

BAOBAB
GLOBAL FUND



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Letter to shareholders:

Mistakes

"It takes a man a long time to learn all the lessons of all his mistakes. They say there are two sides to everything. But there is only one side to the stock market; and it is not the bull side or the bear side, but the right side."

-Jesse Livermore (1923)

What qualifies as a mistake at Baobab?

A number of our investors think the performance of an investment determines whether it was a mistake. In fact the performance of an investment has very little to do with it. What we try and figure out is whether I should have acted differently with the benefit of hindsight. Hindsight is used to figure out whether I could have known better. Say we invested in Shell (the Anglo Dutch petroleum company) when the scandal around the misstatement of its oil reserves broke then I would not have classified it as a mistake. I do not believe that one could have realistically foreseen it and even with the benefit of hindsight it is close to impossible to have put a system in place that would have flagged it.

However, there is no need to use hypothetical examples if we have our own experience to draw from. It will also serve to illuminate the risk in what we do. You will note one of our divestments is Rogers Raw Materials Index Fund. At the time of our investment Rogers Raw Materials Index Fund was one of the few and cheaper options available to gain broad exposure to commodities. I did a thorough due diligence and cleared up a number of issues around the fund with Jim Rogers directly: specifically around leverage and gearing. When our investment target was reached we divested in July 2004. However, in late 2005 Rogers Raw Materials Index Fund moved its futures trading to Refco LLC, which shortly afterwards filed for bankruptcy. Refco Capital Markets, one of the subsidiaries, holds 86% of Rogers Raw Materials Index Fund's assets. Despite the fact that fraud was involved I believe Rogers Raw Materials Index Fund can pretty much kiss those assets goodbye. We certainly would have written those assets down to zero if we were still invested. I still shudder when I write about this, because we had about 10% of our assets invested at one stage. Although we divested more than a year before this happened and made a healthy return I will still go back and try and figure out whether this was a mistake with the benefit of hindsight. However, there is nothing I could have reasonably done beforehand that would have alerted me to the Refco development. I suppose both the Shell incident and the Rogers' experience just prove the sensibility of diversification (up to a point). There are certain risks that we just cannot gauge and to counter it we diversify. However, we still stand to lose around 10% (and sometimes more) of our assets due to unknowables.

The bottom line is that despite our focus on analysing and reporting our mistakes we are investors and [equity] investment comes with a risk warning for a good

reason. Despite our value investment approach we are not immune to fraud, stupidity, etc. It is bone chilling to think that we had such a close shave and it drives me nuts to think that there is nothing I could have done to prevent it, if we were still invested this year.

We were just plain damn lucky!

However, it is unrealistic to think we will always be this lucky and of one thing I am certain; one day we will have our turn. As Jesse Livermore said in 1923,

“Every once in a while a man gets a crack like that in the solar plexus, probably that he may be reminded of the sad fact that no human being can be so uniformly right [on the market] as to be beyond the reach of unprofitable accidents”.

Middle Eastern markets

The majority of our mistakes are certainly mistakes of omission. This particular kind of mistake is especially problematic, because it is easy to sweep under the carpet and difficult to measure.

There is one investment opportunity I feel I could have spotted a mile away if I just sat still for five minutes and spent it on that endangered pastime, which is TO THINK. It all happened in plain view. The whole world saw where the oil price was going and a six year old kid could spot the sea of money that was engulfing the Middle East. So the average Middle Eastern company would directly benefit from this influx of money. If you don't believe me do yourself the disservice of taking a look at the charts for just about any stock exchange in the Middle East. I strongly encourage you; share my pain.

Looking at the market

It is not possible to shut yourself off from the market entirely, but it is possible, even necessary, to actively reduce contact with the market. For one it's an enormous waste of time.

I always find it interesting how people regard time. I know a number of people that are extremely meticulous about their time and hate wasting it. Yet, they will happily spend about 30 minutes travelling to work every day, thereby wasting 5-6 hours per week behind the wheel of their cars. What makes it a shocking reality is if you were to calculate that in terms of work days in a year. You actually end up wasting well more than a month's worth of 8 hour work days.

OK, so let me not forget I am talking about my mistakes here. In the same vein it can be a prolific waste of time and energy following and thinking about the market. However, the real problem lies in the negative influence that it brings to my body of work. In 2005 I caught myself several times looking at what the market is doing. The simplest test for me is when I visit a webpage like Yahoo finance. I ask myself the question, 'what is the first thing I long to look at?' If it is the up or down indicator for the indices then it is a clear indicator of the role that the market plays in my psyche. Of course the fact that I immediately reprimand myself is good, but the best is when I spent time on a webpage like

that, left and forgot to even consider what the markets are doing. All I can say, its work in progress. I would much rather spend that time THINKING. As a wise man once said,

"Staring into empty space is not wasted time"

Banks

I think if I set a goal of getting my head around banks for two years in a row and I do very little towards that end then it qualifies as a mistake. You can rightfully dismiss the following as twaddle with no waddle. Nevertheless, this year I mean business. I have already lined up a legend in the industry that is willing to share his precious knowledge in an attempt to help us become bankers. I always tread cautiously when it comes to these new additions to my circle of competence, but it's a process that at my age still needs widening. We are unlikely to actually invest in any banks this year. The first Asian company only made it into our portfolio three years after I actually started researching Asian companies. So don't hold your breath, be patient.

Performance

"One might wonder why, if the market undervalues the issue [share] at the time he purchases, it should not continue indefinitely to do so and perhaps even increase the measure of undervaluation. There is no theoretical reason why these unpalatable results could not occur. The comfort and encouragement to the intelligent investor are to be found in practical experience. In the long run, securities tend to sell close to a price level not disproportionate to their indicated value. This statement is indefinite as to time; in some cases the day of vindication has actually been deferred for many years."

-Benjamin Graham

Baobab Global Fund ended the year down 3.8% and the above quote does little for the fact that I feel like a horse's ass to present results like these. However, I get paid for investing our assets responsibly over the long term and short term underperformance is par for the course. I highlighted this before by using an illuminating study, which needs repeating.

Is Underperforming an Index 30% to 40% of the Time a Normal Part of Long- Run Investment Success? What we learned from an examination of the year-by-year results for nine value - oriented investment managers with index beating long-term records.

In *Are Short-Term Performance and Value Investing Mutually Exclusive?* Mr. Shahan analyzed the investment records of seven investment managers with exceptional long-term track records, as described in an article by Warren Buffett, *The Superinvestors of Graham-and-Doddsville*. The common characteristic of all seven investment managers in Warren Buffett's article was that they practiced a value-oriented investment

approach.

This sample of investment managers had investment results which exceeded either the Dow Jones Industrial Average (the "DJIA") or the Standard & Poor's 500 Stock Index (the "S&P 500") by between 7.7% and 16.5% per year over periods ranging from 13 years to 28.25 years. None of the seven managers out-performed the S&P 500 every year.

Six of the seven investment managers underperformed either the DJIA or the S&P 500 by between 22% and 42.1% in the years covered. The average underperformance of the six managers was 33.3% in the (underperformance) years covered. Stretches of consecutive annual underperformance ranged from one to six years.

Mr. Shahan concluded, "Unfortunately, there is no way to distinguish between a poor 3-year stretch for a manager who will do well over 15 years, from a poor 3-year stretch for a manager who will continue to do poorly. Nor is there any reason to believe that a manager who does well from the outset cannot continue to do well, and consistently." [I studied the] investment results of the seven investment managers in *The Superinvestors of Graham-and-Doddsville*: Bill Ruane's Sequoia Fund; Warren Buffett's Buffett Partnership; Walter Schloss' Walter Schloss Limited Partners; Charles Munger's Wheeler, Munger & Co. Partnership; J.P. Guerin's Pacific Partners Ltd.; Stan Perlmeter's Perlmeter Investments; and Tweedy, Browne's TBK Partners, L.P. [I also studied] the year-by-year investment record of the mutual fund with the best investment record over the last thirty years (ended June 30, 1994), John Templeton's Templeton Growth Fund, and the mutual fund with the seventh best record over the same thirty-year period, John Neff's Windsor Fund.

Both Mr. Templeton's Templeton Growth Fund and Mr. Neff's Windsor Fund employed a value oriented investment approach over the 30-year period. The best performing mutual fund over the 30-year 1964-1994 period, John Templeton's Templeton Growth Fund, similar to six of the seven investment managers described in Warren Buffett's article, underperformed the S&P 500 in 35.5% of the years. John Neff's Windsor Fund underperformed the S&P 500 in 10 of the 30 years, which is 33% of the years. The sample of nine exceptional long-term investment track records suggests that **under performing an index 30%-40% of the time is a normal part of long term out performance.**

None of these highly successful investment manager outperformed 100% of the time. Outperforming an index 60%-70% of the time was the norm.

A year like 2005 puts significant pressure on me to try and do something stupid. However, my guiding light is our investment principles. These have delivered over the long term and as value investors we have to stick to our knitting.

Divestments

Investment	Date Sold	Valuation at sale	Current valuation	% Compound growth
Next Plc (UK)	7/2003	£2.5bn	£4.4bn	25%
	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	\$23bn	25%
	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.			
Clinton Cards (UK)	8/2004	£177m	£136m	-17%
Natuzzi (Italy)	7/2005	\$8.95	\$7.00	-22%
Gold Bullion Securities (Commodity)	9/2005	\$44.7		
MCI (US)	3/2005	\$23		
Regent Inns (UK)	7/2005	£0.80	£1.09	
Delta (UK)	3/2005	£1.09	£1.12	
Fab Industries (US)	Delisted			
James Beattie (UK)	Taken out			
DFS Furniture (UK)	Taken out			
Holmes Place (UK)	Taken out			
Average				10.4%

Canada

The vast majority of my time and energy is spent on allocating the capital of our business. The buck stops with me and I am obligated to inform you if my priorities change and if my time is spent on other issues. I am of the belief that if I am unable to focus sufficient energy on our business due to other commitments, I should retire as chairman.

I have met with almost everyone and explained to you in great detail the background to the Canadian deal. This is a straightforward yet very significant development and there are a number of things that need repeating.

Our Canadian friends have been most understanding in letting my partners, of which some have supported me for almost nine years, stay on. As much as I would like to claim all credit for myself, the reality is that I could not have done it without you. I am most fortunate in having a group of investors that put such trust in me and let me get on with the job. That gives me an enormous edge to practice my art. Undoubtedly, my long term track record would have looked substantially different if I had to spend time on entertaining capricious investors. So you can share the credit of this achievement with the masters of value investment from which I have learned everything I know. As for the hard work that I supposedly put into this: How can anyone call this work?

"As I have mentioned, the isolated man does not develop any intellectual power. It is necessary for him to be immersed in an environment of other men, whose techniques he absorbs during the first twenty years of his life. He may then perhaps do a little research of his own."

-Alan Turing

2006 is guaranteed to be a learning experience of note. I have the opportunity to work with the best in the field. You know I am forever harping on about working with people you respect and admire; well how can I possibly beat this? The challenge of course is for me to keep up. As daunting as it might seem, I come well prepared with a solid grounding in value investment principles that stood the test of time and together with a willingness to learn I should do just fine. I maintain that value investment is one of the simplest things to practice. Not only does it come with excellent guide books, it also comes with brilliant teachers. At least half the secret is to just stay with the basics. I found the following from Jim Collins' and Jerry Porras' *Build to Last* very enlightening.

"Thoughtful people crave time-tested fundamentals; they're tired of the "fad of the year" boom-and-bust cycle of management thinking. Yes, the world changes-and continues to change at an accelerated pace-but that does not mean that we should abandon the quest for fundamental concepts that stand the test of time. On the contrary, we need them more than ever!"

Anyway, the excitement far outweighs the size of the challenge.

I have an idea of what the future holds, but of course I don't know how things will actually pan out. Naturally, despite my best intentions it's possible that I will neglect Baobab. To put this in perspective I wish to relay the reply of the then Boeing CEO when he was asked what he would do if the first 747 to take off would crash? He replied,

"I would rather talk about something pleasant-like nuclear war"

However, I am confident that the little of my time that will be split will be made up in spades by the resources that will be available to me and an extremely steep learning curve. Ultimately, the nice words and solid commitments will only

carry my so far: the bottom line always stays the bottom line at Baobab. It has to translate in cold, hard cash and a lot more of it than we saw in 2005.

View on the market

In 2005 we continued our 100% success rate in predicting the markets. Our prediction for 2006 is the same as last year and we expect to be right once more.

The markets will go up or down

You can quote us on that.

Precision bombing

"More often than not, business is smell, feel, and touch as much as or more than numbers. If we wait for the perfect answer, the world will pass us by."

- Jack Welch

I have always maintained that investment is more art than science. It was illuminating to read that Jack Welch seem to think the same thing about business. As investors we are further removed from the 'coal face' than Jack Welch. Therefore we will never have the precision we are looking for when it comes to investment. As an investor one must come to terms with the fact that the best we will ever do is 'get a feel' for when it is appropriate to invest. A checklist approach will simply not suffice if the aim of the checklist is to supplant the investment decision.

However, I learned from Charlie Munger that checklists can be helpful. Munger encourages us to develop mental models, but it is important that the basics of these models must be practiced until fluency is attained. This is where I realised checklists are most helpful, just as it is helpful to a pilot. Otherwise we are bound to fall victim to the natural tendency to take shortcuts. It is one of my immediate goals to further develop and more consistently apply my checklists.

The aim is not to rely on the checklists for investment decisions, but I do think I have underestimated how helpful it is in developing our mental models and thereby the filter through which we screen our investments, which ultimately result in a higher quality 'feel'.

Martin van Blerk



Baobab Global Fund
15 March 2006

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