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August 15th, 2017

Letter to Investors: 2017 Mid-year Update

Dear Investment Partner:

For the first half of the year through June 30th, our portfolio* gained 14.6% gross (and 12.0% net of all fees). The S&P 500 gained 9.3% including dividends during this time.

Saber's cash position continues to be elevated more than I'd like, fluctuating between 10-25% throughout most of the first half, and closer to the high end of that range currently. Also, for a number of clients whose accounts were established sometime earlier this year, you might notice a cash level that has been abnormally high so far year-to-date. This is because two stocks that were purchased early last year at much lower prices have appreciated to a level closer to fair value. They remain holdings in the model portfolio, but will likely be sold in the near future and thus haven't been purchased yet for new accounts. So, cash levels will be slightly higher for new accounts initially, but over time the cash level (like the rest of the portfolio) will begin to very closely mirror the model portfolio as new investments get made.

Cash is not held as a hedge (although it can act like that at times). It is also not held because of some prediction for a downturn or some projection I have regarding general market valuation levels (I don't/can't predict the market's near-term direction and I don't make investment decisions based on the valuation level of the S&P 500 or any other market index).

Cash is simply held when I haven't quite found the right investment idea yet. However, I would much rather own good businesses, as they'll produce much more value than cash over time. I expect that, over time, we'll be mostly fully invested. Certainly, a good market drop would help our cause.

Your Interactive Brokers account statements should have arrived in the mail. Those statements contain your 2nd quarter results as well as the current positions and account value as of 6/30/17. You can see your YTD results as well as other relevant details for your account online on your Account Management page at the Interactive Brokers website. Please contact me with any questions regarding your account, your portfolio, or anything else.

Deep Work

I recently read a good book called *Deep Work*. The book is about increasing productivity by prioritizing your time, trimming the "fat" out of a work day by avoiding distractions, and focusing more intently on important projects. Each year I set a few goals, but one goal that always is on top of my list is very simple: "Get Better". I try to refocus each year on self-improvement, looking for areas where I can improve as an investor. The ultimate objective here is to expand my list of companies I follow (and sharpen the understanding of those already on the list). This increases my opportunity set for potential investments.

This year, my focus is to make a conscious effort to **do more deep work** – read more books, dig deeper into companies and subjects, minimize busy work, and cut distractions that tend to keep a lid on productivity and creative thinking.

One of the things I've always loved about business and investing is that they have something very much in common with other things I like such as athletics, music, and chess – and that common denominator with all of those endeavors is that there is always room for improvement. These are examples of crafts – and the way you improve your craft is by practicing.

And unlike Allen Iverson, I've always loved practice. Practice is where you get better, and I've always felt the greatest satisfaction comes not necessarily from the achievement (although that is the ultimate end-goal), but often from the noticeable self-improvement that happens from time to time along the way.

To summarize this concept with a more practical question: how does an investment manager best position himself or herself to achieve great results? One way is to do more focused practice – that is, engage in more "deep" work and less "busy" work.

Edge

I've written before about what I think Saber's edge is, but I think it can easily be summarized in two broad categories:

- We have the ability to maintain a very long-term time horizon
- We have the ability to be extremely patient – waiting for the best investment opportunities

Patience in investing means avoiding the mediocre ideas. There are lots of stocks of subpar businesses that look cheap – but these companies rarely produce a good investment result over time, regardless of how cheap they look currently.

Along with patience, I think it is important for investors to know their limitations. I've learned that simply being honest with yourself about your limitations and your weaknesses is extremely important in investing. This honesty helps you to avoid certain biases that might cause you to invest into situations that are above your pay grade (and, despite my best efforts, most ideas I come across remain stubbornly above my pay grade).

So, patience is the antidote for finite mental bandwidth (the good news is that the bandwidth can be steadily increased over time through continual learning, and even a limited bandwidth can produce plenty of great investment ideas – the key is avoiding the bad ones so the good ones mean more).

Saber's investor base (you!) is one key ingredient that allows me to take advantage of these two important principles, so I thank you for both your long-term horizon and your patience. Most investment managers do not have this luxury, and I believe it is why so many smart investors with well-intentioned incentives, sizable resources, and sound investment philosophies don't ultimately achieve success. Patience, a long-term view, and a like-minded investor base certainly don't guarantee success, but I think they combine to form a cohesive advantage that improves our chances. And because of this, I like our chances over time.

These "keys to success" are often talked about, but not often acted upon. Ubiquitous-sounding bullet points about "long-term", "patience" and a quote or two from Warren Buffett will not get the job done (not that I think there is anything wrong with quoting Buffett, as I have demonstrated over time). Perhaps a passage from Proverbs 14 is more relevant: *"All hard work brings profit, but mere talk leads only to poverty"* (this verse might cause some of you to begin to question why my letters are 3500 words long).

In other words, the key is not the talking points, but actually being able to implement them. And one way to implement them is to slow down, clear your desk, and engage in "deep work".

Embrace Big, "Inevitable" Trends

> *"The outside world can push you into Day 2 if you won't or can't embrace powerful trends quickly. If you fight them, you're probably fighting the future. Embrace them and you have a tailwind."*
>
> - *Jeff Bezos, 2016 Amazon Letter to Shareholders*

Jeff Bezos wrote about four things that an industry-leading company must do to stay on top (or in what he calls "Day 1" – the healthy growth phase of a company's life cycle, as opposed to "Day 2", which is the beginning of a company's demise). One of the keys to staying hungry, according to Bezos, is to embrace these big, sweeping, fundamental trends.

One of these big trends is the Chinese ecommerce market, which has recently passed the US as the largest in the world, and yet is still growing at around 20% annually.

Buffett once talked about companies he considered to be what he called "the inevitables" – durable businesses that he felt were sure to do well over time due to structural competitive advantages. The Chinese ecommerce market could be described as one of these "inevitables".

Studying the online shopping market in China led me to learn about other industries benefiting from the same general tailwind – mobile advertising, video consumption, mobile payments, cloud computing, and many other related industries are certain to grow significantly over time as tens of millions of people in China enter the middle class each year and allocate higher percentages of their growing purchasing power toward these areas.

And unlike burgeoning industries of yesteryear such as automobiles or airlines that produced rapid growth in volumes but created little to no lasting value for owners, the Chinese ecommerce and digital advertising market are dominated by a select few companies that are highly profitable, well-managed, and are well-positioned to create enormous value from these industry tailwinds over time.

As Bezos said in his letter, "these big trends are not that hard to spot" – and the growth in China's online shopping industry is certainly not hard to spot. But just as large-cap stocks can occasionally become sizably mispriced despite their wide following, the usefulness of an insight does not necessarily correlate to how original it is. In other words, it is widely known that China's ecommerce market is huge and rapidly expanding, but there are still plenty of opportunities to capitalize on that obvious trend as investors.

While there will be many bumps in the road, productivity and consumer spending will continue to rise in China over time, and some of the best companies in the world will come from business models that capitalize on this extremely powerful fundamental trend.

One of our investments that will benefit immensely from this tailwind is Tencent Holdings.

Tencent (TCEHY)

In June, I did a presentation for the Manual of Ideas (a value investing website/community) on Tencent Holdings, a company we invested in late last year.

Tencent is a Chinese internet holding company with one of the most powerful network effects in the world. The company operates in numerous businesses that generate significant free cash flow, take very little capital to grow, and have huge runways for growth in China and around the world. These businesses and investments consist of video game publishing, music and video subscriptions, ecommerce, mobile payments, and online advertising among other assets.

But the company's crown jewel is WeChat, which is a mobile app that is unlike any application that exists in the West. WeChat dominates China, and its 963 million users spend more time on WeChat than US users spend on Facebook and Instagram combined. And it's far from just a messaging and social media application. WeChat is used for just about everything in China including messaging, work communication, calls, social networking, online shopping, paying bills, transferring money, and much more. Incredibly, **one-third of WeChat users spend more than 4 hours a day inside the WeChat universe**.

This is a clip from an Economist article that outlines a sampling of what WeChat is used for in China:

> *"Like most professionals on the mainland, her mother uses WeChat rather than e-mail to conduct much of her business. The app offers everything from free video calls and instant group chats to news updates and easy sharing of large multimedia files…*
>
> *"Yu Hui's mother also uses her smartphone camera to scan the WeChat QR (quick response) codes of people she meets far more often these days than she exchanges business cards. Yu Hui's father uses the app to shop online, to pay for goods at physical stores, settle utility bills and split dinner tabs with friends, just with a few taps. He can easily book and pay for taxis, dumpling deliveries, theatre tickets, hospital appointments and foreign holidays,* ***all without ever leaving the WeChat universe.****"*

WeChat is an asset that has barely been monetized yet, but is in prime position to capitalize on numerous fast-growing industries like mobile advertising, online shopping, and mobile payments.

Tencent has a truly exceptional collection of businesses. Despite a vast untapped potential in some of those markets referenced above, the company is already highly profitable. Revenue is growing at close to 50% annually. Thanks to 30% net profit margins, Tencent turns a good chunk of that revenue into free cash flow for the company to reinvest. I estimate that the company is producing about 35% returns on incremental capital investments, and is growing its already sizable $8 billion of free cash flow at 40% per year.

Growth obviously will slow down at some point (40-50% growth rates only last so long), but given its unique competitive position and the huge size of the markets it operates in, there is likely a very long runway ahead for the company, despite already being one of the most valuable companies in China.

To summarize, there are four things I like about Tencent: the huge network effect of WeChat, the massive runway for growth, the high returns on capital and significant free cash flow (despite barely scratching the surface of WeChat's potential), and the fact that the company is run by its driven, long-term focused founder who remains one of the major shareholders.

We bought shares of TCEHY in late 2016 for an average price of $25.

The stock has risen significantly (it has gained around 80% year-to-date), and I have no idea where the stock goes in the next year or so (as is the case with any stock), but I think over a long period of time Tencent shares will likely compound at a rate that roughly mirrors the growth of the company's intrinsic value – and I think this rate of compounding will be quite high (15-20% annually) for a number of years to come.

The slide presentation further details my thoughts on Tencent, and also outlines how I think about the valuation of Tencent, which I view as a long-term compounder.

- Tencent Holdings (June 2017 Manual of Ideas Presentation)

Large Caps

The tailwind of these big, external trends is an insight (albeit not a particularly unique one) that I've been thinking about this year. Another insight that I feel is much less commonly held is that large-cap, well-followed stocks can be excellent investments at times. As I've mentioned before, I don't intend to be investing in large-caps exclusively. On the contrary, I am always hunting for off-the-radar ideas that might be undervalued. But sometimes large-caps can offer significant value, and my objective is to find value, not to win style points by locating the most unique investment idea.

As a quick summary, here is a chart that I put up in last year's mid-year letter, demonstrating how much large cap stocks bounce around:

Top 10 Largest Companies in S&P 500 (as of 6/24/2016)						
Company	Ticker	Current Market Cap ($ billions)	52 Week Low	52 Week High	% Change (High/Low)	$ Change in Market Value ($ billions)
Apple	AAPL	$511	89	133	49.4%	$239
Google	GOOG	$459	515	790	53.4%	$187
Microsoft	MSFT	$391	40	57	42.5%	$134
Exxon Mobil	XOM	$370	67	92	37.3%	$106
Amazon	AMZN	$330	426	731	71.6%	$145
Berkshire Hathaway	BRK-B	$326	124	148	19.4%	$60
Facebook	FB	$320	72	121	68.1%	$141
Johnson & Johnson	JNJ	$318	82	118	43.9%	$100
General Electric	GE	$274	19	32	68.4%	$117
AT&T	T	$255	31	42	35.5%	$69
	Average % Change High/Low				48.9%	
	Average $ Change in Market Value				$130 billion	

Here is the same basic chart updated for 2017:

Top 10 Largest Companies in S&P 500 (as of 8/15/17)						
Company	Ticker	Current Market Cap ($ billions)	52 Week Low	52 Week High	% Change (High/Low)	$ Change in Market Value ($ billions)
Apple	AAPL	$840	102	162	58.8%	$314
Google	GOOG	$640	727	988	35.9%	$196
Microsoft	MSFT	$555	55	74	34.5%	$148
Facebook	FB	$495	113	175	54.9%	$183
Amazon	AMZN	$467	710	1083	52.5%	$184
Berkshire Hathaway	BRK-B	$438	141	180	27.7%	$96
Johnson & Johnson	JNJ	$358	109	137	25.7%	$77
Exxon Mobil	XOM	$334	77	93	20.8%	$68
JPMorgan Chase	JPM	$329	65	95	46.2%	$108
Wells Fargo	WFC	$262	43	60	39.5%	$86
	Average % Change High/Low				39.6%	
	Average $ Change in Market Value				$146 billion	

What's remarkable is that even with volatility being at all-time lows for much of the past year, mega-cap stocks – ten of the largest, most well-followed companies on the planet – still saw an average of a 40% gap between their 52-week high and low prices.

Despite the army of analysts poring over unlimited bits of information that supposedly increases market efficiency, Apple is currently valued at a whopping $300 billion *more* (or nearly 60%) than it was just one year ago.

There are many others in that list that have seen similar fluctuations. In fact, our three largest investments in the last 18 months have come from capitalizing on significant downward fluctuations in the stock prices of very durable, very large, and very well-positioned companies with predictable earning power and good balance sheets. All three of these investments were shunned by many would-be value seekers who felt like they had no "edge". While they most likely lacked an informational edge, they didn't realize that a time-horizon edge is often more significant, and this type of edge can be used to invest in stocks of all sizes.

Along those lines, Apple remains our largest position, although it obviously doesn't offer the same value as it did a year and a half ago when we first started investing in it. For new investors who want to read what I thought about Apple, I summarized my views here, and also in the 2016 letter.

Apple falls into what I refer to as **"Category 2"** investments – stocks of durable, mature companies that occasionally get mispriced by Mr. Market. These are stocks that might offer 30-50%, or even 100% on rare occasions, but typically will be sold as they approach a more reasonable value.

The ideal investments are the **"Category 1"** investments, or the compounders – businesses that produce high returns on capital and have long runways for potential growth.

The nature of the market is that most investment opportunities will be of the Category 2 type, while the biggest winners will be from Category 1.

I continue to seek out investment opportunities in both categories, and as category 2 investments become more fairly valued, I will look to reinvest capital into more undervalued ideas.

Saber Investors: Thank You!

As I said earlier, one of the main advantages that I believe I have as an investment manager is the quality of my investors. Your collective emotional stability, patience, and support are extremely valuable to me, and I appreciate your trust and confidence in our approach and in me personally. Thank you for your investment and your partnership with Saber Capital.

Your Partner,

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Appendix

Here are a few letters and write-ups I've done that further discuss my investment approach as well as my thinking on some of our recent investments:

Investment Philosophy

- Saber Capital Investor Letter – 2016 Review (2/10/2017)
- Saber Capital Investor Note – Time to "Zoom Out" (Election Comments 11/15/2016)
- 3 Paths to Finding Value (10/25/2016)
- What Is Your Edge? (12/12/2016)

Investment Write-ups

- Markel: A Compounding Machine (MKL)
- Berkshire Hathaway is Safe and Cheap (BRK.B)
- The Toll Road of the Internet (VRSN)
- Bank Stock Review (JPM, BAC)
- Apple's Key Competitive Advantage (AAPL)

I will also publish new content on Saber's website periodically, which will be updated here:

- Saber Capital Management Commentary

Disclosures

**Returns are based on the "Saber Capital Portfolio"—a real money account that is managed alongside all other accounts. I also refer to this as Saber's model portfolio. Performance data of this account is produced directly from Interactive Brokers. Returns are not audited. It is important to note that each client may experience slightly different results from the model depending on the timing of deposits, withdrawals, the opening/closing of the account, the fee structure specific to each account, and other timing issues. The valuations of your investments at the time of purchase may be significantly different than the valuations at the time of purchase in the model because of these timing issues. I expect the net results of the model account to roughly equal the results of client accounts over time, although there can be no guarantee because of the timing issues referenced above.*

The gross returns of the Saber Capital Portfolio are taken directly from Interactive Brokers. The net returns are estimated using a 1% management fee and 15% performance fee. Your net returns could vary from the model depending on the fee structure of your account. Your personal account statements with your account specific performance net of all fees will be coming in the mail each quarter, and can also be accessed anytime online. Please note that any performance fees earned during this year will show up in the following year's 1st quarter statement. Also note that the time weighted return (TWR) on your account specific performance summary is net of all fees.

Please contact me with any questions about your statement, returns, fees, or anything else related to your account.