

BAOBAB
GLOBAL FUND



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Results for period ending 31 Dec 2004		
<i>11 months (2 February 2004 - 31 Dec 2004)</i>	<i>Baobab</i>	<i>8.6%</i>
	<i>Net to investors</i>	<i>7.1%</i>
	<i>Index*</i>	<i>9.0%</i>
<i>7.7 years-compounded (22 April 1997 - 31 Dec 2004)</i>	<i>Investment officer</i>	<i>18.3%</i>
	<i>Index*</i>	<i>2.3%</i>
	<i>Current NAV</i>	<i>\$164.95</i>

**Weighted according to the percentage of our assets invested in those markets. Currently the index is made up of the S&P500, FTSE100, TSE300, Hang Seng and Dow Jones Commodities Index.*

"If the job has been correctly done when a common stock is purchased, the time to sell is - almost never" - Philip A Fischer

Letter to shareholders:

Baobab Global Fund delivered a 7.1% net return to investors in 2004 and ended the year with an audited NAV per share of **\$164.95**

The NAV is slightly higher than our preliminary number of \$164.83

I therefore delivered 18.3% net to my investors over the last 7.7 years. The 18.3% is an unaudited number.

Baobab is only one year old. However, I don't talk in terms of one year, since this story started 7 years ago. I'll explain in detail further on.

The aim of this letter is to report in a manner that leave us fully informed about *our* business, Baobab Global Fund. *Our* refers to everyone that works here, and all our investors that work hard to provide us with the capital that we invest. Everyone that works at Baobab or their families are investors so we are all in the same boat.

With this letter we not only try to convey the good news, but more importantly the bad.

Mistakes

1. Setting up Baobab took longer and used more resources than originally planned. It is a bit early to tell, but strong indications exist that this impacted our performance. There is a strong case to be made that we could have prepared better for setting up Baobab. However, Baobab is the first hedge fund in Botswana so there was not exactly a roadmap to go by.
2. I went 'comfortably numb' in my investment thinking for a number of months. This is directly related to the problems mentioned in the previous point and was quite a convenient excuse for focussing on operating rather than investment issues. In this time I said to myself that 'the markets are too high', 'most other value investors are saying 'there is nothing out there', even Sir John Templeton is saying it is the most difficult investment climate he has seen in his lifetime and he is over 90. Somewhere towards the end of the year I sat down and said to myself that the issue is not whether the climate is difficult or not. The issue is when I get up in the morning, whether a suitable investment opportunity exists in our investment universe today and whether I will be able to find it. After I had this change of attitude we also happened to find a number of good investments.
3. Divestments have now moved to the mistakes column, because as a group it performed roughly on par with our portfolio over the last three years. We follow divestments for three years, because we put as much weight on the sell decisions as we do on the buy decisions. Very few of our peers report on this, but we find this exercise valuable. The

performance of the sell decisions are roughly 3% better than Baobab's over the last three years. Although this indicates that the buy decision was correct, we clearly have to rethink our selling strategy and improve on this performance.

Investment	Date Sold	Valuation at sale	Current valuation	Compound growth
Gap Inc (US)	3/2002	\$14.5bn	\$19bn	+9.4%
	We did not fully appreciate the company's debt load when we invested. The subsequent understanding of this and our 16.1% gain in four months prompted us to sell. Gap is very likely to do well over the long term. However, I felt uncomfortable with the debt load.			
ScS Upholstery	4/2002	£71.1m	£137.4m	36.2%
	We bought ScS Upholstery before we bought DFS Furniture. The two companies are similar. However, we think DFS Furniture is the superior company. Later, when we established a position in DFS Furniture we decided to sell ScS Upholstery.			
American Conversion Power (US)	5/2002	\$2.7bn	\$4.6bn	+21.8%
	We did not fully appreciate the company's stock option plan. The subsequent understanding of this and our 19.5% gain in 13 months prompted us to sell.			
Next Plc (UK)	7/2003	£2.5bn	£4bn	40%
	We thought it was overpriced at the time.			
Freeport Plc (UK)	7/2003	£124m	£146m	12%
	Workout that returned 22% in 1 ½ months.			
Progressive Insurance (US)	8/2003	\$13.5bn	\$17.8bn	21.8%
	We thought it was overpriced at the time.			
Rogers Raw Materials Fund	7/2004	\$1,484.00	\$1,593	7%
	This was closer to a workout than an investment. We thought it a better place to park our cash than cash itself, because it has an inflation hedge. If we were up when we needed the money then we'll take it, otherwise not. We were up 12% in 6 months at the time we needed the money.			
Fab Industries (US)	4/2004	\$18m	\$20m	11%
	Workout that returned 22% in 4 months.			
Clinton Cards (UK)	8/2004	£177m	£206m	16%
	Cash flow picture deteriorated. Therefore becoming overpriced			
DFS Furniture (UK), PizzaExpress (UK), Canary Wharf Group (UK) and Holmes Place (UK) have been taken private.				
Average				19.4%

Performance

The number we prefer to discuss is the 7.1%, because it is the only number that matters to the most important fraternity in our business, namely our investors. The 8.6% has its use, but the importance of gross performance numbers is rather overrated. It is akin to turnover in the business world. One cannot deny the importance of turnover, but management is more often than not sidetracked and chase turnover and market share at the expense of profits and cash.

Now, consider that a April 2001 Wall Street Journal Study found that 85% of fund managers did not outperform the market average over the preceding 25 years and that John Bogle later found that only 0.5% outperformed the market by more than 3%. If you consider what the market did over the 7.7 years that we have been investing then I appreciate why my peers prefer to talk about the gross numbers, which are on average quite shocking. If you look at the performance of the markets in which we operate, weighted according to the percentage of our portfolio invested in that market then you are looking at growth of just over 2% per annum. Considering the fat fees that are common in this industry then it tells me that there are extremely few investors that walked away with their capital let alone acceptable growth over this time. For Baobab, it is all about what our investors walk away with.

One of my oldest investors always reminds me to skip to the important part, which is the difference between the cheque he gave me and the cheque Baobab is going to write him. As far as he is concerned the rest is all detail.

Audited and unaudited numbers

I started out by investing my own money then family money and eventually friends of the family's money. In terms of operations, I started managing money out of personal accounts and eventually ended up with Baobab Global Fund, with a number of intermediate steps. The way I started and the intermediate steps are not a model for managing other people's money, but due to the closeness of the investors it was not a problem until it eventually became necessary to put a proper structure in place. That is how Baobab Global Fund came about. The point is that none of my numbers were ever audited until last year. For all practical purposes it is therefore possible that my long term track record, barring the last year's, is questionable. This is a challenge and will only be overcome by long term audited numbers that are not out of whack with the existing numbers. However, for the short term consider the following.

A turkey was chatting with a bull.

"I would love to be able to Get to the top of that tree," sighed the turkey, but I haven't got the energy."

"Well, why don't you nibble on my droppings?" replied the bull. "They're packed with nutrients."

The turkey pecked at a lump of dung and found that it gave him enough strength to reach the lowest branch of the tree.

The next day, after eating some more dung, he reached the second branch.

Finally after a fourth night, there he was proudly perched at the top of the tree.

Soon he was spotted by a farmer, who shot the turkey out of the tree.

Moral of the story: Bullshit might get you to the top, but it won't keep you there.

Baobab is unitized, which means that an investor bought into Baobab or the predecessor at a certain NAV and will eventually sell at an NAV, which is now audited. I believe it is quite impossible for me to end up with an NAV that has now been confirmed by an independent audit, if it was not in step with the 'return story' I have been spinning my investors over the last 7.7 years. Further testimony is the fact that no money has ever left the fund or its predecessor.

One also has to ask the question, why we would only take a cut of the profits above bank interest, if we knew that we could not produce an above average return. Reasoning along those lines would not only render us liars, but quite delusional ones at that.

Speaking of our index.

I did not outperform the index in 2004. However, my job is to outperform over the long term and short term performance is of no consequence at Baobab. Although, it does not help me feeling any better about being unsatisfied with 2004 we can also not afford to have short term

performance cloud our long term objectives. A very important reason for the short term underperformance is our long term primary objective of 'ensuring safety of principal'. More on that later; as Francis Chou would say, 'I would much rather lose half my investors than half my investors' money'.

New twist in an old tale

Baobab Global Fund is a new twist in an old tale. We moved from a private company to a hedge fund structure. It is more cosmetic than anything else. Think of us in terms of your typical racing car that competes in NASCAR. The bodywork is not that important, what counts are the engine, gearbox, chassis, tires and driver. That has not changed. However, we now come with a different body. Therefore a lot that we say this year will be old news to a lot of you, but it is important to repeat the ground rules for the new investors.

Baobab Global Fund is a business

We do not think of Baobab as a fund. This is a business. The main difference between Baobab and your average business is that we are not a typical operating business. Instead of getting up every day and commanding resources that have to be managed actively on a daily basis i.e. employees, debtors, creditors, stock, infrastructure, etc we team up with people who are much better at that than we can ever dream to be. We have 5% of Baobab invested in Berkshire Hathaway. Unfortunately, the significance of that stake has been diluted since 2001, which was the last time we thought Berkshire to be rationally priced, due to the growth of the fund. The point is that 5% of our money is being managed by Warren Buffett and his extremely capable team. Now how do you think that makes us sleep at night? So rather than doing the work ourselves we partner with the best. Put another way, we partner with people we are too scared to compete with regardless of how much capital you might want to give us to take them on.

Capital preservation first

Baobab uses a high water mark. This is referred to in our subscription documents as 'net new appreciation'. Without a high water mark you will pay commission in the final year if the NAV over four years were to be 100, 110, 80 and 90. However, with a high water mark you will not. The high water mark gets set every time the performance fee is charged, which in this example would be 110. Baobab can only charge a performance fee again once you get past 110.

This arrangement is in step with our two fundamental rules of investment.

1. Preserve capital
2. Produce a reasonable return.

Without capital we are nothing!

This brings me onto an important realisation in 2004. It is interesting how your skills develop in the art of investment. At first it pretty much goes up in a straight line, but after you get the basics right you can tread water in your thinking for quite a while. To a certain extent this will depend on whether you subscribe to a more focussed approach like Graham and Buffett or whether you apply an array of mental models as Charlie Munger advocates. I don't believe one is superior to the other, but personally I find Munger's approach more stimulating. I get to read Stephen Hawkins, David Landes, The Bible, Adam Smith, Jim Rogers, Popular Mechanics, etc. and I get to call it work. Whichever approach you choose, you will still end up in a space every now and then where things get a bit stale.

Then suddenly one day your head will spin. This is sometimes due to one single sentence you read. Sometimes it is something new that you are learning or as was the case last year your appreciation for an existing belief will reach a whole new level.

One more thing before I get to the main point. Some things in investment management are done in a certain way, because it limits your risk to the unknown. I might not fully understand

the way it works or I might underestimate its importance. However, I know it works due to the fact that people like Warren Buffett, John Templeton, John Neff, Bruce Berkowitz, etc., say it works. Their track records prove that they know what they are talking about. Therefore, I follow their advice until such time as I fully understand what it is all about.

I always maintained that investment is ultimately a game of odds. If you invest in a certain type of company and maintain a strict pricing discipline then you get the best odds for making money out of equities over the long term. In a certain way this shifts the focus to the second of our two fundamental rules of investment, a reasonable return rather than the first. Then I read the following in an October, 15th interview with Peter Bernstein by Jason Zweig in *Money Magazine*.

It only served to heighten the importance of capital preservation as the *first* rule. The idea is to get the odds in your favour to ensure above all that you survive!

Q: How can investors avoid being shocked, or at least reduce the risk of overreacting to a surprise?

A: Understanding that we do not know the future is such a simple statement, but it's so important. Investors do better where risk management is a conscious part of the process. Maximizing return is a strategy that makes sense only in very specific circumstances. In general, survival is the only road to riches. Let me say that again: Survival is the only road to riches. You should try to maximize return only if losses would not threaten your survival and if you have a compelling future need for the extra gains you might earn.

The riskiest moment is when you're right. That's when you're in the most trouble, because you tend to overstay the good decisions. So, in many ways, it's better not to be so right. That's what diversification is for. It's an explicit recognition of ignorance. And I view diversification not only as a survival strategy but as an aggressive strategy, because the next windfall might come from a surprising place. I want to make sure I'm exposed to it. Somebody once said that if you're comfortable with everything you own, you're not diversified. I think you should have a small allocation to gold, to foreign currency, to TIPS [Treasury Inflation-Protected Securities].

Can you manage yourself in a bubble, and can you manage yourself on the other side? It's very easy to say yes when you haven't been there. But it's very hot in that oven. And can you save your ego, as well as your wealth? I think I might have just said something important. Your wealth is like your children -- the primary link between your present and the future. You should try to think about it in the same way. You want your children to have freedom but you also want them to be good people who can take care of themselves. You don't want to blow it, because you don't get a second chance. When you invest, it's not your wealth today, but it's your future that you're really managing.

This made me sit up straight. It made me value the risk in what I don't know, but most importantly the risk in what I might think I know, but actually don't.

We are acutely aware that we are managing *our* futures at Baobab.

View on the market

We don't understand what the fuss is about when it comes to people saying it is so difficult to predict the markets. We have a 100% success rate in predicting the markets. Our prediction for 2005 is the same as before. The markets will go up or down. These lines above also, more or less make up the sum total of the time we spend thinking about the markets.

Finding bargains

2004 has been the most difficult year so far to find bargains, which of course is our specialty. Bargains are not lying around on the pavement. They were in 2003. If you do not roll up your

sleeves and dive head first into the garbage bin then you are unlikely to find anything. This brings me to the question that we get asked frequently, 'how do you get your ideas?'

For starters, we are lucky enough to have an exceptional peer group of 'bargain spotters'. The great thing about true value investors are that as a group the 'ego factor' is not much of a factor at all. Most of us just love to share ideas. The excitement in finding and committing capital to an unappreciated company is just the best thing, since sliced bread. Once we committed capital the idea has pretty much served its purpose. Then we pass it on. Maybe I should say we use the idea to *pay it forward*, because that idea might still have plenty of mileage left in it and one day a thankful peer might just pass something back to you or he or she will point out something that we missed on a particular investment and save us from losing a bundle.

Then there are the 52-week low lists that are always a good place to look and once in a blue moon we will run some type of screen. Another favourite is the front page of the newspaper. There you will read about MCI that is a basket case, which we bought. There you will read that Marsh & McLennan got a phone call from Eliot Spitzer (New York State Attorney General), which we bought. At the end of the day we can never give people a clear answer when they pose the question of how we generate our ideas. The truth is that we get it from a variety of sources and essentially we just keep our eyes peeled.

Hedge Funds

I believe that any student of the history of financial markets will agree that this little party will come to an abrupt end, everything always does. We don't have any opinion on when it will be, but it will happen. First of all, the concept of Hedge Funds is misunderstood. For most investors it has something to do with hedging and it is not always clear in most investor's minds whether hedging refers to leverage or hedging risk. Essentially a hedge fund is an unregulated pool of money. Due to this fact it is more or less up to the investors of the fund to decide what the financial limits of their participation in certain opportunities are going to be. There is nothing stopping investors to leverage at a 1,000% and committing that money to a bet on how the Yen will move against the Dollar, or whether Liverpool will beat Manchester. This is the main reason why a lot of hedging and leverage takes place in hedge funds. However, one also has to appreciate that there are hedge funds, like Baobab that have no interest in using leverage or investing for the long term in anything other than listed entities. Sure, we appreciate the freedom to venture into non-traditional areas when the opportunity presents itself, but our long term investment record clearly shows our preference for the Berkshire Hathaways, JJBs, MCIs and Fairfax Financial Holdings of this world. So compared to your average hedge fund, we look out of place, because we don't believe in borrowing money to invest and we are long term value investors.

The main reason why we are a hedge fund is because it is the *lowest cost method* to run a pool of money and we have no interest in doing business with the general public anyway, which hedge funds are not allowed to target. We are looking for long term commitments and are in need of capital when the markets tank. The general investment public prefers to jump in and out of stocks and are the ones that run for the doors when the market tanks. That is exactly the time when we phone our investors to request more funds. So the fact that we are unregulated and are by definition therefore not allowed to target the general public or advertise fits us like a glove.

What you have to make a serious note of is the following. The hedge fund industry will at some point collapse, just as all bubbles do!!! It is because the majority of funds are highly leveraged and traditionally get involved in high risk, investments of which the liquidity is frequently very low. Derivatives, a favourite of hedge funds, are very easy to get into, but hard to exit. This is the case in a normal market. In a crisis the effects will be severally compounded. The consequences are going to be painful and maybe even catastrophic. However, one cannot then turn around and say, hang on for a second, is Baobab not a hedge fund? Your risk with Baobab lies with the people that allocate your money and the people that

manage the companies in which you invest. We don't believe in borrowing money to make money and we invest in listed entities. Baobab is not a traditional hedge fund. We mainly use it, because it saves you money.

What we can and cannot do

At Baobab we know what we can and cannot do. We cannot consistently make money over the short term, meaning a year or two. Our target is three to five years. The main reason for this is that the situations that we mainly get involved in takes about three to five years to pan out. Our favourite situation is to invest when great companies stumble. Every businessperson knows that no matter which company you run, every now and then you trip and down goes the cash flows, earnings, etc. It happened to Berkshire Hathaway, Fairfax Financial Holdings, JJB Sports Plc, Marsh & McLennan, etc. Sometimes it is just the point where one's at in the cycle of the industry as was the case with Markel Insurance, Mercury General Insurance, Progressive Insurance, etc. It takes quite a number of years for companies to steady the ship again and start pumping out the cash. However, by the time the company is on even keel then the share price has also shot through the roof. So we get involved when the front pages report catastrophe. After we bought, we sit back for a couple of years and wait for the share price to reflect the intrinsic value of the company.

That of course is the simplified version. The point is that these things take time and our ability to make money for our investors is directly related to that.

We cater for investors that are looking for capital appreciation. A lot of our investors are businesspeople that produce surplus cash in their businesses. Baobab acts as an overflow to take that capital and deploy it to other businesses. With this the investor gets an opportunity to diversify and a piece of some great businesses. Our main function is to allocate capital. The structure in which we operate is a way to pool money and to ensure that we are all in the same boat. We share the risk. First of all we need to make money for our investors and then we share in some of it.

So everything is geared for the long term and for capital appreciation. We don't cater for those that are looking for steady income, although selling some of your shares on a regular basis might be a way to approach the problem. Nevertheless, we discourage it.

My long term record is 18.3% net to my investors. Although I would like to think that I can maintain or even push it up in future, don't count on it. However, we work hard everyday to push that number up.

Value investment

The distinction between different styles of investment is more relevant to selling books than to investment. We loose track of the different styles, but you have technical analysis, bottom up or top down, small cap versus large cap, dividend investing, sector investing and of course the one we believe makes our case the best, investing using astrology. The latter is guaranteed to sell you at least one book. For Baobab there is but one, value investment. Actually for us investment and value investment is the same thing; the rest is for people that just don't get it. Now some of you might not like my last comment, but it does reflect our thinking around here.

Investment is the art of applying cash today in the expectation of getting back more tomorrow. That is the basic definition and in the words of Benjamin Graham,

'An investment operation is one which upon thorough analysis, promises safety of principle and a satisfactory return. Operations not meeting these requirements are speculative.'

In the 'faith' of investment that should be inscribed on your heart. So as far as Baobab is concerned you will serve your financial interests a lot better by focussing on cash today in

relation to cash tomorrow. We prefer equities and therefore we study businesses to improve our skills in establishing what type of cash flows we can reliably expect from a given situation or business. Maybe we just have a one track mind. Maybe it is possible to make money from practising other styles of investment. However, we believe in what Graham said,

'Investment is most intelligent when it is most businesslike'.

Over the years we have come to realise the following. The best performing asset class is equities, followed by property. As we mentioned above, only 0.5% of fund managers outperform the market by more than 3%. Therefore it seems that the average equity investor is a lot worse off than the average property investor. Put another way, the pool of money made via equity investment is bigger than the pool from property, but is shared by fewer. We believe the main reason is the difference in approach to the two asset classes. The average property deal is better researched and is traditionally considered a long term investment. Just those two factors alone are seriously lacking when it comes to equities, especially with professional fund managers.

The fact that only 0.5% of managers produce any worthwhile returns in our industry also alludes to how difficult it is. Value investment makes life a lot easier. Make no mistake it does not provide an automatic exemption from hardships, trials, or permanent loss of capital. Furthermore, the experience of such difficulties does not mean that the investors undergoing them practice value investment incorrectly compared to those who walk away with their capital and satisfactory returns. The same investment discipline that enables some to escape the trouble, enables others to endure it. The same discipline that saves some from permanent loss of capital enables others to succeed. Value investment is not a bridge over troubled waters, but is a pathway through it.

You must realise that we don't hold ourselves out as being perfect 'value' investors. However, we do try our best. We deem it appropriate that you think of us along the same lines as Dr Bob Jones Jr thought of C.S. Lewis.

"Shortly after the war (WWII) the hottest of all hot-gospellers from the 'Bible Belt' of South Carolina, Dr Bob Jones Jr, visited Lewis in Oxford. By a remarkable coincidence Walter Hooper was introduced to Dr Jones in 1954. Hooper popped a peppermint into his mouth to hide any smell of tobacco and asked the ultra-conservative what he thought of C.S. Lewis. 'That man', said Dr Jones fiercely, 'smokes a pipe, and that man drinks liquor - but I do believe he is a Christian!'"

Our faults are many, but we *diligently* attempt to apply our craft *properly* on a daily basis.

The Challenge

Baobab is still classified as a 'small fund', which means we manage less than \$10m. I always tell my partners that life for Baobab begins at \$10m. We have accepted long ago that the task at hand is the mother of all marathons. Thus far we have endured and some say excelled. The latter does not come from us and if we did excel then all I can say is that *we ain't got that feeling yet.*

We have a tremendous track record going for us, we only share in the returns that we produce for our investors, I have all my money invested in Baobab and we have a sensible approach to investment. All these factors add up to an unbeatable recipe.

Rob, Paul and I are extremely positive. We believe that if we cannot see Baobab at \$10m and beyond then we cannot lead others down that road. We see the future very clearly; we are getting up every day with the goals clear in our minds. The only things we can change are those that are within our control. We will succeed!

There is a fine line between complaining and identifying reasons for failure. Reasons for failure must never double as an excuse. Take it from Hank Greenberg, who runs AIG and by the way happens to compete with a number of our investments namely Berkshire Hathaway, Marsh & McLennan, Market Insurance, Fairfax Financial Holdings and Mercury General. Hank is an outstanding manager, despite his downfalls. In a recent Fortune article he said the following,

"We talk all the time about how this cycle is going to be different from the last cycle," says Greenberg. "But whether rates are going up, down, or sideways, human behavior doesn't change. Experienced companies will come through any cycle well. The inexperienced ones, the ones that believe they are smarter than the rest, will fill the empty spots in the graveyard."

Considering that which is in our control then Baobab will end up in the graveyard due to the following ranked by importance,

1. Permanent loss of capital,
2. We stop producing satisfactory returns for our investors,
3. We forget that at Baobab our investors come first and then everything else,
4. We don't attract the \$10m and more,
5. We stop behaving like prudent businessman,
6. We stop having fun.

For us to succeed we need to simply carry on doing what we have done in the past which are the following,

1. We must keep on attracting the excellent breed of investor we have until now and we mean excellent,
2. We must stick to our investment approach which is proven,
3. We must keep on teaming up with outstanding businesses at sensible prices.
4. Keep on coming to work everyday with a spring in our step!

However, the simple fact is that currently the pot is not big enough. So we implore you once again to send the excess cash our way. If you have friends that can use our services then send them to us without delay. We had some good opportunities in the last three months and we have deployed most of our available cash. The tank is getting empty. As Warren Buffett said, if you want to shoot rare, fast moving elephants then you better carry a gun. We will be in trouble if an elephant walks up to us now.

How do you think about specific companies?

This is another question we get a lot. In simple terms we think about a company in exactly the same way as you do about your savings account. You put in \$100 and expect to have say \$5 of cash flow after a year if the account pays 5%. A company, just as a savings account, is simply a mechanism that produces cash.

With a company we are looking for a certain rate say 10% to 15% pre-tax and we prefer closer to 15%. However, with a savings account you know what interest rate it pays and therefore if you put in X then you will get Y in cash flow, while with a company it is more a case that you

know it has \$5 of cash flow. From that you can deduce that if you pay \$100 you will earn 5%, pay \$50 then you will earn 10% and pay \$33 and you will earn 15%.

For us the maths side of the investment process is the easy part. Last year, it would have taken you short of five minutes to figure out that MCI had around \$1 billion of cash earnings during bankruptcy and from that you could infer quite quickly that at a then market value of \$4.5bn you were talking about returns of 20%.

The difficult part is to figure out what the likelihood is that MCI would be repeating those cash earnings in 2004 and years beyond. Maybe it is not a case of it always being the difficult part, but definitely the part that takes up the most time. When you are someone like Charlie Munger then you already have a knowledge bank of a lifetime to draw on. In my case I am still building on that knowledge bank, so frequently I have to get to know a whole industry before I can invest in a single company. The trade off for us as opposed to someone like Munger is that by the time you get to where he is, you are likely to manage such a large chunk of money that you cannot invest in a large section of listed companies, because they are too small for you. We can more or less still get into any listed company.

Getting back to the example of the savings account, there is usually very little risk with a bank. You should almost always get your \$5 of cash flow. However, with a company it is different. You have to figure out the likelihood of you ever seeing that \$1bn of cash flows and this is where risk is the most concentrated. Therefore we prefer to spend our time on worrying about the cash flow of next year rather than about two years and beyond. The reasons for this lies somewhere between what Thomas Carlyle said,

“The task of man is not to see what lies dimly in the distance, but to what lies clearly at hand.”

And the quote by Aesop which Buffett frequently uses,

“A bird in the hand is worth two in the bush.”

Although the above phrase is usually credited to Aesop, I have it on good authority that the Greek poet Hesiod first recorded the proverb in 800 BC. Yet, it was in different form

‘He is a fool who leaves what is close at hand to pursue what is out of reach.’

We like what we call *initial yield*. We want to earn a good return in year 1. Then we also want an opportunity where there is a good chance of those cash flows actually growing in year two and beyond. We don't like the idea that most “growth investors” (as they are typically referred to) focus on and that is that cash flows will grow so fast that the high price you paying now will be made up by the cash flows that are going to be very large 10 years from now. We're not sure whether investors always appreciate how far into the future they are conducting business. If you pay a PE of 10, which in the current market is considered cheap, then you will only have your initial cash outlay back in 10 years if you assume no growth. 10 years in business is a very long time. For us there is a world of difference between someone earning a 15% return in year one and a “growth investor” that's earning 3% in year one, but expects the business to grow cash flows at a 20% clip or better. As we mentioned, 10 years in business is a long time and 20% is a very, very high growth rate. If one discounts at 15% then \$100, 10 years from now is worth \$25. We prefer our jam today and have no problem in leaving the jam tomorrow for the “growth” guys.

Wired for the job

I once toured a perfumery in Paris and was given some insights on the perfume industry. The 'design' of perfume is based on 'music'. The individual elements of fragrances come in tiny bottles and are called notes. The notes are stacked 180° around the composer or *nose* and the rows step up and away from him. All the notes in this configuration are fittingly called a *perfume organ*. We want to focus on the *nose*. There are less than 50 *noses* in the world, they are all either natives of the French city of *Grasse* or have worked in a *Grasse* perfume making factory. Interestingly, *Grasse* was originally a leather tanning town until the 16th century when it moved to perfume making. Anyone who has ever come within a few miles of a leather tanning factory can understand why the town switched to perfume making.

Anyway, the point I am trying to get to is that the average person can smell up to 7 fragrances in a row and then your brain gets confused. To become a *nose* you have to be able to distinguish at least 400 fragrances as a start. *Noses* will then build their *palette* to between 1500 and 3000 fragrances over a career, with few getting over 2000. Apparently, they are all men and the *switch* that switches off after 7 fragrances in the average person does not function properly with a *nose*. What is really supposed to be a disability has turned out to be their good fortune.

When it comes to value investors I have often pondered the thought of whether they are a *blessed* or a *disabled* lot, who just happen to be at the right place at the right time with a peculiar trait that serves them well. You are forced to ask the question when you consider that only 0.5% of professional fund managers is able to outperform the market by 3% or more. Are these *outperformers* at the top of the pile or are they actually more like a *fringe group*? Sure the individuals mentioned earlier like, Buffett, Graham, Chou, Munger, etc. are gifted and very intelligent individuals. However, Buffett frequently tells us that investment is not a game where the person with the highest IQ wins.

There is something else. It is that which enables a person to execute on all the investment knowledge we are forever talking, writing and sleep talking about. Most of us call it discipline and C.S. Lewis referred to this as the '*liaison officer that sits between man's head (the seat of reason) and his belly (the seat of instincts)*'. However, I know a lot of disciplined people that have failed miserably when it comes to investment. I therefore question the notion that good investors are superior in the 'liaison officer' department, but there is something that drives an investor to stick to his/her guns, invest when everything falls into place and takes a perverse pleasure from moving against the crowd. The best description yet of this phenomena I have heard comes from Buffett, which says he is simply wired for his job. It seems to be a case of having a direct connection between reason and instinct, with reason having the upper hand, thereby taking a shortcut past the 'liaison officer', which for most investors confuses the issue. In C.S. Lewis' words,

'In a sort of ghastly simplicity, we remove the organ and demand the function.'

At the core of a good investor lies the ability to actually pull the trigger when things are more or less in place and most importantly, he or she does so consistently.

Stay humble

It is easy to get sidetracked in this business. It is easy to sit back and say, just look at that track record, we are actually good at this. At Baobab we try to remind ourselves frequently of what Horace said,

'Many shall be restored that now are fallen and many shall fall that are now in honour.'

Actually the real reason is that our office is quite small so we can do without the big heads.

The great thing is that we don't have to reinvent the wheel. All the tools of the trade are out there and are extremely well documented. In fact it is my belief that one can read the following in the order presented and quit bothering with the rest,

1. *Intelligent Investor*, Benjamin Graham
2. *Common Stocks and Uncommon Profits*, Philip Fischer
3. *Security Analysis*, Graham, Dodd & Cottle
4. *Warren Buffett's letters to shareholders*.

The fact that the books are rather old has no bearing on its significance. Arguments to the contrary are usually nothing more than *chronological snobbery*, which for some reason prevails in any form of literature. Eternal truths are by definition never out of date and in our view the above is a nice collection of at least 90% of *eternal investment truths*. With the above as your foundation you can spend the rest of your investment career reading newspapers and annual reports and you should do just fine.

We are fortunate enough to have ticked off all the above and ended up with the responsibility of allocating other people's capital. We have an outstanding track record, which is our double edged sword. The most likely reason for our downfall will be us. The day that we forget all that has been taught by Graham, Fischer and Buffett will be the day before we fall flat on our faces.

As allocators of capital we have a huge responsibility not only to our partners, but also to the society in which we operate. Capital flows in a society. In a capitalist society the gate keepers of capital exert an enormous influence over the well being of that society. Money is in many respects the life blood of a capitalist society and is considered its most important resource. If one casts a wider eye on what Berkshire Hathaway has meant to the US over the last fifty years then it goes way beyond the \$85.8 billion in book value it has been able to build. How does one even begin to calculate the value of Berkshire forking out the \$2 billion plus for the World Trade Centre disaster and the cheque actually clearing? *Flightsafety International* through its impeccable and consistent service adds tremendous value to maintaining the safety standards of pilots worldwide. Any town that has ever lost a major employer knows the value of having a company that acts responsibly, finance itself properly, thinks for the long term and ultimately acts as a pillar of that society.

As gatekeepers we get to choose whether we allocate capital to companies like that or we can get involved in the latest craze, throw our partners hard earned capital at the first *nut head* that walks in with yet another wacky idea.

I guess it sounds like I am preaching to everyone, but the truth of the matter is that we like to share this when the opportunity presents itself. More than anything else it serves as a reminder to us at Baobab that we have a wider responsibility in our society. Our decisions do affect the societies in which we operate. Our decisions affect people in Toronto, when we buy into Fairfax Financial Holdings and it affects people in Hong Kong and Singapore when we buy into Guoco Group Ltd. It affects partners' families when we ensure that we make their investment grow and it affects our own families who are heavily invested in Baobab.

At Baobab it is not about the flashy cars, fancy offices and 'brain storming' weekends of which we have none. It's about discharging our responsibilities. That is what keeps us humble and that is what keeps us focussed on delivering an above average return for our partners. We are 100% focussed on allocating Baobab's capital responsibly. In its simplest form it means that we

are 100% focussed on making money for you, because we appreciate the fact that it has consequences.

Martin van Blerk

A handwritten signature in black ink, appearing to read 'M. van Blerk', written in a cursive style.

15 March 2005

Note: Audited Financial statements are presented separately and only to investors.