

10 November 2022

Dear Co-Investor

<i>Period</i>	<i>Return</i>
2020 (starting 11 November 2020)	+3.42%
2021	+18.09%
2022	
*** 1Q	-22.50%
*** 2Q	-1.21%
*** 3Q	-10.10%

Having been through a few bear markets over our careers, one never gets used to market drawdowns. In Hollywood they say, "you're *only as good as your last performance*". In investment management: you're only good as your last year! In the current environment, investment managers are living by their last quarter.

However, what has been particularly inspiring is that despite the market downturn our cumulative redemptions are a mere basis points of the fund.

If we have done our job of evaluating our investment opportunities correctly, it can be argued that our fund's price-to-value ratio has been meaningfully lowered - implying salivating deferred returns in years to come.

In a bear market, as participants get more fearful, their focus naturally defers to short-term outcomes: The common adage "*a bird in hand is worth more than two in the bush*" comes to mind.

At SaltLight, we try to regulate our behaviours to be more thoughtful and disciplined to focus on long-term outcomes.

We set our investment process to what the world could look like in 2028. We are more concerned with the '*two birds in the bush*' so to speak. And then extending the adage further: *what is the price implying to catch these plump birds*.

The challenge with the modern-day investment vehicle is that every night, our fund's value is recalculated to the market price of the underlying securities. These prices are capturing what market participants believe now about various economic and political factors. Factors that we think are mostly unpredictable in a complex adaptive system like an economy.

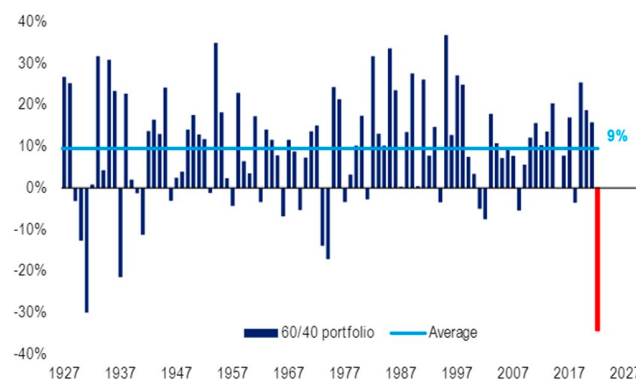
Prices can reflect the popularity of an idea or the fear of the unknown. They can also reflect technical factors such as illiquidity or forced sales. The consequence is that our daily fund price will reflect that fear or exuberance of the day.

If one had to wake up today and look at the current climate, the world's prospects look gloomy. Crisis upon crisis is causing significant disruptions. We do not know how our peers sleep at night playing the short-term game to dissect, analyse and anticipate how to trade these events. It is therefore imperative that one focuses on the underlying value of a business. A pessimistic view sounds smart at this moment however optimism generally wins over years of compounding.

Here is a small taste of what is going on:

- **Rapid currency moves:** (just take the trade-weighted dollar that is up c18% this year). The Dollar strength is a large ship that leaves a long wake. Japan is intervening in its currency. The UK is intervening in their pension funds. Usually, when these kinds of moves happen, a sovereign debt crisis rears its head.
- **Fastest rise in interest rates in four decades** (the average US 30-year mortgage payment has gone up 44% since the beginning of the year). Energy, inflation and rising interest rates are swallowing any disposable income.
- **Nowhere to hide:** This environment has offered few 'safe' asset classes. Equities have been tough (MSCI All World down c. -26%, S&P 500 c. -25%, NASDAQ c. -33%). Bonds (on a risk-adjusted basis) have been catastrophic, gold has been lacklustre (+1%), and commodities are rolling over.
- **Pension fund dislocation:** In many markets, the standard pension portfolio allocation has had its worst return in the last 100 years.

Chart 3: "60/40" portfolio ann. worst YTD return in past 100 years
Annual 60/40 portfolio performance



Source: BofA Global Investment Strategy, Global Financial Data, 2022 is YTD annualized

BofA GLOBAL RESEARCH

- **ZAR Depreciation:** If you're a South African investor, our market appears to have weathered the storm rather well. However, much of this has been disguised by the depreciating ZAR (-12%) and the fact that SA started on a poor-performing base already.

Our Portfolio

We commonly receive questions about why our portfolio does not seem to move in line with general benchmarks and the simple answer is that our portfolio is not constructed like any benchmark.

We own a portfolio of 28 businesses whereas most of our peers run a portfolio of constituents in a benchmark (for example the MSCI All Countries World Index has 1,511 companies!¹). Our peers attempt to engender 'alpha' through under or over-weight positioning in these companies relative to the benchmark. Broadly, their portfolios will not materially deviate from the benchmark.

This method of construction is helpful if one wanted to obtain average performance close to a benchmark (and to hold on to investor capital and associated fees!), but it is a terribly difficult way to generate significantly better returns over the long term. In the case of the All-World Index – there are 1,511 decisions to make and get right. Many would argue that after fees, these funds underperform, and the average investor would be better off simply buying a passive ETF.

With a more concentrated portfolio of businesses, portfolio volatility can be higher, but volatility can be compensated with higher returns.

We wanted to comment on a few portfolio companies that are unlikely to be widely held but we believe are durable and indispensable businesses in their domains:

- **Karoo0000**, a large weighting, is a victim of illiquidity. Karoo0000 is 80% held by the founder and over the last quarter, a mere 1.8% of its total shares outstanding have traded.

Due to the low free float, the benchmark index rules down-weight its benchmark representation to the point that our data shows only one ETF holds it. It is unlikely that our 'benchmark-focused' peers would ever own this type of business.

This is unfortunate for them because Karoo0000 has very favourable business economics. Every year it earns a 25-30% return on net worth and gushes cash because it does not require substantial capital to earn an incremental dollar. Today, it has around R1bn of cash on hand and should grow at 15% in tough years and 25% in good years.

Yet, Karoo0000 is down 36% this year and we certainly can't point a finger at business fundamentals to explain it.

We suspect that a few shareholders are forced to get out for whatever reason and there is a limited buyers pool for illiquid assets. In an orderly market, we think that this business should be trading at a substantially higher value.

- We've spoken about **Brookfield Asset Management (BAM)** (down 32% YTD), our North American alternative asset manager in our [1Q22](#) and [2Q22](#) letters extensively. Rising interest rates will likely adjust some portfolio valuations however offsetting this is that Brookfield is positively exposed to inflationary assets. Management held an investor day last quarter and upgraded their five-year targets.

The spin-off transaction will be completed in the next month, and we'll start to receive back some enviable cash flow. The spun-off manager will likely trade at a 6%-8% yield on distributable earnings and given the growth in the underlying asset management business, this could grow at c. 12-15% per

¹ Source: MSCI, [link](#)

annum. 81% of Brookfield's funds are perpetual or greater than ten years in duration, which means that the base revenues are recurring to at least 2032.

We think that there will be many more opportunities for BAM in the 're-shoring' of key industries like the recent \$15bn Intel Fab funding deal². Few private equity funds can invest these kinds of sums in one deal and over-indebted sovereign balance sheets are unlikely to offer much support. This leaves a wide opportunity for scaled investment managers like Brookfield.

- In South Africa, we own **Brait Exchangeable Bonds**. These are essentially convertible bonds into Brait equity with an attractive risk/reward profile where we should lose very little should things not go to plan, but we'll receive equity-like returns on the discounted Brait NAV³ should management successfully unwind the group.

These bonds are appealing because they were designed to be in a very favourable position in the cash flow waterfall. Virgin Active has been recently recapitalised which has significantly reduced the principal repayment risk in the Brait holding company structure. We're waiting for the Premier IPO that is expected to be launched when markets settle down and we should start to see more management activity to unwind the Brait discount.

This instrument is another off-benchmark, illiquid asset but is a very attractive instrument to own for the patient holder.

- Despite the economic slowdown in developed markets, our Latin American investment in **MercadoLibre (MELI)** had another outstanding third quarter growing revenues by 61% on a USD FX-neutral basis (GMV +32% FXN). Despite this strong growth, it also managed to expand operating profit margins to 11% (compare this to Amazon which is struggling to make a profit in its retail business).

LatAm's e-commerce penetration is still very low compared to Asia and developed markets. MELI is mostly a marketplace but has also adopted models from elsewhere. In the recent past, it has built 3rd party seller infrastructure that has made Amazon so successful, and it is also heavily investing in a mobile-based fintech infrastructure very similar to ANT Group in China. After only launching a couple of quarters ago, their advertising business is already at 1.3% of Gross Merchandise Value.

Why LatAm? It is a highly attractive market for marketplace business models. The average 'take rate' on GMV is around 15%-17% compared to China where the hyper-competitive market averages 3-5%.

We have been highly impressed with management's strong execution despite challenging macroeconomic conditions in countries that most investors avoid (Argentina, Columbia, and Mexico). The business was born in Argentina and management has many battle scars navigating inflationary and currency pressures.

² Source: Intel Press Announcement Aug 2022, [link](#)

³ Net Asset Value

Now some of our investments have not gone according to plan (well...yet).

- Our portfolio investments in China (~10% of the portfolio) have been significant detractors to performance. The recent regulatory headwinds seem to have calmed down and on the current facts, we think there is a low probability of an imminent invasion in Taiwan. However, as always, we remain attentive to new facts as they emerge.

The Chinese Government's COVID-Zero policy has been the strongest blow to our investment thesis. We observe that every time COVID cases in a major city emerge, the share prices of our portfolio companies decline.

If we cast our minds beyond a few quarters, we cannot see how the Chinese government can keep the country locked up and maintain its national ambitions. Certainly, the economic toll of this policy will snowball and China's aspirations of being a global economic power will have to be deferred, or worse, abandoned.

Everything about this setback seems to us like a short-term obstacle rather than a structural reason to sell our investments.

Meanwhile, our portfolio companies are trading at historically low multiples. China sentiment is at an absolute rock bottom. If we apply some moderate probabilities of a policy change, we could see substantial investment returns in future years.

Amid the Downturn, What is Our plan?

Considering the new conditions and new facts, we have spent exhaustive time re-visiting the investment thesis for each portfolio company. Adjustments have been made where the thesis has not materialised, or the margin of safety is not enough to compensate for the world that we now live in. In some cases, we've found that the market is offering such a great opportunity that we have increased our investment at a superior price.

We have no conviction about the direction of the market. We don't believe one can consistently predict this with high accuracy.

We're relentlessly trying to ensure that we're investing for that longer time horizon - *the year 2028* - and not letting the short-term noise distract us.

We are not economists and macroeconomic specialists, but it appears to us that the markets have already done the heavy lifting of tightening conditions ahead of the central banks. At the time of writing, in the US, 10-year interest rates are already at c. 4%. This seems to have worked in bringing down inflation expectations: 1-Year expected inflation is under 3% and 10-year break-even inflation expectations are implying long-term inflation will settle back to around 2.5%⁴.

Amongst our peers, our contra-indicator is that universally everyone believes that the US market will still have some downside expectations and that China is perceived to be 'uninvestable'. This kind of ubiquitous outlook is antithetical to market bubble times where everyone believes that the good times will continue forever. Weekly data is

⁴ Source: *St Louis Fed, Federal Reserve Bank of Cleveland at end of October*

showing record bearish sentiment amongst investors and put options buying (for hedging the downside) is at elevated levels. We offer no prediction, but these kinds of conditions can often indicate exhaustion to the downside.

We would be concerned if US long-term interest rates had to go much higher, to say 6% because long-term inflation, is indeed, structurally higher at 4%. This bear-case scenario is predicated on geopolitical events, a significant financial crisis or a policy error by policymakers. Under this scenario, we could see more volatility, more fund liquidations and, consequently, deeper valuation declines.

Our portfolio of businesses is hand-picked, meticulously researched, and constructed with business-level resilience and optionality in mind. A high proportion of our portfolio companies are run by founders who have gone through many trials and tribulations to get their businesses to where they are. Their honed adaptability is what will drive future returns. Almost all have low debt, high levels of cash and are well positioned to consolidate their industries, take market share, or adapt to new opportunities.

As a reminder: our liquid worth is in this very same fund as yours and we share in these moments right alongside you.

We'd like to thank you for your persistent trust in us and look forward to the deferred returns in the coming years.

Warmly,

David Eborall

Portfolio Manager

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