REFOCUS

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This document describes our thinking behind selected recent portfolio management actions in our portfolios and provides context to their current positioning against the backdrop of their investment opportunity set. Our funds always consist of a diversified portfolio of opportunities and risks; please bear that in mind when evaluating our commentary about individual positions.

BAD BLOOD

In the town of Newmarket in the UK, often referred to as the headquarters of British horseracing, stands a statue of a horse. It might surprise many, given the town's reputation in horseracing, to find that the sculpture is not that of a racehorse, but of a stallion instead. For although the public is more interested in racing than it is in breeding, it is in breeding that the true money lies. A champion racehorse can earn millions in prize money, but make multiples of that at stud. Horseracing is in fact an adjunct to a multinational, multibillion-dollar breeding industry. The races merely serve as a vehicle to establish which horses are the best to breed from.

Horse owners go to great lengths to identify and develop strong bloodlines. A whole industry around the "science" of performance has developed, with expensive research into the likely genetic composition of a good racehorse easily funded. Owners will spend a great deal of money on so-called "experts" to pick horses for stud purposes. All this science and expertise serves to legitimize certain breeding choices. In short, no money is spared in the pursuit of horses with "good blood" – i.e. a strong bloodline that will produce winning racehorses.

But in practice there is no guarantee that great racehorses produce other great racehorses. In fact, a sire is generally deemed to be a success if 6% of his progeny do well at the track. It might as well be a random process. It seems "bad blood" is a lot more prevalent than the "science" would have us believe!

This element of chance, however, means every breeder can dream. The human condition is such that even a small outside chance of great wealth will attract many punters - especially if that chance is dressed up to look like science, backed by the views of experts.
Recently, one of the foremost racehorse owners in South Africa hit the headlines for all the wrong reasons. It turned out that the company he had built up through multiple acquisitions may actually be a fraud. Investors are struggling to reconcile the company they thought they knew and invested in – Steinhoff - with what they are reading in the newspapers today. How could they have been fooled so easily? What happened to all the "science" and the "experts" that helped inform their decision to invest in Steinhoff? Was it "bad blood" all along?

Interestingly, this turn of events coincided with the release of a book by journalist John Carryrou titled "Bad Blood: Secrets and Lies in a Silicon Valley Startup" about the fraud at a Silicon Valley "unicorn" called Theranos. Theranos, under the leadership of founder Elizabeth Holmes, was founded on the technological promise that they had come up with revolutionary handheld devices that could glean vital health information from a small drop of blood. In the end, this turned out to be a lie, carefully covered up with conspiracies and smoke screens. The devices could not back up the hype. The technological promise was a MacGuffin, only there to advance the interests of the conspirators, having no actual substance.

A reading of the book can help us understand what happened at Steinhoff, with some obvious parallels.

In the book, Carryrou describes Holmes as "very intelligent, with heaps of charm and charisma". Also, "Elizabeth's biggest trick was that she wrapped older men with great reputations around her finger". She was able to tell investors exactly what they wanted to hear – "we've invented a great new thing, which will make you very rich" - and then get them to suspend their disbelief by being very persuasive.

If all this sounds familiar, it corresponds closely to the way Markus Jooste, the founder and ex-CEO of Steinhoff, operated. Like Holmes, Jooste has latterly been described as the ultimate con artist. However, the best conmen understand full well that the trick is to sell what their targets want (or at least what they think they want). What Jooste was selling was many South Africans' dream – excitement, capital flight, tax arbitrage - all backed up by the MacGuffin of "supply chain excellence".

This excitement came in the form of a company that made serial acquisitions. Despite decades of evidence that large scale acquisitive activity generally destroys shareholder value, companies that do lots of (large) deals are often regarded as "sexy" by the market. Over the last decade Steinhoff managed to grow their revenue by 22% p.a., and their net profit by 25% p.a. This was achieved through an aggressive acquisition strategy, often paying over the odds for their target companies. This strategy was funded by massive equity and debt issuance. Their equity base increased from R25bn in 2008 to R254bn in 2016, an annual growth rate of 33%. Gross debt also grew rapidly from R17bn to R129bn, an annual growth rate of almost 30%. The more debt and equity Steinhoff issued, the more the market applauded them, and asked for more. Instead of the increased levels of due diligence that should normally accompany such frenetic activity, it seems the "excitement of the deal", coupled with an incessant promotion of their MacGuffin by the protagonists, caused the market to suspend its disbelief and relax its underwriting standards.

Of course, the rapid increase in equity issuance also caused Steinhoff to become a larger part of the index, which in turn created forced buying in itself, but that's a different story.

Research has proven that South Africans are consistently too negative about South Africa – it's been proven that we believe things to be worse than they actually are in reality. In Ipsos's Perils of Perception 2017 survey (See: https://www.ipsos.com/ipsos-mori/en-uk/perils-perception-2017), South Africa ranked as the most needlessly pessimistic nation out of 38 countries. This unnecessary pessimism regarding our local situation may explain why local investors may systematically relax their underwriting standards when it comes to offshore investments, empowering unscrupulous salespeople to create products which can be sold quickly and easily, with little regard to future investment prospects. When Steinhoff's listing was moved to Europe, Jooste effectively took full advantage of this inherent bias, with investors cheering him on. Of course, the fact that these same investors now want to sue the company for "misrepresentation" is somewhat ironic.

Over the past few years, South Africa has become one of the most heavily taxed countries in the world. Personal income tax rates top out at 45%, while corporates are taxed at a relatively high (by global standards) 28%. CGT has also been ratcheted up over the years to where it is now in excess of 20%. Since 2017, dividends have been taxed at 20%. Even VAT was increased to 15% in this year's budget. It should come as no surprise that South Africans increasingly view minimizing their tax burden as a national sport. Equally, anyone promoting a tax efficient investment vehicle is likely to get a lot of support from the market. Steinhoff provided tax-efficient investing in spades, with their tax rate averaging around 15% for the 10 years from 2006.

It is clear that Jooste played the game very well – he sold what the market wanted, and in the process fooled even the smartest investors. And the worst part of it was that it was incredibly difficult to pick up in the numbers alone. Changing year-ends and listing jurisdictions all served to obfuscate. But in the end, as investors, we need to use the Steinhoff story as a learning opportunity.

We have tried to summarize what we believe to be the main learnings. There are probably more, which even greater reflection will uncover, but for now these are the most pertinent for us:

1. In the wake of the Steinhoff debacle, accountants, regulators and even fund managers are imposing increasingly Draconian rules and corporate governance standards. At RECM we think it is better to understand why it happened, and learn from that instead. The reason it happened wasn't a poor regulatory environment. Instead, the alleged fraud happened due to a strong appeal to incentives which caused otherwise smart people to suspend their disbelief. No amount of regulatory intervention will ever be able to eradicate incentive-caused bias.
2. As analysts, it pays to understand not only the numbers that represent the activities of a business, but also the human beings behind the companies. Who are they, what are their reputations, and what are their incentives? These soft issues are as important - if not more important - than the hard numbers.
3. Never ignore the outside view. Our tendency as humans is to favour the inside view. The inside view considers a problem by focusing on the specific situation and making predictions based on that narrow and unique set of inputs. The outside view asks if there are similar situations that provide a statistical basis for making a decision, and if so, what happened? If many corporate disasters are preceded by frenetic acquisitive activity, why would this instance be different? If there are red flags being waved that have indicated fraud in other instances, why did we ignore them this time? We tend not to embrace the inside view as it necessitates throwing out our own cherished findings. But we agree with Michael Mouboussin when he says: "The main lesson from the inside-outside view is that while decision makers tend to dwell on uniqueness, the best decisions often derive from sameness…There is a wealth of useful information based on situations that are similar to the ones that we face every day. We ignore that information to our own detriment. "

Investors can behave like gullible racehorse owners, chasing a dream based on false science or the advice of highly paid "experts" with no skin in the game. Alternatively, they can apply good doses of common sense and judge a situation by the facts at hand - facts that are not shaped by a good story, but by cold hard reality.

To achieve this, it is essential to develop a sensible investment process, and to stick to it.

A good investment process helps distinguish between reality and a rose-tinted representation of what one wants to see. Even the most astute of investors may be blindsided by rogue operators, and suffer losses along the way. A good process will help minimize those losses when (not if) they happen.