Rothschild & Co
Wealth Management

QUARTERLY LETTER | APRIL 2024

LongRun Swiss Small & Mid Cap Fund

Investment philosophy

"Make things as simple as possible, but not simpler." — Albert Einstein

Welcome to the second edition of the LongRun Swiss Small and Mid Cap fund's quarterly letter. We kept the structure similar to the last letter, hoping that you found it intriguing and could not wait for the sequel. As you may know we also manage the LongRun Equity fund. Both strategies share the same investment philosophy. Their chief distinction is the investment universe: Swiss small and mid cap companies versus global mid and large cap companies. More on the first quarter of 2024 and one of our main investments on the next pages.

As stewards of our clients' wealth, we invest the monies entrusted to us in a selective and concentrated portfolio of high quality Swiss small and mid cap businesses. Put differently, we simply want the best.

LONG-TERM BUSINESS OWNERS

We want to own high-quality businesses which will be around and prospering for decades. Hence, we pay little attention to short-term price moves and rather focus on a business's sustainable competitive position. This means we search for companies with enduring superior business models that can compound their earnings. Consequently, we avoid companies in commoditised industries where price is the main differentiator. We seek solid companies in control of their own destiny, immune to external prices swings. A key metric is often management's allocation of capital as if it were their own, with a dedicated emphasis on achieving sustainable superior returns.

We care about valuation but are not dogmatic about it. If a great company continues to prosper, we are convinced that its share price will eventually follow. Furthermore, an obsessive focus on valuation often fails to identify truly exceptional businesses. We are determined to avoid this mistake.

Warren Buffett's advice "It's far better to buy a wonderful business at a fair price than a fair business at a wonderful price" is gospel to us. We are long-term business owners, which, in essence, implies that we envision acquiring a business and happily owning it for decades, if not longer.

DEEP RESEARCH ON A FEW COMPANIES ONLY

As follows from the previous section, we do not continuously screen our investment universe for "cheap" companies nor do we buy and sell based on short-term price changes. Instead, we leave this to machines which go through publicly available data to identify and exploit perceived arbitrage opportunities.

Our research process is thorough. Once we consider buying a company, we invest a lot of time reading its annual reports, conducting expert calls, talking to management and constructing our own financial models. We also read books on companies and their leaders, industry newsletters and listen to podcasts. In short, we leave no stone unturned to better understand a business.

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Values: All data as at 31 March 2024.

Sources of charts and tables: Rothschild & Co and Bloomberg, unless otherwise stated. Past performance is not indicative of future performance and investments and the income from them can fall as well as rise. Strategy performance is shown in CHF, after all fees, in total return, combining income and capital growth.

Please ensure you read the Important Information section at the end of this document.

We do not continuously screen our full investment universe for "cheap" companies and buy and sell based on short-term price changes.

Avoiding permanent capital loss is essential to long-term investment success. Consequently, we conduct deeper research on fewer companies.

We prefer to analyse and own fewer companies, ensuring a deeper understanding. To us, this deep understanding of business models is absolutely necessary even if it is no guarantee for superior long-term performance.

WEALTH PRESERVING PORTFOLIO

Avoiding permanent capital loss is essential to long-term investment success. Consequently, we conduct deeper research on fewer companies. Also, it's an ongoing process, never truly finalised. We always strive to learn more and assess whether a business will be around and prospering decades from now, considering environmental, social or governance risks. Only companies of high quality, firmly in control of their own destiny, make the cut.

Our approach stands in stark contrast to benchmark-relative investing, where the allocation to each company is determined by the benchmark. In this method, any particular company then receives a higher or lower or even no allocation depending on a portfolio manager's view. This frequently results in a portfolio with – we would claim – too many positions. To us, the benchmark serves as a yardstick only, and when looking at its constituents, we select simply the best[1]. That is why our portfolio's deviation from the benchmark as measured by the active share commonly exceeds 65%.

On a portfolio level, our selection of companies is complementary, as they serve different end markets across various geographies, generating revenues in multiple currencies. To us, this represents true diversification. We are cautious about merely adding more companies to achieve diversification by quantity. This results in a robust portfolio.

A robust portfolio is also what then allows us to compound returns over the long-term. Just like we expect our companies to compound their earnings, we also want to compound our clients' wealth.

[1] The SPI Extra defines the strategy's investment universe and is used as the benchmark. Up to a total of 15% can be invested outside of this universe for two reasons: To maintain an existing investment despite benchmark composition changes or to make an investment complementary to the overall portfolio.

Portfolio performance and changes

PERFORMANCE

The fund delivered strong performance, with a return of +6.6% over the first quarter 2024. In comparison, the SPI Extra, serving as the fund's yardstick, gained +4.6% in the same period. Annualised returns since the strategy's inception some four years ago are +7.9% for the strategy and +3.7% for the benchmark[2]. This results in an annualised outperformance of +4.2%-points.

Positive contribution over the quarter came from Accelleron (+29% share price change over the quarter), Comet (+18%) and VAT Group (+11%). Detractors included Belimo (-4%), Kühne & Nagel (-13%) and LEM (-18%).

ACTIVITY

The first quarter saw no portfolio changes. As a reminder, the strategy was launched on November 6, 2019 as a certificate. On June 11, 2023 we launched the fund, which required some adjustments due to regulatory concentration and maximum position size restrictions.

Over the quarter we neither added nor exited any investments but still changed the weights of some. Most notably, we added Inficon in-lieu of Straumann to the largest five positions.

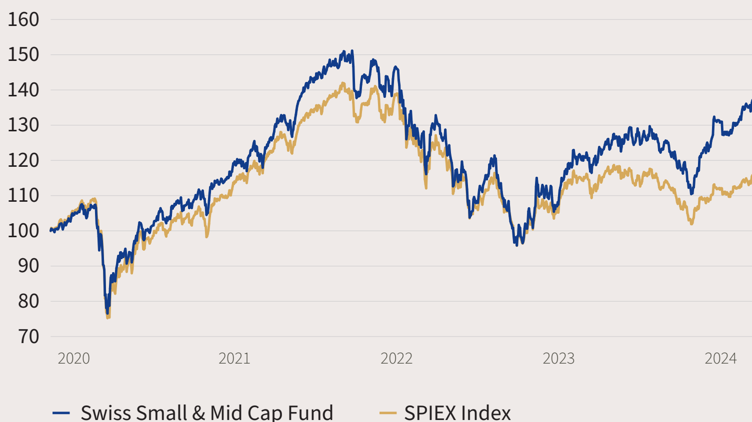
RESULT

Our portfolio comprises high quality businesses as evident from the financial metrics: Cross-cycle sales growth of 7%, 18% operating margin, operating return on invested capital of 25%, a net debt to EBITDA leverage ratio of 0.2x and a strong cash conversion of 70%.[3] We consider current valuations attractive as current free cash flow yield of the portfolio is 2.5% versus 3.0% for its yardstick.

[2] Performance based on a certificate from its inception on 2019-11-06 until the fund's inception on 2023-06-11 and the fund's performance (S share class) thereafter.

[3] Based on internal calculations using ca. eight historical and two future years.

PERFORMANCE (%)[2]



	FUND	BENCHMARK	DIFFERENCE
2024	6.6	4.6	2.0
2023	21.9	6.5	15.4
2022	-26.6	-24.0	-2.6
2021	22.9	22.2	0.7
2020	14.1	8.1	6.0
2019	4.4	4.9	-0.5
CUMULATIVE RETURN	39.6	17.2	22.4
ANNUALISED RETURN	7.9	3.7	4.2

VAT: The vacuum powerhouse

Enabling semiconductor manufacturing

As you can expect from our letters, we provide insights into one of our investments. We do this because, after fundamentally analysing and eventually selecting businesses, we want to share our thinking. This time, we take a closer look at an essential contributor to semiconductor manufacturing, VAT.

Common geographic associations with semiconductor manufacturing are Taiwan, South Korea or the Silicon Valley but not Switzerland's Rhine Valley. Yet, VAT is a key supplier to the industry and has its origins, headquarter and main facilities there.

As stated in our previous letter, we like niche businesses. So, what does VAT do and why is it a niche business? To explain this, let's start with the end consumer. When we browse the internet on a smartphone, both the device and the data centre rely on the latest technology semiconductors or chips. These are manufactured in Asia using machines from specialised semiconductor equipment manufacturers. Manufacturing needs to take place in a controlled and clean environment, which is best assured by a vacuum.[4]
This is where VAT specialises: Designing, developing, manufacturing and servicing the highest quality vacuum valves and related products worldwide.

Today's manufacturing of these chips is particularly challenging because they have features smaller than a hair's diameter. Hence, a single speck of dust or even some particles could prove compromising.

As follows from Moore's Law[5], miniaturisation likely continues until physical limits are reached, therefore vacuum manufacturing is becoming more important. As you can imagine, virtually any latest generation semiconductor has passed a VAT valve during production, including, for instance, Apple's A17 chip powering the latest iPhone. To stay ahead of competition, VAT spends much more on vacuum R&D and related capital expenditure annually than its closest competitor. Its technological leadership grants the firm a win rate of more than 90% for leading semiconductor applications and an overall market share of 75%. We like such technology and market leaders.

Most revenues are semiconductor related with ca. 60% from (repeat) parts purchases and 20% from recurring services. The remaining 20% come from diverse advanced industrial applications ranging from solar panel manufacturing to research uses such as CERN's Large Hadron Collider. Semiconductor equipment manufacturers' core expertise is to develop, assemble, and service machines but leave the manufacturing to suppliers. After launching a machine generation, changes to its set-up are rare. Hence, once selected, VAT remains the supplier until a generation is phased out, thus deeply entrenching it from potential competition. Further, service revenue over a machine's lifetime can reach up to five times the initial selling price. This provides VAT with revenue visibility over longer time horizons.

Virtually any latest generation semiconductor has passed a VAT valve during production.

[4] There are three main pressure environments. Firstly, the earth's atmosphere at sea level with a pressure of 1'000 mbar, where particles are separated by only the distance of a single virus. Secondly, a high vacuum for trailing edge semiconductor manufacturing, with a pressure as low as 10^{-7} mbar and particles spaced between 10 cm – 1 km. Lastly, an ultra-high vacuum for leading edge semiconductor manufacturing or particle accelerators, with a pressure as low as 10^{-12} mbar and particles separated by a distance of two and a half times around the equator.

[5] In 1965, Gordon Moore predicted that the number of transistors on a chip would double about every two years making them more powerful. This prediction has roughly proved true to this day.

Additionally, VAT transformed from a pure parts supplier to a solution partner. Semiconductor equipment manufacturers are increasingly interested in outsourcing the design and making of full modules. These often include several valves and enhancements, making the modules more complex and costly. Their reasoning is that in-house engineers should rather focus on their core expertise. This development not only increases revenues for VAT but also increases customer captivity. Customers include most semiconductor equipment manufacturers (incl. Advanced Materials, Lam Research) and semiconductor factory operators (incl. TSMC, Samsung). What they have in common is that VATs products and services represent a rounding error to their total cost bases.

We also like the operational set-up which is flexible and well-planned. The Swiss headquarter is home to the largest manufacturing facility and most R&D functions. A second sizable manufacturing facility is in Malaysia and benefits from overall lower cost. To meet future demand, VAT is doubling its overall manufacturing capacity by 2027 with a focus on Malaysia. Once completed, this expansion should help increase operating margins from ca. 30% currently to 35% over some years. Ultimately, VAT aims to establish two fully independent supply chains offering its customers dual sourcing from one trusted partner. This is a good example of management's forward-thinking and investing in the future. Semiconductor cyclicality might be the only aspect not to like. Overall, the end-market demand for semiconductors is expected to grow by high-single digits to over USD1trillion by 2030.

We believe VAT will take its fair market share and then some. Whilst we are confident in the long-term trajectory, short-term demand swings can be extreme. For instance, Covid-19 accelerated the shift to flexible working environments. Thus, semiconductor demand surged in 2021 and 2022, only to collapse subsequently in late 2022 and remain depressed over 2023. Arguably, semiconductor cycles could become longer and less volatile as demand benefits from greater global proliferation, including personal device upgrades, cloud computing, the Internet of Things, autonomous driving and artificial intelligence, among others. Further, from a local perspective, reshoring of semiconductor manufacturing may increase demand for VAT's products and solutions.

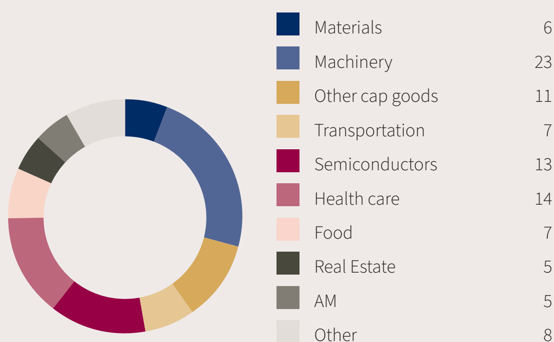
In summary, VAT is the technology and market leader in a growing market, offering critical products and services to a captive customer base. We believe management has put the company on a solid footing to benefit from rising demand, withstand turbulent periods, and potentially take further market share. Hence, in its niche, VAT is simply the best.

VAT is the technology and market leader in a growing market, offering critical products and services to a captive customer base.

Business owner’s portfolio

A deeper look into the strategy and its companies

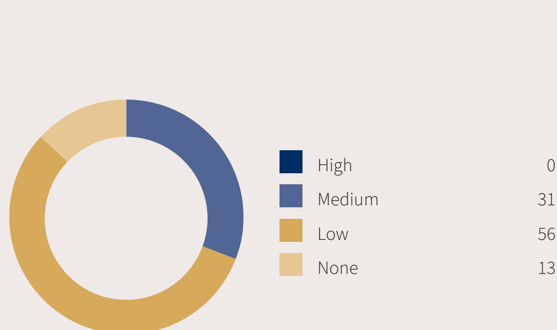
SALES BY BUSINESS (%)



Based on internal analysis.

By weight in portfolio, excluding cash.

DEGREE OF PRICING POWER* (%)

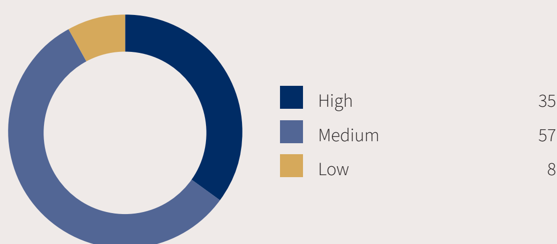


*In the investable universe, approximately 5% of companies have medium or high pricing power.

Based on internal analysis.

By weight in portfolio, excluding cash

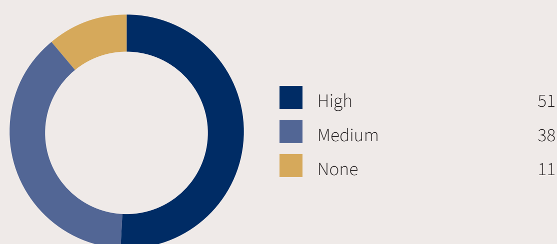
STRENGTH OF COMPETITIVE ADVANTAGE (%)



Based on internal analysis.

By weight in portfolio, excluding cash.

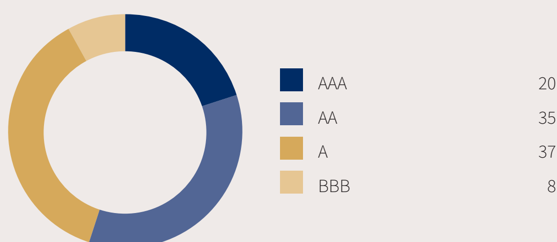
STRENGTH OF SWITCHING COSTS (%)



Based on internal analysis.

By weight in portfolio, excluding cash.

ESG RATING BREAKDOWN (%)

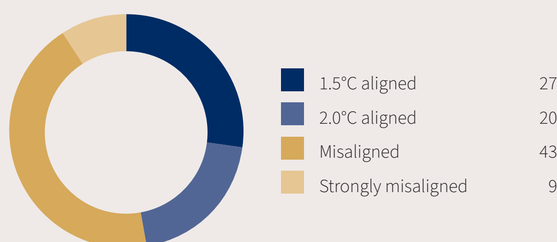


The ESG rating summarizes the ESG performance of a company across environmental, social and governance topics compared to its industry peers.

Data retrieved from MSCI ESG Research LLC.

By weight in portfolio, excluding cash.

IMPLIED TEMPERATURE RISE BREAKDOWN (%)



Implied Temperature Rise (ITR) shows the alignment of companies with global temperature goals. This represents the global warming amount if everyone replicated the measured company’s practices. Categories range from less than or equal to 1.5°C Aligned to more than 3.2°C Strongly Misaligned.

Data retrieved from MSCI ESG Research LLC.

By weight in portfolio, excluding cash.

Notes

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In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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