Value Investor INSIGHT

December 30, 2022

The Leading Authority on Value Investing

Investor Insight: Hosking Partners

Hosking Partners' Luke Bridgeman and Django Davidson explain how they identify opportunity using a capital-cycle lens, what broad trends they believe are working in their strategy's favor, why they hold on the order of 450 positions at a time, and why they see unrecognized upside in such ideas as Hafnia, Permian Basin Royalty Trust and Wells Fargo.

INVESTOR INSIGHT

Hosking Partners
Luke Bridgeman (*l*), Django Davidson (*r*)

While the four managers running Hosking Partners' $5.6 billion global strategy manage their pieces of the portfolio independently, they all take a similar "capital cycle" approach. "There are two areas of opportunity for capital-cycle investors," says PM Luke Bridgeman. "One, where the market expects the high returns of certain companies to turn down sooner than in fact they do. Two, where the market underestimates the likelihood of returns recovering in beaten-up industries."

Through this capital-cycle lens, Bridgeman and fellow portfolio manager Django Davidson see upside today in such areas as tanker shipping, U.S. banks and North American energy royalty companies.

You describe your investing strategy as utilizing a capital-cycle framework. Please explain what that means and why you believe it works.

Luke Bridgeman: The opportunity set in global equities is more than 50,000 listed companies, and we're looking to exploit that opportunity set with as few constraints as possible. This opens up more ideas that are less well understood, less well researched and where the pricing may be more attractive. We're also contrarian: if the herd is in a stampede, we like to wander in the other direction.

With that large field of play and an ethos to go where the fish are rather than where the fishermen are, we need a framework that helps point us to opportunities others aren't pursuing. That's what the capital-cycle approach gives us. It rests on what we've all learned about capital cycles. An industry with high returns on capital tends to attract new entrants, enticed by the prospect of enjoying those high returns. The resulting increase in capacity and competition typically causes returns to fall, eventually in some cases to below the cost of capital. Investment declines, capital stock becomes obsolescent and firms in the industry are forced to consolidate, withdraw or close down. In time, an improving supply side causes returns to rise above the cost of capital and the cycle begins again.

At the same time, equity markets extrapolate current returns, and it's the difference between expected future returns implied by stock prices and our own expectations based on the supply-focused capital-cycle approach that we're taking advantage of. We're looking for situations where the market expects a company's high returns to turn down sooner than we believe they will, or where the market expects a company's low returns to persist for longer than we do.

We believe it pays to be contrarian, and using the capital-cycle lens points us to situations where returns are low and capital has been withdrawn. Going against the grain is uncomfortable and awkward, but our approach gives us a reason-based justification for doing just that and helps overcome an emotional reluctance to get involved in areas that are out of favor.

We're seeing stocks in your portfolio like Amazon [AMZN], Alphabet [GOOG] and Costco [COST]. How do they fit with an approach focused on capital cycles?

LB: Our strategy can also highlight the opportunity in companies with high and stable returns that enjoy barriers to the supply of new capacity which will mean that those returns can resist the gravity of mean reversion for longer than their share prices might suggest. That has certainly been the case for even high-quality growthy companies like Amazon, Alphabet and Costco. Although we have been reducing our exposure to these types of companies in recent years as the gap between our expectations and the market's expectations has narrowed, they remain in the portfolio.

Because it's rather unique, let's talk upfront about your owning on the order of

450 stocks in your portfolio. How does that level of diversification fit with your strategy?

Django Davidson: The fashion over the years has moved toward highly concentrated stock portfolios – we recognize that we're contrarian on this point. As Luke said, we want each of the four portfolio managers who run their own sleeves of our global strategy to be able to operate in the most unconstrained way. That means going anywhere and looking at everything, across geography, industry sector and cap size. We consider the ability to do that a competitive advantage, because you just can't do that if you're running a 20-stock portfolio. If I find something particularly compelling in Sri Lanka – which is top of mind because I'm looking at something there right now – there's room in the portfolio for it.

Our level of diversification also particularly works if you're doing capital-cycle investing. If you're looking to invest in shipping, which has traditionally been regarded as a volatile, capital-intensive and cyclical business, you probably don't want to own just one name if you think the supply-driven cycle is interesting. The starting point for much of the analysis is industry-wide, so it makes sense to us to diversify the company-specific risk with a number of positions. Also, if you're running a 20-stock portfolio, the risk to your career from something going wrong is more painful, so you may find it difficult to buy one shipping company, even if you think the capital-cycle thesis will be in your favor. In general, we think there's less competition in areas that are more volatile and prone to cyclical events, and the investment industry's bias towards concentrated portfolios contributes to that.

LB: To elaborate a bit, our whole approach starts with industries and markets, not individual companies. We look at competitive dynamics, the flow of capital, the expansion or contraction of capacity. At the same time, as students of behavioral finance we are keen to avoid overconfidence in our ability to distinguish which particular company in an industry will be the superior investment. We are conditioned to make a wide number of bets where we are broadly confident, rather than a concentrated number of bets where we are extremely confident. That's why we often express ourselves through a basket of stocks in a particular sector rather than spend the extra time trying to pick just one winner.

One other thing I'd add is that because the total universe of stocks globally is more than 50,000, the number of 450-stock portfolios that could potentially be assembled is massive, greater than the number of atoms in the universe. This is an important point, because it refutes the idea that a large and diversified portfolio simply replicates the index and offers only benchmark returns. The long-term track record of Jeremy Hosking and the team, dating back almost forty years, has demonstrated a clear ability to outperform the market.

ON CAPITAL CYCLES:

With such a large field of play we need a framework that points us to opportunities others aren't pursuing.

For a number of years until relatively recently, many areas where capital has fled have been inhospitable to equity holders. Would you argue the turning tide in that regard still has plenty of room to run?

DD: The last dozen years or so have advantaged investment styles benefiting from low long-term interest rates, low inflation, abundant liquidity and an ever more efficient global supply chain. We do think the tide has turned on a number of fronts and have outlined what we consider to be five important "realities" of the current economic environment.

First, inflation is not transitory and rising interest rates will challenge decades of positive reinforcement for investors around the Fed "put."

Second, the cost of capital is rising. Trends in existing industry capital cycles – many of which reached turning points during the Covid pandemic – will be amplified by higher interest rates. Prior-decade winners are likely most at risk, and vice versa.

The third reality in our view is that energy and commodity shortages are real. Years of under-investment in the fossil-fuel and mining sectors have led to supply constraints that will take years to unwind. The consensus around the energy transition was built in an era of cheap money and cheap energy. We think that will be tested as rising energy and materials prices threaten the returns for new projects.

Fourth, evolving geopolitical spheres of influence will curtail corporate capital spending and institutional investment flows. The severity of Russian sanctions and the general capital-market fallout will reprice capital and limit flows between aligned and non-aligned countries.

Finally, global supply chains are being reconfigured as Covid, the Ukraine invasion and geopolitics around China unpick years of ever-more-efficient global supply chains. One result of that we believe is that corporate profitability – particularly for "global champion" multinational companies – may have peaked for the foreseeable future.

We're counting on our generalist focus on supply rather than demand to help us navigate this unsettled environment. We'll talk about some of these in more detail, but areas we've gravitated to include mining, shipping, refiners, and companies tied to oil and gas exploration and development. It's no coincidence that these are all asset-intensive industries where physical assets represent a considerable competitive advantage at a time when capital is repriced upwards. We have a collection of industries valued at steep discounts to the rest of the market, where we think deep supply imbalances provide a considerable margin of safety against economic weakness, inflation and potential geopolitical earthquakes.

Explain your view of the capital cycle around shipping and how you're looking to capitalize on it.

LB: Shipping is interesting because it is at the intersection of two important ideas underpinning our thinking at the moment. One Django just alluded to is that there's a large energy gap in the world today. There was a massive overinvestment in traditional energy as a result of capital being mispriced in the lead-up to the financial crisis and then in an echo in 2015-2016. Capacity far exceeded demand and costs were uncontrolled, which inevitably led to declining returns and a terrible experience for shareholders of traditional energy companies. Since then, management of those companies has been instructed to reduce capital spending and return cash to shareholders, which has been the case for some time now. That capex discipline has been reinforced by society putting increasing obstacles in the way of new supply for environmental reasons, so that even prior to the invasion of Ukraine the world had a 2% negative energy supply-demand imbalance. This sounds like a small number, but in a market of this scale it's not.

Sanctions against Russia have compounded this situation and rising energy prices have led to higher returns for resource-extraction incumbents – BP CEO Bernard Looney referred to his company as a "cash machine" in 2021. But many of these companies now have management incentive schemes that are aligned with shareholder returns and carbon priorities rather than growth in supply. It's unlikely we'll see the swift supply response we've had in prior upswings. We're also seeing how a transition to renewable energy cannot quickly fill this supply gap. In the short term there will inevitably be noise, but all of that to our mind leads to the level of oil and gas prices remaining higher for longer than is generally perceived.

Which then brings us to shipping. With the exception of containers, most of the shipping industry is about transporting energy such as coal, oil, gas, refined products, even protein. It's about moving energy from where it's produced to where it's consumed. Where there's an energy gap and therefore the price of energy is likely to be high, that's a positive for shipping.

There's also been a capital cycle effect in the shipping industry, very similar to what has happened in energy – cheap capital leads to overcapacity which in turn leads to lower returns, so capital flees and that leads to tightness. One great thing about shipping from an analytical perspective is that ships' finite lives and long lead times for construction provide you with a lot of visibility into the future with respect to supply. You can be broadly confident about the number of ships that need to be scrapped and eliminated from the global fleet over time, and you also have good visibility into supply because you know what the order books of the shipyards look like. That analysis tells us that undercapacity in the shipping industry, broadly speaking, is unlikely to go away for some time.

ON FOCUS AREAS TODAY:

We've gravitated to industries where physical assets represent a competitive advantage as capital reprices upwards.

Other factors support that conclusion. More stringent emission regulations will be phased in over the next decade, encouraging the scrapping of existing ships. Shipowners are also reluctant to order new ships if they don't know the future technology specifications needed to comply with further changes in environmental regulations over the course of the ships' economic lives. On the demand side, the war in Ukraine and more general reconfiguration of supply chains is disrupting transport networks that have been optimized for efficiency. The likely result of that will be an increase in the distances cargo needs to travel, so-called ton miles, effectively adding to demand.

We know that the high returns currently being enjoyed in a capital-intensive industry like shipping are not permanent, we just don't believe they will be as short-lived as some equity valuations suggest. Investors who measure their own performance over short time periods are quick to characterize the earnings power enjoyed by these companies as a one-off blip due to the transient factors. Our focus on long-term supply leads us to a different conclusion. We're investing across a number of shipping asset classes, including product tankers, large crude carriers, LNG transport and dry-bulk shippers. Among the names we own today are Pacific Basin Shipping [Hong Kong: 2343], International Seaways [INSW], Scorpio Tankers [STNG], DHT Holdings [DHT], Hafnia [Oslo: HAFNI], Golar LNG [GLNG] and Flex LNG [FLNG].

Let's talk about one, Norway-based Hafnia, as a representative example.

LB: This is one of the largest product-tanker shipping companies in the world, in what is still a relatively fragmented sector of the market. It came out of a bankruptcy process in which a failed Hafnia Tankers merged with BW Tankers – founded by Y.K. Pao, one of the original Hong Kong shipping tycoons – with the combined company taking the Hafnia name and going public in 2019. We first bought into it at the IPO, paying less than net asset value, which itself was based on what were then depressed charter rates. This was at a time when the order book for product tankers, expressed as a proportion of the total fleet on the water, was approaching an all-time low.

Product tankers take refined oil products from refineries to end markets. Refineries in the developed world have been shutting down for much of the last 10 to 20 years, and what's replaced them are larger, more modern and more complex facilities built closer to sources of crude oil and gas, in the Middle East in particular. Because demand is so global, refined products overall have to travel longer distances from these mega-refineries to end markets. That creates a demand tailwind for product tankers.

Due to its economies of scale, we believe Hafnia's cost structure gives it the lowest break-even point in the industry. Notwithstanding the compelling supply dynamics we have identified, shipping remains a cyclical industry and we think there is an added margin of safety in investing in businesses like this one at the very left-hand side of the cost curve. We also like that after the merger with BW there's been a significant upgrade in both the management and the shareholder base. This is not a group prone to make heads I win, tails you lose bets with shareholders' money.

The stock has done extremely well over the past year. How are you looking at upside from the current share price of around 51 Norwegian kroner?

LB: Given how few product tankers are on order, we're confident that the elevated freight rates and resulting cash flows these companies are generating are not going to expire for some time. If you believe that, the expected dividend yield of 15% and free-cash-flow yield on next year's earnings of around 25% – and the capital return that implies to shareholders – is quite attractive.

INVESTMENT SNAPSHOT

Hafnia
(Oslo: HAFNI)

Business: Owns and operates a global fleet of 100-plus product tankers that transport primarily refined oil products from where they're produced to where they're ultimately used.

Share Information
(@12/29/22, Exchange Rate: $1 = NOK 9.89):

Price	**NOK 51.20**
52-Week Range	NOK 15.92 – NOK 61.30
Dividend Yield	21.8%
Market Cap	NOK 25.62 billion

Financials (TTM):

Revenue	NOK 1.50 billion
Operating Profit Margin	34.8%
Net Profit Margin	31.9%

Valuation Metrics
(@12/29/22):

	HAFNI	S&P 500
P/E (TTM)	8.7	18.6
Forward P/E (Est.)	3.7	17.4

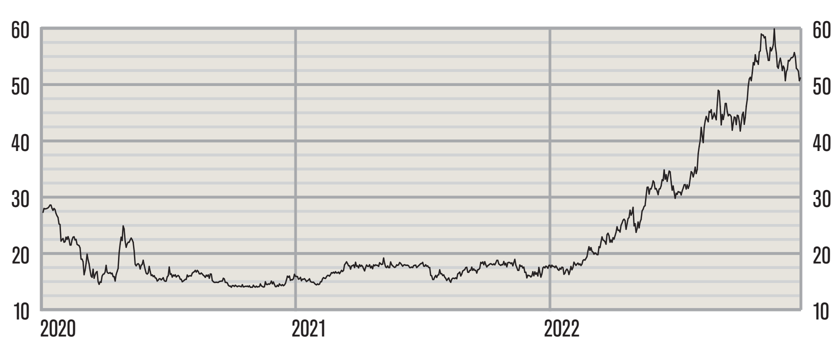
Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Pacific Alliance Inv Mgmt	4.1%
JPMorgan Chase	1.9%
Danske Bank	1.6%
BNY Mellon	1.4%
Skandinaviska Enskilda Banken	1.2%

Short Interest (as of 12/15/22):

Shares Short/Float	n/a

HAFNI PRICE HISTORY



THE BOTTOM LINE

Supply/demand dynamics in the energy and shipping industries bode more favorably than the market seems to anticipate for product-tanker shippers like this one, says Luke Bridgeman. He expects the stock's current 25% free-cash-flow yield on his 2023 estimates – and the capital return to shareholders that implies – to prove quite attractive.

Sources: Company reports, other publicly available information

These typically aren't buy-and-hold opportunities, and sell discipline is important. To us the key issue here is the long period of time in shipping to see a supply response have an impact after such an extended period of underinvestment. One reason we have been a little cautious about conventional oil companies is because the supply response is likely to be somewhat faster, especially with fracking technology. We see that as less of an issue in shipping – shipyard capacity constraints and long order times put a brake on how quickly we will see an inflection in supply growth.

Speaking of oil and gas, you have holdings in North American royalty companies such as Permian Basin Royalty Trust [PBT]. What's behind your interest there.

DD: The primary interest is the energy gap we've already discussed: underinvestment results in an energy shortage that drives energy prices up. At the same time we're coming to the realization that if we're going to get to the lower carbon future we want we need to produce more carbon now. So while it may take time and companies have so far been disciplined, there's huge pressure both politically and financially to extract more energy in North America and we expect to see a sustained period of investment to do just that.

In such an environment we think receiving royalties without much or any need to put in the capital spending for development and production is quite interesting. It depends on the structure of the royalty agreement, but the marginal cost for the royalty owner in producing an extra barrel of oil can be close to zero. We consider that a privileged position from which to play a capital cycle.

We own three energy royalty companies: Texas Pacific Land [TPL], PrairieSky Royalty [Toronto: PSK] and Permian Basin. Permian's principal assets are royalty interests in two Permian Basin properties in Texas that are operated by a company called Blackbeard. Unlike some of the bigger players, smaller operators like Blackbeard are starting to put money into the ground for development, which is a good thing for the owners of royalty streams paid on the production volumes.

Permian Basin's royalty agreement does require that it share somewhat in the capex of the operator, but its incremental margins on future development are still extremely high. The income paid out today is being depressed by the capex spending, but the longer-term earnings power is being enhanced because of the capital going into the ground, which should generate high economic returns.

How do you look at valuation for something like Permian Basin, whose shares after a significant run over the past year now trade at around $24?

DD: There's not a huge amount of disclosure, but there is data published monthly on production volumes and the levels of capital spending, which gives us some insight into future production. Taking all that into account, we believe that at an oil price per barrel of around $70, Permian Basin should be able to pay out about $2 per share in distributions per year, or a yield of more than 8%.

So the basic idea is to own a few of these with already attractive prospective payouts, with upside both from oil prices increasing above current levels and production rising beyond what we've tried to conservatively estimate. Through a capital-cycle lens, we think the risk/reward in a basket of these energy royalty companies is much in our favor.

How does your interest in U.S. banks result from capital-cycle thinking?

DD: This would fall into the category of situations where the market seems to expect companies' high returns to be competed away sooner than we believe they will. Many investors have concluded that banks are the proverbial black box with complex earnings drivers too difficult to forecast, heavy economic sensitivity, and punitive regulation. Throw on top the threat of technological disruption from well-funded fintechs, and the result has been relative bank valuations in the U.S. that aren't much different from their financial-crisis lows.

But what if these views are not just priced in but also outdated? The big four "franchise" banks – JPMorgan Chase [JPM], Bank of America [BAC], Wells Fargo [WFC] and Citigroup [C] – have seen a decade of increasing market share and are benefiting from increasing returns to scale. We believe they have structural advantages in low-cost deposits, well-diversified loan portfolios and difficult-to-replicate customer trust, and that technology is arguably more of an opportunity than a threat.

One of the more extraordinary features of the last 15 years of the venture capital/Silicon Valley boom is the complete lack of success – despite multiple and varied efforts – in disrupting the core deposit-taking business that underpins banking in the U.S. We think there's a strong case to be made that traditional banks' advantages will allow them to continue to fast-follow in creating digital capabilities that will help them maintain their favored positions for a long time.

If we're right about that, and the evidence so far is encouraging, the longevity of cash flows in these franchise banks is

INVESTMENT SNAPSHOT

Permian Basin Royalty Trust
(NYSE: PBT)

Business: Owner of royalty interests tied to the exploration, development and production at two primary Texas oil and gas properties located in the U.S.'s Permian Basin.

Share Information (@12/29/22):

Price	**23.98**
52-Week Range	8.98 – 25.00
Dividend Yield	4.8%
Market Cap	$1.12 billion

Financials (TTM)

Revenue	$42.4 million
Operating Profit Margin	97.8%
Net Profit Margin	97.8%

Valuation Metrics
(@12/29/22):

	PBT	S&P 500
P/E (TTM)	37.8	18.6
Forward P/E (Est.)	n/a	17.4

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Horizon Kinetics	6.6%
Foundation Resource Mgmt	1.5%
Hosking Partners	0.9%
MRM-Horizon Adv	0.7%
Group One Trading	0.6%

Short Interest (as of 12/15/22):

Shares Short/Float	n/a

PBT PRICE HISTORY

THE BOTTOM LINE
Given their extremely high incremental margins, energy royalty companies like this one provide a "privileged" way to play a positive capital cycle in North American oil and gas, says Django Davidson. Current oil prices should support an annual distribution payout of more than 8%, he says, with upside from both increased production and higher oil prices.

Sources: Company reports, other publicly available information likely to be materially higher than the market appreciates, resulting in substantial, under-appreciated terminal value in their equities. I think it was Howard Marks who said you make lots of money not by buying what everyone likes, but by buying what everybody underestimates. We think people underestimate the long-term earnings power of these banks. Currently we own all four of the big U.S. players, Wells Fargo, Citi, B of A and JPMorgan.

Highlighting one of those that has been in the news of late, describe the opportunity you see in Wells Fargo.

DD: Wells is a good example because it's the oldest and most storied of the big banks. It's obviously had – and continues to have – its share of legal and regulatory run-ins over the past several years, but despite all that it still has one of the lowest-cost deposit franchises in the industry, its core retail customer deposits continue to grow, and there's really very little evidence that any of its issues have dented the essential customer trust that underlies all that. Can you imagine what it would cost to replicate the Wells Fargo brand from scratch?

One important aspect of the general opportunity we see in banks is the positive impact on long-term earnings power as they go increasingly digital through mobile-led customer engagement, greater use of cloud-based infrastructure, and dramatically lower physical infrastructure costs as branch systems rationalize. We think the steady-state cost-to-income ratio for a scaled bank could settle in the low-50% range, from the low-70s currently. Smaller banks will find the tech costs of getting there very difficult. Because Wells currently has high operating costs relative to the large peers, the incremental impact on its earnings power as that happens is even higher.

How are you processing any current interest-rate or general economic outlooks?

DD: Our valuation work in these cases tends to look as far as ten years out, but the shorter-term case for banks is hugely aided by higher levels of interest rates. Banks are credit-mediation businesses and as they exchange money their fractional share of the transaction generally is greater the higher the absolute levels of interest rates. As for the overall economic outlook, we don't have a strong view on that, but generally believe that banks like Wells Fargo and others have significant excess provisions for loan losses on their balance sheets after a decade of Fed stress tests. That leaves them very well prepared to weather any general weakness in the economy.

How attractive do you consider the company's shares at today's $41.30 price?

DD: At today's price we're paying just 7.2x our $5.70 per share estimate for 2023 earnings, which does include some benefit from higher net interest margins. Looking out five years we assume reasonable growth in the balance sheet as current regulatory asset caps are removed, and that the cost-to-income ratio is reduced to just under 60%. (For reference, Bank of America on that measure is currently at 62%.) That results in estimated 2027 EPS of around $8.60.

INVESTMENT SNAPSHOT

Wells Fargo
(NYSE: WFC)

Business: U.S. bank holding company operating in four primary segments: consumer banking, commercial banking, corporate and investment banking, and wealth management.

Share Information (@12/29/22):

Price	**41.33**
52-Week Range	36.54 – 60.30
Dividend Yield	2.9%
Market Cap	$157.49 billion

Financials (TTM)

Revenue	$75.12 billion
Operating Profit Margin	27.7%
Net Profit Margin	21.4%

Valuation Metrics
(@12/29/22):

	WFC	S&P 500
P/E (TTM)	11.3	18.6
Forward P/E (Est.)	8.8	17.4

Largest Institutional Owners
(@9/30/22 or latest filing):

Company	% Owned
Vanguard Group	8.6%
BlackRock	6.9%
State Street	4.2%
Fidelity Mgmt & Research	4.0%
Dodge & Cox	3.2%

Short Interest (as of 12/15/22):

Shares Short/Float	0.7%

WFC PRICE HISTORY

THE BOTTOM LINE

Django Davidson believes the market's lack of enthusiasm for the prospects of large U.S. banks like this one may be not just priced in, but also outdated. At 11x his earnings estimate for the company five years out – which assumes reasonable asset growth and reduced operating costs – the stock would deliver a roughly 28% IRR from today's price.

Sources: Company reports, other publicly available information

If on that earnings estimate we assume a P/E of 11x – below pre-scandal multiples of closer to 12x – the share price in five years would be around $95. Adding in cumulative dividends and assuming buybacks shrink the share count by 19% over that period, our IRR on the stock from today would be 28%.

We spoke earlier about high-quality names that make it into your portfolio. Are you looking anew at those types of ideas, many of whose stocks are down more than the market in 2022?

DD: One position we have added to recently is low-cost airline Ryanair [Dublin: RYA], which I would characterize as a quality company in a lower-quality sector. There is a capital cycle underway in European aviation, where in recent years we've seen the bankruptcy of multiple flag carriers and the extension of massive amounts of state aid that will need to be repaid. With capacity reduced, that favors a Ryanair, which has built a Costco-style, lowest-cost-operator model, resulting in competitors' costs per passenger of 60% to 300% higher than Ryanair's. Low costs give them a real moat, which should work to their advantage as demand that is still not fully recovered from Covid and is currently depressed by the economic climate in Europe eventually normalizes.

LB: I would say generally that we're starting to look more closely at classic high-quality companies, but we're not yet there in terms of putting on new positions or adding to existing ones. We're in a sort of curious situation now where we've been in this "everything" bubble that has deflated a little, but hasn't quite burst. You see that reflected still in valuations for many of the top companies that led the market higher on the way up. We'd likely need some further correction in their valuations before we were more active in them. VII

Checks and Balances

The portfolio managers at Hosking Partners see their global approach – unconstrained by industry, cap size or geography – as a real competitive differentiator. "That we can look at more ideas where there's less competition has proven to be a clear benefit over time," says Django Davidson, one of the firm's four PMs. "It's an important structural advantage."

Incremental opportunity in investing can also bring incremental risk. An oil-and-gas stock has a different risk profile than an electric utility. Investing in Brazil brings added risk versus investing in the U.S. The range of outcomes from investing in a microcap are likely much wider and less predictable than for a megacap. Smart investors know all this and take it into account in how they approach research, valuation and portfolio management.

Which brings us to a post-mortem on Hosking Partners' investment in Tinkoff Credit Systems. A Russian credit-card company that became the world's largest online bank by number of customers, Tinkoff for much of its time in the firm's portfolio was a dream come true. Davidson and his colleagues first bought the shares in 2015 in the aftermath of Russia's invasion of Crimea, when the Russian economy and banking system were in turmoil and Tinkoff was rapidly taking market share with its simple, friction-free way to bank online. The shares, traded in London, were at $4.50 when he started buying, only 5x times forward earnings. "One positive lesson is that in emerging-market sell-offs you can buy the best businesses very cheaply," Davidson says. "You don't always have to pay 20x sales."

As Tinkoff's fortunes soared, so did its stock, peaking in 2021 at nearly $125, a 28-bagger from Davidson's initial price. Even at their high the valuation wasn't through the roof, he says, with an $18 billion market cap supported by close to $1 billion in annual profit. "In all likelihood I won't have another investment do this well in my career," he says.

Then comes the punch in the gut when Russia invades Ukraine. While company founder Oleg Tinkoff had no apparent Kremlin ties – and, in fact, renounced his Russian citizenship after the invasion – in short order Hosking wrote off its investment in Tinkoff. Time will tell whether any value is recovered. What was a poster child for investing off the beaten path suddenly became an object lesson in the risks involved.

Davidson's takeaways? One big one is the reinforcement of Hosking's approach to position sizes in holding 400 to 500 positions at a time. While Tinkoff was one of Davidson's largest holdings – each of the four portfolio managers has full discretion over their allocated sleeve of the fund – it never rose above 2% of the overall global portfolio.

He also considers Tinkoff a useful, if painful, reminder of the risks involved in investing in emerging markets: "There's no getting around that the outcome here was bad, but that's not an argument against investing in exceptional companies run by entrepreneurial owners that happen to operate in non-Western markets," he says. "The lesson is to keep in mind that such companies do not control their destiny to anywhere near the extent of their Western counterparts. Portfolio composition should reflect this reality accordingly." VII

John Heins