River Oak Capital

2022-H1 Letter to shareholders

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River Oak's book value per share decreased by 40.9% in the first half of 2022. Our book value on June 30, 2022, was SEK 78.2 million, equivalent to SEK 175.06 per share.

	Investment return	Change in Book value	OMXS30 incl. div.	Difference
2017 (from Feb 7)	13.2%	**8.6%**	5.4%	3.2%
2018	0.0%	**(6.0) %**	(7.0) %	1.0%
2019	61.7%	**50.1%**	30.7%	19.4%
2020	104.0%	**74.3%**	7.4%	66.9%
2021	14.3%	**10.8%**	32.7%	(21.9) %
2022 per June 30	(39.8) %	**(40.9) %**	(20.7) %	(20.2) %
Total gain	157.1%	**75.1%**	44.8%	30.3%
Compounded annual	19.1%	**10.9%**	7.1%	3.8%

When evaluating investment results, it is my strong recommendation that you always look at the longest available period as shorter time periods with their inherent randomness won't tell you much of value. As always, I have included a full track record of the past ten years which includes the results of my Zen Capital Family Partnership from 2013-2016 at the end of this letter.

A word on float

The difference between our investment return and change in book value per share in the first half of 2022 is comprised by taxes paid in the period (0.25% of the difference), operational costs (0.25%), and the use of our so called "float" (0.6%).

Float is a liability on our balance sheet that we can use for investment until we must pay it out. We initially got some float at the beginning of 2021 when we reserved salary costs for the coming three years out of our 2020 profit pool. At the start of 2022, our float was 2.9% of our total assets. It worked to our advantage in 2021 and to our disadvantage in 2022. I expect that use of any float we have will work to our advantage in most years.

Notes to table

[1] Change in Book value per share is reported net of a reserved dividend on the A-shares according to the Company's Articles of Association, taxes, and general operating costs.

[2] The OMXS30 incl. div. column does not include having paid the standard annual tax on Swedish investment accounts which River Oak pays every year. This tax has ranged between 0.4% to 0.5% of total capital so the real difference for a Swedish investor that invested in River Oak instead of OMXS30 incl. div. is thus between 0.4% to 0.5% larger per year than reported in the table.

[3] Estimated currency effects on Investment return: 2017 -10%; 2018 +5%, 2019 +3%, 2020 -6%, years not mentioned <2%. River Oak does not in any way strive to foresee or profit from currency movements. Our belief is that any impact from currency movements will be negligible over time.

Fellow shareholder,

Since we started River Oak, there have been a few moments where I felt that our holding company structure along with the requirement that all investors have a 3+ year time horizon, might not have been the optimal one. This is not one of them. Its benefits shine with its brightest colours in times like these.

Periods like these, which are *guaranteed* to come along every once in a while, are the reason I always strongly emphasize the timeframe and tolerance for large swings to all our new investors. As much as we all want to believe that we will act calmly and rationally in periods of duress, there is nothing like a real-world experience that gives you the chance to prove it.

In addition to our well-suited structure, and equally well-suited shareholder base, getting out of this period in a good way will require some patience and a level head – from myself and from all of you. I have no doubts about you, and I hope you have none about me.

If you have been here since July-2019 or longer, you have achieved a satisfactory result as of today, and if you invested recently, you know that you plan to be here for three years or more. It is not very generous to evaluate results based on a 1-day snapshot right after a 40% decline in six months, but let's do that anyway. Even if you joined River Oak exactly three years ago, in the Summer of 2019, you have a decent result today of 8% per year slightly outperforming 7.4% per year for our benchmark. Come July-2025, I believe it is highly likely that today's new investors will also have achieved a satisfactory result, and I believe the same will be true in most 3-year periods.

Our investment operation

We have raised capital two times this year. The capital raised has been particularly helpful this time. I want to express my appreciation to current shareholders who added to their investment – and extend a warm welcome to the new investors that joined us. You may not be brave on the level of Ukrainian knowledge workers who are fighting on the front lines, and who are perhaps our times' greatest heroes, but deciding to invest at this time shows that you are committed to the long-term, which is exactly the type of investors River Oak aims to attract. Larisa and I also participated with more than SEK 2 million. These capital raises brought our tally to 80 shareholders.

Now is not a great time to evaluate decisions made in the past few years since every purchase will look like a mistake, every passed investment will look wise, and every sell decision looks genius. As you know, I always discourage you to draw any conclusions based on any shorter period let alone a 6-month period, but I want to give you an idea of why our portfolio was marked down so much this year. Our two best performing holdings in the first half of the year, LiveChat Software and Fortnox, were marked down by 15.7% and 19.7% respectively (slightly less including dividends); the rest were marked down by roughly 50% on average resulting in the largest drawdown at the portfolio level since our start.

Earlier in the year, we were sitting with a larger cash balance than at any time since River Oak's start at ~25% of our total assets. This was in part due to capital raises but mainly due to the challenging environment we are in with a war in Europe, covid lockdowns in Asia which affect worldwide supply chains, high inflation, and rising interest rates. As of early June, we are fully invested again after having made two new investments.

Almost half of our portfolio is now priced at an average of around 13 times *past* year's pretax owner earnings. This part of our portfolio is growing slower and generally contains companies with a less deep moat. This is our category of companies that I have previously referred to as the "Goods".

The remaining half is higher-quality companies like for example Qt Group which are growing faster, have deeper moats – and as a result are higher priced. This is the category that I have previously referred to as the "Greats"[1].

Current investment environment

While crazy things happen in the world and markets all the time, these last few years have been a bit out of the ordinary when compared to history. Before River Oak got off the ground in early 2017, there had been 20 stock market declines of 20% or more in the past 90 years, or about one bear market every 4.5 years[2]. We are currently in our 3rd bear market in less than 4 years. Historically, to experience three bear markets, you had to be in the market for 13.5 years. I can understand if you feel the current pace is a bit more than you enjoy.

With the world being more globally connected than ever, with information flowing faster and more broadly than ever before, and with more people having easy access to the markets, is this the new norm? Or will we now have gotten many of the large declines over the coming decades out of the way? Your guess is as good as mine.

I have lately received a few suggestions to consider investing in bank stocks, real estate stocks, and oil stocks – supposedly because these stocks have done comparatively well in the past six months. Ironically, these suggestions tend to come from the same people that were quite enthusiastic about stocks of fast-growing software and online-based companies as recently as six months ago. It's hard to justify why I should now take this newfound enthusiasm of theirs for completely new groups of stocks into serious consideration given how their previous enthusiasm turned out. Also, where will the enthusiasm of this group of people be six months from now?

I will stick to companies I'm familiar with and understand well. I remain focused on studying individual companies (which are all affected by the macro situation to some extent) and making the best possible decisions for us on a bottoms-up basis.

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[1] For those that remember these categories from my 2018 letter, we no longer have a "China" category. Our North Star of keeping things simple doesn't rhyme all too well with having investments in China.

[2] In investing lingo, a 20% decline is the definition of a so-called bear market.

Our investments

All our investments have a lower market value today compared to the start of the year, but it's helpful to separate them into 'Marked down' and 'Failed' investments. While we are in a bear market and have a war in Europe along with high inflation and rising interest rates, we have also had one failed investment which I consider largely unrelated to today's dire conditions. In my assessment, the 'Failed' bucket has a lone occupant so far this year in Netflix (we don't own shares in it now).

Our first goal is to not lose money. What this goal means in practice is that we want to avoid realizing a loss where I was simply wrong. While I never expected a 100% hit rate, with Goodfood and Netflix I failed us in this regard. Although I will sometimes misstep, it remains my primary focus to avoid money-losing investments, as there are few things as painful – and more importantly detrimental to good long-term returns – as permanent losses.

The rest of our portfolio is in what I call the 'Marked down' bucket which has been caused largely by the factors mentioned above with higher interest rates being the main reason. Sinch is really the only one of our current holdings that has disappointed me in terms of business results. I will focus here on the three holdings of ours that have declined the most in the first half of the year.

Qt

You will remember Qt Group from our 2021 Annual meeting. I called it the Photoshop of smart screen software. Qt still seems to be relatively alone at the top when it comes to building well-designed high-performance software for embedded devices where fast response times are important, such as for example car dashboards, medical devices, industrial automation machines, coffee machines, etc. As you may have noticed, the number of devices that incorporate a smart screen are growing at a rapid pace, and so is Qt at more than 30% per year. There have been no operational hiccups here whatsoever.

One thing that has affected Qt and caused results to be "only" great and not better is the pandemic. Once you develop a commercial product with Qt's development studio and sell it, Qt gets a small royalty per device sold. Qt's license sales have grown quickly since 2018 and even more quickly since late 2019, but many of the products developed since then have not reached the market due to supply chain issues. Once this bottleneck is released (or should I say *if*), there should be a gradual and quite significant increase of royalties coming into Qt headquarters.

Qt is currently priced at around 15-20 times my estimate of its 2024 earnings power. This is comparable to stagnant companies in mature markets that are growing slowly with significantly lower inherent margins. If I'm roughly right about Qt's future earnings power trajectory, this type of valuation parity seems very unlikely to stand.

Since our initial investment in March-2020, Sinch revenue has increased by 400% to SEK 25 billion and adjusted EBITDA by 450% to SEK 3.2 billion – exceeding my expectations by about 3x and doing it faster as well. This growth was achieved organically to some extent but mainly due to acquisitions. In this period, Sinch number of shares outstanding has increased by 39% (adjusted for splits) and they have taken on SEK 10 billion of additional debt to finance acquisitions.

Our initial investment was done at an enterprise value of approximately SEK 22 billion, but additional purchases were made at higher prices, which has now caused this investment to be materially underwater. Despite achieving more than a *5-fold increase* in revenue and profits, Sinch shares are currently priced about 5% *lower* than our initial purchase price in March-2020. So, what is going on?

It goes without saying that higher interest rates and generally negative market sentiment have contributed to today's low share price. Let's put that aside for now, since that doesn't tell the whole story.

First of all, is adjusted EBITDA a good proxy for Sinch pretax owner earnings? Deprecation & Amortization are not cash outlays but mainly accounting write-downs of acquired goodwill, so the D&A part is ok. What about adjusted EBITDA? Here Sinch adds back acquisition costs, integration costs, and share-based incentive programs. Acquisition costs are clearly one-time in nature, but the other two are not. While integration costs should diminish over time, deducting SEK 200 million on an annual basis from their reported adjusted EBITDA currently seems fair. Deducting another SEK 200 million for interest expenses should give you a decent proxy for Sinch pretax owner earnings.

Let's now look at some operating factors that affect valuation. While the achieved growth is indeed very strong, organic growth will always be a more colorful feather in the hat, and it's clear that the whole Communication-Platform-as-a-Service (CPaaS) industry has become way more competitive and commoditized than it was 2-3 years ago.

While Sinch many direct connections to operators around the world which they have established over 15 years are important in many use cases, especially critical messages where high deliverability is very important, they are not exclusive in enough geographies to earn them a lot of pricing power with customers – especially since one of their main competitors Twilio recently started a new initiative they call "in and up" which means that they offer customers very attractive rates on messaging to get a foot in the door and then hope to be able to upsell other higher-margin software products such as contact centers, email, etc.

In addition, operators that sell SMS capacity to Sinch have lately increased prices, quite significantly in some geographies too, as they are looking for new ways to grow revenue given the mature markets they operate in, and because they seemingly can. As a result, Sinch has recently been squeezed in the middle between revenue-hungry operators and competitors who do not prioritize profitability. This has caused a hit to their messaging margin. One of the things I got wrong here is that I expected Sinch to have more say on the pricing dynamics as the crucial middleman. This does not seem to be the case so far.

So, what does the future look like?

While Sinch used to get the vast majority of their revenue and profit from their traditional enterprise messaging business, it will now constitute less than half of their gross profit in 2022, and it is likely to keep declining as a share of the whole. Due to Sinch three latest and largest acquisitions by far – Inteliquent (voice services), MessageMedia (mobile messaging for SMBs) and Pathwire (email) – Sinch is no longer primarily an API provider for sending SMS messages, and its overall margin profile should improve materially compared to the recent past. This will all become more clearly visible in 2022 as these acquisitions are fully consolidated in reported results.

Market commentators and media tend to focus excessively on the recent past and in particular on how much certain stock prices have fallen from a recent high, while the only thing that really matters in investing is the *current* price of a company in relation to its intrinsic value.

Combining all recent acquisitions with Sinch results over the past twelve months, we currently have a price in the market of around 13 times pretax owner earnings. This is for one of the leading companies in an industry that is growing rapidly and which I expect will continue to grow at high rates for the foreseeable future.

To give you one hopefully familiar example of why this industry is growing fast, multi-factor authentication (MFA) is one of the larger use cases CPaaS companies help facilitate. You may know it as 2-factor authentication (2FA) which you perhaps use to secure your Apple or Facebook account. One recent global survey found that only 45% of small and medium-sized companies have set up MFA to secure their systems. More should come.

I expect Sinch to grow with the industry at more than 15% per year. The question is what level of profitability that will be achieved.

It does not seem feasible that companies with their core business in other industries such as e-commerce, airlines, ride sharing, etc. will have direct contracts with dozens or even hundreds of operators, and vice versa, that operators will have direct contracts with thousands of companies. One API seems way simpler and more cost-efficient. There should thus be a place for CPaaS providers here long-term or at least until we don’t use SMS messaging anymore, since they have an essential function in the ecosystem where they sit as the relay bridge between telecom operators, customers, and end users.

There should also be a limit to how much operators will raise prices as aggregators give them a lot of traffic which is possible as aggregators get large message volumes from customers that they spread out over multiple operators in different geographies. Operators should not want to price themselves out of this lucrative and growing market.

All in all, growth should be good and a steady-state blended margin of more than 10% should be achievable for Sinch over time as the acquired voice, email and SMB messaging businesses will help bring it up.

Sinch is the clear #2 CPaaS player after Twilio, it does seem to have the broadest geographic messaging coverage, and I believe it will have a place in this industry in the future. In contrast to most (if not all) of their competition, Sinch has a long record of proven profitability which increases the likelihood that they remain standing in the industry when all the smoke has cleared.

Having said that, I do not currently see the same upside as I did before. Capitalism being what it is, in a fast-growing and lucrative industry with relatively low barriers to entry in each local geography, core profitability seems likely to remain under pressure.

Given how the industry has developed, a lower valuation per profit dollar is warranted to some extent. In my opinion, just not *this* low. Insiders agree: the CEO, CFO, Chairman, and some of the founders who are also Sinch largest shareholders, have been buying shares along the way down ever since the enterprise value was above SEK 100 billion.

To sum up, if Sinch margins stabilize or improve from here, which is possible through industry consolidation, more rational competition, passing on operator price increases to customers over time which has historically been possible, successful cross-selling of newly acquired products, or through recently implemented cost control measures – this investment should work out well in the end. If messaging margins continue its decline, and email/voice margins start following suit, it most likely won't.

NETFLIX

For a long time, I have been very impressed with how Netflix have repeatedly been able to pivot their business model, from initially renting DVDs to online streaming to producing their own content – outplaying their competition along the way.

My thesis for our Netflix investment was relatively straightforward. My assumptions were that in a few years' time, Netflix would have:

- Revenue of ~$50 billion
- 300 million subscribers at an average subscription income of $14 per month
- Flattened out content spend; management has repeatedly stated that peak content spend was reached over the past two years
- $20 billion to $25 billion in content spend and less than $10 billion in other expenses would make Netflix a very profitable enterprise at a very attractive price.

Things have been well on their way along this path for a long time with subscribers going from 94 million to 220 million and average subscription income going from approx. $8.5 to $11.5 per month over the past five years.

The last two quarters however made it clear that this thesis was broken. Competition along with higher market saturation than I believed was the case, makes the equation of 300 million subscribers under flat or lower content spend in a few years' time look very difficult. I had not expected Netflix to hit the subscriber "wall" this soon. In the most recent quarter, Netflix disclosed for the first time their estimate of how many households that regularly use their services for free through password sharing with other paying households. It was a quite staggering number: more than 100 million. In light of their current subscriber base of 220 million, this was a quite shocking announcement. Converting 'account sharers' to paying subscribers looks like a gargantuan task; they are in my experience generally not prepared to pay anywhere near full price.

Our Netflix position was a far-in-the-money warrant which allowed us to have a certain exposure with less capital allocated. The downside of a warrant is that if the price of Netflix shares reaches a low enough level below our purchase price, we have to sell the warrant. Since my thesis was already broken at the time this level was reached, it didn't matter much in this case as I would have sold it anyway. Our warrant position was less than 5% of our portfolio at cost but as its value increased in 2020 and 2021, this position has had a slightly larger negative impact than those 5% on our 2022 year-to-date returns.

I have successfully used far-in-the-money warrants on a couple of occasions previously with for example Apple and Amazon but I'm unlikely to use them again. My current view, or call it recent lesson, is that an investment should be attractive enough on its own merits without the "help" that a warrant provides.

While a failed investment is always painful, I don't view this as a mistake based on what I knew. All investments will simply not turn out the way you thought they would.

Inflation and interest rates

Since the sudden and significant increase in interest rates is the main reason for our sharp book value decline, I feel a few comments are warranted on the subject even though they may be of very limited value – both in terms of correctness and predictive power.

There are people who now say it was obvious all along that interest rates would go up and stay up. They tend to forget that they have been predicting higher interest rates for the past 12 years as well. Being 1-for-12 doesn't really make you correct in my book; it simply gives you a batting average of 8.3%. That said, higher interest rates are here and seem likely to stay, so they need to be taken into account. Historically, it has most often been the best approach to find a compromise between the extreme views on each side. If one side believes that interest rates will go back to near 0% and the other that we will have a new baseline of 6%, the base case assumption I usually make is somewhere in between.

Now, if you feel that four paragraphs of macro speculations are a complete waste of your time, I sympathize and urge you to skip ahead to the next section.

Do I believe higher interest rates will pare down the current inflation? The two main components that are causing the current high inflation in the widely cited CPI-U inflation index in the U.S. are cars and energy prices. Both are mainly caused by problems on the supply side. The former is largely due to supply chain disruptions due to China's 'zero covid' policy and other covid related supply delays, while the latter is mainly due to Russia's invasion of Ukraine. It seems very unlikely to me that higher interest rates will fix any of these two problems.

So how does this end? My current assumption is that the war in Ukraine will go on for an extended period. None of the sides show any signs towards wanting to end it. I do get the occasional first-hand report from people who speak to soldiers on the frontlines who confirm this. China's 'zero covid' policy also seems likely to remain in its current state, which increases the likelihood that inflation remains elevated for some time.

In other words, we may get a situation where interest rates are raised while overall inflation remains elevated. Higher interest rate will however dampen the demand side which should lower inflation in at least the housing and food categories which are two other large inflation components.

Why is this relevant for us? Well, as a side effect of all this, higher interest rates also reduce the value of all productive assets with future earnings streams of which we own a few.

It is worth noting that my macro views were similarly pessimistic at the start of the pandemic. Then the miraculous vaccine development happened, and then the benign omicron variant came along and essentially put an end to the pandemic, or at least took it down to a status where it's no longer more dangerous than the seasonal flu.

At some point, if higher interest rates do not seem to help stave off inflation, they will probably stop being raised. The same is probably true if they do help. It's also worth noting that for inflation to stay elevated, prices need to continuously keep increasing like they have in the past year. If prices simply stay at the current relatively high level, next year's inflation will be 0%.

If you made it this far and still want to read on, bless you.

Why are higher interest rates detrimental to company values?

Let's assume that we go from near 0% to 5% interest rates. To simplify let's also assume that interest rates stay fixed at 5% in the coming years. Let's further assume that we are shareholders in Company AB whose earnings power in 2027 will be $100 million.

In our assumed scenario, literally every financial asset in the world that has a future earnings stream becomes less valuable today. Why?

With higher interest rates, those future cash flows that we are looking to "collect" as owners in 2027 become less valuable today. This is because $1 that earns 0% interest will still be worth $1 in five years. Meanwhile, $1 that earns 5% interest every year will be worth 28% more in five years, or $1.28.

Clearly, having cash available today is more valuable in a higher interest rate environment because you can earn that higher interest rate on your available cash balance, whereas if interest rates are 0% you don't earn anything on your available cash.

Conversely, $1 that you will receive in five years is less valuable today since it needs to be discounted back at our assumed 5% interest rate giving you a present value of $0.78 (if the amount you will receive in five years is $1.28, it would be worth $1 today under our 5% interest rate assumption).

Let's now go back to our initial assumption about Company AB's earnings power in 2027. Assuming we are right, come 2027, those $100 million will be there for owners to "collect". They are just somewhat less valuable *today*, which of course means that Company AB is also less valuable *today* since its value is the sum of all future excess cash flows it will generate discounted back to today at an appropriate interest rate, which we have assumed to be fixed at 5% in our simplified example.

How will higher interest rates affect us?

The above is a somewhat unpleasant reality for owners of productive assets, but it's not the end of the world either. While investing may seem less attractive in a period of high inflation and higher interest rates, if one's expected returns exceed prevailing interest rates by a sufficient margin, it makes perfect sense to stay invested in stocks.

In River Oak's case, I believe the earnings power of our companies will on average increase by at least 15% per year over the coming few years. While those future earnings are less valuable than they would have been with lower interest rates, investing is a game of relative opportunities in which an investor must always look for the best *relative* values out there, and lower interest rates are currently not on the menu.

Does our high concentration make sense?

Our highly concentrated portfolio has arguably been the reason why we have significantly underperformed our benchmark over the past eight months. It has arguably also been the reason for our outperformance in all prior years. Let's look at its merits a bit closer.

Howard Marks, cofounder of Oaktree Capital and a brilliantly clear investment thinker, has talked a lot about how investing is always a two-edged sword. There are almost no situations in investing where your choice of strategy doesn't come with both benefits and drawbacks. Of course, one cannot enjoy the spoils of a concentrated portfolio without also being susceptible to its risks.

Its risks are in my opinion mostly associated with short-term volatility – over time, it's abundantly clear that a sensibly managed concentrated portfolio wins out over its less concentrated alternatives – and even though we have had a lot of this recently, our portfolio has not been more susceptible to large drawdowns over time than a broad-based fund.

If you take an arbitrary large fund with a portfolio of 30 to 100 holdings that is investing in similar companies as we are and compare it to the drawdowns we have had over the years, you will find that the fund drawdowns are generally on par with or greater than ours despite the "diversification" that they claim protect its investors against risk. This is somewhat unintuitive, but it has been true since we started River Oak, it was true in the five years prior in my family office, and I would bet a lot it would have been true in the prior 100 years as well.

It has also been shown that the difference in expected standard deviation in annual portfolio returns is almost negligible when going from a portfolio of 10 stocks to 1,000 stocks. The former showed a 24% expected standard deviation while the latter showed 19%[3]. Is it really worth to diversify into 1,000 stocks and give up any chance of meaningful outperformance to spare yourself of an additional 5% swing in your portfolio each year?

There are other reasons for focusing on fewer companies as well. In a study looking at stock market returns over the past 90 years, Professor Hendrik Bessembinder found that,

"...just 86 stocks have accounted for $16 trillion in wealth creation, half of the stock market total, over the past 90 years. All wealth creation can be attributed to the top 4% performing stocks, while the remaining 96% of stocks collectively matched one-month T-bills."[4]

While I and our Board members admire a great many companies, River Oak will only invest in a select few. The reality is that high concentration in my best ideas gives us a real chance to meaningfully outperform the averages over time (it also exposes us to the risk of underperforming them). If we don't give ourselves this chance, there is little reason for our existence at all as I see it. If we were to simply "hug" the index, you would all be much better off investing in that index directly through a large-scale financial institution such as Avanza in Sweden or Vanguard in the U.S. where the costs to get that exposure are zero or near zero and where there is no risk to ever underperform it.

We have benefited substantially from having a concentrated portfolio over time, and it requires being able to take the good with the bad.

Looking ahead

One of my favourite movies of all time is 'The Big Short' which tells the true story of a few investors who all bet big on the US housing market crash of 2008. Michael Burry whose housing crash prediction was spot-on is the movie's main hero. It is relevant to note though that Michael has kept on predicting a few other maladies in the subsequent 15 years as well, none of which have played out like how the housing crash did. Love him or not, I think it's fair to say that his nature is a bias on the side of pessimism.

I am the opposite. I tend to err on the optimistic side of things when I'm wrong. This contributed to giving River Oak a very strong period from 2019 to October 2021. The other side of the coin are times of deep pessimism such as we have currently where it remains to be seen how we will fare over a multiyear period. If history is any guide however, optimists tend to be happy in nine years out of ten while the reverse is true for pessimists – and I not sure they are very happy in that one year either. They're merely "right".

It has been interesting to observe how the market's movements have completely shifted investor mindsets of what is needed for successful investing. When markets were going up in

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[3] Meir Statman, "How many stocks make a diversified portfolio?" *Journal of Financial and Quantitative Analysis* 22 (1987): 353-363, doi: 10.2307/2330969. Available at https://www.jstor.org/stable/2330969

[4] Bessembinder, Hendrik (Hank), Wealth Creation in the U.S. Public Stock Markets 1926 to 2019 (February 13, 2020). Available at: https://ssrn.com/abstract=3537838 - Thanks to Worm Capital for highlighting this study.

the past few years, it was "*You really need to let your winners run. I made a mistake by selling this great company too early…*"

This year as markets have steadily been going down, it has become "*You really need to take profits once in a while. I made a mistake by holding on to this great company…*"

The hindsight could've, should've, would've are all utterly useless. Since it's impossible to continuously predict market inflection points with any precision, the best one can do is learn a few lessons and move on.

What if we keep underperforming like we have in the past eight months? I don't expect us to underperform over many 3- and 5-year periods, but I will point out that at the world's most successful investment company of all time, in Berkshire Hathaway's first 50 years, its book value growth underperformed the S&P 500 in more than one out of every five years on average. If you look at Berkshire's share price, which supposedly also bakes in soft variables that are not visible in its book value, it underperformed the S&P 500 in one out of every three years on average. Please view that as a definitive *upper* limit of what is possible to achieve in an investment operation like ours over time.

What should you make of our recent decline? If you look at all previous drawdowns I have experienced while managing River Oak and my family office – there has been seven occasions in the past 10 years when our portfolio declined 15% or more – they all look like speedbumps a few years later. The current one is admittedly our largest speedbump so far, but I believe it will prove to be just that: a large speedbump. It won't be easy, but I'm committed to make it so.

I will end by paraphrasing a few words by author Vickie Worsham: Life is not about having everything go right, it's about facing whatever goes wrong. Now we need to do just that.

Life is also not about being without doubt, it's about moving forward despite it. I do not know what the borders of Europe will look like five years from now; I do think it is wise to assume that things will work out alright, and I know for sure that it's more productive and meaningful to move forward as best as you can rather than hoarding sticks and stones in anticipation of covid-24 and World War III.

In times like these, it's good to remember that while the future is almost never as good as it seems when things are going well, it is also never as bad as it seems when things are going less well. As always, I look forward to River Oak's future and will strive to make the most of it. I'm very happy to have you along with me.

July 8, 2022

Daniel Glaser
Chief Executive Officer

Founding principles

Our basic idea is simple:

1. **Make a bet on human progress.**

   Human progress is the reason why stock markets have historically produced average annual returns of 6% to 10% over the past 200 years.

2. **Invest in companies that are better than average or available at lower prices.**

   The objective here is to add some additional returns on top of the 6%+ returns that the general market has provided and is likely to keep providing investors over time.

Goals

1. **Don't lose money.**

   We always think about the downside first.

2. **Earn an average annual investment return of 15% over time.**

   This will result in an average annual increase in book value per share of ~11.5% after a dividend on the A-shares according to the Company's Articles of Association, taxes, and general operating costs.

Historical returns

Feb 7, 2017 – June 30, 2022: River Oak Capital AB
Jan 1, 2013 – Feb 6, 2017: Zen Capital Family Partnership

	Investment return (pretax)	Net result	OMXS30 incl. div. (pretax)	Difference
2013	41.0%	**30.8%**	25.5%	5.3%
2014	45.0%	**33.8%**	14.0%	19.8%
2015	35.1%	**26.3%**	2.2%	24.1%
2016	20.5%	**15.4%**	9.4%	6.0%
2017	19.6%	**14.0%**	7.7%	6.3%
2018	0.0%	**(6.0)%**	(7.0)%	1.0%
2019	61.7%	**50.1%**	30.7%	19.4%
2020	104.0%	**74.3%**	7.4%	66.9%
2021	14.3%	**10.8%**	32.7%	(21.9)%
2022 per June 30	(39.8)%	**(40.9)%**	(20.7)%	(20.2)%
Total gain	804.0%	**368.3%**	136.5%	231.8%
Compounded annual gain	26.1%	**17.7%**	9.5%	8.2%

Notes to table:

[1] Change in Book value per share is reported net of a 20% dividend on the A-shares according to the Company's Articles of Association, taxes, and general operating costs.

[2] The OMXS30 incl. div. column does not include having paid the standard annual tax on Swedish investment accounts which River Oak and Zen Capital pay every year. This tax has ranged between 0.4% to 0.5% of total capital so the real difference for a Swedish investor that invested in River Oak or and Zen Capital instead of OMXS30 incl. div. is thus between 0.4% to 0.5% larger per year than reported in the table.

[3] Estimated currency effects on Investment return: 2014 +7%, 2016 +2%, 2017 -10%; 2018 +5%, 2019 +3%, 2020 -6%, years not mentioned <2%

River Oak does not in any way strive to foresee or profit from currency movements. Our belief is that any impact from currency movements will be negligible over time.

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Comment on Sinch July 17, 2022

I normally don't comment on corporate events of our holdings in between my biannual letters. This will not change but Sinch announcement this past week calls for an exception.

On Monday, July 11th, shortly before midnight, Sinch announced that they are reassessing their historical Costs of Goods Sold by SEK 162 million. As a result, I sold all our remaining shares in Sinch the next morning on Tuesday, July 12th.

Related research work

A couple of months ago right after their Q122 earnings report, I contacted Sinch about the discrepancy between their reported EBITDA and cash flow in the past twelve months. This discrepancy had not been there before, and I wanted to make sure everything was in order. This is part of normal routine work I do every week. Sinch gave me three main reasons along with detailed amounts for each:

1) Late invoicing to large customers (they said this is not uncommon at the beginning of a year),
2) Consolidation of three very large acquisitions,
3) Prepayment of traffic to a very large operator to get better pricing.

Once I reconciled the amounts they gave me with the reported numbers, the remaining discrepancy was small enough that I considered it fully within normal deviations. They also said this would go back to normal in the coming year.

I had no reason to believe they were lying or withholding any information and I considered their explanation fully reasonable. It didn't cross my mind that a misreported income statement was a fourth reason, none the least considering how rare this type of thing is in the Nordics.

My current thoughts

Some of you probably concluded, rightly so, that I didn't sound as enthusiastic about Sinch in my recent letter as I normally do about our holdings. After conducting and reviewing dozens of interviews with industry experts over the past year, including current/former employees at Sinch and some of their main competitors as well as customers, I concluded I would sell our shares a few months ago.

Considering the recent excessive negative market sentiment that I believed had caused an unduly low share price however, I decided to hold out for a better price. Last Monday's announcement changed those plans.

I cannot recall ever seeing misreported numbers of this magnitude in the Nordics unless it turned out to be a fraud. I do not currently believe Sinch is one – after all, repeated insider buying is not a typical hallmark in companies that intentionally game their numbers – but I believe they knew about this and should have disclosed this way earlier. After all, if SEK 162 million is missing in your bank account compared to what you expect to have, it seems reasonable to assume it's a priority to find them and that a few people at the company knew about it. (Sinch says the invoices that caused the misreporting had all been paid – but, by mistake, these payments were not included in their reported income statements.)

If this was indeed an honest mistake as Sinch claims, why do I consider this breach so serious?

First, net revenue is equal to the income Sinch receives from customers less costs to operators. Thus, understating costs to operators is equivalent to overstating their net revenue and earnings.

Second, one of the main question marks in their messaging business: the profit margin, which has already been declining over the past year – is even lower and declining more rapidly than reported. The misreported amount is equivalent to roughly 15% of reported 2021 messaging earnings.

Third, either someone at Sinch decided to recognize revenue for a bunch of messages but did not book costs for them even though the invoices had been paid, or Sinch control systems are remarkably deficient. A mistake of this magnitude raises a lot of questions about other control functions (or lack thereof) they have in place. Ultimately, the CEO and CFO are responsible here.

Fourth, Sinch revenue and earnings have been the basis for Sinch share price over the past 18 months. I assume they have also been important during the process of getting bank loans for acquisitions. These loans and Sinch shares have in turn been used as currency to acquire four other companies in 2021. This currency, as it turned out, was based on incorrect and too high numbers. It seems very likely that we will hear more about this in the coming months and that lawsuits may be coming as well. Unfortunately, I don't think we have heard the last controversy from Sinch.

Conclusion

In my opinion, Sinch is now either one of the more undervalued companies in Sweden, or the opposite if there are more cockroaches in the kitchen. When the range of outcomes is this wide, I don't want to play. Even if this proves to be a true one-time mistake by Sinch, it is unlikely they can restore my confidence in their business and reporting without some management changes.

Updates to our investment process

Our outcome here is not Sinch fault. Neither is it the fault of the audit firm who did not raise any concerns when signing Sinch 2021 annual report. At the end of the day, it is my job to make sure we don't get tangled up in outcomes like this.

Most of our negative investment outcomes over the years could have been avoided by applying the following rules:

1) Don't invest in companies that report adjusted EBITDA.
   (I wrote about the perils of adjusted EBITDA companies in my 2015 family partnership letter.)
2) Don't invest in companies whose reports require >1h to go through and understand.
3) Historically, I have given our holdings a shorter lease – if there was a negative sign that potentially changed the trajectory of the business or if a surprise came up of which I wasn't aware at the time of investment, I would sell. In the past year, I have favoured being more forgiving to give companies a chance to get over the occasional hiccup.

   I believe this is due to workings on a subconscious level. Once I have written publicly about a company, I have tended to sell it much later when a negative event of serious nature occurred than I otherwise would have. This should be possible to avoid if I write about our investments only once they have been in our portfolio for a while or after they have been sold.

To avoid similar adverse outcomes in the future, I will apply all three rules going forward.

If you have any questions or comments on the above, please call or email me anytime.

July 17, 2022 Daniel Glaser