

Newsletter 1

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Compound Equity Group – Investment Newsletter – July 2024

Some Background on Compound Equity Group (“Compound”)

Welcome to Compound’s first newsletter. I recently founded Compound in order to manage my personal assets. I have spent the last 32 years with the Capital Group, where I ultimately managed around \$50bn across five flagship global and international funds. I loved the job and retired on amicable terms. I have enormous respect for the founder generation of Capital Partners, a wonderful cluster of maverick investors. I was fortunate to deliver robust career returns, in Capital’s global fund I compounded clients’ money at 14.36% annually for 19 years in US\$, a return of 641 basis points a year in excess of the MSCI global index before fees.

I have a passion for investing and, as I am 63, I recognised that if I wanted to carry on for another 20-25 years, I would have to manage my own funds, the Compound Global Funds. I envision the Compound Global Funds as global family office. Global because we will search the world for outstanding companies, family because I will invest a substantial proportion of my personal assets in the funds for the benefit of philanthropy and future generations.

My aspiration is to build a small team of excellent investors. We will focus on a pool of around 150 of the best companies in the world and from this pool we will invest in 20-25 companies. We will strive to hold companies for the long term so fund turnover will be low, I would anticipate around 10-15% a year, which will help keep trading costs down. Our future depends entirely on our ability to consistently make good investment decisions. We will be enormously attentive to “certainty” in our decision process, relentlessly asking ourselves what do we actually know? Do we think we know something or do we actually know something? Our decisions will be driven by data and facts, not by hunches and trends. We will endeavour to be patient, to sit on our hands, and to ignore Bloomberg’s urgings to own the new stock du jour. We will be suitably paranoid, constantly re-examining our decisions and probing our assumptions. We will not invest in private companies to ensure the funds are as “liquid” as possible, allowing fundholders to exit should they wish.

I do not underestimate the difficulty of the task ahead. The investment management industry has several examples of successful fund managers imploding on their second fund management career. We will need to stay extremely humble. We will undoubtedly make mistakes, and we shall acknowledge, analyse and learn from our failures. All Compound team members, myself included, are on an unending apprenticeship as we try to correctly anticipate the future. A crucial point is that the funds will only be appropriate for long term investors, and even then, there will be times when we will likely test investor patience. The great Charlie Munger, an icon of long-term investing, experienced several periods where he was down 30% in his exemplary investment career, and I would not be surprised if the Compound Global Funds experience the same. Investors should also be aware that we will not focus on stock market indices. Our aspiration over the long run is to deliver absolute returns well ahead of inflation, thereby increasing the purchasing power of the Compound Global Fund holders.





The core of the portfolio will consist of businesses that display the following characteristics: a substantial moat; a medium to high incremental return on capital employed (ROCE); medium to high free cash generation; the ability to redeploy a medium to high percentage of their free cash flow (FCF) at reasonable to high returns; managements that are honest and at least reasonably competent; and businesses that have a reasonable runway.

The challenge with investing this way is there will be moments when the Compound Global Funds are hugely out of sync. For example, in 2022 this approach would have lagged the stock market. At these moments the financial media and the financial planners may declare the Compound approach extinct, and that the Compound team have no idea what they are doing. At these moments we need to triple check every holding, and if the data supports our holdings, we should absorb the criticism and have the courage to persist. Remember, these funds are only suitable for long term investors, there are plenty of index funds for investors who wish to mirror the index.

Some Thoughts on the Current Investment World

The current investment world is as challenging as any I can remember in the last three decades. Today, the world is deglobalizing, whereas when I started in 1992 globalisation was a driving force. In the early '90s the Berlin Wall was coming down; China was opening up and becoming a prolific source of growth; imports of cheap Russian energy were helping to ignite economic growth in Europe. Today the world is much more polarised and fractured. The West is at war with Russia. There is a technology war with China, and an ideological war with Islam. Biden's Inflation Reduction Act is inward-looking and very anti-global. The investment optimism that once supported emerging markets has largely evaporated. As already mentioned, the West is openly hostile to Russia and China and many other emerging markets are mired in corruption and mismanagement. India has been a rare and positive exception for emerging market investors with improvements in infrastructure and governance, and reductions in corruption.

Here in the West, national governance has also been lacking in many major countries. Take the United Kingdom as an example: despite years of Conservative government, tax receipts for the fiscal year ending April 2024 were £1.1 trillion, a staggering 40% of GDP. The last time the UK was at this level was in the early 1980s. In the year ending April 2024, the UK government borrowed an additional £121bn, 4.5% of GDP, or around £1700 for every individual. Public debt to GDP is around 98%, or 90% if you exclude bank of England debt. On top of all this the UK treasury is required to send the Bank of England enormous sums, £44 billion last year, to cover losses on Gilts (government bonds) held by the Bank of England following quantitative easing (for context the UK defence budget is around £33 billion). An imminent Labour government is unlikely to be any more restrained, on the contrary. Additionally, the UK current account deficit is 3.3% of GDP. All of this represents a stern headwind for growth and corporate profitability. I fear this fiscal profligacy is bad news for the





average earner and saver, as the profligacy may stoke inflation and devalue their hard-earned savings.

Political polarisation and populism also represent an immense and rising challenge. Across the world, and certainly here in Europe, the voter is expressing their wrath at the ballot box. Consider France, obviously an economically important G7 nation. In the recent European elections in France the two parties on the extreme right, Marine le Pens “Rassemblement National” (RN) and Zemmour’s “Reconquete”, won an unprecedented 31.5% and 5.5%, 37% combined, of the vote respectively. Meanwhile four parties on the left, essentially the Parti Socialist, La France Insoumise, the Communist Party and the Greens are forming a “Popular Front” with around 25% of the vote to counter this tsunami on the right. La France Insoumise, led by the combustible M. Melanchon, is pro-Palestine which vexes some in the centre and may push them to the right. For the moment France is undoubtedly abandoning the centre ground for a more polarised future. At Compound, we are not political analysts, but we need to try to understand what is going on and what is fuelling the wrath of these voters. You may recall the “Gilets Jaune” protests that punctuated Macron’s first term. The Gilets Jaune are anti-establishment, they are incandescent with the French government and the EU in Brussels whom they perceive to be very arrogant; they wish to preserve a certain French way of life; they are fed up with unremitting waves of regulation; they want French cars and French jobs, not Chinese cars; they want French agricultural produce and French farmers, not imported food. Why dwell on this? Because inevitably with this political backdrop, France and to some extent the EU, will become more nationalist and more populist. We also need to understand that polarised politics has a core of “zeal”, it is not always rational, and the downside for businesses can be dramatic, for example a business might be nationalised. All the while national debt to GDP is 110% and the budget deficit 5.5%, this is sovereign bond downgrade territory.

I would also argue that in recent years Central Banks have meandered and lost focus on their primary objective, controlling prices, letting us all down by losing control of inflation. I resonate with The Economist, which stated there has been an “insidious change amongst central banks globally”. Bored with managing the business cycle, their tentacles are reaching out to issues such as climate change. The former governor of the New Zealand Central Bank, Graham Wheeler, wrote: “Confident in their ability to maintain low inflation, central banks began diverting resources to other topics such as climate change and inequality. Such issues bear little if any relationship to the reasons why central banks exist – ensuring price stability and financial stability”. I am not even sure the official inflation figures we are given are correct.

All of the above, this litany of grimness, are givens for Compound. We can do nothing about them, this is the environment and reality in which we all live and operate. Compound’s job is to identify and invest in businesses that can do well despite this challenging and difficult economic and political environment. Our purpose is to preserve and improve the purchasing power of the savers who trust us with their savings.





Some Facts about and Commitments from Compound

Focus: Our unwavering focus, our “raison d'être”, is to achieve investment excellence, defined as robust absolute long term investment results for Compound Global Fund Holders that more than offsets the erosive effects of inflation. We will not be distracted by other issues. As the name suggests, Compound Equity Group exists to gradually “compound” fund assets over the long term.

Decision process: Compound is in the Investment Ideas industry and we recognise the decision process is vital. Our success depends on making good investment decisions. We will be enormously attentive to certainty in our decision process - what do we really know? Our decisions will be driven by data and facts.

Culture: We will strive to be collegial, constructive, humble, open-minded, and operate with a flat structure. We will also encourage disagreement and intellectual dissent, recognising that none of us know all the answers or the future. We understand there are no future facts. We will tolerate all opinions and perspectives, however ghastly and unwelcome some of us may find them. We will endeavour to have fun and leave room for humour. We understand that investors can endure long periods that are very painful. Wherever possible we will pursue simplicity. We will say no frequently. We will not tolerate bureaucracy.

Portfolio: The core of the portfolio will comprise businesses that display the following characteristics: a substantial moat; a medium to high incremental return on capital employed (ROCE); medium to high free cash generation; an ability to redeploy a medium to high percentage of their free cash flow (FCF) at reasonable to high returns; managements that are honest and at minimum reasonably competent; and businesses that have a reasonable runway.

Risk: We will encourage well analysed and considered risk-taking.

Integrity: We will strive to be intellectually honest with each other and in turn share that honesty with our fund-holders. We will acknowledge our mistakes as rapidly as we can and endeavour to learn from them. We will never put our interests before the interests of fund-holders. We will meticulously comply with the requirements of regulators. We will comply with all laws.

Fees: Our fees will be simple and understandable. We will not obfuscate, nor will we be greedy. We will keep in mind that the original funding for Compound came from family and friends. We will strive for low turnover to minimise trading costs. We will have no performance fees.

Hiring: All hiring will be based entirely on merit and ability. Ability is defined by analytical skills and strong mathematical skills; an ability to express an idea simply; an understanding of risk; a healthy dose of paranoia; the ability to think independently and against the grain; comfort





with uncertainty; acceptance of change; a passion for investing; a consummate work ethic. Hiring of investment associates will always be conducted by the investment team, never by others.

Ownership: Compound Equity Group will initially be owned by Jonathan Knowles. It is effectively a family office with access to open-ended global funds. In due course, Jonathan will sell some of his ownership to high-performing partners. This succession planning is vital to ensure the fund can continue for many decades. The younger partners recognise that they will manage this fund after Jonathan's death for the benefit of his philanthropic interests and descendants, always adhering to the core principles and values of the founder.

Training: We are all in continuous training. We recognise the need for relentless communication and ideally being in the office together. For young partners who are learning, the expectation at Compound is that you are always in the office except when travelling.

Mental health: Asset management is a stressful job, bad decisions can grind you down and impact your judgement. As part of developing the mindset to make good decisions we understand the need to take our holidays and make time for our families and friends.

Communication and media: We will communicate via an annual meeting of fund holders where we will endeavour to field as many questions as possible. We will write an investment letter from time to time discussing the environment, possibly a stock, or even a mistake. If we can master it and set the correct tone, we may advance to You-Tube.

ESG: Environmental, social and governance ("ESG") is a blitz that has hit the investment industry in the last decade, with fund managers and companies competing to demonstrate their worthiness. At Compound we are somewhat wary of "blitzes". I would also note many good investors have been quietly applying the principles of ESG for several decades before this blitz, so the core tenets of ESG are nothing new. In terms of Environment ("E"), the Compound Global Fund will likely rate very well, not because we are trying to mollify the environmental movement, but because we generally avoid businesses with negative externalities on the environment. These negative externalities may become financial liabilities in the future. The beauty of owning just 20-25 businesses is that we can readily choose not to own "polluters". Our definition of Social ("S") is a merit-based company – I have always preferred companies where employee and management progression is based on merit, not on your golf handicap or your Ivy League pedigree. And as for governance ("G"), good governance is a must, though candidly easier said than done. I have personally been "taken to the cleaners" by scheming CEOs on several occasions and have also given too much credit to weak, ineffective or wrong CEOs. To stay objective and watchful with CEOs I find it helps to never get too familiar with them.

Liquidity: Compound Global Funds are open-ended funds. Fund owners should always have the right to withdraw their money. We need to ensure that investors can withdraw all your money whenever you wish.





To Summarise,

This is a new investment journey. My objective is to deliver to the holders of the Compound Global Funds returns considerably in excess of inflation. Whilst I have managed to do just this for the last 19 years in a global fund managing substantial sums of money, I have honestly no idea whether we shall succeed going forward. I am however hopeful, the ambition and desire is there. I am committing a substantial portion of my personal wealth to the funds; I will be applying the principles and processes that have worked for me in the past; I will endeavour to change as required; I will continue to think about investing 24/7/365; I need to inculcate a new investment team with this mindset and process. On a recent visit to the wonderful La Sagrada Familia in Barcelona I came across this quote from Anthoni Gaudi: "To do things right first you need love, then technique". The love is there, we love investing. The Compound team and I shall be working on the technique.

Yours Sincerely,

A handwritten signature in blue ink that reads "Jonathan Knowles". The script is fluid and cursive, with the first name and last name clearly distinguishable.

Jonathan Knowles, Investor

