Inactive *asset management*

For us to invest our clients' money in a company, we interrogate that company on our four qualitative pillars of Governance, Management, Balance Sheet and Sustainability of Cashflow. We set the hurdle high, which means that most companies don't make it to the next stage of ascertaining if buying that company introduces the risk of overpaying.

by Alex Dearman

Diversification is more than a numbers game

In the context of the South African market, which is already narrow by global standards, this distils the investment universe down quite considerably. If you consider the Granate BCI Balanced Fund, we are invested in 14 South African listed companies (including property REITS) and 22 global listed companies (also including property REITS). Great investment opportunities are scarce, so we have to work hard to identify them. If we were to sprinkle in less desirable ones, it would be like adding cayenne pepper to a kid's ice-cream. In essence, we would be decreasing the odds of a desirable outcome.

This concept is beautifully articulated by an investor we have a lot of respect for, Nick Sleep. *"The church of diversification, in whose pews the professional fund management industry sits, proposes many holdings....we would propose that if knowledge is a source of value added, and few things can be known for sure, then it logically follows that owning more stocks, does not lower risk but raises it."*

This does not mean that we disregard diversification. Making sure that our portfolios can benefit from a wide range of economic drivers is a critical aspect of our process. What we *are* saying is that diversification is not a numbers game.

Choosing what to sell is just as important as choosing what to buy

Our equity holdings can currently be segmented into three broad categories:

1. Individual companies that pass our hurdles and are priced pessimistically by the market (e.g., Nedbank, KAL Group, British American Tobacco and AIA Group.

2. Companies that pass our hurdles within a cyclical industry that we think has reached the bottom of its down cycle (e.g., our property exposure).

3. Companies that are exceptional when measured against our hurdles, are on a structural growth vector and have a significant competitive advantage (e.g., TSMC, Capitec, OUTsurance and Microsoft).

Our sell discipline will be sensitive to valuation measures for the first two categories. It's possible that valuation alone may result in us exiting these shares. This is less likely to be the case for companies in the third category. It's not to say we disregard valuation altogether; we are not aware of anyone fond of paying more for something than it's worth. What is a more likely scenario, however, is that we reduce the weighting very gradually, for example by allocating fewer inflows to that company. Often there will be an opportunity to increase that exposure again on the back of a share price decline. To once again borrow the words of Nick Sleep: *"…to invest is to buy shares in great businesses at a reasonable price and let the business grow. This appears to require just one decision (to buy the shares) but, in reality, it requires daily decisions not to sell the shares as well! Almost no one does this, in part because it requires patience."*

Take Capitec, for example (our largest equity position in the Granate BCI Balanced Fund and Granate BCI Flexible Fund). This is a company that has enormous growth potential and is run by an exceptional management team. Every day presents an opportunity to sell out of this position and lock in quite handsome profits for our investors. It's easy to justify selling if you place any predictive powers on high P/E ratios to the direction of a share price. In fact, it's very difficult to resist the urge to sell and to be inactive.

Deliberate inactivity

Below is an excerpt from a piece I wrote in 2021:

Let's imagine you had bought Capitec in August 2014, you would have paid R212 (P/E 11x). 8 months later the stock had more than doubled to R560 (P/E 22x). You could have been forgiven for selling at this level with handsome profits. But what would you have invested those profits into and how would that have performed? At what levels would you have bought Capitec again? Would you have waited for it to get back down to that original P/E 11x when you made all that money? Waiting for that perfect time to buy again would have been expensive. It has never been on a PE of 11x again. Granted, there have been opportunities to trade share price fluctuations, but we don't have predicative skills in determining the random journey of share prices. Today the share price is R1 900 at a whopping PE ratio of 49x. Our investment case remains the same and their opportunity to grow continues to improve. If Capitec continue to implement their strategy, selling out today could be as damaging as selling back in 2015. We believe the best action we can take in this instance is inaction.

Capitec's share price is R3 326 at the time of writing this (with a P/E of 28x). Resisting the urge to sell out of this exceptional company and be a little inactive has served our investors well.

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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**.

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