

Dear Shareholder,

Most investors we speak to appear increasingly nervous about the recent stock market rally.

Latitude tends to attract *valuation conscious* investors so, perhaps, we operate in a nervous echo chamber, and the rally will continue for years.

Who knows about that, but there is good news for those fretting about markets, and that lies in **their breadth**.

Market indices are almost entirely driven by AI narratives these days, given the scale of the companies exposed to it. However, companies outside of technology and the US are also enjoying huge success, which looks set to endure.

This clearly benefits our relative value approach and offers investors a highly asymmetric alternative to simply “buying the market” or chasing relative returns through AI stocks, if you are as unclear about their future as we are.

We published our views on AI over-capacity risk in February¹ and see many others making similar arguments more recently. We won’t add to those points, although they still stand firmly in our minds as *risks*. When wrapped in elevated optimism and valuation, we think it’s rational to steer clear for now.

The truth, as ever, is we don’t know where stock markets will be a year or so from now. We don’t know if the companies building out this massive AI infrastructure will ultimately be the beneficiaries of that spending or if, like the telco rollout twenty years ago, others will reap the benefits decades later.

We do believe the risk-reward tradeoff here is far less attractive than in other areas of the market.

Capital allocation is always a decision of *relative value*.

In most of our recent investor correspondence we are guilty of having dwelled on the risks and, last quarter, we discussed our worst performing stocks.

So, in this letter we focus on **optimism**, some of our portfolio companies’ recent successes, and where we see opportunities which others may not over the years ahead.

We discuss:

Interactive Brokers

Cencora

McKesson

AutoZone

JP Morgan

Eiffage

Ryanair

Sony

Our Portfolio

At the end of the third quarter the portfolio was up 17% in sterling, 25% in US dollars and 10% in euros, all net of fees.

Our investments are doing well because our companies are doing well, growing their cash earnings while delivering large amounts of capital back to shareholders through dividends and buybacks (almost 5% of our

¹ [Latitude Comment: Data Centres | The boom and bust of bits and bytes](#)

annual return comes from this return of capital, due to the highly cash-generative nature of the businesses we invest in).

We own stocks listed in six different countries and ten different sectors.

In constant currency terms, our US stocks have performed in line with our non-US stocks with an average total return of 24% in USD (in GBP this is closer to 15% for each group).

Companies in every sector have performed strongly, with each sector making a positive contribution to returns so far this year.

Industrials, Consumer Discretionary, Financials and Communications Services (just **Alphabet**) have performed best, with Consumer Staples, Healthcare and Materials the worst, although still positive.

This is to say that the rally this year has been broader based than the headlines give it credit. Due to the overwhelming impact that a few AI stocks have on market indices, they make the headlines, but they are not the only ones making progress.

Our Companies

Eight of our holdings (out of 23) have generated total returns greater than 30% this year.

Interactive Brokers	56%
Cencora Inc	39%
Mckesson Corp	36%
Autozone Inc	34%
JPMorgan Chase & Co	33%
Eiffage	33%
Ryanair Holdings Plc	32%
Sony Group Corp	31%

Of particular note has been the ongoing strength in customer account growth at **Interactive Brokers** (IBKR). Five years ago, the company had one million accounts, and this broke through four million this year.

The stock is +56% year to date as EPS has doubled from this time two years ago.

The business model lends itself to continued growth not just across the individual customer segment but increasingly their institutional clients.

In a comment redolent of Jeff Bezos' "their margin is our opportunity" quote, we note this comment² from an interview in Barrons with excitement:

Let me put it this way: When I see that large investment banks and trading firms report trading profits amounting to about \$200 billion a year, that indicates that the trading public and institutions are losing \$200 billion a year when trading. I'm not saying that those margins could be eliminated, but they could be reduced.

² <https://www.barrons.com/articles/interactive-brokers-peterffy-automated-securities-trading-4b3c5a19>

Jacopo and I were recently interviewed on a podcast³ covering this stock, since then nothing has changed in our view.

This is a best-in-class technology platform which has moved from being a consumer-facing business to also being a dominant player in the institutional client service industry.

Their continued investment in technology and automation, as well as their decision to cut out the middleman and allow customers direct market access to stock exchanges, means they are always in a position to undercut competitors, a position they press.

As any investor in technology shares knows, scalable, network platforms are capable of creating huge shareholder value over time. Layering in the lowest cost proposition at IBKR allows their fly wheel to spin faster, with growth accelerating despite the business being fifty years old.

Over the next five years we expect the company to emerge as a dominant player in institutional business throughout the world (this is truly a global business across the US, Europe and Asia).

Earnings will be volatile, as they are linked in the short term to overall stock prices and interest rates, although the sensitivity to the latter is feared by the market more than it should be. We estimate that net interest income would fall 10% for every global 1% cut in interest rates, and there would likely be some positive offset within their equity trading commissions. Set against account growth of 35% and profit growth of 25%, this cyclical volatility is a price to pay for exposure to a very long runway of potential growth.

McKesson and **Cencora** both operate in the US drug distribution industry, overseeing about 65% of the market between them.

The shares are up 36% and 39% respectively in the first nine months of the year, and 130% each over the past three years.

Despite this performance, they trade on around 18x PE and a lower multiple of free cash flow.

The drug industry in the US tends to grow a bit ahead of GDP, and the market share between the distributors has been relatively stable, so the source of stronger growth comes from specialisation and efficiency.

The core businesses are increasingly complex. Following the opioid crisis, compliance has increased with tracking required down to the individual pill in some cases. This added complexity has required investment and is now a source of both higher margins and stronger barriers to entry.

From a competitive standpoint it's worth remembering that seven years ago Jeff Bezos, Jamie Dimon and Warren Buffett attempted to revolutionise this process by hiring Atul Gawande to manage a joint venture healthcare delivery business, with Amazon managing fulfilment.

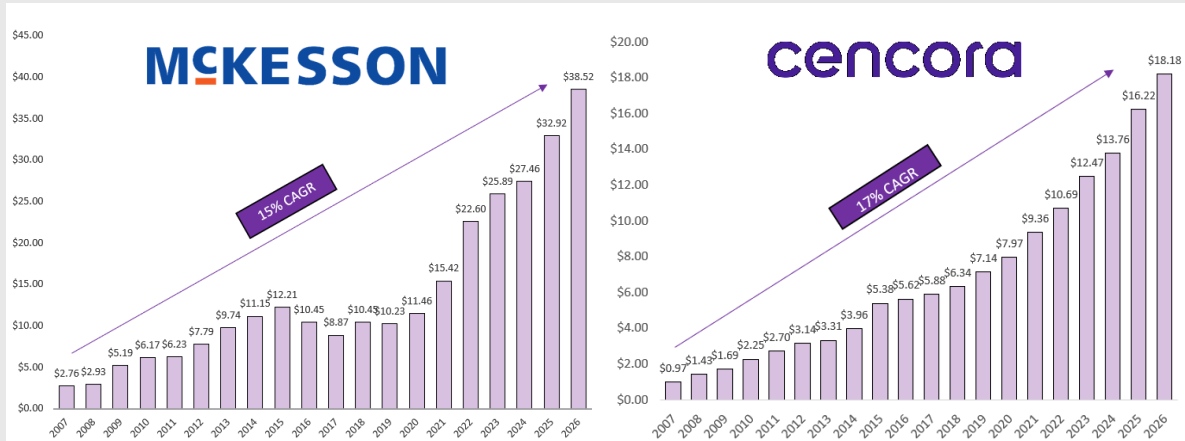
All four of these men have influenced us over the years yet, despite this, their collective efforts could not dent the progress made by McKesson and Cencora, giving us confidence that their positions are sustainable.

Aside: when we analyse companies we do so in the pursuit of "intrinsic value growth". In practise, this means we look for two things: demonstrable growth in bottom line financial metrics like EPS and cash flow, alongside strengthening in competitive positioning. Our confidence in the interplay of these two factors for McKesson and Cencora is why we allow ourselves to own both in an otherwise highly diversified portfolio.

³ [Colossus: Business Breakdowns Podcast – Freddie Lait and Jacopo di Nardo on Interactive Brokers](#)

To further benefit from their market positions, both businesses have invested in specialisation – from specific delivery processes for hard to handle biotech compounds, through to technology solutions for their customers and suppliers.

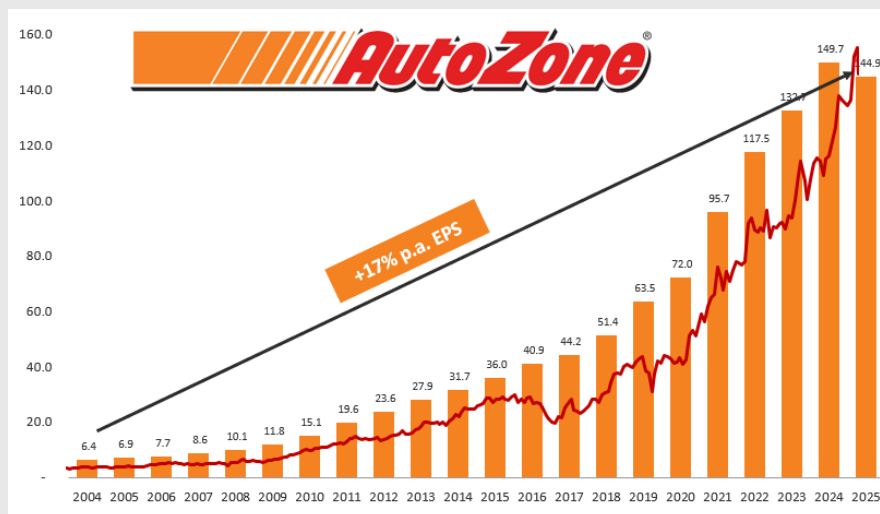
Recent EPS growth has been ahead of the very long-term average of 15%-17%, itself more than ample given the valuation. According to our estimates, these stocks will grow more rapidly than at least half of the “Mag 7” companies, trade at more than twice the starting free cash flow yield and are more defensive in nature.



As long-term readers will know, we have discussed **AutoZone** many times. The business has generated c.15% EPS growth for the past ten years and operates in a still highly fragmented marketplace, selling auto parts to individuals and garages in the US and Latin America. 50% of the industry remains comprised of very small groups, often individual stores, who struggle to compete with AutoZone’s integrated wholesale distribution model.

This integrated model has worked well for companies like Costco and works well here too. It’s an intrinsic advantage and, unlike Costco, competing with smaller competitors is preferable to competing with Walmart, Target and Kroger.

Also, unlike Costco, AutoZone doesn’t yet trade at crazy multiples of profit: 24x PE (26) versus 46x. The stock has returned 34% this year. A small point but recent earnings weakness has been driven by an inventory accounting rule (LIFO) which depresses current EPS, as more expensive, recently acquired, inventory is deemed to have been sold first by the bookkeepers.



Over the past ten years we have owned shares in four US banks at various times, and today we own the market leader **JP Morgan**. It has returned 34% this year, 275% over the past five years, and 580% over the past ten, **outperforming the Nasdaq substantially over each timeframe**.

For capital intensive businesses (and only those) there is a great framework pioneered by Marathon Asset Management in the UK, called “the capital cycle”⁴. It simply states that in a high return industry competition increases to compete those returns away. And, importantly, vice versa.

We determined in 2016 that the extraordinary pressure put upon banks in the aftermath of the GFC had peaked when, during a systematic capital review called the CCAR, the Federal Reserve allowed most banks to return capital to shareholders once again.

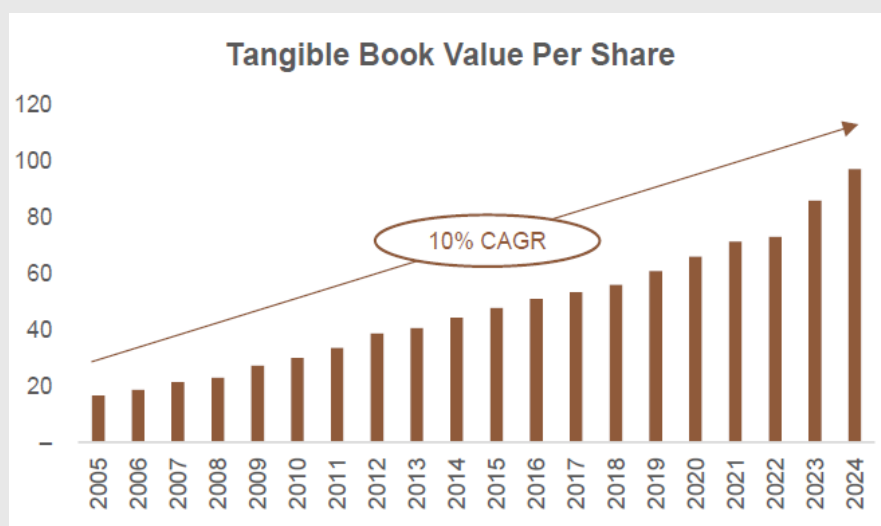
From these periods of hardship, industries often emerge stronger, and this was the case with the US banking system.

When we are modelling forecasts for our companies, and explicitly modelling their growth rates, it’s important to know *where* this growth is coming from. In some instances, this can be from the underlying industry growth itself. In many this comes from either new products or services, or from competitors.

This is why our work focuses so much on the peers (public and private) who may be competing for the same pie. In this particular case, the EU banks were clearly in a far weaker position as regulators continued to extract their pound of flesh, and the US peers seized this opportunity. All of the formidable European investment banks withered.

At the same time the US domestic banking system remains incredibly fragmented. In 2003 the top 25 banks had 41% share of total assets. That figure is now 64% and we are confident this can move higher over time.

JP Morgan alone spends \$18bn per year on technology. There are c.4,000 banks in the US and only sixteen of them have *revenues* higher than \$18bn. This company already generates 20% returns on tangible capital, and is set to grow its share of deposits, assets, and cash flow within an increasingly consolidated industry, with structurally higher returns on capital and strong competitive positioning due to their unrivalled investment in technology. It trades on 15x earnings.



⁴ [Capital Returns: Investing Through the Capital Cycle: A Money Manager’s Reports 2002-15](#)

Three European industrial stocks (**Vinci**, **Eiffage** and **Ryanair**) have contributed meaningfully to returns this year, with Eiffage and Ryanair returning 33% and 32% respectively, and Vinci lagging slightly with 22% returns.

Eiffage and Vinci are very similar. They are predominantly infrastructure businesses which own airports and toll roads around the world. Despite continued operational success, the shares remain unloved due to the unfortunate fact that both firms are based in France, where the politics cast a long shadow at present.

Notwithstanding that, EU-wide changes to spending rules, specifically defence and infrastructure spending, have helped sentiment, and will create long-term growth opportunities ahead of what we'd originally forecast. Germany is their second largest market, and this is where we expect the fastest pick up in spending.

The French political backdrop may keep valuations depressed for longer yet (Vinci trades on 12x PE, and Eiffage on 9x) but with 4% dividend yields and earnings growth potential above their ten-year average of 12% per year, we can see why the market became a little more interested this year.

We covered **Ryanair** in a letter recently so we can keep this one brief. Since we bought the shares a year ago, they have almost doubled and are up 32% this year so far. Despite this, we see a very attractive valuation compared to the growth opportunities we see.

The key concern for investors had been, initially, that plane deliveries would be delayed. Once it became apparent that this delay helped deliver stronger ticket pricing due to the tight supply / demand impact, they now seem to fear the incoming delivery of these delayed planes over the next year, and the impact this will have on *load factor* (how full the planes are).

We believe the market can absorb the capacity. While it may lead to softer fares in the near term, Ryanair has a thirty-year track record of putting new planes to work, creating problems for everyone else in the industry but not themselves.

Like with IBKR, this is possible in part due to their focus on cost management and passing this benefit on to customers. Ryanair's revenues per seat are lower than other competitors operating costs per seat.

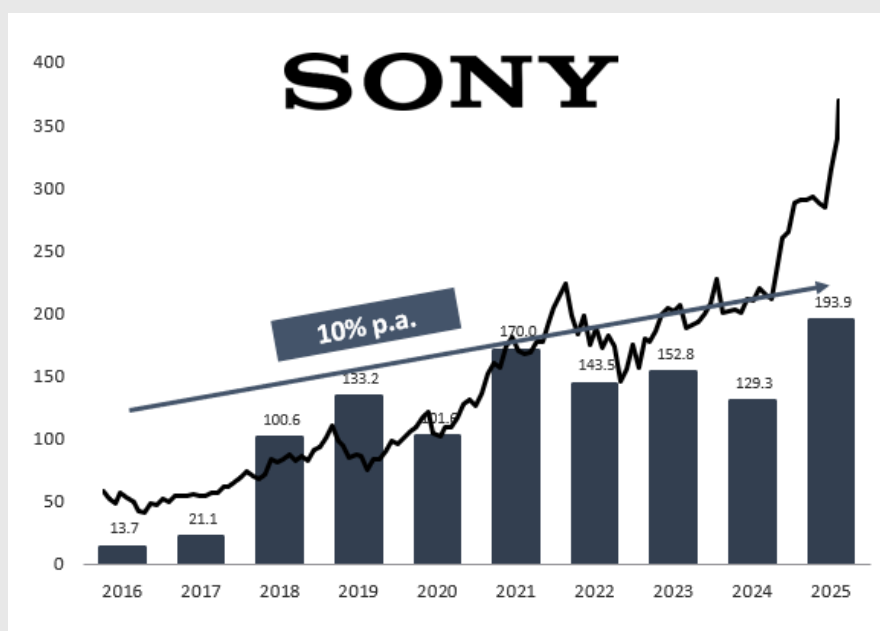
As we noted before, Ryanair's investment in planes is likely to be half as much as it has been for the past fifteen years, as capacity growth slows across Europe and the company reaches its plateau in market share. This, and the fact that the company has cash on its balance sheet, allows for meaningful share buybacks. The company has retired 7% of their shares outstanding in just the last year.

Our differentiated view beyond that, is that prices will rise marginally over the coming five years, and every €1 of price increases is an incremental 10% growth in profits (as they currently make profits of around €10 per passenger), on top of the underlying 10-20% growth. At 12x PE this seems attractive to us despite the move since we invested, so we retain a position.

Sony has been in the portfolio since inception and has generated strong returns since then, and also this year to date, up +32%.

Their core media assets are the PlayStation franchise, Sony Pictures, and Sony Music. An incredible group of businesses with proven durability across platforms (cf. the direct TV to streaming or CDs to Spotify transitions).

ASIDE: Sony is a great example where, in the short term, simply looking at earnings per share masks the underlying growth in the business. Financially and competitively, Sony has grown significantly over the past five years. Since 2019 sales across the company have grown 40%, yet EPS growth has been relatively anaemic. We report consolidated GAAP EPS for our portfolio as a consistent guide for our investors, but we are not slaves to this metric when considering individual businesses.



Sony has made incredible strides over the past ten years in fixing their electronics business and managing cost throughout the company. They have spun off their financial business, which was of reasonable quality but muddled the balance sheet and investment proposition. They have made canny early investments in Netflix, Spotify, and M3, the latter two they still own today, as well as Crunchy Roll which we discussed last time we wrote.

In simple terms, they have built the foundation upon which the next leg of the growth story kicks in.

Margins for the group are around 10.5% at present, with potential to increase meaningfully from here.

Margins will rise for two reasons:

1. Because of the way PlayStation cycles work. In the first few years you sell the machines, at a loss, in order to grow the installed base. Then, for the latter years, consumers buy on average eight games with very high incremental margins, generating a strong through-cycle return. We are in the latter half of this cycle for the PS5.
2. The company is finally discussing with shareholders the areas of opportunity to press margins within all the divisions. We see some low-hanging fruit which, if addressed, could easily add 1-3% to operating margins. When you consider the nature of this firm which, at its core is a content and platform technology company, it doesn't seem unreasonable to expect them to be able to expand from here without any competitive response.

Disclaimer: All stock performance is quoted as total return and in local currency, unless otherwise stated.