Quality first, price second
why we don't mix the two

"I can resist everything except temptation." Oscar Wilde

Everybody loves a good bargain. It's the surprise sachet of sherbet at the bottom of the lucky packet, or the unexpected change that lets you buy a jawbreaker to go with it. Better yet, it's the box in the corner of the café with stock that hasn't been marked up.

by Alida Malherbe

Perhaps it's the thrill of getting more than anticipated, or the relief of securing an opportunity that may be fleeting. It could even be a sense of accomplishment in making a deal that's better than average. But what it comes down to is this: It's hard to resist a sale. And it's easy to shop indiscriminately when one comes your way.

As investors, we are also susceptible to these urges. How then do we avoid acting like kids in a candy store when opportunities come our way that appear to offer an outsized kicker? At Granate, we've chosen to separate our discussions on quality and price.

As a first step, an investment must meet certain **qualitative hurdles**

These hurdles are the same across fixed income and equity. We undertake deep analysis on a potential investment's balance sheet strength, debt metrics and the sustainability of its cash flows. We place just as much emphasis on making sure that a business is responsibly run and governed. In the credit market, most significant events of default occur due to mismanagement or fraud – just think back to Enron and Steinhoff (where books were cooked) or the former African Bank, whose downfall was caused by aggressive risk-taking and weak oversight. While these may be extreme cases, any lapse in trust from investors could lead to critical taps of cash (money borrowed from banks or investment companies) being turned off. This is especially problematic for issuers who rely heavily on debt capital markets (lenders other than banks) for funding.

What do we look for? Firstly, a management team with a demonstrable track record of pursuing growth, managing risk and creating a healthy corporate culture. Secondly, a qualified and well constituted board that can provide relevant input and proper oversight, with an appropriate level of independence. And importantly, any evidence of prior wrongdoing or current relationships that may result in a conflict of interest. We also consider the complexity of corporate structures and where there may be room for obfuscation.

The final part of our governance review for credit involves assessing the structure and vehicle through which we invest, and the documentation that forms part of our investment contract. Here, we tend to gain comfort by dealing with large institutional originators with whom we have longstanding relationships, and from covenants designed to offer debtholder protection.

Part two of our process considers **risk compensation**

Assessing absolute risk independent of price avoids the temptation to write off potentially material risks as already accounted for by a low share price or high credit spread (the excess yield offered above what you'd get when lending to a bank). The phrase *"It's in the price"* could indicate that you're tempted to shop indiscriminately. Only once we gain comfort on investment quality do we move to a relative risk assessment. What are we being offered to take on the risk we *are* comfortable with, and how does this stack up when we consider what else is available?

We are willing to **step away** from an investment at either point

Following a detailed qualitative review, we recently precluded a large European corporate from investment off the back of governance concerns. We revoked our approval of a local credit counterparty on similar grounds. Our requirement for attractive risk compensation is reflected in our portfolio make-up. For example, the steady contraction we've seen in local corporate credit spreads over recent years means that corporate credit (which excludes government and bank bonds) now comprises just over 10% of the Granate BCI Multi Income Fund – down from between 50% and 60% five years ago. Furthermore, banks make up the bulk of our non-government bond exposure, given that spreads remain attractive on a relative basis while risk is mitigated through regulatory capital requirements.

(Dalya recently wrote about the opportunities we're finding in offshore credit given the low spreads available locally. You can read her quarterly commentary here.)

Our focus is on protecting capital and **delivering consistent returns**

When it comes to our fixed income portfolios, we're not trying to shoot the lights out. We're aiming to preserve capital and provide steady, dependable returns. We're very cognisant of who we're investing for: our clients who need their capital to last and who rely on their investment income to provide for or supplement their living expenses. Key to achieving this not only means making good calls, but also avoiding bad ones. We believe that the distinction we draw between our decisions on investability and price gives us a better chance of getting it right. It might mean that at times we forego some sherbet, but it also means that we reduce the odds of chipping a tooth against an old jawbreaker.

Granate is a people business.

We are committed to creating a rich and rewarding culture through our shared values. Granate is configured thoughtfully and intentionally so that our team can thrive for the benefit of our clients. We care about the same things you do and are *relentlessly* **committed to protect and grow your savings**.