Dear friends,

Welcome to the inaugural letter of Mustard Seed Capital. This venture has only taken off thanks to the love and support I've received from all of you. Without your patience, this would not have been possible.

I continue to make mistakes along the way, but thankfully, none have been so great as to jeopardize the base capital. Many mistakes continue to be acts of omission rather than acts of commission. While missing out on prospective gains can bruise the psyche, I'd still rather err on the side of caution than make an investment that I don't understand well enough. Every dollar committed to MSC was hard-earned and did not come easy. It is imperative that I steward each dollar with equal diligence.

The primary purpose of this letter is to remain objective and accountable to you as stakeholders of this venture. I know many of you have spent countless hours in conversations and counsel with me. At the very least, you deserve a progress update. After several years in the making, I'd like to present to you the results of our time spent together.

Below you will find the unaudited records as generated by the brokerage:

Cumulative Year Results	**U.S. Equity ETF (SPY) %**	**Global Equity ETF (URTH) %**	**Mustard Seed Capital (MSC) %**
Currency	**USD**	**USD**	**SGD**
2019	31.22	28.14	33.22
2020	55.33	48.35	66.45
2021	99.98	81.40	99.46
2022	63.64	48.82	75.60
2023	106.50	84.49	130.58
Annualized	**15.61%**	**13.03%**	**18.19%**

To remain consistent and objective when measuring performance, it's important to select a fair benchmark that does not change from year to year. The benchmark should also be selected beforehand rather than afterwards where a convenient benchmark can be found.

I believe the most equitable comparison would be to compare the returns of MSC against a global equities benchmark such as URTH (Global Equity ETF). The primary reason is because MSC's mandate is an investment in global equities within developed countries. Not just equities within the USA.

Please note I've chosen the symbols SPY and URTH to represent U.S. and global equity benchmarks respectively for 2 reasons:

1) Those symbols are the only available ones that the brokerage offers in the portfolio analysis segment. I can easily generate this without much hassle.
2) These are traded ticker symbols that any individual investor can easily purchase on the open market. There are also other traded symbols that can be used (VOO etc), but more

importantly, all of them should yield fairly similar results to broad U.S. and global equity benchmarks.

The last point of consideration is that SPY and URTH returns are in USD while MSC is in SGD. We should also factor the currency conversion. From Jan 2019 till Dec 2023, the USD/SGD has declined roughly 3.7%; therefore, the overall SPY and URTH returns should also be adjusted downward by the same percentage to reflect SGD terms.

Understanding Global vs U.S. Equity Benchmarks

URTH (Global Equity ETF) captures roughly 1500 of the largest companies across developed countries. This includes both the largest companies in the US and the largest companies in Japan, UK, France etc. In short, this is a more diversified portfolio, and it also allows the investor to capture not only the growth from US companies, but also the growth from other global companies.

SPY (U.S. Equity ETF) captures roughly the largest 500 companies within the US. There's a ton of material on this popular index so there is no need for much elaboration. The basic premise is that an investment in this ETF is an investment in the US. If the US continues to do well, so will the investor.

Over the years, SPY has outperformed URTH because US companies as a group have done better than their global peers. If this trend continues, then SPY should continue to do better than URTH. However, if the global companies start to outperform their US peers, then the URTH will do better than the SPY.

It's anyone's guess which ETF will do better over time, but both should produce acceptable returns in the long run. The US has experienced phenomenal growth over the past few decades and consequently, have done better than their peers for a long time. However, it's probably unwise to think that the US has a monopoly on this outperformance forever. Global companies are starting to catch up (LVMH, Samsung, Nestle, ASML etc).

This is also one of the reasons why MSC's mandate is to source for undervalued equities globally rather than strictly US equities. I narrowed the scope to developed countries mainly because the risk of outright fraud is much lower. If I make a bad investment, it's more likely the result of faulty analysis on my part.

Why include a U.S. equity benchmark? Because it's no shoddy competitor.

Most active managers struggle to beat broad U.S. equity benchmarks after fees. In 2008, investing legend, Warren Buffett, issued a million-dollar bet to the entire hedge fund industry. The bet was simple: A passively managed U.S. equity ETF (e.g., SPY, VOO, IVV etc) would outperform a portfolio of hedge funds. The results of the infamous bet are summarized below:

Year	Fund of Funds A	Fund of Funds B	Fund of Funds C	Fund of Funds D	Fund of Funds E	U.S. Equity ETF
2008	-16.5%	-22.3%	-21.3%	-29.3%	-30.1%	-37.0%
2009	11.3%	14.5%	21.4%	16.5%	16.8%	26.6%
2010	5.9%	6.8%	13.3%	4.9%	11.9%	15.1%
2011	-6.3%	-1.3%	5.9%	-6.3%	-2.8%	2.1%
2012	3.4%	9.6%	5.7%	6.2%	9.1%	16.0%

2013	10.5%	15.2%	8.8%	14.2%	14.4%	32.3%
2014	4.7%	4.0%	18.9%	0.7%	-2.1%	13.6%
2015	1.6%	2.5%	5.4%	1.4%	-5.0%	1.4%
2016	-2.9%	1.7%	-1.4%	2.5%	4.4%	11.9%
Gain to Date	**8.7%**	**28.3%**	**62.8%**	**2.9%**	**7.5%**	**85.4%**

The truth is, active portfolio management is not easy. For many, the best strategy is to buy into a low-cost index fund, and hold it for the long-term. I can't advise which index to pick. What I can say is choosing either one or even a combination of either, will allow you to participate in the upside of growth from the US and/or growth from developed countries.

The challenge of actively-managed funds:

One of the primary reasons actively-managed funds struggle against the passively-managed index fund is because of the fees and expenses the active fund has to cover.

First, funds have to lease prime locations. Then, they have to pay for miscellaneous fees like compliance, lawyers, audits, fund administrators, fees and filings etc. That's not even counting the expensive equipment and services they need to lease for their team of analysts. Just the ever-essential Bloomberg terminal alone will cost $25,000 USD per user, annually!

To pay for these expenses, the typical fee structure of active funds is to charge a management fee, which is usually 2% of assets under management (AUM). A performance fee is also added on top, which is usually charged at 20% of any profits.

Naturally, there are great incentives with increasing AUM. Since the management fee of 2% is deducted annually even *before* any performance is delivered. Once a high AUM is reached, the fund can be paid handsomely even if they fail to deliver any returns to their investors.

There is also another issue that exists. When the fund does well, the fund managers profit on the upside through the 20% performance fee. However, when the fund fairs poorly, the fund does not participate in the downside. Instead, only the investor pays the price.

So what do we do?

There's really no easy solution for the predicament above. Many of the costs are essential. Of course, some of these expenses can be reduced, but even before beginning, the deck is already stacked against the active fund manager.

While we can tweak the usual 2/20 fee structure a little, I think one of the most important additions that will protect the investor is a high watermark.

This is a simple mechanism that ensures the fund does not earn a performance fee for poor or volatile performance. The mechanics is much easier explained with an example:

- Year 0, the fund starts: Starting total value: $100,000
- Year 1, the fund grows 20%: New total value to $120,000
- Year 2, the fund shrinks 30%: New total value to $84,000
- Year 3, the fund grows 40%: New total value to $117,600

The initial high watermark (or highest point) was set in year 0 when the fund first started at $100,000. This high watermark was then replaced by the subsequent increase to $120,000 thus establishing a new high watermark. Since year 2 and year 3 performance never crossed $120,000, the high watermark still remains at $120,000.

What does this mean for investors? The investor only pays fees for the performance in year 1 (from $100,000 to $120,000).

Despite the exceptional performance in year 3 where the fund grew by 40%, the investor does not have to pay any fees on that performance. In other words, the fund has to recoup all prior losses for the investor (up to the high watermark of $120,000) before the fund can charge any performance fee. Of course, there are some adjustments due to client withdrawals, deposits and fees due, but the main point is the investor does not double pay for the same performance.

This may sound tough on the fund as it collects no performance fees for a few consecutive years, but still has to cover all the expenses. But why should a fund be rewarded for relative performance when the only person who suffers is the investor? It may seem ludicrous, but the high watermark is not a standard criterion for all funds. So, many funds continue to charge for relative performance instead of absolute performance.

Eating one's own cooking:

After we've ensured that the fund only gets paid for delivering performance, we move on to perhaps the most important question: Does the manager have skin in the same game?

While performance can never be guaranteed, it's important to see if the manager's incentives are aligned with their investors. Observe how much of the manager's money is sitting inside the fund. The more the better.

While the manager cannot guarantee performance, the manager can guarantee that if there are any losses absorbed by the client, the manager's own capital will be at risk too. If the manager has 10x more capital, then you can be sure the manager will receive 10x the pain, and perhaps, exercise 10x more prudence when selecting investments.

So what's a fair fee structure?

I think this highly depends on the funds ability to control its expenses. It's a bitter pill to swallow, but a lot of this is not within the fund's control. However, I think we can come up with some principles on how to handle this.

1. **Management Fees:** Instead of automatically applying a 2% fee ad infinitum, I think this should scale down as the AUM increases. Enough to cover expenses, but not so much that we end up creating perverse incentives. My preference is for this to be as close to 0% as possible. This approach ensures the fund does not make AUM increment its primary objective.

2. **Performance Fees:** The typical 20% performance fee seems fair to both investor and the fund. There is some allowance for adjustment here, but the primary focus should be on performance.

3. **High Watermark:** This is a crucial feature. Funds should be rewarded for absolute performance. Not relative performance.

What MSC does:

It's now time to answer the most important question: What I actually do for MSC.

I'm not in the business of forecasting. I do not know what is going to happen to the economy in the next year or even the next few months. Instead, I focus my efforts on understanding and analysing businesses. If I come across a business that I think I can understand, then I can have an idea on what the business may be worth.

Valuing a business is simple, but it's not easy.

- Take the cash flow of the business from now until judgement day.
- Discount those cash flows to present day.
- Total them up, and you have the value of your business.

Bonds have those cash flows printed as a coupon rate. The job of the manager is to analyse the company and print those cash flows out. Then, *investing is simply waiting for the opportunity to purchase the stock for less than what it's worth.*

Not an exact science:

Valuation can be a very technical subject if you want it to be. The more technical you get, perhaps the more precision you may *hope* to achieve. In some cases, some may be convinced that they can derive the precise value of the business down to an exact dollar and cent.

I certainly can't.

Valuation is like making an educated guess on the weight of someone. If I'm inexperienced, then I may guess a weight between 40kg to 120kg. If I am more experienced, then I may have a narrower range. Perhaps a weight between 60-80kg.

In the same way, if I understood a business, I could value it, and arrive at a valuation range between $40 to $120. It's not precise, but I can be fairly confident that the value of the business lies in that range. If I have a better understanding of the business, then I may arrive at a narrower range between $60-$80. However, no matter how experienced and technical I am, there is no way I could arrive at a precise dollar value (say $71.83/share) *and be confident about it.*

Fortunately, success in investing is not reserved only for the technical individual with a high IQ (or superb weight guessing skills). You don't need to have immense precision or even arrive at a very narrow range of values. You just need to be right about the range you have chosen.

Valuation in a live auction market

Now, let's add a little colour to the weight guessing example. Imagine you are in a weight guessing contest.

- There is an endless line of people walking up on stage to have their weights guessed.
- There is a temperamental auctioneer who offers you all kinds of odds to guess the weight of each person that takes the stage.
- You can take the bet anytime, or you can reject the bet anytime.

At times, the auctioneer may give an outsized payout if you can guess the *precise* weight *(say 71.83kg?)* of the person. At times, the auctioneer may reduce the payout, but offer you some flexibility in the weight guessing; you may guess a range of weights (*say 60-80kg*) instead of a precise weight. For the most part, the auctioneer is sane, skilled, and pretty good at being the house.

Sometimes, the auctioneer comes to work drunk and depressive so he offers you odds that are in your favour. The payout may be average (or even high; depending on how drunk and depressive the auctioneer is), but the probability of being right is high.

Mr. Market:

Sounds like a silly story, but the stock market does work in a similar way. First coined by Ben Graham, the temperamental auctioneer is known as Mr. Market.

Mr. Market is your partner in a private business. Everyday he comes to you with a new offer to either buy your stake in the business or sell you his stake. He also has some endearing traits:

Mr. Market is wildly temperamental:

- On some occasions Mr. Market gets wildly euphoric about the future prospects of the business. He talks up the monumental changes the business is capable of, and demands a high price for the business.
- Other times, Mr. Market becomes wildly dysphoric about the future prospects of the business. He says the business is doomed for failure and names a depressive price for the business.

Mr. Market doesn't hold any grudges:

- If you think his bid price is too high, you can reject his offer for your stake in the business. He will happily return the next day with a new price in hand.
- If you think his offer price is too low, you can accept his offer to buy his stake in the business. He won't feel taken advantage of. He will again return the next day like clockwork.

This is one of the most important aspects of investing. Without the temperamental Mr. Market, I would not be able to earn a profit for MSC. Mr. Market's (mis)pricing should be used to serve the investor—not guide the investor.

Using Mr. Market

My job is to wait for the business that I think I can understand well enough. When that comes along, I should be able to estimate the value of the business with some confidence. The exact valuation need not be precise *($71.83)*, but I must be confident in the range of values *($60-$80)* that the business sits comfortably in. Even if the range is slightly wider, that's okay. The most important thing is confidence in the range of value.

If I'm unable to come up with the valuation of the business, that probably means I don't understand the business well enough. That also means I have no business doing deals with Mr. Market. It is better to sit out than act foolishly; or act when the odds are against me.

There are all kinds of bets issued every day. Sometimes there are outsized payouts if participants take great risks with moonshot bets (or at precision weight guessing). The payout can be huge if a participant gets it right. There are many stories of people getting 100x their money or even 10,000x. But there are also many who have been cleared out. It's easy to get enamoured by moonshot bets because the payout is so huge. However, you only need to be cleared out once and you lose your seat at the greatest game ever created.

It's tough to sit idly by, while watching everyone around you get rich from calling the next big thing. The next time you have an itch to scratch, just remember the wise words of Buffett: “The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs”.

The general market of 2023

One of the biggest headlines for 2023 was inflation and increasing interest rates. When there is too much money chasing too few goods, the prices of goods will rise, thereby causing an increase in prices (or inflation). Strictly speaking, inflation is good if it’s kept in a healthy range, but too much of it can become a huge problem. To control the increasing prices of goods (or to reduce inflation), governments have to reduce the money supply and increase interest rates.

Rising interest rates means the opportunity cost of each investor dollar also increases. In other words, when interest rates were 1%, investors didn’t care so much about where their capital was stored. However, when interest rates are 4-5%, investors start to care more (think of the rising fixed deposit rates or MAS bills that have become much more attractive this year). When investors start to be more demanding, more will start to pull their money, and thus the overall cost of capital will also increase. Fund managers will also have to be more selective on how they allocate capital; so it was not surprising that the market experienced an overall decline in 2022 which extended into early 2023. Ultimately, interest rates act like gravity on asset prices.

So with an understanding of where the general market was, how do we capitalize on it to generate a return? I don’t know. I certainly didn’t know how the market was going to react or where it was headed. I’m really not in the business of forecasting. My job is to wait for the companies that I think I can understand, and then wait to purchase them for less than what they’re worth.

Our activities in 2023

In 2023, MSC gained 31.31%. We started the year with around 30% in cash and 70% in equities. We ended the year with 26% in cash and 74% in equities. In comparison, the URTH (Global Equity ETF) gained about 23.97%.

I did not come across many undervalued companies during 2023—at least not many that I could understand well enough. In such circumstances, the only rational choice is to sit out and wait for the fat pitches. I’d much rather sit idly by twiddling my thumbs than lower our investment standards. Throughout the entire year, I made 3 significant investments that allocated around 5-6% of assets in each bet. Two investments didn’t really do anything for most of the year. The other one, Foot Locker, made about 2x so far.

I made the Foot Locker purchase when the company was valued at around $1.4 billion (net of cash and debt). The growth prospects aren’t great, but this is a company that has regularly earned between $300-800 million post-tax. There is no doubt that retails stores have serious competition against their online counterparts.

One of the biggest advantages e-tailers have is an endless selection and a cheaper real estate footprint. Most times, assuming the same product is sold, the e-tailer wins the retailer even after subsidizing the cost of shipping. However, when the customer returns a parcel, the retailer stands a chance. Of course, it depends largely on how much it cost to ship the parcel as well.

With apparel, parcels are often light and compact which make postage cheap. However, shoe boxes are much larger which make postage more pricey. So if a customer buys and returns multiple shoes to the e-tailer, there's a good chance the retailer has the edge. Since there's also a good chance that many customers do not find the right model and the right size on the first try, I think the retailer still has a decent chance of surviving.

Of course, Foot Locker has some growth engines that they are tapping on, but whether that works out is anyone's guess. As long as I didn't pay for it, I will receive the benefit of any positive development in the future. In the meantime, as Foot Locker continues to work on these growth initiatives, the core business still looks competitive enough. At 2-5x earnings, I see value in this purchase.

Not trying to time the market

Much of the returns that MSC gained were from seeds that were planted in 2022 during the increasing interest rate environment. Businesses were cutting back. Investors were pulling money from the market as they demanded more from the same dollar. If I tried to save capital and allocate it only when the uncertainty was clear, I would have certainly missed the boat.

From the low of October 11, 2022 to Dec 22, 2023, the URTH (Global Equity ETF) advanced about 32%. There were a total of 304 trading days; if you missed out on the best 9 days, your returns would've been a mere 4%.

The uncertainty was certainly palpable, and that diminished the growth prospects of many companies. Fortunately, Mr. Market started to devalue many companies as well. As a result, some dominant companies that were way too expensive before, started to look attractive. I put around 8% of assets in Meta, and 5% of assets in Spotify. Both of these investments have more than doubled in 2023. Thus, adding to MSC's returns for most of 2023.

In retrospect, things always seem more evident. Both of these companies were trading at single digit multiples (after some adjustments) for most of 2022, and there was nothing wrong with the business.

The economy certainly looked dimmer than before, and investors may have gotten upset that Meta was burning billions on the unproven metaverse. The threat from competitors have also increased over time; however, at the low of 2022, you could purchase the entire company for $200 billion (net of cash and debt). And this was a company that was still regularly earning $20-40 billion a year post-tax.

Despite its gargantuan size, Meta has still continued to grow and maintain its user-base. So its core business was definitely not in shambles. While user growth will eventually taper off or even decline, Meta hasn't fully utilized all its monetization capabilities—not even close. Even if the above doesn't materialize, the low purchase price would more than offset the risks.

Following the crowd

Investors pay a hefty price for a rosy picture. The truth is, great companies will never be available at affordable prices when everything is bright and rosy. Many can see how a great company will be dominant for many years to come, but once the company experiences headwinds, many also start to shy away. I have certainly been guilty of this time and time again. There is a certain sense of safety in moving with the crowd. Both humans and animals do it instinctively.

After spending weeks or months studying a company, I often feel entitled to have an opinion on the company, but the market doesn't owe me anything for the time and effort spent. I'm rewarded only if my analysis is right.

On the idle cash balance

For most years, there's usually a cash buffer that is present throughout the year. This is not done intentionally. The cash balance simply means I couldn't find any investment that made financial sense. Since cash typically earns a much smaller return as compared to equities, that will also penalize the overall returns of MSC. Even so, I'd much rather suffer a drag in portfolio returns than allocate the idle cash in a foolish manner.

In baseball, the hitter only gets 3 strikes to hit the ball. In investing, there are no called strikes. You can stand there pitch after pitch without any penalties. Every now and then, a fat pitch comes along. There's no guarantee you will hit it, but the odds of hitting it are high. If you can remain patient and accumulate fat pitches, you should do well over time—even if you miss the occasional fat pitch. Investing is not about swinging for the fences. It's about surviving long enough to remain in the game.

Expectations over the long term

Over the last 30 years, global equity benchmarks such as URTH (Global Equity ETF) and U.S. equity benchmarks such as SPY (U.S. Equity ETF) have delivered around 8–10% annualized returns, with U.S. equities showing a slight edge.

My goal is to deliver about 12% over the long term. While a few percentage points do not seem like much, over a long period of time, these small wins will start to add up in a very meaningful way. The past few years have been kind to returns, but unlike most businesses where advantages gained during the year can be transferred over to the next year, in the investment business, everything resets on January 1st.

I've also deliberately focused our investments on large companies in developed countries to ensure that we are never limited by our capital size at any point. In other words, even if our capital size grows significantly, our universe of investments will not shrink. More importantly, I also believe the experience we gain from analysing large companies will accumulate over time. While investment returns always reset on January 1st, the knowledge accumulated does not.

Over time, these little wins should pile up in a very nice and meaningful way. We've tried to keep things as simple as possible, but it's by no means an easy task. However, if we can repeat these small wins with steady frequency, then MSC should do quite well over time.

Cordially,

Frederick Tye

1st Jan 2024

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This letter may contain forward-looking statements, which are not guarantees of future performance. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors. Past performance is not indicative of future results.

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Appendix on fees:

What a small 1 or 2% does over a long period:

Initial Sum:	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Annualized return:	8%	9%	10%	11%	12%	13%	14%
Years							
10	$215,892	$236,736	$259,374	$283,942	$310,585	$339,457	$370,722
20	$466,096	$560,441	$672,750	$806,231	$964,629	$1,152,309	$1,374,349
30	$1,006,266	$1,326,768	$1,744,940	$2,289,230	$2,995,992	$3,911,590	$5,095,016
40	$2,172,452	$3,140,942	$4,525,926	$6,500,087	$9,305,097	$13,278,155	$18,888,351

<u>Appendix on fees:</u>

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2023	106.5	84.49	130.58
Annualized	15.61%	13.03%	18.19%

Assuming a fee structure of:

- 0% Management fee
- 20% Performance fee
- High watermark

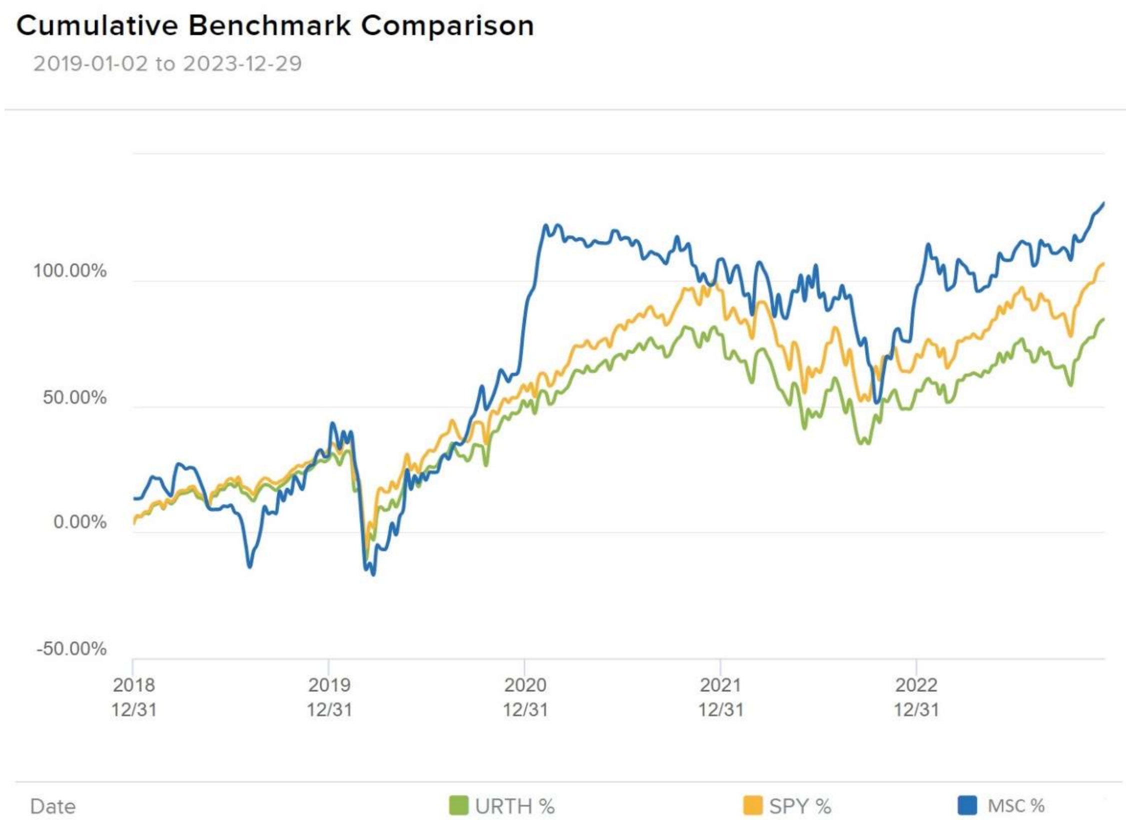
Currency	SGD	SGD	SGD
Annualized after currency conversion	**15.16%**	**12.64%**	**18.19%**
Annualized after fees	**15.16%**	**12.64%**	**14.63%**

Assuming a fee structure of:

- 2% Management fee
- 20% Performance fee

Currency	SGD	SGD	SGD
Annualized after currency conversion	**15.16%**	**12.64%**	**18.19%**
Annualized after fees	**15.16%**	**12.64%**	**12.19%**

Appendix on MSC performance



	Cumulative Returns (%)			Annual Returns (%)		
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2021	99.98	81.4	99.46	28.75	22.28	19.83
2022	63.64	48.82	75.6	-18.17	-17.96	-11.96
2023	106.50	84.49	130.58	26.19	23.97	31.31