considerations (especially the second and third) are important and deserve to be taken into account, there are some points that suggest that the market may have been overly negative in its assessment. In particular, there is growing evidence that the introduction of electric vehicles will be more neutral for dealers than it might at first appear. For example, Nordic Europe, a market where EV penetration has been much higher than in the US, should be a good case study to see what has happened to dealers operating there and what the future could be for their American counterparts. In this regard, Bilia AS, one of the largest groups in the region, has shown very consistent results in recent years, with an average ROE of 28% over the last five years – although this has been partly helped by the supply chain bottlenecks. In its Investor Day Presentation 2022, Bilia acknowledged an erosion of the repair and maintenance business in the coming years, although it expected this to be gradual over the decade and to have a small impact in any case.

What do I mean when I say that Asbury and its peers are trading at "very depressed valuations"? To get an idea of the magnitude, it is interesting to start with the company's track record over the past decade. From 2011 to 2022, Asbury grew total revenue at a compounding annual rate of 13%, net operating profits at 25%, net operating assets at 20%, and residual operating income - the metric we really care about – at 32%. In other words, despite the impressive growth in operating assets, the marginal return on capital has not suffered – otherwise the growth in residual income would have been lower than that of net operating assets. Not surprisingly, returns on net operating assets have been phenomenal, averaging 16% over the decade (return on equity has risen to 35%, benefiting from the company's moderate financial leverage). With the company trading at 1.3 times net operating assets (1.6 times book value), *no heroic assumptions about future growth are required to guarantee double-digit annual returns for the company over the next decade*.

Finally, it would be remiss of me not to mention the last crucial aspect of Asbury's thesis, which is none other than the quality of the investors that populate its shareholder base. Not only are *there two of the investors I most admire, who are arguably among the best in US history*, but there is also a socially responsible investment fund with a successful track record of returns, as well as other investment funds with similarly concentrated styles and philosophies based on the study of business fundamentals.

Of course, we may all be wrong about the merits of investing in Asbury, but it won't be because of groupthink, as I'm sure each of us has come to similar conclusions by different routes. Apart from sending an important signal about the attractiveness of the investment, the most important advantage of having such a large group of excellent investors is that it ensures that the allocation of capital in Asbury remains rational and that investors will ultimately benefit from the enormous value creation that is yet to come.

Kaspi.kz (KSPI:LI)

Kaspi was one of the largest contributors to the Fund's profitability during the year, in stark contrast to the heavy losses with which it closed 2022. Over the past twelve months, my investment thesis for the company has not changed. Kaspi remains the most profitable technology platform (marketplace, payments and fintech) in the world, with ROEs approaching 100%, led by an excellent management team, with growth opportunities ahead and still trading at a very attractive valuation, both in relative and absolute basis.

Despite the market share that Kaspi already has in Kazakhstan in the payments business (and increasingly in the marketplace), there is still plenty of room for growth, not just in terms of increasing commissions or adding advertising to its platforms, but in entirely new businesses. As evidence of this, in 2023 Kaspi created two new businesses from scratch that are growing rapidly: a B2B payments platform used by wholesalers to streamline invoice payments, and an online supermarket business. In both cases, the businesses are scaling at record speed and have already reached the point where they are beginning to be profitable, even in the case of the online supermarket, a vertical where the international experience of other companies has shown that it is mostly a business with low returns on capital.

It is important to note that *both businesses simply did not exist when we took our first position in Kaspi in 2021, and therefore it was impossible to include them in any realistic estimate of the company going forward*. Something similar has happened in the travel business, which was launched that year and is already an important contributor to the marketplace business after only a couple of years in operation.

Irrespective of how much this or that business contributes, I think the above shows that the management team has a clear roadmap ahead, that they are extraordinary performers in the day-to-day operations of the company, and that the Kaspi app is so integrated into the lives of the Kazakhs that the company is able to enjoy network effects that are simply unattainable by any competitor.

Finally, this year Kaspi acquired a company of classifieds (Kolesa) that offers its services in two verticals: the buying and selling of used cars and the real estate market. Although Kolesa is small compared to the rest of Kaspi's businesses, it is highly profitable and also opens up the possibility for Kaspi to use the data generated on these platforms to refine existing businesses (the amount of data is particularly relevant for a correct credit study in the banking business) as well as to create entirely new verticals. For example, I do not rule out the possibility that Kaspi will soon enter the market for car loans, a market in which it is not currently present (Kaspi's banking business is focused exclusively on BNPLs and consumer loans) and which has historically been highly profitable in other geographies. This market is also relevant in each country due to its size and could eventually represent a significant percentage of Kaspi's banking business.

At the end of the year, Kaspi's market capitalisation was around $17.5bn, which, given the company's book value of $2.2bn at the end of the third quarter, would imply a P/BV of less than 8x. Given the company's high ROEs, even without assuming any future growth (a completely unrealistic hypothesis), returns on the investment will be double digits over the next decade, which shows that the margin of safety in terms of valuation is wide. As I have pointed out on previous occasions, the real risk to this thesis lies in Kaspi's relationship with the government. Despite the unrest in Kazakhstan two years ago, the country is enjoying a degree of social stability, and so far Kazakhstan has an unblemished record of respecting the rights of international investors in Kazakh companies - even in those where the shareholding is public, as in the case of Kazatomprom.

Northeast Bank (NBN:US)

I explained the thesis on Northeast Bank (NBN:US) in detail in the letter of the first half of this year, so I refer investors interested in the details of this very unusual bank to the previous letter. In summary, NBN is a US regional bank acquired in 2010 by Rick Wayne, a banker with an extraordinary track record of creating value through a single strategy: buying real estate commercial loans from other lenders (banks, credit funds, etc.) at a discount. Since implementing this strategy in the early 1990s, the annualised returns generated by Rick and his team have been nothing short of phenomenal, with NBN's share price, for example, up 5x since 2010. So much for a lost decade for bank shareholders!

One of the reasons I identified in the previous letter as the main cause of these abnormal returns is that *"the key element of NBN's strategy is its structure as a bank, a competitive advantage that I believe will be long-lasting compared to credit funds with similar strategies. [...] most importantly, NBN's liabilities can grow quickly as opportunities arise through the issuance of certificates of deposit and its access to Federal Home Loan Bank (FHLB) advances. Although these are more expensive sources of funding than a traditional deposit, the high-yielding assets that NBN acquires allow the interest margin to be higher than that of a traditional bank. Conversely, if there are no investment opportunities available, NBN can return the advances to the FHLB and let its certificates of deposit mature, unlike a mutual fund, which has permanent capital and is under pressure to be always invested, regardless of market opportunities."*

Although the above explanation may sound convincing, it is not intuitively obvious why this way of operating would be a structural advantage that would last in the long term – after all, Rick and his team have been successfully implementing this strategy for decades without attracting many imitators.

The fact that *small changes in the way a financial institution operates can be the genesis of a lasting competitive advantage is not unique to banking, but has been repeated throughout history in companies that on paper offer an undifferentiated product but end up assembling franchises that are far superior to those of the competition*. Perhaps the most paradigmatic case is Berkshire Hathaway's insurance business, which has undoubtedly been one of the cornerstones of Buffett's success as an investor. As early as 1977, in his annual letter to investors, Buffett very clearly outlined the "commodity" nature of the insurance business:

> *"Insurance companies offer standardized policies which can be copied by anyone. Their only products are promises. It is not difficult to be licensed, and the rates are an open book. There are no important advantages from trademarks, patents, location, corporate longevity, raw material sources, etc., and very little consumer differentiation to produce insulation from competition. It is commonplace, in corporate annual reports, to stress the difference the people make. Sometimes this is true and sometimes it isn't. But there is no question that the nature of the insurance business magnifies the effect which individual managers have on company performance."* (W. Buffett, Letter to Shareholders, 1977)

The letter to shareholders two years later was again a masterclass in the workings of the insurance business, but this time to explain Berkshire's *modus operandi* compared to its peers and the importance of taking a long-term view when it comes to underwriting policies through the economic cycle:

> *"We hear about a great many insurance managers talk about being willing to reduce volume in order to underwrite profitably, but we find that very few actually do so. [...] It is our policy not to lay off people because of the large fluctuations in work load produced by such voluntary volume changes. We would rather have some slack in the organization from time to time than keep everyone terribly busy writing business on which we are going to lose money."* (W. Buffett, Letter to Shareholders, 1979)

Although, as I said, Berkshire is probably the most obvious example one can think of, the list of insurance companies that have made "small changes" to their established way of operating is not limited to Berkshire, but encompasses a wide variety of companies (e.g., Progressive, State Farm) and geographies (Admiral in the UK).

In fact, if we widen the spectrum to companies other than insurers, we will find legendary companies such as NVR in housing (popularising the use of options instead of buying land outright) or Costco in retail (through a loyalty club and the use of "scale economies shared", to use Nick Sleep's terminology), to name but a few.

Fortunately, in the case of banking, we have a perfect example of how to run a bank differently, and it is none other than the story of Andy Beal. For those who have never heard of him, Beal is the wealthiest banker in the United States, with an estimated net worth of around $10 billion. It is not just the amount that is impressive, but the fact that he made his fortune from scratch and in an unconventional way.[1]

Beal founded his two banks in 1988 (Beal Bank) and 2004 (Beal Bank USA), which have always been characterised by opportunism and concentration in their investments. To give an example of the variety of assets in which the Beal banks have been active, suffice it to say that they bought utility bonds during the 2000-'01 crisis following the deregulation of the sector in California, airplane-back debt following the 9/11 terrorist attacks, mortgages during the 2008-'09 subprime mortgage crisis, energy company bonds during the shale crisis a few years ago and, more recently, TIPS to hedge against a spike in inflation.

It is important to note that Beal carried out all these operations on the secondary market, buying the assets in question from other counterparties when the situation was ideal, since the capacity of both banks to make new loans was always minimal.

The key to being able to make all these bets is not simply that Beal is an unconventional fellow, which he is, but the different way the two banks operate. The Beal banks operate with an "accordion-like" balance sheet, which expands dramatically when opportunities arise and deflates when there are no interesting opportunities. The *key point is to understand that the limiting variable in the management of the bank is the capital of its shareholders, not the total size of its balance sheet* – that is, for a certain amount of the former, the total size of the balance sheet can be expanded rapidly by issuing certificates of deposit or going to intermediaries who facilitate the acquisition of new deposits. Conversely, if there are no investment opportunities, assets will gradually decline *pari passu* with deposits, thereby reducing the total size of the balance sheet.

This way of looking at banking is rather unorthodox for a number of reasons. First, *there is no emphasis on the bank's deposit franchise*, because it is more important to be agile and to be able to take advantage of opportunities than to have a permanent fixed cost base that requires one to be always invested to cover it. In other words, a high interest margin is achieved not through cheap funding but through highly profitable opportunistic purchases. Secondly, the flexibility of not being permanently invested allows you to be more selective and, in Buffett's jargon, to operate within your circle of competence. Finally, operating only in the secondary market allows you to have assets that already have a credit history behind them, *so the person buying these loans usually has a better idea of the quality of the underlying asset than the bank that originally originated them*.

The NBN business has many similarities to the way the Beal banks have operated. Although Rick and his team have always focused on the commercial real estate market, the other elements of the NBN strategy, such as balance sheet flexibility, an unrivalled credit underwriting track record (with virtually no losses), make me very optimistic about the opportunities for NBN in the coming years.

In summary, NBN has a flexible business model that is superior to that of its competitors, an exceptional banker who will push the boundaries of that model, and a share price that is attractively valued (slightly above book value). Aside from the prospect of double-digit

[1] For those interested in more details about Andy Beal, Forbes published an excellent article about him with the suggestive title *"The Banker Who Said No"* (here). In addition, Michael Craig published a book in 2005 entitled *"The Professor, the Banker, and the Suicide King"* in which he explores Beal's (one of his greatest hobbies is playing poker) involvement in one of the most famous poker games in history. Finally, in *The Alchemy of Money* Substack, Frederik Gieschen presents the extraordinary profitability record of the Beal banks (here).

returns, the best thing we can do with NBN is sit on the sofa, grab some popcorn and watch in real time a case study in value creation by one of the best bankers of recent decades.

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