BrightGateCapital
INVESTMENT~INTELLIGENCE

**Annual letter to the co-investors of the BrightGate Focus Fund**

January 3rd, 2026, Madrid

*"Peppa Pig: I am taller than George.*
*George: Oh.*
*Daddy Pig: Don't worry, George. As you get older, you get taller.*
*Peppa: Yes, but I will always be taller than you, George, because I will always be older."*
*Peppa Pig, Chapter Gerald Giraffe.*

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 2,132.5, representing a return of 13.8% for the year, compared with 17.9% for the S&P500, 21.1% for the MSCI World and 8.5% 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, international equities and high yield 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 operating in predictable industries where past may be a reasonable guide to the future, with minimal debt, with management teams with a high integrity and trading at reasonable valuations – that can capitalise our investments at rates of at least 7-9%. Finally, the required rate of return on our fixed income investments is similar, after the corresponding currency hedging costs are taken into account.

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 targets set at inception (Euribor plus 700 basis points), short-term movements in NAV, both up and down, may be largely random and not representative of the value creation (or destruction) that has taken place in each of our companies.

This year, the Fund has underperformed the two equity indices mentioned above, but has outperformed the high-yield bond index. As I explained in the letter six months ago, a significant part of this divergence was caused by the dollar's depreciation, which was "*one of the most significant since the introduction of the single currency*". Similarly, if we had taken into account the 13.5% depreciation of the dollar during the year, *the results of the two indices mentioned above, both denominated in US dollars, would have been substantially lower* – in fact, lower than the results for the vehicle. Throughout the year, we have also maintained a cash position of around 10% and, naturally, avoided exposure to the *momentum* stocks that were all the rage. While a few of these companies have business

models as profitable as Nvidia's or the *hyperscalers'*, which I don't have anything to add,[1] a large chunk of the indices is still made up of companies with questionable business models. These companies have weak returns, are at high risk of rapid technological obsolescence, depend on generous markets to finance their projects, and sport valuations that are plainly absurd.

In last year's letter, I identified several hallmarks common to all major bubbles in the history of capitalism, while also highlighting the inevitable differences between them. Since the chance to live through a bubble that will likely be remembered as one of the largest ever doesn't come every day, I think it is appropriate to devote this letter to exploring a topic in which confusion reigns among market participants; namely, current valuations. While some claim they are the highest on record, others are more optimistic, maintaining that, although elevated, they are still below the levels reached in the dot-com bubble. Behind this debate lie not only the incentives of each participant, but also a genuinely interesting and legitimate conversation about which valuation metrics are most appropriate.

Our preferred metric for measuring the valuation of US indices is the one popularized by John Hussman, which relates the market capitalisation of non-financial companies to gross value added. While it does not provide such a direct reading as profit-based metrics (after all, investors pay for profits, not for gross value added), it is our favourite because, *historically, it has had the greatest predictive power in estimating the long-term future returns of indices* – say, seven, ten, or twelve years. According to this metric, the expected nominal annual returns of the S&P 500 over the next twelve years are at their lowest level ever, firmly in negative territory.

Conversely, it's common to hear many analysts argue that current multiples are not the highest in history. They cite the levels of several simple valuation multiples as evidence, such as the forward price/earnings ratio (chart 6) or the Shiller CAPE. They also argue that, since interest rates are substantially lower than during previous episodes of elevated valuations, equities are comparatively cheaper than at other times in history and the multiples are therefore wholly justified.

The previous argument has several flaws. Firstly, there is the attempt to justify high valuations by appealing to low interest rates. History provides numerous clear counterexamples to this, such as the recent three-decade (!) episode in the Japanese stock market, which was characterised *by depressed valuations and interest rates close to zero*. Unfortunately, *economic systems are more complicated than our simple discounted cash flow valuation models would have us believe – models that treat the discount and growth rates as independent variables, when, at an aggregate level, they are not*. Even disregarding the above empirical evidence, the argument has another, more practical weakness: accepting that valuations are high because rates are low essentially means (on the

[1] Actually, I do have something to add, as I wonder whether some of these businesses are really as good as people currently think they are. Take Nvidia, for example. It is currently the world's most valuable company and is primarily engaged in GPU design. Twenty-six years ago, Intel dominated the semiconductor world through its CPU design, manufacturing prowess and x86 architecture. A quarter of a century later, Intel has clearly been surpassed in all three areas. Although Intel enjoyed its dominance for several more years after 1999 (Apple launched its first iPhone with ARM architecture in 2007, and TSMC did not surpass Intel in manufacturing until the late 2010s), shareholders who invested a quarter of a century ago have enjoyed returns close to zero to date. In my opinion, to think that Nvidia's results will be more durable than Intel's were in their day is very optimistic.

flip side) admitting that future returns will be low. For an investor, *that is not a particularly appealing prospect*.

In any case, the underlying problem is that multiples cannot be correctly interpreted without having a sense of the denominator of the multiple – the earnings of the US corporate sector. Both the CAPE ratio and the forward price/earnings ratio are currently distorted, albeit for different reasons. In the case of the former, the distortion stems from the fact that there has not been a prolonged recession in corporate profits in the US economy since the Great Financial Crisis, regardless of the time horizon taken. The original purpose of the CAPE was to use the average of earnings over a full business cycle, ensuring that both good and bad years were represented in order to smooth the cycle's swings and thus obtain a "normalised" multiple.

The explanation of why forward multiples are not at their historical highs is relatively easy to understand and comes down to two facts. Firstly, forward earnings are the result of aggregating analysts' estimates, which are always optimistic – particularly after a period of seemingly endless earnings growth. In most cases, analysts simply extrapolate trends without much critical thought to support them. This behaviour is akin to Peppa Pig's in the opening line of this letter ("*Yes, but I will always be taller than you, George, because I will always be older* "), where extrapolation *ad infinitum* is the norm and logical and economic constraints seem not to apply.

Secondly, as will be shown in the next section, US corporate profits as a share of GDP are at an all-time high. To understand the forces behind this phenomenon, I will introduce the theoretical framework that we use internally to analyse the evolution of aggregate corporate profits. The conclusion of that analysis is as follows: *not only are earnings multiples elevated, as we have seen, but profit margins are also at record levels*. While we are entirely agnostic as to whether these margins will contract or continue to expand in the short term, we do believe that it is perfectly conceivable that a moderate contraction in margins could offset growth in profits in absolute terms, even if GDP continues to grow at a normal pace. In other words, it is by no means certain that profits will continue to expand at the rates observed in recent years.

Finally, in keeping with the tradition of letters from previous years, I will summarise the most notable developments in the Fund's main portfolio holdings over the year. You can find these summaries in Appendix I of this letter.

## The Levy-Kalecki profit equation, or the irrelevance of bottom-up estimates

This section develops the theoretical framework that we use to think about corporate profits at the aggregate level. This is a subject close to my heart, and one that I have reflected on for many years – at least since I wrote the Kalecki entry on Wikipedia at the tender age of twenty-two. Without exaggeration, it is one of the few macroeconomic ideas that clearly aids asset management; not in the sense of providing day-to-day investment ideas, and even less so for a fund with a bottom-up philosophy like ours, but rather it acts as a compass, helping us navigate the economic cycle and set plausible profit growth expectations.

Despite the fact that the profit equation is now almost a hundred years old, it is still remarkable how extraordinarily rudimentary, to put it mildly, the way in which Wall Street and academic economists think about aggregate profits remains. With a few notable exceptions over the past two decades,[2] this approach has consisted of carrying out a simple (simplistic?) bottom-up analysis, aggregating the market's estimates for each constituent of an index – the S&P 500, for example. Not only does this method suffers from the inevitable optimistic bias of sell-side analysts, which was discussed in the introduction, it also suffers from a more fundamental logical problem known as the "fallacy of composition." This issue naturally arises in complex systems *where the whole is different from merely the sum of its individual parts*. Economies, full of transactions and diverse agents and sectors interacting with one another, are fertile ground for an external observer to make this type of reasoning error. To give a couple of simple examples, wages represent a cost for an individual firm but also represent purchasing power and potential profits for other firms. Alternatively, consider a company's investment in machinery, which has no immediate impact on its income statement, since the asset will be depreciated over subsequent years, whereas for the company selling that machinery, it boosts profits immediately. In other words, can we consolidate all these transactions into a few aggregate concepts that help us understand their impact on the evolution of profits at the macroeconomic level?

Two economists, Jerome Levy and Michał Kalecki, provided the answer independently in the 1920s and 1930s, respectively. Starting from very different theoretical frameworks, they arrived at a simple equation that links the level of aggregate profits to other macroeconomic aggregates through accounting manipulations. Beginning with the definition of net domestic product from both the income and expenditure sides, and assuming an economy with no foreign trade or government for the time being, the accounting identity is as follows:

$$Wages + Profits = Consumption + Net\ investment$$

Net investment comprises the investment of both households (mostly in residential assets) and firms, and is net of depreciation – that is, gross investment spending must exceed capital depreciation (consumption of fixed capital, in the terminology of national accounts) for net investment to be positive. Assuming for the moment that households save nothing, so wages equal consumption, the previous equation boils down to:

$$Profits = Net\ investment$$

[2] For those looking for bibliography on the subject, the best introduction to the profit equation remains the one written by David Levy and his collaborators many years ago, *Where Profits Come From*. In a post from twelve years ago, Philosophical Economics explains how to reconstruct the equation using real data. Finally, James Montier has used the equation in various articles for both the United States (here and here) and Japan.

Now, the equation is an accounting identity, a logical truism that is always satisfied, but it does not allow us to determine the direction of causality – does investment determine the level of profits, or vice versa? Intuition would lead us to think that profits determine the volume of investment, since no firm has ever instantly generated higher profits simply by investing more. However, this is yet another clear example of the fallacy of composition: what is true at an individual level does not necessarily apply to the system as a whole. As Kalecki brilliantly explained, albeit using slightly different terminology:

> *"The answer to this question depends on which of these items is directly subject to the decisions of capitalists. Now, it is clear that capitalists may decide to consume and to invest more in a given period than in the preceding one, but they cannot decide to earn more. It is, therefore, their investment and consumption decisions which determine profits, and not vice versa".*[3]

Additionally, we can relax the assumption that all wages are spent, allowing households to save, in which case the equation becomes:

*Profits = Net investment – Household savings*

One might naively assume that higher wages would automatically have a negative impact on profits. However, as can be seen in the equation above, the level of wages itself plays no role. If households were to spend all their wages, the household savings term in the above expression would be zero, and we would return to the simple starting equation; *it is ultimately households' savings decisions, rather than wages, that determine the impact on profits.*

Finally, introducing a government and an external sector results in the most general form of the equation being as follows:

> *Profits after taxes = Net investment – Household savings + Fiscal deficit – Current account deficit + Dividends*

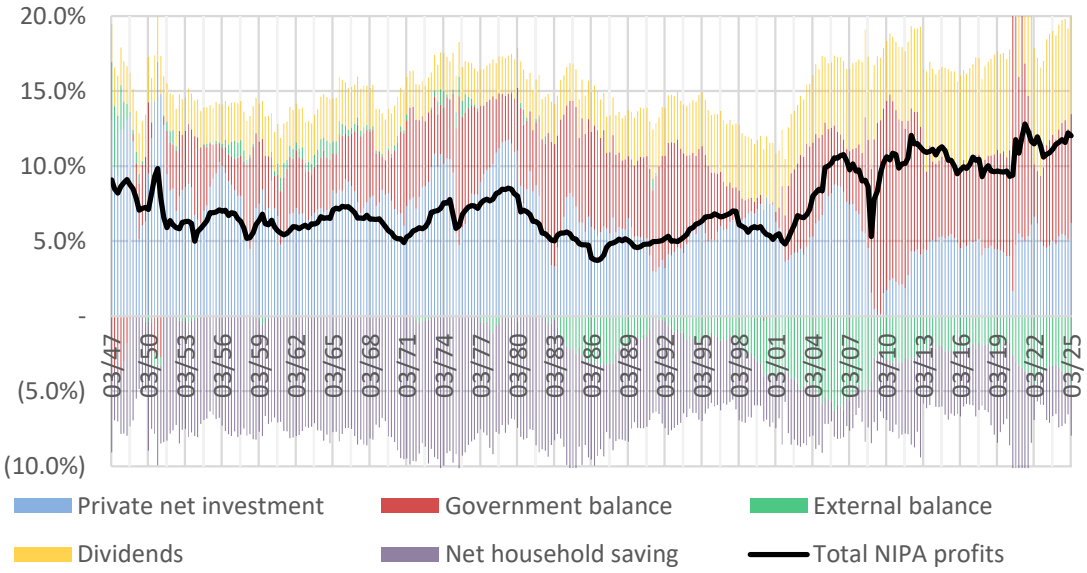
Regarding the three newly included terms, it is important to add the following remarks. The fiscal deficit works as a source of profits and can become an important component, as has been the case in the United States over the past two decades. The current account balance also determines total profits, but, unlike fiscal deficits, external deficits subtract from a country's profits – they flow to firms in other countries. Since current account deficits/surpluses are usually below 3% of GDP in most countries, the external sector does not typically contribute significantly to profit generation, although there have been some important exceptions – such as the United States during the period from 2004 to 2008. Finally, dividends are the most counterintuitive source of all, but the explanation is simple. At the individual level, dividends do not appear as an expense on a firm's income statement, but as a cash outflow on the cash-flow statement. Therefore, an increase in dividend payments has no impact on a company's accounting profits. Once distributed, however, dividends (which, again, are not a cost) can be consumed, increasing profits for other firms; if they were saved in their entirety, the increase in dividends would be equal in the equation to the increase in household savings, cancelling both terms and leaving macroeconomic profits unaffected.

[3] Kalecki, M. (1956), Theory of Economic Dynamics: An Essay on Cyclical and Long-Run Changes in Capitalist Economy.

The profit equation has two clear advantages over the widely used bottom-up approaches. Firstly, it is internally coherent (without committing the fallacy of composition), showing how profits evolve in light of the behaviour of the other variables in the system. Secondly, national accounts provide homogeneous series spanning long periods of time, enabling analysis to be framed within a broader historical context.

The equation also has *the advantage of clearly identifying the direct sources of profit generation in an economy; any other causal factor must flow through one of these variables, otherwise its impact on profits would be nil*. People usually invoke factors such as the degree of monopoly in an economy or productivity increases to explain the long-term evolution of profits. However, these explanations are not based on easily verifiable data, and from the theoretical standpoint of the profit equation, it is clear that such explanations are methodologically reductionist. For example, in his July 2004 letter, Jeremy Grantham, the founder of the asset manager GMO, wrote the now-famous line that "[p]rofit margins are the series that most systematically mean-reverts in finance. As we often say at GMO: 'If profit margins do not revert to the mean, capitalism is broken!' High margins should attract competition — and they always have — and that competition will cause margins to fall." As we will see, US profit margins have gone almost a quarter of a century without reverting to the mean, and there is no evidence that "capitalism is broken" – the more prosaic explanation is that the level of dividends and the current fiscal deficit are higher than ever.

With this background in mind, we can move on to working with real numbers. The chart below shows the historical evolution of corporate profits in the US economy since 1947, based on the Levy–Kalecki profit equation:



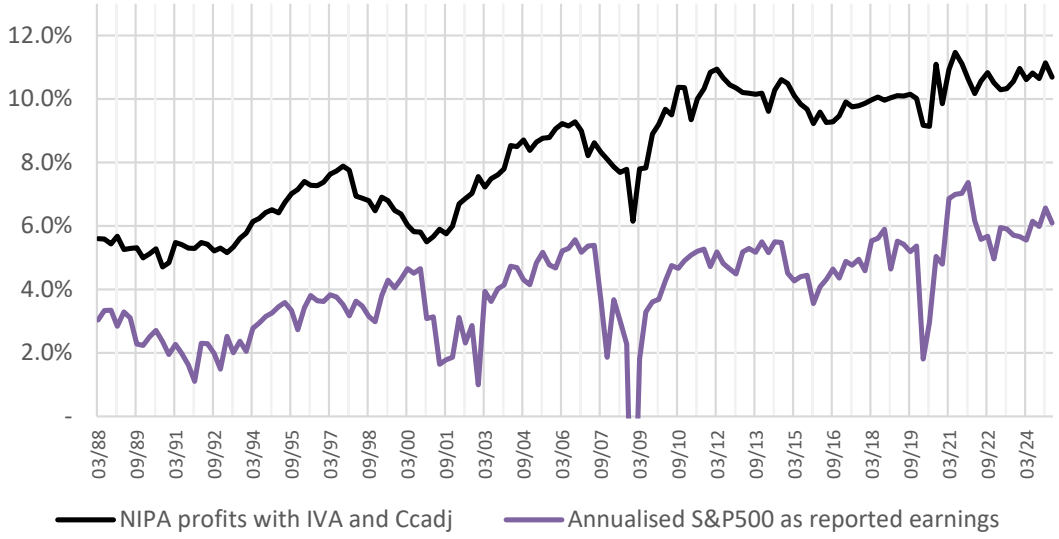

*Aggregate US corporate profits as a percentage of GDP, and decomposition according to the Levy–Kalecki profit equation, from 1Q'47 to 1Q'25. Source: Bureau of Economic Analysis and own elaboration.*

Positive bars indicate factors that contribute to profits (for example, fiscal deficits or dividends), while negative bars show factors that detract from profits (such as an external deficit). As the chart shows, corporate profits fluctuated between 5% and 10% of GDP during

the second half of the twentieth century, with no clear long-term trend.[4] In fact, by the end of the century, the margin had reached one of its lowest levels at around 5%. It was this apparent stability that led Buffett to state in 1999 that, "In my view, you have to be wildly optimistic to believe corporate profits as a percent of GDP can remain well above 6% for a prolonged period." Over the last twenty years, however, this assertion has aged poorly, as reality has been quite different. Since the 2007 crisis, the profit share has almost doubled, reaching around 11%. The post-Covid period has only reinforced this dynamic, leaving margins at the highest level ever.

A second reading of the chart reveals how the different components have evolved over time. During the 1950s and 1960s, high private-sector investment (from firms and households) was the main source of profits, aided by fiscal deficits of around 2%. In contrast, high household savings were the largest detractor, while the external sector ran modest surpluses – a situation that has not been repeated since the collapse of the Bretton Woods system in the early 1970s, when the United States became a permanent debtor to the rest of the world. More recently, profits have been supported by rising fiscal deficits and dividends, which have more than offset weak private-sector net investment and moderate external deficits.

Aggregate series are useful because they place an upper bound on the profits of S&P 500 companies, since the profits of these firms cannot exceed those of the economy as a whole by definition.[5] The chart below shows the historical evolution of aggregate profits (NIPA profits) compared to profits reported by S&P 500 companies:




*Aggregate US corporate profits (NIPA) and S&P 500 company profits as a percentage of GDP, from 1Q'88 to 1Q'25. Source: Bureau of Economic Analysis, S&P Global and own elaboration.*

[4] Corporate profits do not include "mixed income," which arises from businesses that are not organized as corporations — for example, sole proprietorships or partnerships. Because it is difficult in these businesses to separate value added into labour income and capital income, mixed income is recorded as a separate item from wages and from corporate profits in the national accounts.

[5] There are other methodological differences that I will not discuss here, such as the accounting treatment of fixed-capital depreciation and inventories, which differs in national accounts from GAAP standards. In addition, the profits of S&P 500 companies may be affected by the revaluation of certain financial assets measured at fair value, whereas national accounts profits include only items related to production. Finally, S&P 500 constituents earn profits abroad, while national accounts profits capture only those generated within the borders of the United States.

As can be seen, both series have followed a similar path over time; short-term divergences have mainly reflected the different definitions used by each series. A notable example of this occurred in 2000–2002, when S&P companies reported much larger profit declines due to negative revisions of many liquid investments that were recorded at market prices – items that, by definition, are not included in the national accounts. However, what is most striking about the chart is that S&P 500 company profits still represent around 50% of total US profits – a figure that has barely changed in the last three decades. Despite the large dispersion within the index (the tech giants have captured a disproportionate share of profit growth over the last five years), the index's profit growth has remained in line with that of the rest of the economy – in other words, the S&P 500's recent operational performance is nothing special, despite what we read in the headlines every day.

The previous analysis, which used series as a proportion of GDP, gives us a correct perspective on profit growth in recent years and, more importantly, highlights the downside risk if margins were to moderate. To put some numbers on it, a 2% contraction in margins (from 11% to 9%) over five years would result in an absolute decline in profits of over $600 billion. In such a scenario, even if GDP were to grow by 3% per year, aggregate profits would remain unchanged over that period. This is not a prediction, but a simple numerical exercise that shows how a change in margins can affect profit growth in the short term.

To avoid making this section any longer, I will summarise the key ideas. US equity valuations are at historic highs, so future returns should be abnormally low, *unless we experience a further multiple expansion or very strong profit growth*. While the former is not impossible, the latter starts from very demanding margin levels. In the following sections, I will explain how the Fund's positioning has evolved over the year, and the opportunities I have identified in this complex environment. At the risk of repeating the mistake that many active managers have made over the last decade, I firmly believe that *the current combination of high valuations and extreme concentration will be precisely the most favourable environment* for active managers who offer a different approach and select companies with judgement and patience.

## Main investments and divestitures made during the year

In line with the vehicle's three-to-five-year investment horizon, the turnover among positions with a weight above 4% in the Fund has been low this year. The only significant additions were the positions in Molina Healthcare and PulteGroup, with no positions above 4% being disposed of. Other movements among the main holdings were driven by changes in market prices, and in one case by a company in our portfolio being acquired and delisted (Mr. Cooper).

The main additions to the portfolio were, in alphabetical order, American Coastal, CarMax, Elevance Health, Molina Healthcare, Private Bancorp, and PulteGroup. Given their relevance to the Fund, the theses on health insurers are developed in detail in the appendix to this letter; below, I provide a brief overview of the others.

American Coastal (ACIC) is a Florida-based insurer specialising in wind coverage for apartment buildings – hurricanes and tropical storms. Although at first glance the business may appear to be dependent on the vagaries of weather, the company's track record shows otherwise. As Buffett always says, there are no "bad risks" in insurance, only mispriced

premiums. The properties insured by ACIC have historically experienced much lower losses than other real estate assets: they are more modern, low-rise, and not located on the beachfront. Furthermore, the company's chairman and founder has been insuring similar buildings and risks in Florida for over 20 years. I believe our capital is in good hands with him since, even in years with major hurricanes, the company has not lost money. With a market capitalisation slightly above $600 million and shareholders' equity of $330 million, the stock is trading at less than two times book value. With normalised ROEs above 25% (currently around 40%) and modest expected growth, I believe this is a reasonable opportunity to achieve low double-digit returns and, moreover, returns that are effectively uncorrelated with the economic cycle.

Private Bancorp (PBAM) is a commercial bank based in La Jolla, California, focused on ultra-high-net-worth individuals, professionals, family businesses, and real-estate developers along the Southern Californian coast. Under the current management team, who arrived in 2018, PBAM has become one of the most profitable banks in the United States, with current ROA and ROE figures of 1.8% and 18%, respectively. Well-run Californian banks are extraordinarily lucrative franchises due to the high average deposit volume per branch and the abundance of small local businesses (whose number exceeds that of San Antonio, Dallas, and Houston combined), which are often underserved by larger banks. With a still modest asset base of around $2.5 billion, the potential to grow toward the $10 billion mark is significant. Given the modest valuation of 1.3 times book value, I estimate that the investment should offer IRRs of 12–15% over the coming years.

Finally, PulteGroup is the third-largest homebuilder in the US by number of homes delivered. The thesis for Pulte is similar to the one we have defended for large homebuilders since 2022: a structural housing supply deficit, moderate economies of scale favouring larger companies, a business that is not subject to technological obsolescence, healthy balance sheets, high returns on capital, and rational capital allocation policies. As with PBAM, Pulte should deliver low double-digit returns over the next few years under conservative assumptions – i.e., RNOAs below 20%.

The main disposals during the year were Atkore International, Lithia Motors, and OSB. We added OSB at the end of 2023 after sharp declines that year, and it was sold at a profit thanks to double-digit dividends and multiple expansion – rising from our average purchase price of 0.64 times book value to 0.75 times. Since the sale, the stock price has continued to rise and, in retrospect, the exit was premature. While I remain sceptical about the bank's diversification into verticals other than buy-to-let, the valuation still left a reasonable margin of safety, since the bank should continue to generate ROEs above 12%. The acceptable IRR we obtained on this investment, above 20%, was more due to the favourable entry point than the mediocre exit.

The outcomes in the cases of Atkore and Lithia have fallen well short of my expectations, particularly in the case of Atkore, which we sold at a loss of 30%. In both cases, *I made two fundamental mistakes*. Firstly, I overestimated the companies' normalised profits in a post-Covid environment. Secondly, I underestimated the impact of the poor acquisitions made by both firms over the last three years, paying high valuations for assets with modest growth. Lithia's capital has been partially recycled into shares of another company in the same sector that has exercised greater discipline in its acquisitions and has continued to repurchase

shares at attractive prices (AutoNation). In Atkore's case, the capital was reinvested in a completely different sector (insurance).

**Structure of the portfolio**

Turning to the main metrics of the portfolio, as of 31 December, the Fund held 10.1% in cash, with the remainder invested as follows: equities 72.7%, fixed income 0%, special situations 13% and preferred shares 3.1%. By geography, our largest weighting is in North America (66%), followed by Europe (14.2%), Middle East (6%) and Africa (2.6%). Excluding the ones labelled as "special situations", all of the companies in our portfolio have a long and proven track record of profitability, measured by return on net operating assets (RNOA). Furthermore, the incremental investments that these companies are making exceed our cost of capital in most cases. I believe that, in the event of a valuation pullback, our current combination of liquidity, attractive companies at reasonable prices and, in some cases, defensive businesses will leave us better positioned than the indices and our competitors, giving us the flexibility to seize investment opportunities as they arise.

The weighting of the fixed-income portfolio has decreased dramatically over the past year, and we currently have no exposure to credit. Because the portfolio is built solely on the individual characteristics of each security, it is impossible to predict whether the fixed-income weighting will increase over the next year; however, *I can say that if credit spreads remain at current levels, the likelihood of finding credit opportunities offering returns close to the Fund's target with moderate risk is extraordinarily low*. After all, fixed income is an asset class with lower dispersion of returns than equities, so the chances of discovering a mispriced credit are also smaller.

The portion invested in US equities is partially hedged against currency fluctuations, while the fixed-income portion is fully hedged. While I believe that the dollar will structurally appreciate versus the euro over the coming years, these macroeconomic considerations are irrelevant to portfolio construction, which is based solely on my conviction in each security, regardless of its currency denomination. As I mentioned in the introduction, the dollar's depreciation has weighed somewhat on this year's results, but I simply view it as the price that euro-denominated investors must pay. At the same time, given our long-term investment horizon, full currency hedging would be prohibitively expensive.

I remain at your disposal to answer any questions you may have or to discuss any of the securities in our portfolio in more detail.

*Nullius in verba*,

Javier López Bernardo, Ph.D., CFA
*Portfolio Manager*

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## Appendix I. Summary of the theses of our main positions

### Northeast Bank (NBN:US)

For another year, Northeast Bank (NBN:US) remains the largest holding in our long-term equity portfolio. For those unfamiliar with the rationale behind this small-cap US regional bank, I set out the details in the H1 2023 letter; in the year-end letter from the same year, I delved deeper into the qualitative factors that have placed Northeast among the regional banks with the best returns; finally, in last year's letter I explained some of the recent avenues for growth, such as the SBA lending business.

Unlike 2024, 2025 has been a quiet year for the share price, which has remained largely unchanged over the last twelve months. Operationally, however, the reality has been very different. The bank closed the 2025 fiscal year (ending in June) with an average return on assets (ROA) of 2.3% and an average return on equity (ROE) of 19.2%, both of which were higher than a year earlier. Efficiency ratios fell below 40%, credit losses (excluding the SBA business) remained minimal once again and, as the gap between ROA and ROE shows, the bank continues to operate with a conservative balance sheet. Consequently, book value per share increased by a robust 26%, rising from $46 to $58.

The poor share performance can be attributed to three factors. The first has been the absence of material loan purchase transactions.[6] In recent quarterly updates, management has reiterated that the volume of opportunities is high due to increased acquisition activity. However, they have also made it clear that they will remain disciplined on price; being a "take-it-or-leave-it" business means that either they acquire a loan portfolio or another buyer who has offered a more attractive price does so instead.

The second factor was a slowdown in the small SBA loan business, caused by the temporary US federal government shutdown in October and much of November, which prevented loan operations because the SBA is a federal agency. Although the amounts look small in aggregate ($5.3 billion in loans were estimated to be unable to be approved by the SBA), the impact on Northeast's financial statements was somewhat larger because, besides being small, the bank has captured a significant market share in this niche. While profits from this vertical may not be durable, the very high ROEs generated by being "capital light" (gains from the partial sale of originated loans provide the capital to hold the retained portion) will help to grow book value in the coming years.

Finally, 2025 was a subdued year for the banking sector as a whole: valuations for many banks corrected following the strong re-rating in 2024. In the case of Northeast, the stock moved from about 2 times book value to around 1.7: the strong growth in book value during the year was almost fully offset by a contraction in the multiple, leaving the share price at a similar level to that of the previous year.

Needless to say, none of these reasons has shaken my conviction in the company; in fact, we bought some additional shares during the year. Firstly, I am certain that Rick, Pat and their team will soon close significant loan purchases at attractive returns. The absence of recent deals is, in truth, *further evidence of management's discipline, not a lack of opportunities*. Regarding the SBA business, while I remain sceptical in the long term, I expect volumes to recover in the next few quarters. Finally, "market sentiment" surrounding regional banks is

[6] Shortly after I wrote these lines, the bank completed a significant transaction amounting to $525 million before the end of the year.

irrelevant to our thesis, since I estimate that the bank will continue to capitalise at rates of 15–20% under normal conditions – and with limited downside risk. And if multiples keep contracting, *management has demonstrated in the past that they are one of the few teams in North America that understands all the capital allocation levers (both issuances and buybacks) to create value.*

**US healthcare insurance companies: Elevance Health (ELV:US), Molina Healthcare (MOH:US)**

The most significant additions this year were two US health insurance companies: Elevance Health (ELV) and Molina Healthcare (MOH: US). Given their combined importance to the fund, amounting to around 10%, and the fact that I have not previously explained this thesis, I will devote more space to them than to the other names.

Interestingly, the fund held positions in both Centene Corporation (CNC:US) and Elevance a few years ago, and both were liquidated at a profit. The impending Medicaid redeterminations were undoubtedly one of the reasons I sold them, although I did not expect the decline to be so pronounced – most stocks in the sector are currently trading at five-year lows.

The investment community has been well aware of the long-term thesis on health insurers for some time. The sector benefits from structural tailwinds in the form of population growth and rising per capita healthcare needs. Additionally, those insurers with government exposure (all of the major players except Cigna) have the growing penetration of Medicaid and Medicare, managed by private companies, as an additional tailwind. These three factors have enabled insurers to achieve consistent profit growth of around 8-11% over the last decade – and that figure does not take into account additional growth from acquisitions or share buybacks.

The impact of the pandemic on the healthcare system has altered this algorithm. To understand this, it is helpful to consider the case of Medicaid. Under normal conditions, the various states, which are responsible for implementing Medicaid in their territory, carry out an annual process known as “redetermination” to verify whether individuals continue to meet the programme's eligibility criteria, such as income level, household composition, and address. The pandemic disrupted this process, and continuous coverage protection, easier enrolment and the suspension of redeterminations were introduced in response to the health emergency. In other words, people continued to enter the programme but did not leave. Consequently, the number of people covered by Medicaid (including the Children's Health Insurance Programme, CHIP) increased from approximately 70.6 million in 2019 to 92.4 million in 2022.

The redetermination process resumed in 2023, and since then, enrolment in Medicaid has fallen, with 79.6 million individuals insured in 2024. The partial figures we have for 2025 show a further decline, albeit to a lesser extent.

The reactivation of redeterminations has not only led to a substantial drop in membership and a consequent reduction in the dilution of insurers' fixed costs, but it has also resulted in healthier, lower-cost policyholders leaving, which has left behind a smaller, sicker group. This has increased the use of high-cost services, such as mental health services, specialised care, and more expensive medicines. Average per capita costs have increased, yet the

premiums charged by insurers ("capitation fees", the fixed monthly premiums they receive per insured person) have not yet been adjusted to this new reality.

Understanding Medicaid pricing is essential for grasping the industry cycle and the future of our two investments. By law, capitation rates must be "actuarially sound", meaning they must cover "all reasonable and appropriate costs" of the services and populations they cover. Although this principle dates back to at least 1981, between 1981 and 2002, the rules only set a cap on rates, equivalent to the cost to the government of providing the same services to an 'actuarially equivalent population', without setting a minimum. In 2002, this ceiling was replaced by a more rigorous actuarial standard: rates must now be set "in accordance with generally accepted actuarial principles and practices, appropriate to the population and services covered, and certified by a qualified actuary". Finally, in 2016, the standard was updated to require state actuaries to develop and apply trend factors to the base data using actual Medicaid experience.[7]

Capitation rates are calculated prospectively for a period of 12 months and must be submitted for approval 90 days before the start date of the new contract. When determining these rates, each state takes into account factors such as base costs, tariff cells (subgroups within the covered population), cost projections, the scope of benefits and any special contractual provisions. The rates must be sufficient to enable managed care organisations to spend at least 85% of total capitation revenues on covered services and no more than 15% on other activities, such as plan administration and profits. In practice, this framework has resulted in medical cost ratios (MCRs) of 87–90%, administrative costs of 7%, and net margins of 2–4%.

Once the scheme is understood, *it becomes clear that insurers will receive higher revenues per member once states incorporate recent premium spending trends to restore actuarial soundness*. This should reduce current MCRs above 90% to below 90% and restore margins over the next 24 months.

In government-subsidised private insurance markets (also known as *marketplaces* or ACA exchanges), the dynamics are similar to those of Medicaid: insurers have faced increased costs and an increased risk of illness among their customers. Between 2023 and 2024, many former Medicaid enrolees who were affected by the revisions migrated to the individual markets, which worsened the overall morbidity rate. Recently, the Trump administration's potential non-renewal of certain subsidies has added additional noise. In any case, the full recovery of the individual markets is not central to the thesis for either Elevance or Molina.

Elevance is the second-largest insurer in the United States, with almost 45 million policyholders and a presence in the private, Medicaid, Medicare and individual insurance markets. Molina, on the other hand, is a smaller competitor as its business is almost exclusively focused on Medicaid, with no presence in the private sector. As Molina is less well known, I will provide some additional details about its business and the valuation that I estimate below.

Molina operates in 21 US states and has 5.6 million members, divided between the Medicaid programme (4.6 million), the Medicare programme (0.3 million), and the individual/Affordable Care Act (ACA) market (0.7 million). The company has a clear focus on low-income populations. California, Washington and Texas are the only states in which

[7] This introductory document, from which the above quotations are taken, provides further details.

Molina generates more than 10% of its premium income. Nationally, Molina holds a 7% market share, making it the fourth-largest operator in the country. If only the states in which it operates are considered, its market share rises to 11%.

This concentrated geographical footprint is relevant, as states assume operational and reputational risks when outsourcing healthcare programmes to new or small providers. Molina is one of the companies preferred by state administrators in order to limit these potential risks. An indication of Molina's good reputation is the success rates often cited by the management team since 2019: 80% for new awards and 90% for contract renewals. These figures are well above those of its competitors, which typically hover around 60–70%.

Molina's vertical focus and concentrated geographical coverage result in a streamlined cost structure, making it one of the most efficient providers in the industry. Its administrative and general expense-to-premium ratio is among the lowest in the sector (around 7% for the combined company, and even lower for Medicaid), and its MCRs have been 200–300 basis points lower than those of its competitors since 2018. This is important because most of its contracts are capitation-based, meaning that as a low-cost provider, Molina can retain part of the difference. I say “part of the difference” because states also establish “corridors” that guarantee minimum benefit spending in order to prevent plans from earning excessive profits while limiting losses if healthcare costs rise more than expected. In short, *these corridors mitigate extreme fluctuations in MCRs by capping gains or losses outside a certain range*.

In terms of valuation, Molina has historically achieved a net operating profit per member ranging from $150 to $200.[8] Assuming a standardised net operating profit of $180 per member, the aggregate net operating profit would be $1.26 billion per year. Assuming a discount rate of 8% on net operating assets of $3.4 billion, the residual operating profit would be around $1 billion. With a modest growth rate of 2%, the insurer would be worth around $17 billion in this scenario. Incorporating the value of investments and net financial debt on the balance sheet, the value to shareholders would increase to approximately $19 billion, or around $380 per share. These figures are not intended to be “precisely correct”, as Keynes would say, but rather to illustrate the substantial margin of safety relative to the current share price of $165.

Finally, given the business's relatively countercyclical nature, I believe that the returns on both stocks will not only significantly outperform the indices over the next five years, but also do so with a much more favourable risk profile.

[8] This is calculated as operating profit after tax from the underwriting part of the business. Taxes are adjusted for the tax shield on Molina's financial debt and on the gains or losses from its liquid investment portfolio, which is primarily made up of government bonds.

**Auto dealerships: Asbury Automotive (ABG:US), AutoNation (AN:US)**

One year on, our investment in US dealerships remains a significant exposure in the Fund, accounting for around 9% of the portfolio and concentrated in two positions: Asbury Automotive (ABG: US) and AutoNation (AN: US). Lithia Motors, which was our third largest holding last year, is no longer in the portfolio for the reasons outlined above.

Although 2025 has been a turbulent year due to the uncertainty surrounding tariffs, my thesis on these stocks has not changed since I set it out in the letter two years ago. Tariffs simply added noise to this year's figures because consumers brought forward their vehicle purchases in anticipation of them, generating good volumes and margins for dealerships in the first few months of the year. Conversely, once consumers had brought forward their purchases and understood the impact of the tariffs in the second half of the year, sales slowed down. Overall, the global results for the year have not changed dramatically, although this has prompted countless "analyses" from the sell-side on this or that minor detail.

What has evolved over the year is my relative view of the different players. Last year, I argued that "Asbury is the one that best captures a combination of an attractive valuation, an excellent management team and, as I will explain below, the most straightforward business plan of the three". However, this year I have come to *the conclusion that AutoNation is the company that has made the best capital allocation and is the lowest risk of all of them*. I acknowledge that my perception may be unduly influenced by the recent performance of share prices, and I will seek to justify this change in the following paragraphs.

Firstly, it may be interesting to analyse a longer time horizon. Since 1 January 2020, before the distortions caused by the pandemic and subsequent supply chain issues in 2022, Asbury's shares have increased by 2.2 times, AutoNation's by 4.2 times, Group 1's by 4.1 times, Lithia's by 2.3 times and Sonic's by 2.1 times. Penske, which I am not including due to its exposure to the truck business, has increased by 3.4 times. In other words, companies that have prioritised share buybacks (AutoNation and Group 1) have comfortably outperformed those that prioritised acquiring new stores.

There are several reasons for this performance, but they are easy to understand. The dealership business has a very low fixed cost structure; employee compensation is one of the largest cost components, and it is largely variable as it is linked to sales commissions. Other significant costs, such as parts purchased for repairs, are also variable. This highly flexible cost structure, combined with the resilience of the repair business, is why dealerships have weathered past economic crises without making losses: when sales volumes plummet, the lack of operating leverage means that costs adjust quickly. However, *this argument works both ways*: multiplying the number of stores does not substantially reduce the fixed cost base, so economies of scale are modest. While there may be synergies for large groups in terms of advertising or logistics, these are usually not decisive.

Secondly, industry executives exhibit the same tendency as their counterparts in other sectors: *making acquisitions when the sector is temporarily generating abnormally high profits*. Most of these purchases were made between 2021 and 2023, when the sector was enjoying unusually high margins in the used car business. Even the most recent acquisitions, which were made at multiples of normalised variables, raise doubts about value creation for shareholders. A case in point is Asbury's purchase of the Herb Chambers Group, a chain of dealerships with a significant presence in the luxury car segment, this year. Asbury paid $1.35 billion for revenues of $2.9 billion – a sales multiple of 0.46, similar to Asbury's own.

Additionally, the operational efficiencies derived from the acquisition appear to be limited, given that Herb Chambers was already operating efficiently. During the second quarter earnings presentation, Asbury's CEO commented on the acquisition as follows:

> *"I just had one first one on just the Herb Chambers acquisition. You now have them under the hood for a couple of weeks. It looks like the SG&A to gross profile for Herb Chambers is slightly better than the legacy Asbury business. I'm curious have you been able to -- given the couple of weeks you've had, any incremental opportunities do you see to improve like just metrics at the store, other areas around services or used cars that you see you can bridge the gap to versus like -- versus Asbury orders versus like border industrial peers that have better metrics. Just curious if you could just give us some more insight into, what we should expect to see as the acquisition gets integrated further."*
>
> *"And there was [sic] a few things that we think about their mix of luxury over 60%, the name in the marketplace that they have and the scale that they have in the market was most interesting to us along with the quality of people and tenure that they have. So we think we align philosophically on how to run the business. The best part about this in any transaction, there's always opportunities to improve. There's [sic] opportunities to improve in our same store, there's opportunity to improve with any acquisition that we have. We'll work with the team over time to look for efficiencies to improve upon the business. But this was a strategic market for us. It's a defensive position. New England isn't a growth market, but it's a very stable market. It performs well in a downturn. And with the luxury mix and the presence in this market, with the level of service that they offer, we think this creates great stability for Asbury over time.*

The acquisition appears to have been based more on "strategic" and "defensive" criteria than on creating value for shareholders. While the acquisition price seems fair, the debt incurred by Asbury to finance it reduced its ability to buy back shares at critical moments around Liberation Day, when shares across the sector fell sharply. While AutoNation's outstanding shares have fallen by 5.5% in the first nine months of the year, especially in the first quarter, Asbury's have remained virtually unchanged.

A few weeks ago, Asbury announced changes to its executive management team. David Hult, who has been CEO since 2018, is stepping down in favour of Daniel Clara, who has been COO since 2002. In the seven years prior to Hult's arrival (2011–2017), Asbury's outstanding shares fell from 31.3 million to 20.8 million, while net operating assets grew modestly from $780 million to $1.27 billion. This combination of modest growth and aggressive share buybacks worked wonders for shareholders, establishing Asbury as the company with the best track record of value creation at that time. However, under Hult's leadership, the number of shares increased from 19.3 million to 19.6 million by 2024, while net operating assets skyrocketed from $1.27 billion to $6.6 billion due to the acquisition policy, with most of the growth concentrated in the euphoric years from 2020 to 2023. It remains to be seen whether Dan Clara will bring about a change of course now that the store network is well established, although I am not particularly optimistic given his background as COO, where one prioritises operational excellence over efficient capital allocation.

That said, the sector continues to trade at attractive levels in both absolute and relative terms. This is why we maintain a significant weighting in the Fund. I estimate that both stocks should deliver low double-digit returns over the next few years. These could be higher if Asbury's capital allocation improves, or if the opportunity to buy back shares at attractive prices arises again.

**BRP Inc. (DOO:CA) and Garrett Motion (GTX:US)**

Finally, I would like to highlight the two investments that make up the top five of the Fund: Garrett Motion (GTX:US) and BRP (DOO:CA). Fortunately, both were added last year and have performed well over the last twelve months. I provided a detailed explanation of the BRP thesis in last year's letter, so I will not repeat it here.

Although it has been a good year for both companies' share prices, volatility has been higher than usual due to the introduction of tariffs. In Garrett's case, we have since seen that it has been able to pass the tariffs on entirely to its customers, with no impact on gross margins. The situation for BRP has been more complex, however. The company manufactures most of its products in its Mexican plants in Juárez and Querétaro, which has received significant investment in recent years to increase production capacity. At the same time, however, BRP's largest market is the United States, so the impact of tariffs has been felt not only on production in Mexico, but also on products manufactured in Canada (mainly Ski-Doo snowmobiles, as well as some Can-Am vehicles), Finland (Lynx) and Austria (Rotax engines). BRP's production assets in the United States are minimal; the main facility is in North Carolina and is responsible for producing some aluminium components. While the tariffs have ultimately had a moderate impact as some of BRP's products fall under the USMCA trade agreement and are not directly taxed, they have introduced additional costs and uncertainty into an already cyclical market.

Despite these fears, the stock recovered the losses incurred in recent quarters and ended the year positively, driven by the normalisation of inventories in the powersports industry. As I explained last year, the industry has spent the last two years digesting excess inventories. Now that inventories have normalised, sales to end customers should match units sold to the distribution channel, resulting in increased volumes and improved margins. It should be noted that, unlike recreational vehicle or car dealerships, BRP has a high fixed cost base due to its highly automated manufacturing process and high R&D expenditure.

Although I have reduced my exposure to both, especially BRP, following the rises, I still believe they should yield low double-digit returns over the next few years. Garrett's aggressive share buyback programme should provide some protection in adverse scenarios. Overall, I consider the above returns to be reasonable, given the dominant positions that both companies hold in their respective markets.

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