Owner's Manual

Is Knysna Capital a suitable partner for me?

Knysna Capital aspires to generate long-term returns that make a meaningful difference by investing in under-appreciated listed companies with a business-owner approach. Unfortunately, medium-term returns are likely to be volatile and different from benchmarks. Hence a partnership with Knysna is not suitable for investors who do not have a 10-year horizon or who cannot stomach significant drawdowns.

What is your competitive advantage?

When considering an investment in a company, one of the most important considerations is the extent to which it has developed a sustainable competitive advantage. Companies without a competitive advantage may earn a good return for a short period but given the competitive nature of capitalism they cannot earn attractive returns in the long-run.

As a current or potential client you may rightfully ask: "What is the competitive advantage that will allow you to earn a good return for clients in the long-run?" There are so many fund managers and surely good investment ideas can be copied?

Our primary advantage comes from focusing all aspects of our business to enable Knysna Capital to be a **Rational Long-Term Business Owner**

This sounds straightforward and easy to copy but at the same time has proven to be extremely hard since only 19% of active funds outperformed Vanguard's equivalent passive strategies for the 10 years to December 2020. Below we explore the three terms in more detail:

Rational

As humans we are simply not as rational as we would like to think. If greed and fear could lead Newton to lose a fortune in the South Sea bubble and "inconsistency avoidance" could cause Einstein to reject the full implications of quantum mechanics later in his life, then we as mere mortals need to be careful!

To mitigate the pitfalls of human psychology, Knysna Capital makes use of an "Evidence-Based" investment philosophy. This aims to achieve:

- Intellectual honesty that avoids overconfidence
- A higher bar to clear before making decisions removes the impact of short term emotions
- A de-emphasis of opinions, however hard this may be:
    - Focus on facts and reasoning makes decisions less subjective
    - It is easier to change your mind if you have not committed to an opinion but rather dispassionately reconsider evidence and reasoning
    - We aim to regularly challenge our own understanding of how the world works
- A willingness to own companies that fall outside mainstream ESG parameters assuming this is backed up by sufficient evidence and reasoning (see ESG below)

- Despite a long-term mindset we will not hold on to an asset if a better opportunity exists

We also strive to communicate in a way that helps us to be rational:

- Transparency is good for everyone:
    - Create realistic expectations from clients that avoids disappointment
    - Talking about mistakes ensures lessons are learned and we stay humble
- Avoid communicating too often
    - Stock price movements overwhelm changes in the underlying business at most times which can cause one to confuse present day news with what is important in the long-run
    - Discussing short-term movements with clients makes it harder to change our opinion when later facts or improved reasoning arrives
- We are not willing to box ourselves into a particular style ("value", "growth" or "quality"), sector or geography. Boxing yourself in can lead to irrational decisions in the future when, for example, all "value" shares are junk, all "growth" shares are unsustainable or all "quality" shares are overpriced

Long-Term

The necessary consequence of a stock market that offers good long-term investment opportunities is that medium-term price movements are unpredictable. For example: Berkshire Hathaway, Amazon and Tencent shareholders averaged 37% p.a. returns in the long-run but endured a greater than 25% share price decline once every 4 years on average (Amazon's share price declined 94% between 1999 and 2001!). Hence we strive to attract a client base that affords us the luxury of having a long-term focus.

Being fully invested alongside clients enhances alignment since it creates a preference for returns over size. Hence, when presented with a scenario where client assets exceeds investment opportunities we are more likely to close to new investment or actively reduce assets (by returning capital to investors) to retain attractive return opportunities. Many asset managers attract substantial inflows after generating attractive returns. This is often followed by mediocre performance when a large asset base makes it hard to add value. Sometimes poor performance at scale wipes out good initial returns leaving most clients with a disappointing outcome.

When considering ESG issues we focus on the direction of long-term improvement rather than which companies look the best in the near-term (See ESG below)

Business Owner

Given that the stock market is open to trade it is tempting to think of an investment as an instrument that can be sold at a higher price in the near term by predicting changes in investor sentiment. An owner mindset protects you from short-term thinking and focusses the evidence and reasoning on the most important business issues. It also encourages delving deeper than superficial income statement and balance sheet numbers:

- Are the managers honest and competent?
- Will company culture help/hurt?
- Will technology help/hurt?
- Will capital allocation decisions help/hurt?
- Is the competitive advantage likely to grow or shrink?

How do you approach Environmental, Social and Governance (ESG)?

Our society is increasingly aware of the impact that businesses have on people and their environment and the role that responsible ownership can play in making the world a better place. That said, asset management gatekeepers[1] are still exploring practical ways to hold asset managers accountable for their role in this process.

Like most new paradigms, a shortcut approach is most tempting initially. In ESG today the shortcut options result in institutional asset managers avoiding "hot topic" industries because of explicit exclusion lists or implicit pressure when discussing their portfolios. This has counterproductive consequences in new shareholders that are less likely to be responsible owners and potential underinvestment by companies which could lead to shortages of commodities and unhappy consumers.

Cultivating a client base that understand what we do and have a long-term horizon combined with our evidence-based philosophy uniquely positions Knysna Capital to navigate ESG issues. Instead of employing exclusion lists or carbon limits we acknowledge that the world is imperfect and it is not easy to judge the morality of a corporate entity. In fact, there are no morally perfect companies that we are aware of.

Instead of judging absolute impact we consider the direction of improvement to be important within the context of what is possible. The direction of improvement holds various advantages relative to an absolute measurement:

- The base indicates what you inherit where direction shows intent/execution from an organization
- The potential improvement from a high impact base is most significant
- Inheriting a low impact base should not exempt an organization from striving for improvement

At scale we believe this encourages companies to avoid shortcuts and rewards management teams that are acting in the best long-term interest of society. For example, consider cement. Producing cement is a carbon intensive process since converting limestone to cement will always release carbon dioxide from the chemical reaction ($CaCO_3$ -> $CaCO + CO_2$). Cement is a critical part of modern infrastructure and many companies indirectly depend on cement to function and there may not be substitutes in the near term future. Instead of not owning any cement company as part of our investment process we would consider a cement company's track record and future plans to assess how this will directionally impact the environment and shareholders. If an environmentally friendly substitute is being commercialized improvement may not be sufficient to justify an investment.

Interestingly, the stock market currently rewards this approach by offering "hot topic" companies at prices that reward long-term shareholders like us.

[1] Pension fund asset consultants and Financial Advisors that interact with asset mangers on behalf of clients