Sifter Global Fund

Quarterly Report Q1/2020

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A roller coaster ride

The outlook for growth has turned into a speculation of the depth and duration of the financial difficulties.

A roller coaster ride is in many ways a good analogy for the past quarter in the capital markets. Not only because of rising and falling stock prices, but also because of investors' rapidly fluctuating emotional states. The beginning of January was already the spring of the global economy. Several indicators suggested growth for the global economy, and in particular the Q4 business results and the outlook for 2020 were encouraging. Equity prices and valuation levels were supported by steady growth, low interest rates and few good alternatives at hand.

A Black Swan appeared in late February

Very few can, without hindsight bias, say that the extent of global economic disruption caused by the coronavirus was predictable.

Looking forward, we should ask ourselves: what has changed? The outlook for growth has turned into speculation of the depth and duration of the financial difficulties. Businesses are fighting for survival. Central banks and governments have opened monetary to prevent corporate cash crisis. Interest rates are lowered again, and they will stay low for a long time. The biggest change is however that company valuations and stock prices are down.

Crises create opportunities

After all the crises, the reconstruction period is often more powerful than one might imagine in advance.

In this crisis, we are once again able to shift the focus of Sifter's portfolio to buy even better companies' future cash flows at a lower cost and sell lower-yielding companies. After the crisis, the reconstruction period is often more powerful and comes sooner than one might imagine in advance.

As construction begins again and uncertainty diminishes, pent-up demand will drive strong growth, especially in investment goods. It is clear that drinking coffee, for example, will not double at Starbucks coffee shops, but car sales, for example, can increase significantly. We do not believe that people's behavior will change significantly, for example regarding air travel. However, it all depends on how long the downturn will be.

During Q1 Sifter Fund outperformed the index by 3.8 %.

Fund Performance

During the Q1 Sifter Fund total return decreased by -15.7% vs Index -19.5%. As depicted in table 1.

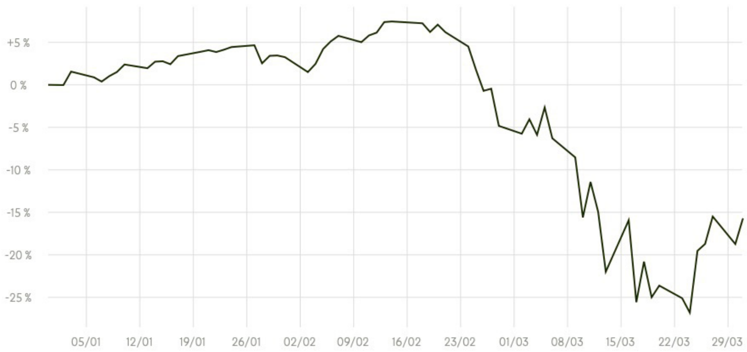
- Annualized return since inception of the Fund is 7.7% (2003/6 -2020/03).

- The Fund has performed better than the comparison index (MSCI ACWI) which has an annualized return of 6.9 %. On an annualized basis, Sifter Fund's return is 0.8% better than the index.

- Since inception, Sifter Fund R/I Class has returned 243.5% in total, which is 39.4% better than the index.

Our hypothesis is that Sifter's quality companies should perform a bit better than the index in the bear market as can be seen in the table 1.

In 17 years time Sifter Fund has outperformed the index by 39.4 %.



Graph 1. Sifter Fund Global NAV changes Q1/2020.

	March	YTD	2019	2018	2017	Annualized since inception (2003–)
Sifter Fund Global	-11,4 %	-15,7 %	31,3 %	-4,1 %	8,5 %	7,7 %
Benchmark index	-14,8 %	-19,5 %	29,9 %	-6,1 %	9,0 %	6,9 %
Difference	3,4 %	3,8 %	1,4 %	2,0 %	-0,5 %	0,8 %

Table 1: Sifter Fund performance vs Index (MSCI ACWI, Total return EUR).

Microsoft's weight in Sifter's portfolio was significantly above average, amounting to 7.2 %.

Best & Worst businesses in Q1

TOP CONTRIBUTORS*

Microsoft	0.23%
-	-
-	-

TOP DETRACTORS*

Hexcel	-2.26%
Autoliv	-1.82%
Safran	-1.77%

*Average weight x total return

During Q1, Microsoft was the only company in the portfolio with a positive total return, a rarity in the broadly declining market. Microsoft's weight in Sifter's portfolio was significantly above average, amounting to 7.2%, which supported the fund's returns in Q1. Microsoft is of course not entirely immune to the impacts of Corona virus as supply chain issues may impact the sales of Windows licenses and Surface computers. However, most of Microsoft's business remains resilient.

The worst performers of the quarter were Hexcel, Safran and Autoliv. The outlook of the first two was negatively impacted by the rising financial distress among airlines, which threatens to stall aircraft production. Before the crisis escalated, we had already reduced our position in Hexcel as we identified risks with the proposed Hexcel-Woodward merger. This limited the negative impact from the later stages of the quarter.

Meanwhile, Autoliv's prospects were hurt by the slumping demand for cars, which reflects the rising consumer uncertainty and lower appetite for discretionary spending for now.

Why are you fully invested?

We are often asked why we don't keep more cash so we could take advantage of crises like this and thus improve our returns.

There are two clear reasons for this. First, crises rarely come, but when they come, no one knows when. Market timing is a losing long-term strategy. Second, we do not want to keep our investors' cash. You can place your money under the pillow and wait for the right moments to buy when it suits you. Sifter is fully invested in all market situations.

Safran has been a great, quality company by Sifter's criteria.

Portfolio changes in Q1

During the quarter, we increased our position in Cisco, Oracle, Atlas Copco, Johnson&Johnson and Lam Research. We see that these companies offer good yields relative to their current risk levels.

Meanwhile, we reduced our position in Check Point, Mohawk and Hexcel, as mentioned above. We see that the yield offered by Check Point and Mohawk was no longer attractive, given the competitive risks involved.

In addition to the trades mentioned above, we did some rebalancing to limit the combined weight of our largest positions.

10 largest holdings

Representing 53.1% of total portfolio (31.03.2020)

Microsoft Corp	NORTH AMERICA
Lam Research Corp	NORTH AMERICA
Taiwan Semiconductors-Sp	ADR ASIA-PACIFIC
Intel Corp	NORTH AMERICA
Cisco Systems Inc	NORTH AMERICA
Alphabet Inc	NORTH AMERICA
Johnson & Johnson Inc	NORTH AMERICA
Verisign Inc	NORTH AMERICA
S&P Global Inc	NORTH AMERICA
Deutsche Börse	EUROPE

Aerospace sector under pressure

This time of crisis has hit especially travel, tourism and related industries. We have two companies in the portfolio that are part of the aerospace industry.

Safran in France, which mainly produces airplane engines and Hexcel in the US, which manufactures composite materials for the same airplanes.

Safran has been a great, quality company by Sifter's criteria. Unfortunately, speculation about Boeing's problems and future airline bankruptcies has drastically lowered Safrans's share price. However, we will hold on to Safran due to its large share of maintenance and it's competitive advantages.

We had already started reducing Hexcel before the crisis, because we saw that the future merged company of Hexcel Woodward would be somewhat less attractive than Hexcel as a stand-alone company. We will sell rest of Hexcel once we find a better replacement.

SINCE NO ONE can guess the length of the crisis, we decided to sell a few challenged companies during Q1 and added secure quality companies such as Johnson & Johnson, Atlas Copco and Cisco to our portfolio.

Many companies have more cash in hand than interest-bearing debt.

SIFTER INSIGHT 1

The sifter team's response to the "Black Swan" event

When the corona crisis hit the stock market, analysts at Sifter rolled up their sleeves. Within a few weeks, we had conducted a three-part review of all thirty companies in the portfolio.

The actions taken by governments to limit the spread of the disease will significantly delay economic progress and tighten the operating conditions of companies world-wide.

As a first step, we wanted to make sure your money is safe. We went through the portfolio from company to company and assessed their financial condition and prospects for weathering a long storm.

Because Sifter's stock selection method favors companies with a low leverage , the average net debt of the portfolio companies is well below the stock market average. Many companies have more cash in hand than interest-bearing debt.

In the analysis, we focused specifically on companies that have a net debt to EBITDA ratio over 1X.

Attention was also paid to the maturities of corporate loans.

What are their credit ratings?

If companies' demand and, as a result, earnings fell significantly, would there be a risk that S&P or Moody's would downgrade the debt of our investments to non-investment grade status? Collectively, credit ratings seemed to be in good shape, and most were several notches above the junk bond rating.

Attention was also paid to the maturities of corporate loans. Would companies be able to finance their outstanding loans with free cash flow even if demand dropped significantly?

Of course, the review had to take into account the specific features of each company. For example, customers of Safran, the aircraft engine manufacturer, and their customers are in the aviation industry, which is perhaps the worst affected by the Corona crisis.

We found that at some of our companies, earnings yields at current prices have risen to over 10 %.

Airline bankruptcies are likely, which in turn jeopardizes demand for Safran's largest customers, Boeing and Airbus. Airbus is financially quite strong, and both are very important companies for their respective governments, so we don't see them ceasing operations.

Evaluating optimistic scenario, and a pessimistic scenario

After obtaining a high degree of certainty about the survival of the companies, we focused our attention on the companies' business.

We calculated a baseline, an optimistic scenario, and a pessimistic scenario for each company. Of course, they are all very inaccurate, because there are only better and worse guesses about the duration of the crisis.

The outlook was set for a short period (1-2) years and a longer period (3-5) years. What kind of income would the companies bring in each scenario?

We found that at some of our companies´ current earnings yields are rising to over 10%.

Looking for opportunities to buy and sell

When buying a quality business at an exceptionally cheap price, you should stick with it

In the third phase, we are changing the weights of the companies within the portfolio.

In panic sales, investors sell their shares with great urgency, regardless of quality or business. When investors are guided not by sound judgment but by distress, the markets are exceptionally inefficient.

As a result, some companies end up being unduly profitable investments. When buying a quality business at an exceptionally cheap price, you should stick with it.

Stock investor's classic question: "Is it a good time to invest more?"

SIFTER INSIGHT 2

A long-term investor has an opportunity to buy the cash flows of quality companies at a good discount

Last week, I got a call from our French investor. He contacted me and initially, I assumed he was scared about his investment. I was thoroughly surprised when he stated that he had a very calm mind.

However, he had two questions.

First, he wanted to know how our investments are doing in these exceptionally tough circumstances. Second, he asked the stock investor's classic question: "Is it a good time to invest more?"

The first question was easier to answer because Sifter's investment strategy favors quality companies that can be expected to do better than their peers in difficult times.

I raised three points.

1. Low debt and healthy balance sheet

Companies with sufficient cash can operate a business in a downturn without risking permanent damage.

In a low interest rate environment, money has been leveraged, but we at Sifter have always been reluctant to use leverage. One of the criteria of our screening method is low debt.

We like low-debt, even cash-rich companies. Especially in times of unexpected crises; it gives peace of mind. When a company has a lot of money relative to debt, its risk of bankruptcy is low, even if the economy is in a big shock, as it is now.

A strong company also gets money from the market on reasonable terms, which opens it up to opportunities if weaker competitors are in trouble.

Credit rating agencies also value Sifter's portfolio companies. The most common credit rating of our portfolio at S&P is A.

The median ROIC for the companies in Sifter's portfolio is 15 %.

2. High return on capital

A high return on capital is a classic feature of quality business. That is why in Sifter stock selection we pay great attention to the return on invested capital (ROIC) of companies. Return on invested capital is the ability of a company to create value for money invested by an investor.

When the company's ROIC is, for example, at an excellent level of 15%, the euro invested in the company's business returns EUR 1.15 to the company.

The best companies do not distribute all their profits to their owners but reinvest part of the profits in their operations at a high rate of return. It adds value to the owner.

When a company consistently makes a return on invested capital of more than 15% and is expected to do so in the future, we are happy to buy a part of that future cash flow. That is why we consider quality companies' shares to be very attractive and, in the long run, safe investments.

The median ROIC for the companies in Sifter's portfolio is 15%. This can be contrasted to the median ROIC of the S&P 500, which is 9%. This is a simple, but arguably the most meaningful metric which suggests that the Sifter 30 are of superior quality.

3. Predictability of results and competitive position

In uncertain times, predictability falters.

For years, we have been looking for 30 companies with a clear and predictable earnings model in Sifter's portfolio. The products and services of such companies are often important to the customers and the nature of the turnover is continuous.

An example is US-based Verisign, which maintains corporate Internet domains (such as .com and .net). The domain name is important to the company but its cost to the company is negligible.

Even if the coronavirus persists, companies such as Verisign remain relatively predictable in revenue and earnings.

“Can I buy from the market bottom?” I can easily answer that: “I very much doubt it.”

Is now a good time to invest?

I had to tell our investor that I was not allowed to give direct investment advice. And even with the permission, I wouldn’t give advice.

The question includes another question: “Can I buy from the market bottom?”. I can easily answer that: “I very much doubt it.”

It would be tempting to sell shares at the start of the downturn with the idea of buying them back at the beginning of the up-trend. While good in theory, In practice it is very difficult, if not impossible. This is because the strongest rallies often come very quickly and suddenly.

However, I said: “If you believe in long-term investment, you can keep your extra money invested for more than five years and, most importantly, believe in growth, capitalism and the adaptability of companies in the post-corona world.”

So far, Sifter’s investment strategy has kept it ticking. Since the beginning of the year, prices for almost all shareholders have fallen sharply, but companies in the Sifter portfolio have fallen slightly less. So we are + 3.8 % ahead of the Index (MSCI ACWI). Sifter Fund -15.7 % vs -19.5 % (3/31/2020).

KEY TAKEAWAY “If you believe in long-term investment, you can keep your extra money invested for more than five years and, most importantly, believe in growth, capitalism and the adaptability of companies in the post-corona world.”

Sifter companies are better than the S&P 500 on average with these metrics.

SIFTER INSIGHT 3

The strong become stronger

One of the hypotheses of Sifter's investment strategy is that strong quality companies will strengthen during a recession.

For this reason, we closely monitor the four indicators of our companies' quality and one measure of valuation (Table 2.) We compare these indicators e.g. S&P 500 for similar companies.

Another assumption is that stock prices follow cash. Since, we don't have a crystal ball to tell us where stock prices are going, we monitor the key KPIs of the Sifter companies ongoingly.

KPIs	2014	2015	2016	2017	2018	2019	Sifter Current	S&P 500 Current
ROIC	14%	13%	14%	15%	16%	15%	15%	9%
Operating margin	20%	20%	22%	26%	26%	25%	25%	16%
Sales growth	2%	4%	8%	9%	9%	6%	3%	4%
Net debt/ EBITDA	0.4x	0.6x	1.0x	-0.1x	0x	0.5x	0.4x	2.1x
EV/EBITDA (Current)							10.8x	11.0x

Table 2. Key Performance Indicators (KPI's) for Sifter businesses vs S&P 500.
*Trailing. 12 months, median

ROIC is one measure of a quality business

15% ROIC is one clear indication that we own quality companies.

High-quality business operations generate high returns on invested capital (ROIC). ROIC is calculated by dividing net operating profit after taxes by the average of invested capital.

The average ROIC of the Sifter portfolio has been well in the double digits during the last five years. The current median ROIC for Sifter companies is 15 percent, which compares favourably with the S&P 500 median ROIC of 9 percent.

We like companies that are efficient and have high margins.

Operating margins

The operating margin measures how much profit a company makes on a dollar of sales, after paying for cost. For example, Sifter companies sell their products for € 10, use € 7.4 to make them and make a profit of € 2.6 before taxes. Table 2 shows that the Operating margins of Sifter companies are clearly better than that of S&P 500 companies

The problem with fast-growing companies is often the promise of future profits.

Growth is important, but ability to make money is more important

We don’t look for super-growth companies, but our investees show healthy growth that exceeds the average rate of market growth as well as GDP growth.

In many cases, profits come only when the company has reached a certain number of users or market share. If the growth targets are not met, the money-making will not be achieved either. Because of this, we want to own companies that primarily make a profit and, in addition, grow slightly above the average for their own industry.

On average, the indebtedness of Sifter companies is very low.

Low debt and healthy balance sheet

The companies we invest in have strong balance sheets. This is reflected in fairly low net debt relative to EBITDA, for example.

Low indebtedness and preferably ample cash are a lifeline for many companies in times of crisis. For us, it is the norm when choosing companies for a portfolio. We don’t like leverage for growth. Especially if it leads to a large amount of goodwill on the balance sheet through acquisitions.

The low leverage of Sifter companies is highlighted when we compare them to S&P500 companies: The median net debt / EBITDA of S&P500 is about 5 times higher than the median for Sifter companies.

CONCLUSION If the Sifter Fund were a listed company, its key figures would make it a very profitable and high-quality business. In addition, the company’s valuation is in line with the market.

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People behind the Sifter Fund

This report has been produced by Sifter's Investment Committee (IC) and Advisory Team.

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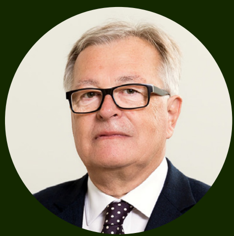

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Do you need help?

If you have any question regarding our investment strategy or want to place an investment in Sifter, please contact Mr. Santeri Korpinen or check www.sifterfund.com

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