Dear friends,

Thank you for your continued support and welcome to the second letter of Mustard Seed Capital.

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

	Cumulative Returns (%)			Annual Returns (%)		
	S&P 500 (SPY)	**MSCI World Index (URTH)**	**Mustard Seed Capital (MSCAP)**	**S&P 500 (SPY)**	**MSCI World Index (URTH)**	**Mustard Seed Capital (MSCAP)**
Currency	**USD**	**USD**	**SGD**	**USD**	**USD**	**SGD**
2019	31.22	28.14	33.22	31.22%	28.14%	33.22%
2020	55.33	48.35	66.45	18.37%	15.77%	24.94%
2021	99.98	81.40	99.46	28.75%	22.28%	19.83%
2022	63.64	48.82	75.60	-18.17%	-17.96%	-11.96%
2023	106.50	84.49	130.58	26.19%	23.97%	31.31%
2024	157.89	118.93	187.77	24.89%	18.67%	24.80%
Annualized	**17.10%**	**13.95%**	**19.26%**	**17.10%**	**13.95%**	**19.26%**

We're currently in year 6 of measuring the fund's performance. A $100 invested at inception would be worth $287.88 as of today. Since inception, we've adopted a strategy that has had a decent record of success. While yearly results may not be dependable, in the long-term, this strategy has proven to be quite dependable.

The strategy is no secret. The greatest investing legend, Warren Buffett, clearly laid it out, generously preached about it, and closely followed it for more than half a century. The result is a stellar long-term record unrivalled by anyone.

In Buffett's wise words, look for a business that:

1) has a durable competitive advantage,
2) is run by able and honest people, and
3) is available at prices that make sense.

While the strategy is simple, mastering it is anything but. I still struggle with identifying criteria 1 and 2, but I think identifying criterion 3 is achievable even for mere mortals like us.

Finding Prices that Make Sense

Attaching a price to a business requires some understanding of accounting and valuation, but there is no need to be a chartered accountant or a professional valuer. Understanding the basic principles of accounting and valuation is sufficient, and with practice, they are quite knowable subjects.

While accounting is the language of businesses, valuation helps to quantify the business narrative—it's impossible to invest without them. Sacrifice either one of these tools, and the investor is handicapped. In the wise words of the late Charlie Munger, "you're like the one-legged man entering an ass-kicking contest".

Finding prices that make sense is about marrying both concepts of accounting and valuation. It is as much an art as it is a science. We use very simplified models and we spend most of our time understanding the quality of inputs rather than fretting on how well built our models are or how statistically significant an input might be.

After we can value a business, investing is just patiently waiting for the opportunity to purchase a business for much less than what it's worth. We believe this is the most important point. We can't reliably have an information edge or even an analysis edge consistently; however, we can have a temperament edge. Since inception, that has been the guiding principle for all our investments.

Omission vs. Commission: The Discipline Behind Every Decision

Having the right temperament to remain patient and do nothing is harder than it sounds.

After spending many weeks or even months studying a business or industry, it's hard not to feel entitled to invest. Add to that all the psychological biases that we've accumulated over the investigative period. It takes a lot of discipline to walk away if we think the price is too high. While the whole point of investing is about making good bets, we believe the act of omission is just as important as the act of commission.

The challenge is especially pronounced when we believe we understand a business but choose to stay on the sidelines because we think prices are too high. Then after, the stock goes up, and other participants continue to profit enormously while we continue to wait; we do take comfort in knowing that losing 50% on one bet, means having to gain 100% on another bet just to cover the original loss!

Ultimately, we may miss out on some of the gains, but we will always prioritize capital protection rather than capital gains. Every single dollar entrusted to us was hard-earned so we won't have it any other way.

The Ever-Elusive Durable Competitive Advantage

In our investigative process, there are two questions we are trying to answer:

1) What is the economics of the business and the industry?
2) Do we have confidence on what the business will look like in the next 5-10 years?

While we can often feel confident about the former, the latter is where the uncertainty lies. Predicting the future competitive landscape *with confidence* is a far more elusive endeavour.

There is usually an abundance of material available that thoroughly explains business models and industries. After reading these reports or entire books dedicated to demystifying a particular business or sector, one might feel well-informed and even entitled to make an educated forecast about a company's future. The only thing I'm comfortable forecasting is just how difficult forecasting really is. We remain cautious not to underestimate the powerful forces of creative destruction—both a strength and a drawback of capitalism. Even the most rigorous research and well-grounded assumptions can be swiftly overturned by unexpected shifts.

Most companies that are reported on the news are exciting and even go on to change the world; however, we do not have the slightest clue on what the industry, let alone what the company will look like in the next 5-10 years. So why would we think we could pick out the one stock that will do well? We might follow the news for curiosity sake, but we would never bet our hard-earned capital on it.

Investing in stocks, implicitly, requires a prediction about the future performance of the business. There are simply too many moving variables at play. The key to reducing errors lies in minimizing the number of unknowns. This is the main reason why we try to stick to the simple businesses that are part of a slow changing industry.

Finally, once we find a business that fulfils our investment criteria, we wait for one of Mr. Market's depressive moments. Without the erratic behaviour of our beloved auctioneer, generating a profit would be almost impossible for us. We just won't know where to start. Our goal is to leverage Mr. Market's erratic tendencies to our advantage rather than let them work to our detriment.

Margin of Safety

If Mr. Market is the most important concept of investing, then the second most important concept is margin of safety.

It's a fairly straightforward concept. If you are driving a 5-ton truck and you meet a bridge that says 5 tons, you don't drive over it—you find another route.

It's highly likely that the engineers who designed the bridge incorporated some level of tolerance, and construction authorities likely mandated such safety measures as well. However, depending on that assumes everything went according to plan, overlooking the possibility of corners being cut during construction or critical components deteriorating due to adverse weather. Betting something so valuable on those assumptions seems completely irrational—I certainly wouldn't take that bet.

In the same way, if we find a stock that is trading slightly below its intrinsic value, we try our best not to jump in immediately. We usually demand a larger margin of safety and we want the stock to trade well below what it's worth before we make our purchase.

1) If our analysis is incorrect, the margin of safety helps minimize potential losses, reducing the financial impact of our mistake.
2) If our analysis is correct, the margin of safety increases our potential return. We receive the benefit without paying for it.

The benefit of always demanding a margin of safety is twofold, and the only thing required is patience—a virtue we are more than willing to exercise.

Our Activities in 2024

In 2024, MSCAP achieved a return of 24.8%, while the MSCI World Index gained 18.67%. After deposits were accounted for, we started the year with around 31% in cash and 69% in equities. We ended the year with 40% in cash and 60% in equities.

As a reminder, we use the MSCI World Index as our benchmark because MSCAP's mandate focuses on global equities—not solely on U.S. equities. While the S&P 500 has outperformed the MSCI World Index, it also has way more concentration in US stocks. The same top four companies represent around 17% of the MSCI World Index, while they account for about 24% of the S&P 500 Index—we prefer the global strategy. I've also discussed the features of each index in our last letter, so I won't rehash it here. Currently, less than 30% of our portfolio is allocated to U.S. equities; the remainder, is invested internationally and held in cash.

At MSCAP, we typically maintain a relatively concentrated portfolio, with individual position sizes ranging from 5% to 15% of our assets. I think holding a portfolio of 10-15 stocks provides a good balance of diversification and concentration. Exceptional investment opportunities are rare, so when we identify a compelling idea, we believe it's inefficient to dilute its potential by allocating only a small portion of our resources for the sake of diversification.

During 2024, we invested in two stocks, each representing approximately 5% of our assets; we also took up smaller positions in other companies. As we deepen our analysis of these businesses and their industries, we may choose to increase our stakes or, if our outlook changes, reduce or exit these positions entirely.

Applying Our Strategy: A Seed We Planted in 2022

One factor contributing to the increase in our cash balance was the exit of a large position we had held in Spotify, a Swedish company that we've been invested in since 2022. While it may seem counterintuitive for a value-focused fund to invest in growth companies with negative earnings—something that might make value investors' stomachs turn—this decision was made with careful consideration.

Back in 2022 when we first made the investment, Spotify had never produced a single year of earnings yet the whole company was trading at around $20 billion. For this investment, the big question was how well Spotify could control its margins. Upon taking apart the annual report, we saw that the company was spending close to 25% of revenue on marketing and R&D.

We believe these costs fall well within the company's control, and with deliberate effort, the costs could be significantly reduced. If the company were to reduce these expenses by 50%, the company would be earning around $1.5 billion. After factoring Spotify's net cash position and applying a conservative multiple of 10x (on the adjusted earnings), the upside potential ranged between 50%-100%. We saw this as an intriguing opportunity that warranted further investigation.

While this outcome appears possible, our focus is on assessing probabilities rather than merely speculating on possibilities. The next section delves into detailed security analysis. If that bores you, feel free to skip to the last section. Otherwise, we hope you'll pardon the lengthy analysis—we're genuinely excited to share our findings with you.

Investigating the Cost Control Capabilities

The most obvious solution is to reduce the cost of subsidy to the customer. Remember all those Spotify family and student plans? The annual cost of these subsidized plans cost around $3 SGD per user. For reference, the current global average revenue per user was around $6 SGD per user. Apple music, a worthy competitor, also charges around $3 SGD per user for its family plan so increasing the subscription cost will definitely increase margins, but this may also be detrimental towards the competitive position of the company. Customers may opt for an Apple music subscription instead.

The R&D budget could also be reduced immediately with hiring freezes or downsizing; however, a decision like this cannot be taken lightly as Spotify has well capitalized competitors like Apple music and YouTube Premium to compete against.

Ultimately, while it was heartening to see that a lot of the costs were within the company's control, there were also knock-on effects that we had to consider. We continued our research because we still needed more compelling reasons on how the company could also increase its margins in the longer term.

The Lead Weight Attached to Spotify

One of the biggest cost components to Spotify was that they had to pay the record labels 70% of any revenue earned through streaming. This was a needed trade-off because when Spotify first started, the world's music catalogue was owned by a handful of record labels. There was no incentive for the record labels to allow Spotify access to their media library. The industry has very high barriers to entry. Without a comprehensive music catalogue, there was no way to get users. And without users, Spotify had no bargaining power.

The only way to get started was to give the lion-share of profits to the record labels. That decision helped Spotify grow immensely, but it also attached a lead weight to the company and margins have suffered.

Can the Lead Weight Be Removed?

If Spotify could keep its massive user base while becoming less reliant on the incumbent record labels, then margin expansion was highly probable. This undertaking would mean ensuring its users could still listen to music, but not music from the incumbent record labels—a tough feat as the incumbent record labels owned the rights to a vast library of music.

To decipher that, we have to first understand the industry. Broadly speaking, the record labels provide 3 services: The discovery of artists, assisting them in the creation of music, and then distribution of their work.

There were 2 variables that we thought about:

1. Could Spotify provide these services in a more efficient manner?
2. How could Spotify steer them towards audio from other sources?

Spotify was working on a 2-sided marketplace. It created tools to help artists create music more efficiently and assisted in distribution via its massive user base. Then it complemented this with a recommendation engine that helped promote their music. Spotify was also investing heavily in other forms of audio like podcasts and audiobooks.

As Spotify gained traction with this strategy, we looked at the improving economics. Its most expensive podcast to date was the Joe Rogan podcast which cost them around $200 million over 3.5 years. The figure seemed large, but more importantly, there was no longer a 70% cost attached to each stream—the cost was now fixed. With a large number of users, the cost could be successfully amortized over a large base and over many years. In other words, the more users or streams there were, the cheaper the cost per stream would be—we like this economics better. While the podcast was not a genre of music Spotify created, Spotify successfully popularized it to its advantage.

I also observed how my listening habits and the listening habits of others was starting to change over time. There was now a good number of independent artists that had found their way into streaming charts and playlists of numerous users. Through its recommendation engine, Spotify was successfully steering its users towards these independent artists. This meant one very important thing. The streams were no longer produced by the incumbent record labels and thus no longer cost Spotify 70% per stream. The better and longer Spotify could do this, the stronger their competitive position would be.

Looking at the annual reports of the incumbent record labels, we also saw one very interesting figure. 70% of their revenue now came from streaming and subscriptions. While not all of this revenue will be attributed towards Spotify as there are other competitors like Apple Music etc, it's becoming increasingly clear that streaming is now the preferred choice, and we were happy that Spotify owns a significant part of the highway tolls.

We saw that Spotify and other streaming companies had successfully disrupted the music industry. The record labels could no longer cut the streaming companies out because the streaming companies occupied such a large chunk of the record labels' revenues, and over time, if Spotify could continue to execute its strategy well, their position will only strengthen. In essence, the incumbent labels were watching the streaming companies eat their lunch, and there's really not much the record labels can do about it.

There was a silver lining for the incumbent record labels. Most of them owned a decent stake in Spotify as well. We like this kind of win-win-win scenarios. We are, however, happy that Spotify was going to be the biggest winner.

Conclusion on the Lead Weight

Ultimately, to answer the original question posed—we do believe the lead weight can be removed, and margin expansion was a very probable scenario. To reiterate an earlier point, I did not have any foresight on this matter. Just the benefit of hindsight, and the patience to watch it roll out. There was no esoteric math or excel models we had to run. We used simple algebra and tried our best to ensure we had confidence in the inputs.

Satisfied with our thesis, we put about 5% of assets in Spotify. After waiting a couple of years, we made a healthy 4x on the investment. While this was a successful investment, we did commit a serious act of omission on this investment. We should've made a larger investment, and we had every intention to do so. However, as we researched more deeply into the company and industry, the stock went up a little bit and we were just too cheap. This is an example of the anchoring bias that worked against us.

How We Judge Our Investments

While we are cognizant of market cycles, our abilities to forecast it still fall short. Instead of waiting for our forecasting abilities to mature, we are happy finding individual companies that are mispriced. Most of these investments usually take between 2-4 years to pan out.

Why 2 to 4 years? We are strong believers that business fundamentals drive stock prices and not the other way round. Stocks are usually mispriced for what looks realistic reasons—at least on the surface; the accuracy may not be sound, but there may lie a shred of truth that was blown out of proportion.

Mr. Market's mood may be prone to erratic swings, but he is still a relatively skilled auctioneer. Our profits require us to successfully capitalize on Mr. Market's errors, but I would be extremely careful about overestimating our own abilities. We always maintain a healthy respect for the market, but we also practice a healthy dose of scepticism.

Instead of having market prices guide us, we are concerned with where the competitive position of each company lies and whether that position is permanently damaged. If it is merely a transitory phase, then these improvements and turnarounds take time. Making fundamental changes at any company takes time, but for larger companies, this process will take even longer due to their size and complexity.

In the long run, if a business does well, its fundamentals will improve and so will its financials. That in turn will be reflected in the stock price. We anticipate, this takes between 2 to 4 years.

Our Expectations Over the Long Term

With each passing year, we hope to be a little wiser, but we will continue to make mistakes along the way. Our focus will always be on preventing errors rather than hitting home runs. By accumulating small wins over a long period, we hope to produce a roughly 12%-15% return over the long term so there is just no reason to jeopardize what we have and need for what we don't have and don't need. We do hope to exceed this compounding rate, but it's important we set the right expectations from the start. Our primary objective is to always remain responsible stewards of the capital that was entrusted to us.

After fees, we hope to deliver around 10%-12% to our prospective partners. While we have over exceeded this target over the past 6 years, I'd like to remind everyone that in the investment business, everything resets on January 1st. The MSCI World Index and S&P 500 Index have produced roughly 9% and 10%, respectively, over the long term. We think it's possible to beat the index by a few percentage points, but we would be cautious in overestimating our ability to do anything beyond that. As noted in our last letter, a few percentage points accumulated over a very long period will produce quite meaningfully differentiated returns.

Allow us to end the letter with a short excerpt from one of Warren Buffett's speech.

> "If you're going to get married and you want a marriage that's going to last. What quality do you look for in a spouse? Just one quality.
>
> Do you look for brains? Humour? Character? Beauty? No. You look for low expectations."

In the same way, I want our partners to have low expectations coming in because it is a financial marriage when they join us at MSCAP. I don’t want anyone thinking that we are going to do things that we are not going to.

With that, I would like to conclude our letter and thank everyone for their continued support.

Cordially,

Frederick Tye

30th January 2025

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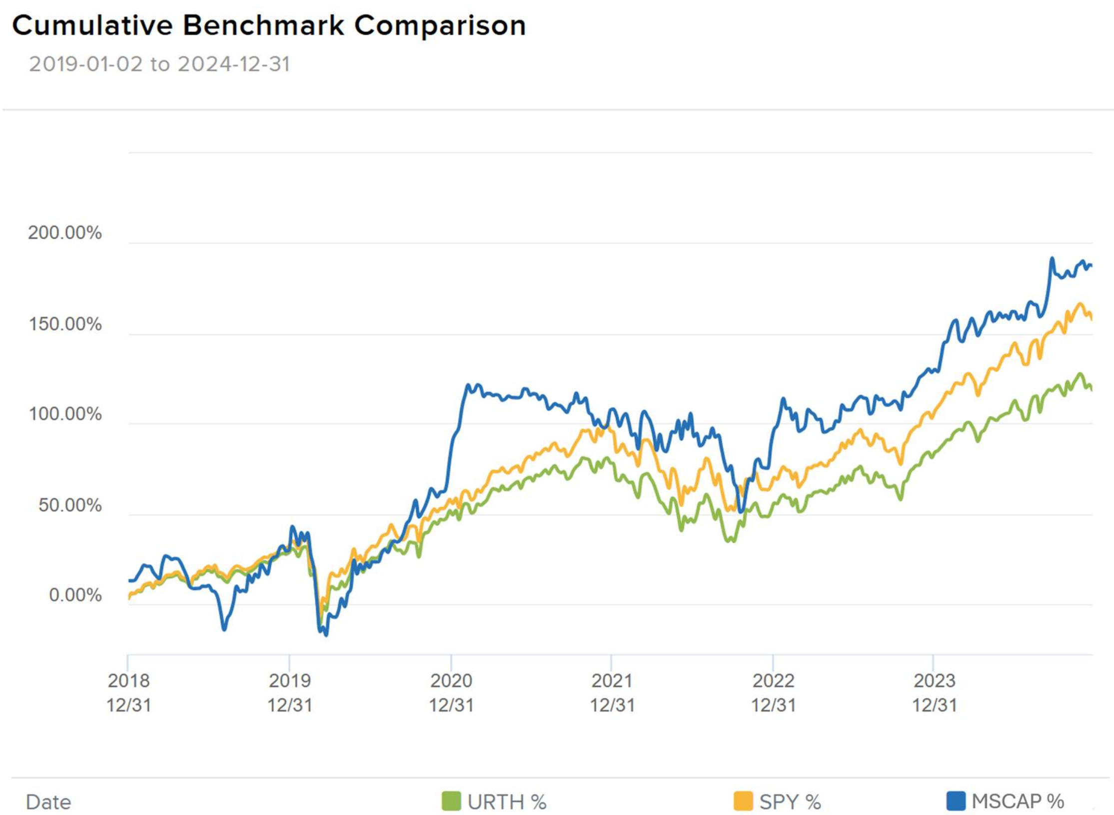
Appendix on MSCAP performance



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2023	106.50	84.49	130.58	26.19%	23.97%	31.31%
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