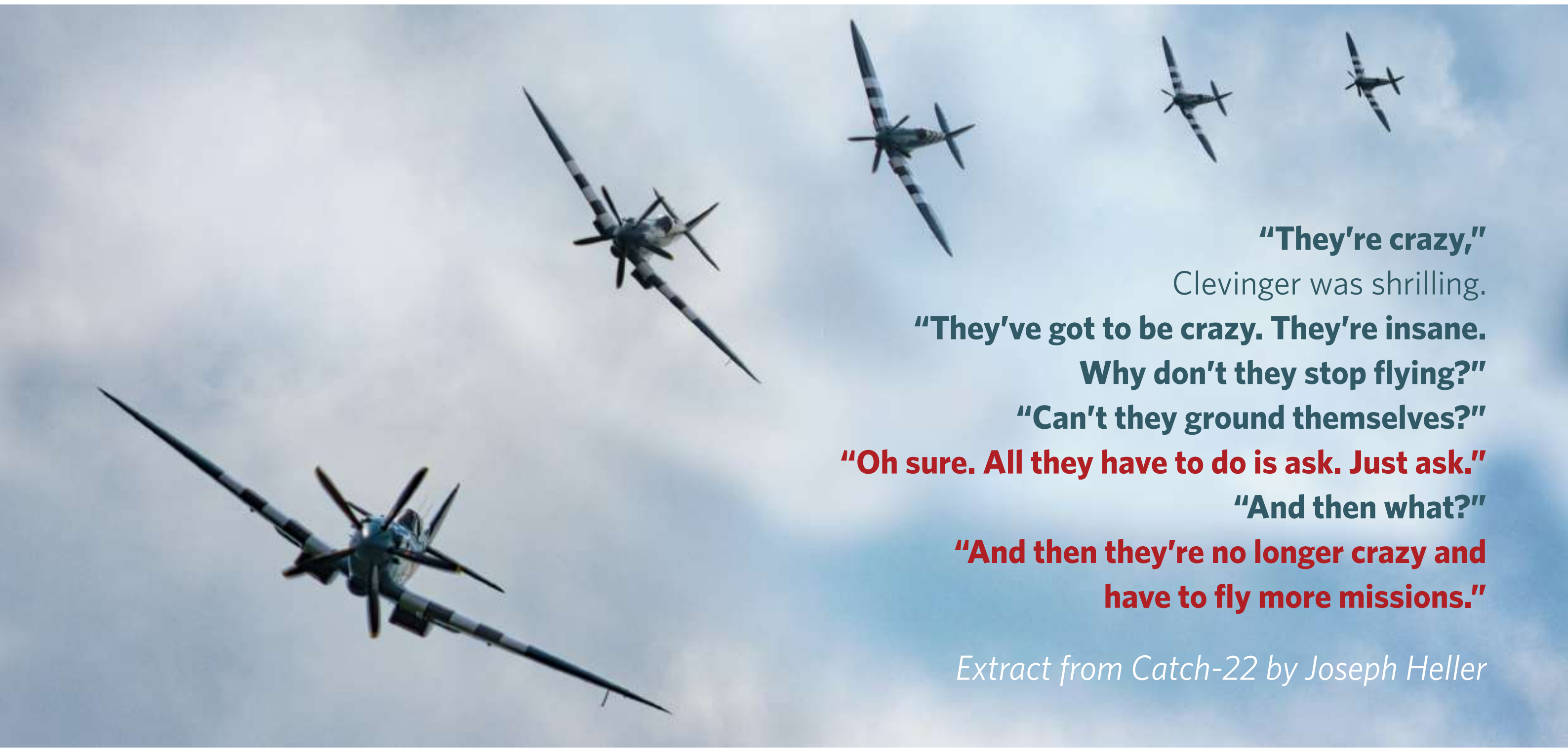

How does peer relative *underperformance* influence our thoughts and actions at Granate?

Since inception, the Granate BCI Balanced Fund and the Granate BCI Flexible Fund have outperformed their respective benchmarks by 6.9% and 6.3% per annum, and have therefore outperformed inflation by 12% and 12.3% respectively per annum. Both these funds are also at or near the top of their respective peer groups over all measurement periods longer than a year. Generating these real returns for our clients over the last five-and-a-half years brings us joy. Granate exists to provide for clients' future needs. Over-providing therefore brings us great satisfaction.

However, we know that some clients do monitor the peer-relative performance of funds. This is perfectly rational. The opportunity cost of selecting a lower-returning fund is a real cost. Some clients also compare peer-relative performance over shorter periods and will have noticed that while our fund values have kept growing, they have been lagging some peers over the last year. When we compare less favourably, we naturally feel some pressure. We want happy clients. Always. So how do we deal with this?

There is a natural inclination to dismiss short-term performance lags as noise, and to remind our clients to focus on the long term. There is also the standard response that any investment process will underperform from time to time, and that periods of underperformance are not necessarily the time to make drastic changes. There is certainly merit to both these responses. However, we use these times as reminders that we could be wrong about what we currently own, or don't own, in our funds.

We will make poor investments, and miss opportunities – those are givens in investments. So rather than denial, why not use relative underperformance as a trigger to assess the merits of the positions in the outperforming funds? Testing our blind spots is integral to sustained investment success, so we jump at every opportunity offered, especially when offered by other investment teams with good long-term track records. We dig out their commentaries and throw ourselves at their bull and bear cases, trying to ignore our preconceived ideas. We reason from first principles (or at least try to). We find this process energising and refreshing. Humans develop a very strong attachment to their initial views, especially when they have voiced them publicly. We are constantly on the lookout for this same weakness in our reasoning.

Could this lead us *astray* from our philosophy and process?

Our philosophy and process assess the quality of what we are considering investing in before (and separately from) our assessment of its price. This means that we simply wouldn't invest our clients' capital if the quality of an asset is sufficiently lacking, irrespective of how cheap or attractive it may initially appear. The explicit separation of quality and price assessments is fundamental to us, and we are certainly not tempted to change this philosophy. Therefore, by focusing attention on other areas of the market, or revisiting previously explored areas, we are merely stirring ideas and debate within the team to put candidate companies through our existing process. In doing so, we often also find ourselves reconsidering and debating our own previous conclusions about companies our funds do hold exposure to. We see this as a healthy process, and believe it aligns well with our ongoing philosophy and approach.

What are the current *differences* between us and some of our peers?

Let's consider some investments that are currently paying off for some of our peers, resulting in our funds underperforming them over the short term.

Firstly, we have almost no exposure to platinum group metal (PGM) miners. There are some quality companies in this industry, but when it comes to valuation we have always wrestled with the range of outcomes for PGM prices.

If we can build conviction that the balance of supply and demand will for many years be tilted in favour of a price that renders prevailing share prices attractive, we will be likely to participate. We revisit this thesis from time to time and now is one of those times. There is no shortage of managers and market commentators publicly sharing their thoughts on PGMs. This is handy information, and some of it will therefore form part of our thesis-testing exercise.

Similarly, we hardly have any exposure to gold, nor to gold mining companies. Gold is running hard and fast, and it hurts. Many gold bulls are sharing their reasons for continuing to hold, even at these higher levels. There are serious merits to some of these views, and we are not afraid to indulge ourselves in this food for thought. Sharing, discussing and debating opposing views is both a coffee machine endeavour and an investment committee meeting agenda item at Granate. For now, we remain cautious, as the gold price is driven by emotion in both the short- and long term. The share prices of companies that compound their profits for long periods of time are driven by emotions in the short term, but not the long term. In the long term, prices are driven by profit growth. This makes these companies simpler candidates for long-term investment decisions.

Finally, Naspers and Prosus have been running and we own none, and again, it hurts. We have always held the view that variable interest entities (VIEs) are not investable, as investors don't own true equity in the underlying company (in this case, Tencent). Rather, you are participating via a structured product. Importantly, this structure has not been broadly endorsed as legally binding by the Chinese government. There is, however, a counterargument to our view that carries merit; namely, that the Chinese government is unlikely to take actions that frighten investors away from VIEs on a wholesale basis. It simply cannot afford such a disruption at this stage. We believe it would be more inclined to steer toward broad wealth creation in the capital markets to counterbalance the wealth deficit citizens have suffered from the housing market crisis. Also worth considering is that the Chinese government has been through a crack-down phase on selected 'tall trees' in the private sector, and even as part of that process did not challenge the VIE structure. These are just a few examples of the elements we are debating around VIEs, and while we have still not invested in a VIE, a healthy internal debate continues.

What changes have we made over the past 12 months?

We do act when we find new ideas or our opinion changes. We completely exited our Growthpoint exposure on the back of some concerns about the sustainability of cashflows in their Australian subsidiary. We also exited positions in British American Tobacco, Berkshire Hathaway and Markel Group (a U.S.-based insurance company). These decisions were largely valuation driven.

On the other hand, we have significantly increased our exposure to Standard Bank, OUTsurance and Interactive Brokers. In all three cases we have growing conviction that the market is underestimating the true quality of these businesses. There are also several new offshore names included in our portfolios. These are mostly small positions, with the potential to increase in size if our conviction in their respective investment cases grow. New names include Disco Corporation (a Tokyo-listed semiconductor manufacturing equipment company), Hong Kong Stock Exchange, Kweichow Moutai (a Chinese-listed luxury spirits producer), Keyence Corporation (a Tokyo-listed sensor manufacturer), Mercadolibre (a Latin American e-commerce platform) and Shopify (a Canadian-based e-commerce platform enabling online retail companies).

In none of these decisions were we swayed by near-term price expectations, index weightings or peer portfolios. This means that there are likely to be periods where our portfolios are vastly different to those of other funds – and therefore our performance too.

Our door's open

We accept that our funds will lag others from time to time, hopefully not too often nor for too long. So, if you feel like you hate us a little bit when others are doing better than us... that's okay, we get it. Of course, we don't want you to sell out of our funds at such times and we do love talking to our clients, so please give Alex, Ryno or Gus a call, anytime. Also, Alex enjoys lying back on our office sofa with his shabby-chic size-9 vellies up, while attentively listening and chatting to a visiting client, so do stop in for some therapy if you find yourself in the neighbourhood. Longtime readers will already know this, but Granate's door at the Mill will always be open for our clients, during the good times, the not-so-good times, and the bad times.

And finally, if you ever catch us being dogmatic, complacent or too arrogant to think where we could be wrong – then it is no longer a transitory issue and we need to be called out. We invite you to do so.

Why did we start this commentary with some of the wit and wisdom of Joseph Heller? *Catch-22* is a superb book, packed with humour and lessons about how people in the army follow process without independent thought. Watching peers could result in us following the herd and thereby failing to offer our clients something uniquely good. However, if we don't think about what our peers are thinking about, we could be naïve and offer our clients something uniquely poor. Catch-22. Our response to this delicate balance is to relish original and independent thought. Join us at our coffee machine if you want to chat gold or just to have a golden chat.

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**.