

# MANAGEMENT'S LETTER TO PARTNERS

Dear Partner,

I hope that you and your family are well, that the pandemic has not disrupted your life any more than it needed to, and that you're managing to regain some degree of normality in these extraordinary and tumultuous times.

In 2021, the Aquamarine Fund returned **23.8%**. This compares with 28.7% for the S&P 500. Since the fund's inception in September 1997, our capital has compounded at a rate of **10.1%** annually, versus 8.9% for the S&P 500, 8.9% for the Dow Jones Industrial Average, and 3.8% for the FTSE 100. The Aquamarine Fund's total return from inception is **938.9%**, versus 690.1% for the S&P 500 <sup>1</sup>

<sup>1</sup> These figures are net of all management expenses, incentive fees, and brokerage expenses, so these are actual returns. The figures for the S&P 500 include dividends, making this an apples-to-apples comparison.

## The Game We're Playing

On an absolute basis, our return in 2021 was more than decent. I'll happily take any year in which our capital grows by almost a quarter. That said, this return wasn't enough to match the S&P 500, let alone beat it. This is the third year in a row in which we've trailed the index.

I'm never particularly thrilled to report these periods of relative underperformance, but I regard them as an inevitable part of our long-distance investment journey. Since the fund's inception in 1997, we've lagged the S&P 500 in 11 out of 25 years. Yet we've beaten the index by 248.8 percentage points during the life of the fund—a healthy margin of long-term outperformance.

As I explain in Aquamarine's Investing Principles (which you can find on page 24), "My goal is to compound wealth at a high rate, while minimizing the risk of permanent losses of capital. In order to keep my sights on the horizon, I frame the investing challenge as follows: I seek to double the Aquamarine Fund's price per share as many times as possible over the course of my investing lifetime." To achieve this goal, I aim to "compound my investors' wealth at the highest possible rate but in a manner that minimizes the probability of a loss."

Part of the challenge in a year like 2021 is that the S&P 500 became increasingly skewed and unrepresentative. Its returns came primarily from an ever-narrowing group of stocks—mainly the FAANGs and a few other market darlings, including cloud computing companies, software-as-a-service companies, and some other new economy businesses. In fact, 34.5% of the S&P 500's return came from just five stocks: Microsoft (+52.5%), Apple (34.7%), Nvidia (125.5%), Alphabet (65.3%), and Tesla (49.8%).

As long-time shareholders in Berkshire Hathaway, we have some exposure to Apple, which is an

immensely profitable business. Beyond that, we've not had any exposure to the raciest realms of the market, not because these aren't excellent businesses, but because their heady valuations created too much risk of loss.

Over the last year or two, I saw more and more investors (including many professionals) throwing caution to the wind as they jumped on the high-growth bandwagon. They piled into hot stocks like Tesla, Zoom, Peloton, Spotify, Netflix, Roku, Cloudflare, and others at multiples that made no rational sense to me.

In some cases, these investors would argue that it was perfectly reasonable to pay 20 times revenues—or even 100 times revenues—for the privilege of owning a money-losing business that might one day dominate its market and make a killing. At times, you got the distinct impression that they thought you were too dumb or old-fashioned or closed-minded to understand why it was so smart to pay these vertigo-inducing prices.

For the most part, I do believe that many of these rapidly-growing companies have genuinely fantastic futures. But I've struggled mightily with the sort of investment analysis that allowed investors to claim that they were getting a bargain when they bought into them.

As long as the market kept soaring and the tech darlings maintained their upward momentum, this type of risky investment behavior was richly rewarded. It was also supported and fomented by Silicon Valley, which is full of brilliant people who are equally brilliant promoters. And, of course, many of these companies are run by talented and charismatic CEOs who are masters at selling blue-sky dreams.

Robert Shiller talks about "narrative economics," and the narratives spun by these companies and their boosters in Silicon Valley often sound incredibly compelling. But when I looked under the

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hood and studied the most popular growth stocks, I typically came away with an impression that the narrative had become disconnected from economic reality. It reminded me a little of WeWork, where the popular narrative was once that this was a new type of business, yet it turned out that it was really just another real estate company rooted in the unexciting economics of shared office space.

Typically, I would glance at the financial statements of all these hot growth companies and see much the same pattern repeated: revenues would be growing rapidly, but the company would either be losing substantial amounts of money or, at best, breaking even. For the cheerleading analysts touting these stocks, none of this was a problem. Their way of thinking has been simply to ignore the losses and claim that the companies are spending in order to grow to the maximum possible size. Why worry

about anything so quaint as profitable growth at the enterprise level or the virtues of a healthy income and cashflow statement?

To justify their enthusiasm, these analysts like to focus on their own favorite measures of corporate well-being. They talk about unit economics, customer acquisition cost (CAC), and lifetime value of the customer (LTV). These metrics allow them to claim that a company is, indeed, profitable—on a unit basis—and they then predict what a steady state would look like.

If the ratio of LTV to CAC is high and the total addressable market (TAM) is large, this will justify spending all of the company's free cash on acquiring new customers in what might well be a never-ending cycle of profitless growth. Then, at some unspecified future date, the cash-guzzling caterpillar of a company will transform, butterfly-like, into a cash-cow monster behemoth. Just like Amazon did under Jeff Bezos. And so, whatever we pay for the company today will be worth it. No matter what the valuation. Because the company will be worth so much more down the road. The unit economics show it. Or so this breathless reasoning goes.

As you may have gathered, I'm not exactly convinced by this way of thinking. Of course, it turned out to be emphatically correct and valid in the case of Amazon and, perhaps, in a few other cases. But this all seems so ethereal and ungrounded to me. Estimating CAC, LTV, and TAM seems to be an exercise in forecasting an unknown and unknowable future. You need to make all these heroic assumptions that are hard to pin down and connect to actual economic reality. It all reminds me of Charlie Munger's reply to a question about alternative measures of profitability like EBITDA (earnings before interest, taxes, depreciation, and amortization). His advice: every time you see that word, "just substitute the phrase 'bullshit earnings.'"

It used to be that successful investment analysts were expected to do serious scuttlebutt research.

This would involve visiting the company, doing channel checks, talking to people with valuable insights into that business. Today, it feels like much of that arduous work has been replaced by listening to podcasts. Pundits on these shows offer their firmly held views, often with little more than anecdotal evidence to support their claims.

In recent months, many of the hot growth stocks that had dominated the market for years have come crashing back to Earth, losing half of their value or more. It's a timely reminder that economic reality still matters, not just narratives about blue-sky dreams. Venture capitalists are great at promoting the hell out of money-losing businesses. But if you ignore the hype, why is it so bad for a company to make an actual profit on its (purported) way to global domination?

As I see it, the key for us here at Aquamarine is to remain firmly focused on economic reality—on what's tangible, reasonable, and rational. Inevitably, there are periods when financial metrics don't seem to matter and when discipline is penalized—at least, for a while. It's not pleasant when your investment approach is out of favor. Still, it all comes back to the timeless insight from Benjamin Graham that, in

the short run, the market is a voting machine, but in the long run, it's a weighing machine. Valuation still matters. It always matters.

I'm not writing this to be defensive about Aquamarine's period of relative underperformance, but to clarify what type of game we're playing—and, equally important, what type of game we're *not* playing. We're not in the game of fixating on fanciful narratives of infinite growth. We're not in the game of ignoring valuations. We're in the game of investing in profitable, durable businesses with the potential to compound for decades. We're in the game of maintaining our discipline to invest in these companies that are rooted very tangibly in economic reality. This isn't dreamy or visionary, but it works well over time.

This mindset helps to explain why the bulk of our assets are invested in mature businesses that generate current cash earnings and that trade at undemanding valuations: companies like Berkshire Hathaway, Nestlé, American Express, Bank of America, and Moody's, to name a few. The good news is that businesses like these tend to be unusually resilient, grinding out a solid result even in times of geopolitical turmoil and heightened economic uncertainty.

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Our emphasis on resilience and durability was out of fashion in 2021, but its benefits are much more apparent in an increasingly volatile period of global conflict, economic sanctions, high inflation, and expectations of rising interest rates. Financial firms, including those mentioned above, are likely to fare relatively well in a period like this. By contrast, companies like Zoom, Roku, Tesla, Peloton, Cloudflare, and Netflix have swooned.

In the current environment, it makes sense that rational investors are now focusing more keenly on the value of near-term earnings—whereas earnings that may (or may not) appear in the distant future take on diminished significance.

It's tempting for me to declare victory and to feel some sense of vindication. I'm relieved that virtues like commonsense, discipline, and prudence are now prized again, after all! But the situation is not that simple. I'm certainly glad that I didn't make the mistake of buying into these businesses at overstretched valuations. Still, in earlier years, their valuations were not nearly as unreasonable. Had I been more astute, we might have been able to participate.

I also recognize that many of the businesses emerging from the tech world (including some of those mentioned above) are extraordinary and deserve to be studied carefully. While it's true that Silicon Valley, like Wall Street, is a powerful promotion machine, it's also filled with some of the brightest minds on Earth. I can't afford to remain locked into a traditional, Norman Rockwell mode of seeing the world. I've been too slow to update my frameworks to understand the impact of some of these newer business models.

One way to remedy this is by closely studying the methods of the best venture capital firms. They are intensely competitive and meritocratic, have generated some of the highest returns in the history of capitalism, and have thought through so many things so well. These days, I'm paying particularly

close attention to VC firms like Sequoia Capital, Andreessen Horowitz, NFX, Index Ventures, and a few others. I've initiated an internal research project to study their investments so that I can glean as many insights as possible.

I'm not looking to ape their investment moves, even if I were capable of doing so, and I'm as wary as ever of all the hype. But I need to continue challenging and updating my thinking. Not long ago, I read a tweet by Bill Brewster, a private investor who hosts the Business Brew podcast. He wrote, "The single biggest mistake I made in my life was using high valuations as a reason to dismiss and/or not deeply study something. Don't be like me." I agree, and I will try to keep learning and expanding my knowledge, despite my habitual skepticism.

The truth is, there are many good ideas in the portfolios of aggressive growth investors like Cathie Wood. Good ideas can be taken too far, especially in a bubble. But if the prices come down further, I would look to invest in some of these exceptional businesses. One characteristic of 100-bagger companies is that they rarely look cheap. Still, I'm not going to throw valuation out the window, and I can't foresee *ever* paying 100 times revenues for a money-losing company. The math simply doesn't work. For me, at least, the challenge is not only to identify superior businesses, but to pay a reasonable price for them. There's the rub.

## Two Stocks We Own And One We Don't

Looking back on 2021, I think it's also worth pointing out that much of our performance for the year was driven by two of our lesser-known investments, one in China, one in India: **BYD Co** (1211.HK) and **Indian Energy Exchange** (IEX). Why does this matter? Well, for one thing, it shows you that the S&P 500 is not a particularly useful benchmark for the Aquamarine Fund. It's perfectly reasonable to compare the fund to a benchmark like this as it gives you a way to gauge our performance. But our relatively concentrated portfolio of high-quality

businesses from around the world is significantly different from the index.

In order to illustrate the game that we're playing, it might be helpful to discuss these two investments in more depth because they reflect a gradual evolution in my style of investing. Then I'll discuss a third company that I decided not to buy—a decision that also reveals something about the way that I manage the Aquamarine Fund.

The first stock is BYD, a Chinese electric car and battery company, which we've owned since 2011. What first piqued my curiosity was the fact it had passed through the filters of three of the smartest investors in the business. Li Lu, a Chinese former dissident who subsequently became a protégé of Charlie Munger, had invested heavily in BYD and brought it to the attention of Charlie and Warren. In 2008, Berkshire bought about 10% of the company for \$232 million—a stake that's now worth billions. Munger has described BYD's founder, Wang Chuanfu, as “a combination of Thomas Edison and Jack Welch—something like Edison in solving technical problems, and something like Welch in getting done what he needs to do.... I have never seen anything like it.”

Founded in 1995, BYD had started out as a rechargeable battery maker. It then entered the automobile business and later diversified into cell phone assembly and solar cell manufacturing. Leveraging its strength as a battery maker, the company transformed itself into a leading developer and manufacturer of electric and plug-in hybrid vehicles. BYD's outstanding results may have originated with Wang's remarkable abilities, but the firm now also has the advantage of being able to deploy more than 10,000 engineers at a fraction of the cost that an American or Western European competitor would have to pay.

At the time that I made the investment, BYD was not at the center of my circle of competence—certainly not based on my technical knowledge of batteries

or electric cars. I might never truly understand those businesses with the level of granular detail I would want. But the price had dipped, and I knew that I needed to pay attention to this opportunity.

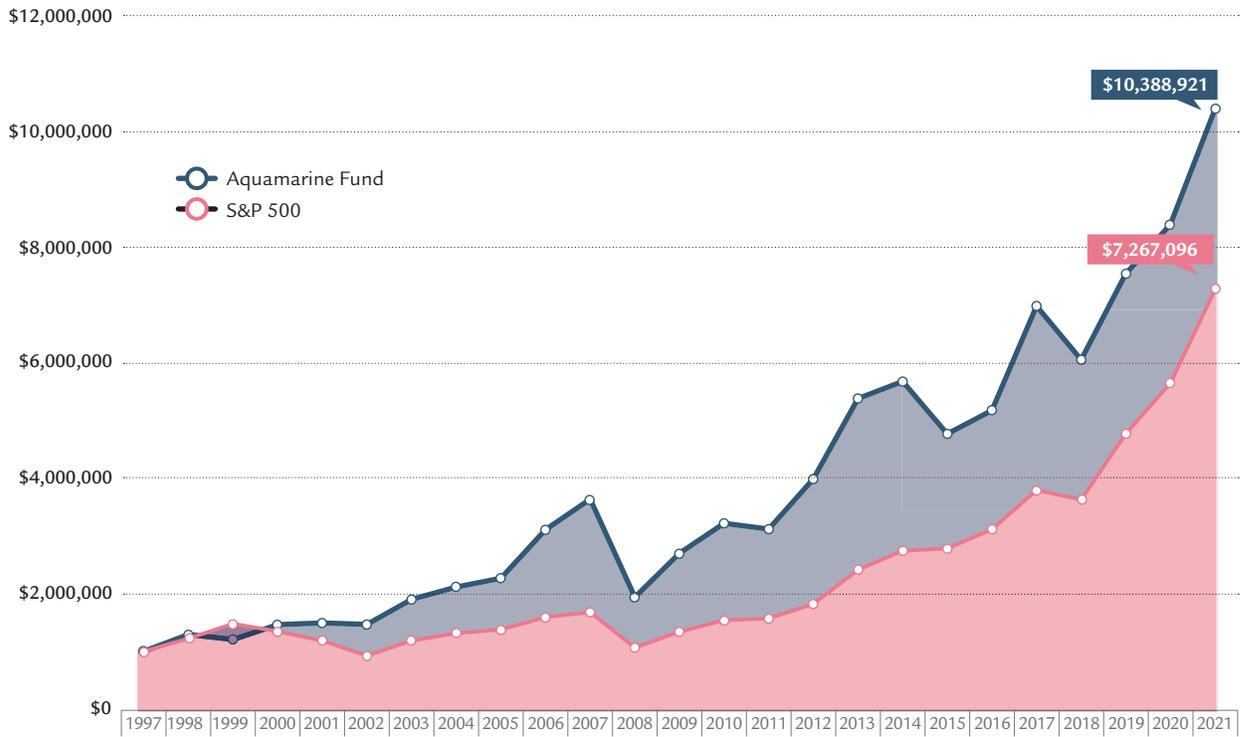
I had met many of the key players, starting with Li Lu, Charlie Munger, and Warren Buffett, and I had studied them all closely. But I barely knew Wang. Nor did I feel equipped to evaluate him or Stella Li, the president of BYD in the U.S.

All I had to go on were BYD's annual report, the views of some people I highly respected, and some personal anecdotes and impressions. For example, I was very impressed with Wang's demeanor at Berkshire's annual meeting, where I saw him sitting in the middle of his entourage of BYD executives, listening with rapt attention. He was genuinely and deeply curious to learn as much as he could from Warren and Charlie. And the one time I introduced Stella Li to someone in my network, she was extraordinarily responsive. My interactions with both Li and Wang had been fleeting and limited. But they both impressed me in the same way that Jack Byrne (a former CEO of GEICO) and Don Keough (a former director of Berkshire and Coca-Cola) had impressed me when I met them.

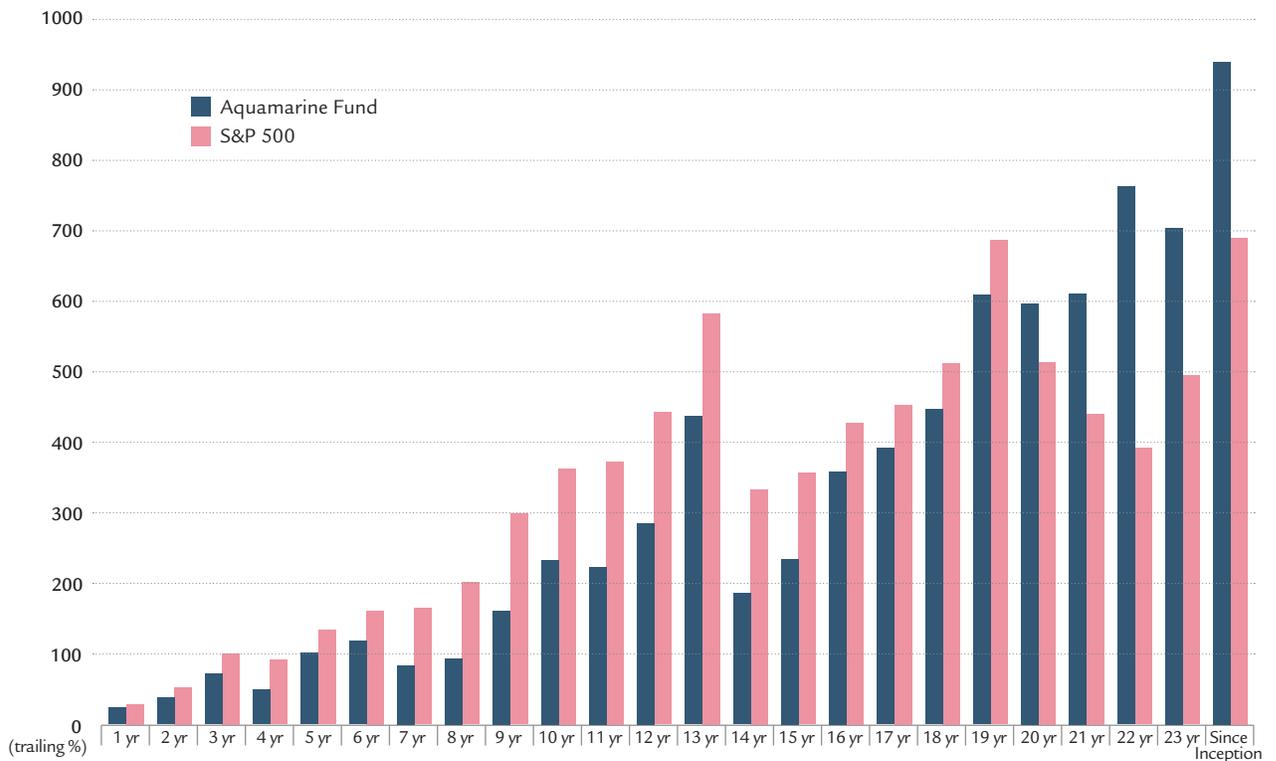
In the early years of my career, my disillusioning experience of working at a failed investment bank, DH Blair, had dented my confidence and made me pretty wary of human nature. I tended to assume that the businesspeople I met had to be mediocre because the very best people would not be in my circle—and if they behaved well, perhaps it was an aberration. As a result, I was typically willing only to trust the hard numbers in an annual report, instead of relying on my assessment of the management. But by the time BYD came along, my attitude had started to change, and I was more willing to venture out of this comfort zone. Wang Chuanfu and Stella Li struck me as hugely accomplished executives who were likely to continue delivering the type of performance they had produced in the past.

## Aquamarine Fund Performance Relative to the S&P 500 Index

Comparison of changes in \$1,000,000 invested in Aquamarine Fund vs S&P 500



## Cumulative Returns for the 24 Year Period 1997-2021



I'M A HUGE BELIEVER IN FREE MARKETS AND THE INVISIBLE HAND. STILL, INVESTING IN CIGARETTE COMPANIES, CASINOS, AND LOTTERY COMPANIES ISN'T THE PATH I WANT TO TAKE. IF YOU ARE ALREADY REASONABLY WELL-OFF, WHY GET RICHER BY DANCING ON THE GRAVES OF CIGARETTE SMOKERS OR EXPLOITING THE CREDULITY OF VULNERABLE LOTTERY-TICKET BUYERS?

Instead of doing a forensic, spreadsheet-style analysis of BYD's current operating performance, I looked at the company as a growing organism. I asked myself whether, based on past results and achievements, it was likely to succeed in entering adjacent markets and continue to deliver a great return on its engineering, research, and development spending. I was also comforted by two more things: the company had a history of being highly profitable, and it seemed central and strategic to China's future—unlike a gaming company or even Kweichow Moutai, the Chinese beverage brand we used to own. The fact that the Chinese government recognized BYD's strategic importance seemed to reduce the political risk of this investment.

Still, I wasn't sure if I had ventured too far outside my circle of competence. So I sized the position appropriately, committing around 5% of our capital base at the time. This position was big enough so that it would have a significant impact on the portfolio if it worked out. But it was small enough so that I didn't have to think about it all the time. I felt comfortable ignoring the stock price and only checking in on the operating results from time to time.

As I'd hoped, BYD continued to deliver strong operational results. But its stock went nowhere for several years. Meanwhile, one of its competitors, Tesla, was on a tear. Still, none of this bothered me, given my appropriate position sizing, so I just sat there quietly and waited. In time, the market recognized BYD's value and the stock has risen 963%, growing to be almost 15% of the Aquamarine Fund's assets.

What's the moral? In part, it's about the benefits of partnering with world-class management and operating in an environment filled with exceptional people like Warren Buffett, Charlie Munger, Li Lu, and Wang Chuanfu. In part, it's about having the patience to remain invested in a superior business that's well-positioned to benefit its entire ecosystem. In part, it's about looking

beyond the numbers in a company's financial statements and seeing the business instead as an unfolding organism that's delivering value to all of its stakeholders. When you find a great business that's developing like this, it's a wonderful thing to own a piece of it and to hold onto it for dear life. Inspired by Mohnish Pabrai, I used to think that I shouldn't sell a stock within two years of buying it. Nowadays, I'd be inclined to extend that to five years.

The second company that I'd like to discuss is Indian Energy Exchange. My interest in IEX was sparked during a trip to India in 2018 when I attended a couple of investment conferences and visited dozens of Indian companies. Amongst all of them, IEX stood out as a company with some very rare characteristics. Like BYD, it's strategically important. IEX is essential to India's development, so it occupies what I regard as the economic high ground.

IEX runs an electricity exchange that's not dissimilar to a stock exchange—except that it's much more critical and central to a country's infrastructure than a stock exchange. Instead of dealing in stocks, a power exchange deals in power flows, which are traded in time slots. A country's electricity grid has to remain in balance from second to second, minute to minute, hour to hour. Otherwise, the whole system can go down. Also, in an era when more and more of our energy comes from renewable sources like wind and solar, it's increasingly critical to match supply and demand efficiently. In Europe, where power trading is the most advanced, as much as 70% of the market is traded. In India, less than 10% is traded.

Electric power is absolutely central to India's economic development. A key element of this development is that participants in the energy market—from power producers to consumers—must be able to trust the market-clearing price for power. IEX plays a crucial role. It provides an exchange on which an excess of energy can be offloaded

to other market participants. This liquid market provides a reliable price-discovery mechanism, so that participants in India's energy market have the confidence required to make huge investments in power infrastructure, which India needs in order to grow efficiently. IEX delivers immeasurable value for India by providing this rational pricing.

This also happens to be an excellent business in which an established and dominant player like IEX continues to win because it's trusted to provide reliable liquidity and execution. I also liked the fact that the company is highly regulated and that the vast majority of its counterparties are state-regulated organizations, including power suppliers, distributors, and large consumers. This was important to me because, despite the enticing opportunities in Indian stocks, it can be a treacherous place, especially for naive foreign investors. By some estimates, more than half of listed Indian companies are frauds in one way or another. Having the company embedded in this network of regulated entities reduces the risks of fraud.

What also attracted me to IEX was that it has an extremely long runway. There's an immense amount of work to be done in the Indian power industry over the coming decades. Electricity production per capita will need to more than triple for India to reach the levels of developed countries—and we can also expect a much higher proportion of India's electricity to be traded in the future than it is today.

One concern was that IEX wasn't cheap. But my thinking has gradually evolved on this front. If I want to buy the best businesses, it's often necessary—within reason—to pay up. I believed that IEX was worth a premium price, given all of the forces working in its favor. As with BYD, I initially invested about 5% of our assets in IEX—enough so that it would have a significant impact if it worked out, but not so much that I needed to worry unduly about the risks or be in a particular hurry for the investment to pay off.

After I bought IEX in March 2019, the stock did little for a couple of years, but the business continued to advance. Then, in 2021, the stock quadrupled. As with BYD, I expect that there's still a long way to go, and I intend to hold onto both stocks for years to come. In February 2022, I returned to India with Mohnish to meet with Satyanarayan Goel, the chairman and managing director of IEX. This visit reaffirmed my sense that IEX stands at the very center of India's developing power infrastructure—a position of prime economic importance. The value it can bring to the country is immense, and I'm excited to be a partner in its growth.

The third company I'd like to discuss is one that I evaluated at around the same time as IEX, but ultimately decided not to buy: **Française des Jeux**. As the national lottery company in France, it was a protected monopoly with very high returns on invested capital and strong current income. It's a well-run and attractive business, and the valuation was very reasonable. But when I asked myself whether the company advances the public good, the answer was obvious. Some see lotteries as a relatively harmless form of entertainment. But lotteries can also be seen as a regressive tax that disproportionately takes money out of the pockets of the people who can least afford it. Overwhelmingly, it's the poorer and less educated segments of society that fall for the dream of winning the lottery, even though the odds of that actually happening are vanishingly small. Personally, I don't want to make money off businesses that don't improve their customers' lives—and, arguably, make their lives worse.

In the past, I've come to a similar conclusion about tobacco companies and their suppliers, which are lucrative businesses that are morally compromised. Some investors argue quite reasonably and defensibly that it's fine to invest in regulated companies that make legal products. It's a classic Milton Friedman argument that the only real responsibility for businesspeople is to maximize their profits in a legal manner. Politics, government, and the law should take care of the rest. I'm not convinced.

I'm a huge believer in free markets and the invisible hand. Still, investing in cigarette companies, casinos, and lottery companies isn't the path that I want to take. I don't want to pass moral judgment on the companies themselves or their investors. But I do believe that investing, which involves allocating our surplus resources, has a moral dimension. If you are already reasonably well-off, why get richer by dancing on the graves of cigarette smokers or exploiting the credulity of vulnerable lottery-ticket buyers?

There's also a very practical reason for this stance. It's extremely difficult to do a detailed risk analysis of any business—one that takes into account all of the possible calamities that might befall it. None of us can predict the future. But I believe that companies that benefit society tend to be more resilient than companies that harm it. The latter, I suspect, are far more likely to be hit with nasty surprises. I discuss this idea in more depth in Aquamarine's Investing Principles, which I revised this year to include several new principles. As you'll see, one of them is principle 21: "Look For Companies That Have A Noble Mission."

I've also learned to be wary of dominant companies that have achieved this enviable position not through business performance, but through the help of a state—through the granting of licenses, contracts, or (in the case of Française des Jeux) a state-granted monopoly.

With all of this in mind, I declined to invest. I later learned that the European Commission recently opened an investigation into Française des Jeux and the French government for operating an unjustified monopoly and for anti-competitive practices. This has placed a dark cloud over the company and its share price. I certainly didn't foresee this, but I'm glad to have dodged the bullet. The truth is, I'm much happier partnering with companies like BYD and IEX, which are benefiting society in vital ways. Of course, these companies may also face serious challenges in the

years to come. Still, on the whole, it's less risky to invest in businesses like these that are truly aligned with the best interests of society.

### **How We're Positioned To Handle Inflation And Geopolitical Turmoil**

When you follow the news these days, it's natural to feel unsettled and upset. As I write this in early March 2022, Russia has invaded Ukraine, causing unimaginable suffering and destruction; inflation has reached levels that we haven't seen in 40 years; energy prices have soared; and the COVID-19 pandemic continues to have profound effects on the way we live and work. There are so many complexities involved that it's impossible for any of us to foresee where this is heading, geopolitically or economically, or what the impact on financial markets will be. Nonetheless, it's fair to ask how I'm thinking about this broader context and how the fund is positioned to navigate these tumultuous times.

First of all, let's look at the challenge posed by inflation, which was recently estimated at 7.9%

in the United States. It seems that the era of low interest rates and low inflation has come to an end. So I want to take a moment to update you on my thinking about this topic. If you're not interested in economics, feel free to skip ahead!

This is not the first time in history in which a crisis (in this case, a pandemic) has been dealt with through a vast surge in government debt. But where does the world go from here?

Some expect an era of stagflation (in other words, a combination of high inflation and stagnant growth) that would be reminiscent of the 1970s during the oil shocks. While we certainly shouldn't rule that out, I don't see it as inevitable—especially not in the rich, developed economies of North America and Western Europe, which are the Aquamarine Fund's core markets.

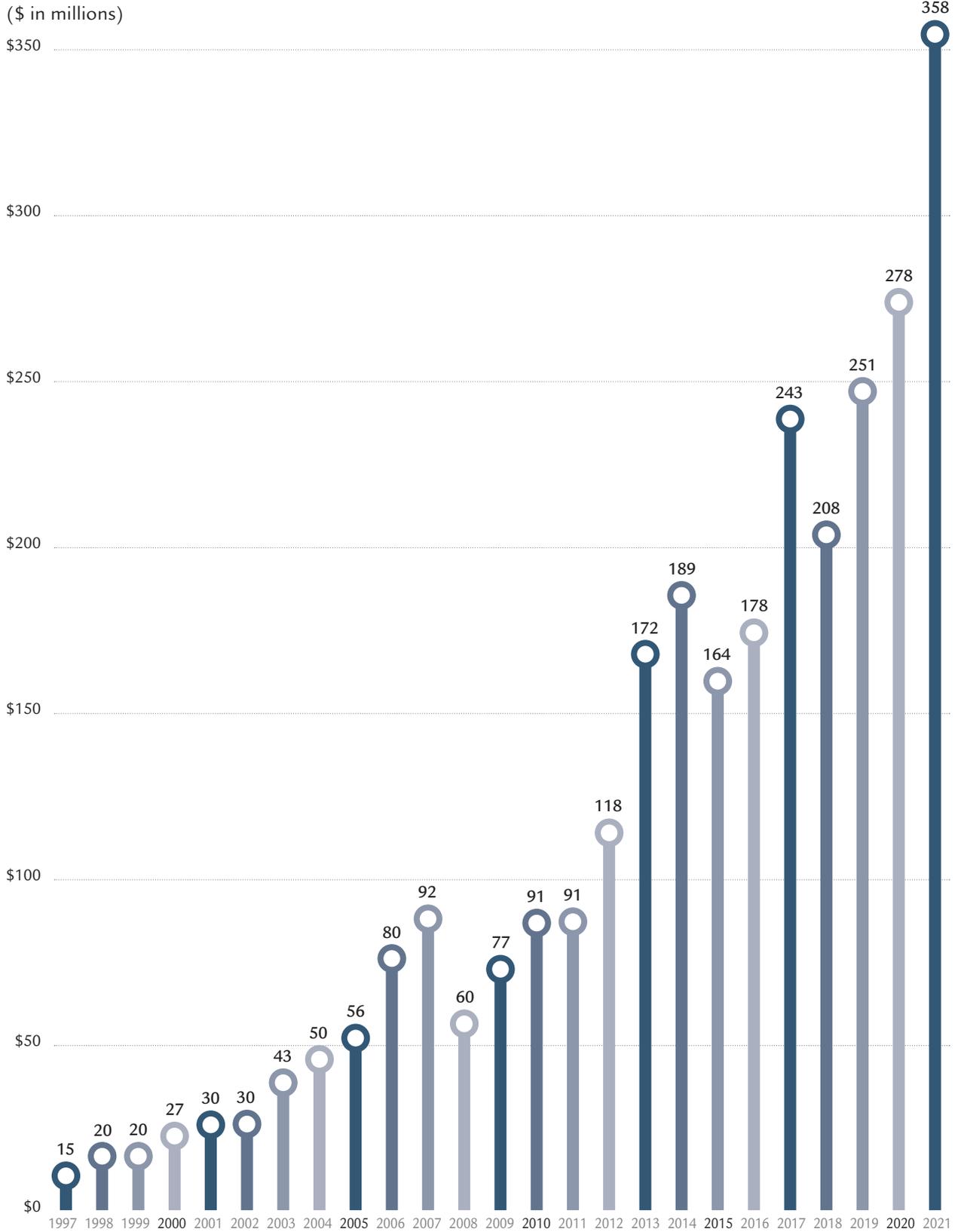
Without going into too much detail, there are a myriad of paths out of the apparent debt overhang that is spurring such worries. With the help of the

To give you a clearer sense of how your money is invested, here's a snapshot of our largest positions—at cost and at their current market value—as of December 31, 2021:

Holding	Market Value \$	Percentage of Partners' Capital	Original Cost \$	Gain/(Loss) \$	Gain/(Loss) %
Berkshire Hathaway	55,559,260	15.87%	13,381,800	42,177,460	315%
BYD Auto	53,001,308	15.14%	4,986,800	48,014,508	963%
Indian Energy Exchange	44,782,934	12.79%	10,557,400	34,225,534	324%
American Express	34,356,000	9.82%	10,906,129	23,449,871	215%
Bank of America	34,161,424	9.76%	5,181,863	28,979,561	559%
Mastercard	23,625,290	6.75%	1,019,194	22,606,096	2218%
Cash	8,613,478	2.46%			

# Assets Under Management

As of December 31, 2021



economists Carmen Reinhart and Kenneth Rogoff, we can categorize them—in decreasing order of attractiveness—as follows:

1. **Growth:** We might simply grow our way out. If the economic growth rate exceeds the interest on the debt, then it will subside as a proportion of GDP. This would be the most benign path, and it's happened before—for example, it's part of what happened in the U.S. in the 1950s in the aftermath of World War II.
2. **Privatization:** The government could also sell off assets, privatizing state-owned companies and other state-owned resources to help pay down debt.
3. **Austerity:** The government could tighten its belt by reducing expenditure on non-essentials and by raising taxes.
4. **Financial repression:** This is where the government forces lower-than-market interest rates on local savers. Think of the Japanese savings bank system, which has paid below-market interest rates on savings accounts for decades, depriving the Japanese of a market return on their hard-earned cash. Or think of rules in the U.S. forbidding banks from paying interest on deposits and requiring banks to hold non-interest-bearing reserves on those deposits. Reinhart and Rogoff have shown that financial repression has been a pervasive and widespread mechanism for reducing government debts. It's not pleasant, but it's easily preferable to the last two options, which are both profoundly unpleasant.
5. **Default:** This might be a full default or it might be a one-off, forced reduction in interest rates. It might also be a default on the government's non-financial obligations—for example, by reducing the effective payout on social security, which provides medical support and supplemental income to retirees, people with disabilities, and survivors of deceased workers.

**6. Inflation:** This is the silent, stealth tax that insidiously affects everyone. Inflation and default are the two most unattractive of all six paths.

Which combination of the above will take us out of the current debt overhang? Unfortunately, inflation is the easiest to implement. It doesn't require legislators to pass budgets, raise taxes, cut expenditures, privatize assets, or engage in a discrete default of any kind. They don't have to bother with irksome political discourse or the painful process of reaching an agreement. They can simply print more money. Moreover, our politics are so polarized that it's hard to imagine reaching the kind of consensus required to take difficult actions that would reduce the debt overhang. So this leaves inflation as the easiest option to implement—even if (with the possible exception of default) it's the most destructive.

To understand the broad impact of inflation, I invite you to join me in a thought experiment. Imagine that society is divided into two classes of people: savers and borrowers. Savers tend to be older, richer, and retired. They own assets—perhaps a business, an investment portfolio of bonds and equities, or pension assets. The mortgages on their real estate tend to have been paid off. Broadly speaking, the Aquamarine Fund's investors fall into this general category.

By contrast, borrowers tend to be young and working. They own few (or no) assets—and, if they *do* own assets, they are likely to have mortgages and other liabilities against them.

In order to place this artificial but meaningful divide in a historical perspective, we can use other terms to describe it. A Marxist would talk about the workers versus the owners of the means of production. A historian of feudal times would refer to the nobility versus the serfs. In the period of nation states, we would talk about the rulers—along with their bankers and courtiers—versus their subjects.

Broadly speaking, this division between the haves and have-nots is relevant across all human societies, even if it's blurred today. And while it was starker in older times, it can easily be discerned in our modern economies as well. In the U.S., think of the East and West coast elites versus the coal miners of Ohio, or think of the well-established residents versus the new immigrants. In the U.K., think of the rich Southeast versus the red-wall North.

If the inequalities between these two groups widens, as it has in recent years, pressure arises to reset society and restore some balance—hence the popularity of books like Thomas Piketty's *Capital* and the increasing appeals to populism by our political leaders.

But achieving a reset using one of the first five options we listed is difficult. In a polarized world, which is unlikely to achieve consensus and compromise, those five options become much less likely than the sixth option: inflation, which doesn't require anybody's explicit buy-in and which inflicts harm on its victims in an indirect way that's more surreptitious.

What's the effect of inflation? Well, it drastically resets the relationship between borrowers and lenders by erasing—or severely eroding—what is owned by savers. By contrast, it wipes the slate clean for the other side: borrowers. Inflation may not seem so obviously disruptive, dramatic, and extreme as the social revolutions of times past, but its effect is not dissimilar: social upheaval and a great reset in who owns what.

If you are a saver, if you are old and rich, if you have paid off your mortgage and have saved up for a rainy day, then inflation means that you are potentially in for a financial bath. It's a disaster—because, by stealth and without warning, the value of your hard-earned claims on society might just melt away. By contrast, if you're a borrower, if you're young, if you don't own much, if most of your well-being comes from money that you earn

today (rather than money you earned in the past), then consider yourself lucky. Rather than having a previous generation's debts passed on to you, you will see them vaporized instead. The claims of society are depreciated against the savers' current wealth and income, instead of being dumped on you to work off yourself.

As savers and investors, this situation doesn't bode particularly well for people like you and me. Inflation can be likened to a storm. The best we can do is find shelter in areas where the least damage possible is done to our savings. But we can't get rid of the storm. If sustained and high inflation stays with us, it will affect us all.

Given this slightly gloomy prognosis, what should we, the investors in the Aquamarine Fund, do? What should I, as the manager of the fund, do? Where can we, as prudent long-term investors, invest in order to preserve and actually grow our wealth over time?

I've thought about this for much of my investing life, but never more intensively than in the last few years, and I have an increasing sense of clarity about what I believe we should do. It's impossible to have certainty about this, but I hope my perspective will be helpful to you.

One popular view holds that staying in equities is too dangerous in this type of environment. In a world of rising interest rates, multiples can only contract, and prices might come tumbling down. This conclusion would suggest that you should redeem from the fund with alacrity and that, similarly, I should sell our investments and raise our cash levels.

But if we dig deeper, it becomes quite clear that these are not the best options. Indeed, they are quite probably the worst—by a wide margin. Here's why:

When it comes to inflation and higher interest rates, these two forces work against each other in



GIVEN THE POTENTIAL FOR GLOBAL INSTABILITY, I FEEL MOST COMFORTABLE INVESTING HEAVILY IN THE U.S. AND WESTERN EUROPE, FOLLOWED BY THE VAST EMERGING ECONOMIES OF CHINA AND INDIA. ALTHOUGH THEY ARE NOT AS WELL-ENDOWED AS THE U.S., CHINA AND INDIA HAVE GREAT STRATEGIC DEPTH AND SEEM LESS VULNERABLE TO DISRUPTION THAN MANY PARTS OF THE WORLD.



the stock market. While higher interest rates do, indeed, tend to drive asset prices down, inflation will have the opposite effect and drive asset prices up. That's why stock markets around the world typically do so well in inflationary economies—at least, nominally. Under inflation, asset prices tend to rise at a high nominal rate—even if, because of inflation, purchasing power is not improving by much. So the stock market is actually not a bad place to park money during an inflationary period. Indeed, I believe that a well-selected portfolio of equities is by far the safest and best place to protect our savings in an inflationary environment—with the possible exception of high-quality real estate.

What are the alternatives to owning stocks? Let's start with cash. Over the long run, cash is a lousy bet because it depreciates in value. That's what inflation does. So holding cash—unless it's to meet a near-term and necessary spending purpose—is not a smart or viable alternative to stocks. What about other stores of value, such as precious metals like gold and silver? Like equities, their price may fluctuate a lot—and, in the long run, they will almost certainly underperform good businesses. What about cryptocurrencies, such as Bitcoin? Like gold, cryptocurrencies won't generate a current income. Personally, I consider them too volatile, too unseasoned, and too uncertain to provide a dependable alternative to stocks. By contrast, real estate may be a good option. As a real asset, it will get repriced up, along with inflation.

Thus, in my view, the wisest and safest places to hide from inflation over the long run are real estate and equities. All other assets seem likely to underperform. But which equities? Under inflation, not all companies will perform equally well.

To understand how different businesses will perform amid inflation requires a careful examination of their economic characteristics. I won't bore you here with all the reasoning, but what we are looking for is companies with pricing power, that are capital efficient, and that have a high return on their

## THE BEST WAY TO PROTECT OURSELVES FROM ECONOMIC AND GEOPOLITICAL TURMOIL IS TO INVEST FOR THE LONG TERM IN GOOD, CASH-GENERATIVE BUSINESSES THAT DELIVER REAL VALUE TO THE SOCIETIES WHERE THEY OPERATE.

invested capital. Ideally, they should have made much of their investment into the business in the past and require limited investment going forward.

Which businesses meet those criteria? Certainly not those vaunted tech and new economy firms that are spending vast and increasing amounts of money in the hopes of eventually capturing a profitable share of their total addressable market. By contrast, businesses that will do better than most include banks (many of which borrow at fixed interest rates and lend out at floating rates), financial services firms, and all of the companies that are able to price as a percentage of nominal prices. That includes credit card networks, stock exchanges, and credit rating agencies. Branded and luxury goods companies should also do pretty well.

In this regard, I'm happy to report that these are exactly the types of company that we're invested in. This is not to say that we will win big if high inflation becomes more than a transitory problem. But I'm confident that our businesses will prove much more resilient than most and will provide a more dependable store of wealth than almost any other type of asset that we might choose to own.

For what it's worth, it was striking that many of the racier and more speculative tech stocks that had soared in 2021 plummeted in the first two months of 2022. By comparison, sturdier companies like Berkshire Hathaway have held up well in this tempestuous period. For me, it's yet another

reminder that we want to own good businesses that are built to last.

This is particularly true now that we find ourselves in an intensely volatile geopolitical environment. This is a time when it's all the more important to own companies with the strength to survive through thick and thin. I also think that we're seeing the great benefits of investing primarily in countries that are geopolitically stable, while staying away from those that are particularly vulnerable.

The war in Ukraine is the most obvious and shocking example of how dramatically the geopolitical landscape is changing. With liberal democracies in retreat and the U.S. losing its luster as leader of the free world, non-democratic capitalist autocracies like Russia and China have seen an opportunity to exploit the weakness of the West, where we are increasingly divided and where both sides of the political spectrum are now in the thrall of populists.

Yuval Harari has written that the liberal West was built on a quaint 18th-century Enlightenment fiction that humans possess autonomy and free choice. While it was never entirely true (think of the Church or mass advertising), it was a useful idea that helped to convince people in the West to live together harmoniously. But today it is patently not true. Humans are now a hackable species. Through vast computing power, enhanced by artificial intelligence, it's now possible to manipulate people on a mass scale—in quite precise ways—as Russia,

China, Cambridge Analytica, Donald Trump, and Dominic Cummings have all demonstrated. This is deeply troubling and doesn't bode well for our freedom and prosperity. But I hardly need to theorize here about these uncertainties. I have no answers. All I can say is that all of this gives me pause for thought and makes me feel doubly and triply responsible for the task of responsibly and prudently protecting your life savings.

I'm doing this not only by investing in unusually strong and durable businesses, but by investing in parts of the world that are particularly resilient. Geographically, the bulk of Aquamarine's assets—around 56%—are invested in the United States. I've written in the past about how miraculously benign the U.S. is for the sort of capitalism that we practice. Sitting between two great oceans and two friendly neighbors, the country's strategic location is unparalleled. So are the country's natural resources—the agricultural breadbasket of the Great Plains, the waterways, the vast mineral and oil wealth, and the sheer size of the land.

Equally important, the U.S. has a remarkable political system that has—so far—succeeded miraculously in bringing out the best in its people in ways that no other country in history has surpassed. It has taken in immigrants in massive numbers and turned them into some of the most industrious, inventive, and productive people on the planet. Out of this cauldron, we've seen the emergence of companies like Apple and Tesla, universities like Harvard and Stanford, the technological innovations of Silicon Valley, and so much more.

Of course, we all worry now that this might be broken. But the American Civil War demonstrates the extraordinary capacity that the U.S. has to rejuvenate and reboot, despite terrible setbacks. And I'm confident that it will do so again. When I look around the world, I have no doubt that the U.S. is still the most favorable investment destination of all. Despite all of the country's problems, it's still the place where our capital seems to be most secure.

Given the potential for global instability, I feel most comfortable investing heavily in the U.S. and Western Europe, followed by the vast emerging economies of China and India. Although they are not as well-endowed as the U.S., China and India have great strategic depth and seem less vulnerable to disruption than many parts of the world.

When it comes to smaller countries, I'm far more wary. Switzerland, the headquarters of Nestlé, is likely to be fine as a small country at the center of Western Europe. In the past, I've also invested in a variety of smaller, non-traditional markets—including Oman, Jordan, Zimbabwe, Brazil, and the Philippines. Today, I'm much more reluctant to invest in such countries, which I view as potentially or actually perilous. One day, you think you own something. The next day, you might not—for reasons that have nothing to do with the business, and everything to do with local or global politics.

Not too long ago, I came across an excellent Ukrainian company called Motor Sich—a kind of Eastern European Airbus or Boeing Corp that was a major aerospace supplier to the former Eastern Bloc. In the end, I passed—even though it was a good business and the stock was cheap—because I had no idea how the political and economic situation in Ukraine would unfold. Today, the stock is no longer publicly traded. I'm not entirely clear what happened, but I heard that the company was taken back by the Ukrainian state. And who knows what will happen to this once-healthy business now that war has broken out with Russia? Ukraine, like Turkey, used to be described as a bridge between East and West. But as my friend Hossam Shobokshi recently opined, “In good times, bridges get stepped on. In bad times, they get blown up.”

I find it telling that companies like South African Breweries and Anglo American re-domiciled from Johannesburg to London when they got the chance. Likewise, HSBC, which was founded in

Hong Kong in 1865, moved its headquarters to London in 1993. Similarly, when Russian oligarchs and Chinese tycoons wanted to move their money somewhere safe, they invariably favored places like London and New York. Why should I think any differently? I want to invest in stable places that are governed by the rule of law, where our property rights and other social arrangements are likely to be respected.

Over and above these geopolitical considerations, the best way to protect ourselves from economic and geopolitical turmoil is to invest for the long term in good, cash-generative businesses that deliver real value to the societies where they operate—companies like Berkshire Hathaway, Moody's, Bank of America, BYD, and Indian Energy Exchange. In my experience, there's no benefit to trading in and out of long-term holdings like these in the vain hope that you can time the market. It's simply better to stay put and ride it out.

In times of turmoil, fearful or irrational investors often decide to cash out of the stock market until the dust settles, or they sell individual stocks that they hope to buy back one day at a lower price. This may seem like a smart precaution, but it tends to be a fantastically reliable way to destroy your investment returns. One reason is that it's all but impossible to time your exit from the market and your return to the market. If you get lucky and make a well-timed choice on the way out, chances are that you'll fail to get back in at the right time.

Why does this matter? One reason is that the worst days in the stock market are often followed quickly by the best days—and you don't want to miss out on those sharp upward rebounds, which can account for a lot of the market's overall return. Please look at the chart on page 22, which shows that you would have earned 9.4% a year by investing in the S&P 500 for the last 20 years and simply staying put. If you had missed just ten of the best single days in the market over those 20 years, your annual return would have fallen to 5.09%. What if you had missed

the 30 best days over those 20 years? Your annual return sank to 0.21%.

The moral is really simple and really important. Do not try to time the market. Do not sell. Do not trade. Do not delude yourself into thinking that you'll know when it's time to get back in. Simply ride out the stressful times, endure the volatility, and benefit from the long-term upward trajectory of high-quality businesses that compound over time. I hope this is clear.

The reason I feel so strongly about this is that I've seen this movie before. During the global financial crisis of 2008-09, several investors in the fund got rattled and cashed out, locking in significant losses during that period of extreme volatility and then failing to benefit from the immensely profitable rebound that followed over the next decade. Let that person not be you.

Perhaps I can also illustrate my way of thinking by sharing a conversation that I recently had with a relative and friend, Itai Spier. His grandparents, like mine, came from pre-war Germany. Like me, he'd been thinking hard about how to invest in the face of potentially enormous disruptions. I wanted to explain why I was staying put, not going to cash or moving my investments around. Rather than talk about the highly resilient companies in our portfolio, I used the following analogy:

Imagine that I own some excellent downtown properties in major cities like London, Paris, Berlin, New York, Chicago, and San Francisco—unlevered, class-A office blocks, hotels, and tower residences in prime locations. Imagine now a terrible scenario in which a world war is coming and three of these cities will be carpet-bombed. What should I do? Should I sell the world's best real estate, go to cash, and keep the proceeds hidden away in a vault? Should I sell some of my prime real estate and buy non-prime properties on the edge of these cities or in a less desirable city that might also be bombed?

Or should I stick around with the best assets and take the hits if and when they come—safe and secure in the knowledge that I'll still own some of the world's best real estate on the other side of this extreme turmoil?

My point is this: if you already own some of the world's best, highest-quality assets, then why dance around? You're unlikely to gain much, and you're very likely to lose by straying off course. As it is, we own a set of very high-quality assets in unusually robust locations. I trust these businesses to continue compounding our wealth over the long run much more than I trust my own ability to dance in, out, and around. This is why our portfolio did not change much in 2021 and might not change much in 2022.

### **Aquamarine's Value Proposition**

As I write to you each year, I remind myself constantly that my principal obligation is to build wealth prudently and judiciously for all of the partners of Aquamarine. I take great pleasure in the fact that you and I are on the same side, and that I'm rewarded only if I perform well on your behalf. I continue to believe that the Aquamarine Fund offers exceptional value to its investors. Our value proposition is built on three pillars:

- Low or zero management fees.
- Alignment of your interests and mine, with the fund genuinely structured as a partnership.
- A conservative, long-term, value-oriented approach in which we partner with the very best enterprises we can find, compounding wealth in a disciplined and durable manner.

### **Assets Under Management, Subscriptions, And Redemptions**

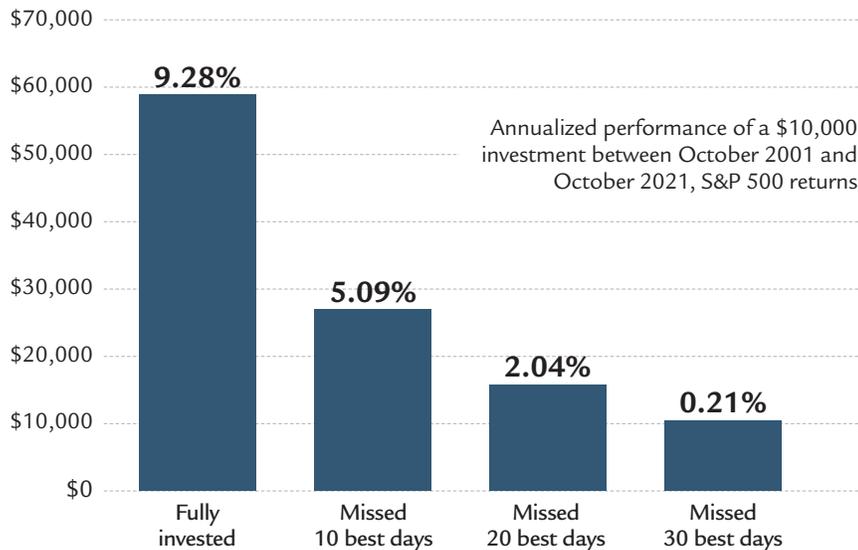
In 2021, we received \$12 million in new capital and received redemption requests for \$12.7 million. I regard this as part of the normal ebb and flow of assets as our investors' life circumstances change. We ended 2021 with \$358 million in assets, which gives us sufficient scale to run the fund comfortably, but still allows us the flexibility to react nimbly when necessary.

While I may be sad to see investors leave the Aquamarine Fund, it gives me intense satisfaction to see friends and family benefiting from the appreciation of their holdings over the years. My only concern was in a couple of recent cases when I wondered if the investor in question may have redeemed their shares not because they needed the money—for example, to buy a new home or to fund their retirement—but because they

**I REMIND MYSELF CONSTANTLY THAT MY PRINCIPAL OBLIGATION IS TO BUILD WEALTH PRUDENTLY AND JUDICIOUSLY FOR ALL OF THE PARTNERS OF AQUAMARINE. I TAKE GREAT PLEASURE IN THE FACT THAT YOU AND I ARE ON THE SAME SIDE, AND THAT I'M REWARDED ONLY IF I PERFORM WELL ON YOUR BEHALF.**

## It's Always Darkest Before Dawn

Seven of the ten best days occurred within 15 days of the ten worst days.



Source: J.P. Morgan Asset Management analysis using data from Morningstar Direct. Data is as of October 31, 2021. Analysis is based on the J.P. Morgan Guide to Retirement.

were anxious to take their money off the table in the face of inflation, rising interest rates, and geopolitical uncertainty. As I explained above, I strongly believe this is a mistake, given the benefits of staying in the market for the long run and the impossibility of timing the market with any consistency.

To emphasize this once more, let me quote Bill Miller, who recently explained why he shares this belief: “In the post-war period the U.S. stock market has gone up in around 70% of the years... Odds much less favorable than that have made casino owners very rich, yet most investors try to guess the 30% of the time stocks decline, or even worse spend time trying to surf, to no avail, the quarterly up and down waves in the market. Most of the returns in stocks are concentrated in sharp bursts beginning in periods of great pessimism or fear, as we saw most recently in the 2020 pandemic decline. **We believe time, not timing, is the key to building wealth in the**

**stock market.**” I couldn’t agree more. Time in the market, not timing the market, is the key to long-term investment success.

### Location

As many of you know, I moved from New York to Zurich in 2009, having realized that this new environment was calmer and more conducive to my style of investing. As I wrote in my book, *The Education of a Value Investor*, being based in Manhattan had a destabilizing effect on me: “Moving to Zurich allowed me to cut through the whole Gordian knot of my unhealthy relationships with fund marketers, equity analysts, and other professional ‘helpers’ who had unhelpfully oriented me toward a standard, New-York-hedgie model of life.”

Thirteen years later, in 2022, I finally made the decision to complete the last part of this transition by formally moving Aquamarine’s head office from New York to Zurich. In reality, this is simply

a formal recognition of the fact that our core team at Aquamarine is based in Zurich, where they work closely with me every day. They are a talented, driven, and deeply committed group who provide the structure and stability required so that I can concentrate on our investments. We still have a few people in the U.S., London, and the British Virgin Islands, but I realized earlier this year that it was a no-brainer to centralize our operations in Zurich—the city that I chose in 2009 for efficiency, peace, and tranquility.

From a practical perspective, nothing will change. But this formal move means that we will need to update our fund documents in 2022, so they reflect the presence of the investment manager and our investor relations team in Zurich, with support from our other locations.

## Thanks

I feel extremely fortunate to have such a remarkable group of shareholders. The Aquamarine Fund's base of sophisticated and loyal partners has stood firm over many years, enabling us to take advantage of the great buying opportunities that arise during times of heightened uncertainty and volatility.

Most of the partners in our fund came to us through recommendations from existing shareholders who were pleased with our performance and our culture. If you know of someone who might benefit from investing in the Aquamarine Fund, please don't be shy about introducing them. Feel free to contact me about referrals or anything else by calling +41 44 210 1900 or +1 212 716 1350 or via email at [investorservices@aquamarinefund.com](mailto:investorservices@aquamarinefund.com).

I'm happy with the current size of the fund and have no interest in promoting it merely in the hope of growing bigger. Naturally, I'm always pleased to partner with the right shareholders: that is to say, patient, value-oriented, long-term investors who'd like to join us in compounding wealth over many years, without unnecessary risk.

I'm particularly fortunate to partner with investors who have valuable experiences, insights, and networks of their own. I've enjoyed an ongoing dialogue with many of our partners about different industries and companies and have found their views extremely thoughtful and enlightening. Whenever we can welcome such people into the Aquamarine fold, I regard them as a very valuable addition.

Thank you for joining me on this journey. I would like to think that I'm now approximately halfway through my career as the manager of the Aquamarine Fund. If the next 24 years match the last 24, Aquamarine's original investors will make about 96 times their money over 48 years. I will be working hard over the next 24 years to be worthy of, and to reward, the faith you have placed in me.

Warm regards,



Guy Spier  
*Managing Partner*