January 2020

Blue Sky Investing

As investors we are trained to be conservative ("there are no free lunches"), to expect less in future ("markets mean revert") and to avoid the hype of the moment ("this time it's different"). This conservative mindset underpins an industry which has the responsibility of managing other people's money. Could it be though, that this conservative mindset is a net cost to the same investors we are aiming to serve? Are we overly conservative in our assessment of investment opportunities, and do we overestimate the risks because of our own biases?

The early 'founders' of modern investing – the likes of Benjamin Graham and David Dodd – put forward a sensible approach, premised on "not overpaying". This lies at the heart of a valuation-based approach, common amongst most investment managers globally. This approach is useful in the case where a company's prospects are reasonably known, its operating costs established and its profit margins observable through analysis over long periods. The Graham and Dodd approach encouraged diligent fundamental analysis. Investors would then do well to buy those shares which were undervalued and sell those which became overvalued.

If diligent analysis is required, then this also assumes a company and the industry in which it operates are broadly understood. What happens then, where a company or industry is entirely new and is set to disrupt the status quo going forward? Where these companies have the potential to put the long-standing companies from the Graham and Dodd world entirely out of business, to grow to become future leaders?

This segment of the share market – your "blue sky" investment opportunities - is where we focus our attention to now. Research by Hendrik Bessembinder[1] highlights that just 4% of shares ever listed in the US have created all of stock market wealth; and just 90 companies out of over 24,000 listed since 1925 have created half of all wealth. The number of truly successful companies is simply very small over time.

There are two significant examples of 'blue sky' investing, both coming out of the US over the past 20 or so years. The first is Amazon, founded by Jeff Bezos and initially displacing Barnes and Noble as the leading retailer of books. Today Amazon's business model enables it to target an ever-increasing spread of industries as the world of ecommerce becomes broadly accepted.

Then in 2003, a business called Tesla was founded by Martin Eberhard and Marc Tarpenning with the primary initial investor being Elon Musk. Originally setup to manufacture electric cars, it now has its sight set on all forms of mobility, powered by electric energy rather than fossil fuels.

With Tesla reporting profit for the first time in late 2019, the share price has responded by increasing over 400% since June 2019. As a result, Musk may now qualify for a payday of over $346m (given he takes no salary, and is paid entirely in shares should the company reach its ambitious targets).

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So, do investors rejoice in the fact that the potential for this company to start disrupting the worlds largest automakers is starting to bear fruit? Well for the most part, they don't. And they don't because Tesla is not a share favoured by most investors, so they don't hold it. The following attributes provide some insight as to why Tesla is not a widely held share in investor portfolios:

- The business had not made a full year profit, ever.
- No dividends have ever been paid
- Debt levels are high and climbing (peaking at 80% of total business value)
- Productions targets have consistently been missed

Typically, these traits would be a no-go zone for most investors. After all, as Graham and Dodd would likely attest, how do you perform diligent research when its not possible to observe any reasonable financial outcome for the business, and you don't even know what their target market looks like over the next ten years? Tesla has one of the highest 'short interests'[2], indicating most investors think the share is wildly overvalued.

Why is it so difficult to invest in shares like these, foregoing the blue-sky opportunities for investors? We provide some reasons below.

1. You don't know what you are buying

Firstly, as an investor, you are not buying established businesses with an observable business model that is easy to value. You are buying businesses that are generally early in their business cycle, are disrupting incumbents and driving new business models, have no established market as they are often creating new markets (think Apple and iPods, Facebook and social media, Netflix and online streaming), don't know their client base yet, are often making a loss and have very little foresight of margins. You are buying an idea or dream, often with a visionary leader leading the charge.

2. Very few companies are successful

Secondly, the nature of these 'high-risk startups' means that failure rates are high, so the selection is very important. A study performed in the US between the period 2008 to 2018, tracked 1119 US tech startups that received seed funding between 2008 – 2010. The study found that by the end of 2018, 67% of those companies had failed and less than 1% had become 'unicorns' (a market cap of over $1bn)[3]. Some of these companies are the most-hyped tech companies of the decade, including Uber, Airbnb, Slack, Stripe, and Docker. It is not surprising then that the behavioural bias of risk aversion is hard for managers. No one wants to be the fund manager who has a share go to zero.

3. You need be a long-term investor

Lastly, the nature of these businesses, the stage of their business cycle when you generally first invest, and the fact that selection is so important means that once you choose to invest you need to be invested for the long term. It may take years for the business model of these businesses to materialize. This can be challenging, and often further capital investments will be needed as the company requires funding. Leaders also require guidance (or removal, as in the case of Uber's Travis Kalanick). If we use Tesla as an example again, shareholders have been tested over the past few years, not only with uncertainties about the business model but also by some of the statements and behaviour of Musk himself.

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So why do traditional investors miss these opportunities?

Traditional active investors can be separated into two broad investor types, 'quality' and 'value' investors.

Quality investors are generally looking for businesses which are well built, have strong market positions, a stable client base and a defendable long-term product or service. They look for businesses that have a demonstrable business model and are performing well. They want to see reliable earnings and margins, and determine, with a certain degree of comfort, what a business will look like in five years. They are not too concerned with the price they are paying if the business is able to protect and grow its earnings above the market average.

Value investors are typically looking for established businesses which are at a cyclical low, or where a specific event has meant they are trading below their fair value.

The investment DNA of these investors will simply not allow them to invest in a share like Tesla where the blue-sky attributes don't provide the earnings power or margin of safety they seek.

For this reason, most investors will miss out on the opportunities presented by these high growth shares, rather accessing a broad spectrum of average to above average companies, trading within a close proximity to their fair value, leading to solid but not exceptional outcomes.

Comparison	Value Investors	Quality Investors	High Growth Investors
Shares they seek	Shares undergoing problems, which have lead to price declines	High quality businesses with strong barriers	Disruptive businesses growing new products or services
Typical Industry	Established, cyclical (energy, financial services, commodities)	Stable industries like consumer shares	Any industry, but a technology underpin is more dominant now
Business Maturity	Mature	Mature	Immature
Profit levels	Low relative to expected	Persistently high	Low or negative
Price or Value	Low relative to expected	Persistently high	Very high, for what appears as a loss making business.
Dividend Yield	Average	Average	Zero
CEO's	Mostly non-founders	Mostly non-founders	Often founder-lead.

What types of investors can capture this type of return?

We identify investors who get excited about businesses like Tesla, as growth investors. Growth investors at their core are trying to identify businesses where expected earnings growth is significantly higher than average in future and believe even an expensive price to pay is justified given the potential outcome. They are optimistic by nature as they make decisions with little or no sight on earnings or business model. They put a big emphasis on the 'what ifs' of an investment case. They are risk-taking rather than conservative as they ride the winners rather than sell them down and generally have a very low turnover of holdings.

They require a very deep level of research and insight into a business, particularly given the business is still finding its own growth path. Rather than research being focused on financial statements, they have a focus on emerging industries, changing behaviours and innovation to inform their views.

They also need to be comfortable making mistakes, as often they have more losers than winners in their portfolios. However, because of the types of businesses they are investing in (businesses that can grow to many multiples of their current size) the winners far

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outweigh the losers. Growth managers refer to this as asymmetric returns, where you can lose a maximum of 100% of your capital on the losers, but you can make back multiples of your capital on the winners. We can see an example of this in Figure 2, where we see Baillie Gifford's top and bottom stock returns for their Long-Term Global Growth Fund.[4]

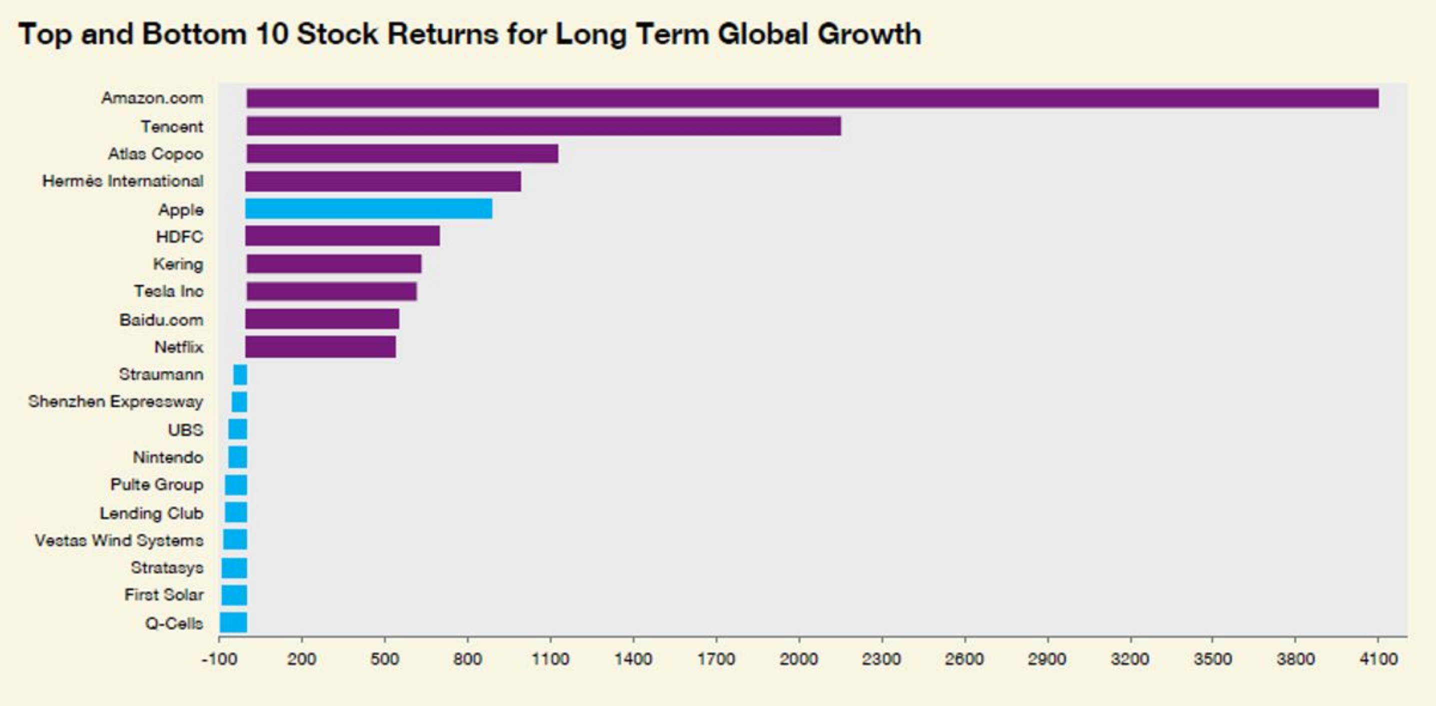

Figure 2: 10 Top and Bottom stock returns for Baillie Long-Term Global Growth Fund.

What should you expect from a Growth Manager's portfolio?

The risk in these portfolios should be clear by now. There is a high failure rate in the pool of companies they are investing in, and the concentration risk is high as a large portion of the portfolio returns are generated by few holdings. Often the businesses in the portfolios are still driven by their founders and there is significant key man risk. How much of Tesla's success is due to Musk, or what does Amazon look like without Jeff Bezos? Because of this, investors in these funds should expect higher real returns with bigger drawdowns and more volatility. Moreover, there are very few professional investment managers offering this sort of portfolio, given the career and business risks attached.

In our efforts to ensure our clients are fully exposed to the full range of investment opportunities in the market, we seek out managers who can deliver on this sort of potential, to complement their overall portfolio. To invest successfully, we also need to come to terms with our own behavioural biases, and cast our perspective wider than the more conservative stance which pervades our industry.

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[1] Do Stocks Outperform Treasury Bills, 2017.

[2] Short sellers bet on, and profit from, a drop in a share's price. Therefore, if an investor believes the share price of a company will decrease in the future they will 'short sell' that share.

[3] CB Insights

[4] This fund is a good example of a blue-sky growth fund.

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31 January 2020

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.3%	-1.7%	7.1%	5.3%	5.0%	11.0%	11.5%	11.8%
FTSE/JSE SA Listed Property	ZAR	-4.3%	-3.1%	-9.5%	-5.2%	-0.8%	10.5%	13.1%	13.4%
SA All Bond Index (ALBI)	ZAR	3.3%	1.2%	8.5%	9.3%	6.7%	9.0%	7.0%	6.9%
SA Cash Index (SteFI)	ZAR	1.7%	0.6%	7.3%	7.4%	7.2%	6.5%	0.1%	0.2%
Balanced Benchmark	ZAR	0.9%	0.7%	10.7%	7.4%	6.9%	11.4%	7.5%	7.4%
SA Inflation (1 month lag)	ZAR	0.4%	0.3%	4.0%	4.4%	5.0%	5.1%	1.2%	1.2%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	5.3%	-0.6%	18.4%	12.1%	9.6%	10.5%	11.6%	12.9%
Emerging Markets Equity (Datastream EM)	USD	2.4%	-4.7%	4.2%	8.3%	4.9%	4.1%	16.0%	17.1%
Global Property	USD	0.6%	1.0%	13.2%	10.7%	6.5%	10.3%	11.2%	13.7%
Global Bonds (Barclays Global Bond Index)	USD	0.7%	1.6%	6.1%	4.3%	2.4%	2.0%	5.4%	5.3%
Global Cash	USD	0.5%	0.2%	2.3%	2.0%	1.4%	0.9%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.3%	-1.7%	7.1%	5.3%	5.0%	11.0%	11.5%	11.8%
Global Equity (Datastream World)	ZAR	4.9%	6.6%	33.8%	16.1%	15.3%	18.3%	15.7%	14.0%
Emerging Markets Equity (Datastream EM)	ZAR	1.9%	2.3%	17.8%	12.2%	10.3%	11.5%	13.7%	12.7%
Global Property	ZAR	0.2%	8.3%	28.0%	14.7%	12.1%	18.2%	16.1%	13.9%
SA All Bond Index (ALBI)	ZAR	3.3%	1.2%	8.5%	9.3%	6.7%	9.0%	7.0%	6.9%
Global Bonds (Citigroup)	ZAR	0.3%	9.0%	20.0%	8.1%	7.8%	9.3%	15.5%	14.2%
COMMODITIES									
Gold (US Dollars)	USD	5.1%	4.4%	20.0%	9.4%	4.5%	4.0%	13.0%	15.8%
Gold (Rands)	ZAR	4.6%	11.9%	35.6%	13.4%	10.0%	11.3%		
CURRENCIES									
Rand / Dollar	ZAR	0.4%	-7.3%	-13.0%	-3.6%	-5.2%	-7.1%	16.1%	15.3%
Rand / GBP Pound	ZAR	-1.4%	-6.7%	-13.3%	-5.2%	-2.5%	-5.0%	16.8%	14.7%
Rand / Euro	ZAR	1.1%	-5.9%	-9.2%	-4.5%	-4.8%	-4.7%	14.8%	13.5%

Spot Rates		31-Jan-20	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	15.00	13.98	13.27	11.63	7.55	6.31
Rand/GBP	Rand	19.76	18.55	17.44	17.47	12.09	10.23
Rand/EUR	Rand	16.62	15.70	15.23	13.13	10.49	6.17
RATES							
Libor 6m $	US$	1.75	1.91	2.80	0.36	0.38	6.29
Repo Rate	Rand	6.25	6.50	6.75	5.75	7.00	11.75
Prime	Rand	9.75	10.00	10.25	9.25	10.50	15.50
All Bond Index Yield	Rand	9.50	9.55	9.36	7.38	9.12	9.74
COMMODITIES							
Gold ($/oz)	US$	1,586.70	1,520.50	1,322.59	1,273.24	1,077.85	283.05
Platinum	US$	959.00	971.00	821.00	1,221.00	1,512.00	495.00
Oil (Brent Crude) $	US$	58.23	66.31	62.28	48.04	71.79	26.91
INFLATION							
SA Inflation	%	4.0	4.0	4.0	4.5	6.1	9.4

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