GRANATE
ASSET MANAGEMENT

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Annual letter to investors

Never callin', unanswered letters,
how you been, feelin' better?
Never lookin', but you're hearin',
never speakin', but you're feeling
All the silence, and it's wounding,
you're not healing, just concealing
- *Meat Loaf ('Razor's Edge')*

Stock markets used to be conversations, not ticking numbers

The earliest stock exchanges were not the crowded screaming matches we're likely to call to mind, but discussions in coffee houses. Originating in major seafaring cities in the Benelux Union and England, certificates of ownership were simply handwritten pieces of paper exchanged between buyers and sellers. The first formal stock market is said to have been founded in 1531 in Antwerp; at the time, Belgium's commercial centre and the second-largest city in Europe. It was also the city from which the influential van der Beurze family operated. As a result, early stock markets were called Beurzen. Many years later in the late 17th century, stock and commodity prices were pinned to the wall in Jonathan's Coffee House in Change (or Exchange) Alley, London. The coffee house – and those holding discussions inside – witnessed many momentous events in the history of stock market trading, some of which we touch on in this letter.

Jonathan's coffee house engraving, London, c1881.

We make our own coffee, but continue to harness the power of conversation

The days of coffee house trading are long gone. Screens of flashing red and green numbers updated every second have since transformed a practice of talking into trading. We believe that the more conversations we have within our investment process, the better the odds of success. Conversations refine complex decisions by bringing multiple experiences, perspectives and shared wisdom to a cutting point. Conversations prevent us from going down mental rabbit holes. Conversations find flaws in logic, recentre our minds and energise us.

At Granate, we talk a lot. We talk to each other, we talk to the people at the companies we review (and keep talking to them once we invest), and we ask friends and family about their experiences at companies or in specific industries. Over the last year, we were lucky to have more face-to-face conversations within the team than in 2020. In 2022, we hope to have far more conversations with our clients too.

Of course, time spent in conversation carries an opportunity cost. A meeting may come at the expense of placing a trade or researching a great company that has recently sold off. So an interesting question is how we would conduct ourselves if there were no secondary markets – no live market prices? If what is bought is held until you receive the cash reward from the investee entity.

Well, this is what we would do:

- We would lend money to trustworthy entities at rates that are mutually beneficial.
- We would provide capital to businesses where we have faith in the people.
- We would spend time talking to the people to whom we have provided capital.
- We would spend time looking for new investment opportunities.
- We would spend time discussing these opportunities.
- We would spend time talking to our clients.
- We would not spend time looking at prices.

There would be plenty of conversation and no temptation to let past or expected prices influence our thinking. Quite a tempting world to simulate.

Prices don't always hold true, but timeless principles do

Market prices do exist – tracing as far back as the pin-ups in Jonathan's Coffee Shop. And because people tend to confuse prices with underlying value, they've caused plenty of pain over the course of history.

It was barely 20 years after prices were first displayed that devastation struck for the first time. The South Sea Bubble was caused by prices of the South Sea Company, a slave trading enterprise, rising to levels completely unhinged from reality. Prices were pushed higher by the company buying its own shares, lending money to investors so that *they* could buy more shares and talking up the reality of the underlying trade. The founders were trading on inside information and politicians were bribed to ensure the lies lived longer. As a result, the company's share price moved way beyond what it could ever return in cash flow. Once this became evident, the price dropped back to only slightly above where the shares were first offered. The collapse was so significant that the British economy took a big hit – and thousands of investors learned a very expensive lesson. Notably, one of them was Sir Isaac Newton, considered one of the most brilliant scientists the world has ever known. Having successfully traded the share before, Newton continued to follow its meteoric rise and bought in again near its peak – only to fall victim to its dramatic decline. As he once remarked, "I can predict the movement of heavenly bodies, but not the madness of crowds."

It's a lesson many more investors would learn in years to come – and the reason we prefer not to make predictions. More recently, the world witnessed crashes like the dot-com bubble that burst in 2001 and the devastation of the financial crisis in 2007/2008, during which the prices of debt instruments were hardly portraying underlying quality. Truth dies in the anonymity of tickers.

There are, however, benefits to secondary markets, such as the ability for you to invest new money into our funds or (heaven forbid) withdraw your investment. In such cases, we need to go to the market to buy or sell securities. Our intention is for the prices of the securities held in the funds to be higher when you withdraw than when you invest – and for us to better recognise true value by harnessing timeless principles.

What we believe to be true

Whether you are extending capital to the captain of a ship in the hope that he will return with sought-after spices, lending money to a small enterprise or investing in semiconductor companies, there are many investment truths that hold as true today as they did in the 17th century coffee shops:

- Thinking in terms of probabilities gives far better odds of success than thinking in absolutes.
- Individuals who recognise the value of other people in the outcome of their investment decisions will make good long-term decisions more often.
- Incentives matter, as this is where true motivation lies.
- When supply exceeds demand, prices go down. The opposite also holds true.
- People will panic and overreact, selling good assets at low prices.
- People will get carried away and pay too much for both good and bad assets.
- People will fight about spoils, resulting in instability.
- Most people don't have the patience to allow the power of compounding to work for them.

- Most investors will focus on short-term returns, causing market volatility.
- Many grown-ups will lie to hide mistakes or to make more money than they have earned.
- Simplicity is safer than complexity.
- Companies that create positive net value for customers are likely to thrive.
- Companies with no or low debt are unlikely to go bankrupt.
- Governments that are largely domestically funded are extremely unlikely to default.

While we invest your money in a very uncertain world, we believe that the more we configure and shape ourselves to harness these timeless principles, the greater the odds of a good outcome for your money.

Therefore:

- We look for investments that are simple to understand.
- We strive for calmness so that we can buy when others panic and sell when others get carried away.
- We do very thorough work on the people we are partnering with when we make investments. Not only do we try to avoid dishonest people, but we are also looking to harness the power of capable people.
- We look for management teams whose incentives align with our interests as long-term investors.
- We are happy to invest for more certainty at the expense of exciting possible returns, to allow compounding to work for you.
- We place significant weight on the health of balance sheets.
- We do not try to predict the future but build portfolios that will hold up in different future realities.
- We lend money to carefully selected entities, including the South African government, when the interest rates are attractive relative to inflation.
- We make time for conversations.

How does this play out in our funds? Let's consider two examples:

1. We are currently investing in South African government bonds because they pay a dependable, high return.

   Bonds produce income for investors who rely on their investments to generate dependable cash flows. For this certain outcome, these investors generally pay a 'certainty premium' by accepting a lower overall return in exchange for peace of mind. We have highlighted in several prior commentaries that we think South African government bonds have become particularly attractive in this cycle, with their 'certainty premium' completely mispriced to the benefit of investors.

   Why? By trusting two timeless principles – our government is largely domestically funded, and fear around fiscal concerns have driven prices in favour of investors who can take a long-term view. We have been able to invest in government-guaranteed 10-year bonds at 11.5%. That's a very attractive return of 5.5% above a conservative inflation estimate of 6%.

2. We are invested in the semiconductor industry because it is hard to imagine a world that does not need more processing capacity.

   Any increase in capacity requires more semiconductors – and a very limited number of companies can make them. Even more limited are the companies that can make the machines that make the semiconductors. This takes us back to one of the most basic first principles: the relationship between supply and demand. We believe that given the cost and technical expertise required, the supply of semiconductors and the machines used to make them is very unlikely to exceed demand. We therefore happily hold companies that do both.

It's no secret that those screens with flashing numbers have flashed favourably for our exposure to the semi-conductor value chain. Had Granate been just one person alone in an office with a screen, there would have been many occasions when an index finger hovering over a mouse could easily have capitulated and sold our holdings. Profit locked in. The words of Meatloaf – "*All the silence, and its wounding*" – ring true. What saved us from making that mistake? Conversations. Earlier in this letter, we said that conversation carries an opportunity cost. However, we think it is normally far more expensive to avoid the conversation.

Thank you very much for trusting Granate with your money. We remain steadfast in our commitment to you to protect and grow your savings. If you would like to visit us for a conversation and a coffee, we would be happy to host you. Our door remains open and you will be warmly received by Vivian, our Granate glue.

Regards

The Granateam