INTUITION
7 OCTOBER 2022

Using “O” to explain last week’s Intuition

Last week Robin asked if anyone understood markets. This week we add some more perspective and use a company example to explain some of Robin’s points. Are you investing for the share price movement or because you like the company? I think it is easier to like the company (i.e. what they are about, how they make their money and how they reward you as a shareholder) than to try and second guess the share price movement. Comments by the CEO of a locally-listed company drive home the point that it all boils down to company fundamentals. One of the greatest investment icons said even he cannot predict the markets.

SPEED READ

- **We keep reiterating the Harvard House investment philosophy. Markets are as volatile as ever but despite this, quality companies continue to do what they are best at - delivering returns and dividends.**
- **The CEO of Capitec said it clearly in an interview after their results: a listed company should focus on the fundamentals. It is not their (management) role to manage the share price.**
- **One of Warren Buffet’s pearls of wisdom was confirming that he tried his utmost best to predict where share prices will go until he threw all that theory out and started to buy companies with good fundamentals.**
- **We believe a company that helps to explain more from last week’s Intuition and our investment philosophy is Realty Income.**

Willie Pelser

In the previous issue of Intuition, Robin wrote about the current state of financial markets and how emotions and sentiment can potentially result in behavioral changes that can have a detrimental effect on how investors act with their investments. This week we’ll continue along these lines. In an interview after their results, the CEO of Capitec, Gerrie Fourie, made an interesting remark (and I continued to go back to it a few times, so I know it is at 1 minute and 22 seconds into the interview). He was asked to comment on the drop in the share price of Capitec after they delivered what was a good set of results. He said this: “We don’t manage the share price; we manage the fundamentals of the business”. However, sentiment had pushed the share price before these results to excessive levels relative to the underlying fundamentals.

I want to tie this in with an interview I watched with Warren Buffet a few years ago. He was asked what was one of the best lessons in his early career. He described in his answer how he was trying everything he could to predict share price moves, where the markets will be in a year, and by how much it will go up (or down). For myself, the defining moment was when he said that he realized that no one can or could predict that. He threw out his technical analysis books and said to himself that he is buying businesses, some of which might just happen to be listed on a stock exchange.

One of my own lessons during my “formative years” was from David Shapiro (who we interviewed as part of our recent 50th anniversary celebrations.) His advice to me as a youngster was to do the homework and when you buy a share (doesn’t matter how many) in the company you researched, remind yourself that you, as a shareholder, own the company (yes, perhaps only in part) and see it as if you have asked the CEO and his management team to take care of it whilst you busy managing something else.

Over the remainder of this article, I am going to use Realty Income (listed in the US with share code “O”) as an example of how our investment philosophy, together with Robin’s comments and my observations above, overlay our research process to understand companies.

In summary, what drew me to this company is the following:

- I can do a lot with the share code: O…what a beautiful company, O what a nice dividend yield, O … the share price is falling (or is that O O nO!) The list goes on. (Apologies to the serious readers – but surviving investment markets also requires a sense of humour!)

- A compounded total return of 15% p.a. and a compounded annual growth rate in their dividend of 4.4% since listing in 1994, 627 consecutive monthly dividends declared, and positive earnings growth delivered in 25 of their 26 year history. (There are some serious Harvard House Investment philosophy metrics locked up in here.)
- The company's founding philosophy, "The goal was simple - generate a reliable monthly income for investors."
- Many of the company's tenants are listed companies in which you can invest directly. Alternatively, I can own Realty Income which "owns lots of them". (For example, I like coffee, so I can invest in Starbucks (the company) or I can own their landlord, who has numerous other tenants), thereby spreading the risk.
- Finally comes the homework of researching the company before making the investment call.

> "Realty Income is one of a handful of property companies that leases freestanding properties on a triple-net lease basis."

Our research process uncovered reports, the titles of which would either scare you away or convince you to invest. These titles ranged from: "More pain may be ahead", "Realty Income is the bedrock for a retirement portfolio" to "Your second chance to buy in at 4.3% Yield" and "A better buy Realty Income's 4.4% yield or WP Carey's 5%". These headlines are designed to drive

REALTY INCOME SHARE PRICE

The price is volatile, a reflection of the ebb and flow of sentiment, yet the trend ultimately reflects the growth in underlying profits and dividends.

Convenience stores are a common asset within the Realty Income portfolio.

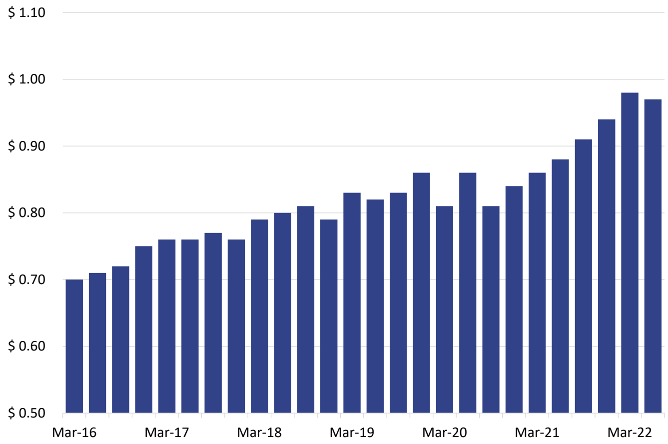
sentiment and emotion, which lie behind the volatility in the share price, as seen in the chart.

However, as we have been trying to explain, when you focus on the fundamentals you can often see a different picture - literally.

Realty Income is a property company (landlord) operating under a REIT structure. It was founded by William and Joan Clark in 1969, in California. The goal was simple – to generate a reliable monthly income for investors. The real estate portfolio started with the acquisition of a single Taco Bell property through a sale and leaseback transaction that year and has grown to encompass over 11,400 properties. In 1994, they began trading on the New York Stock Exchange.

Realty Income is one of a handful of property companies that leases freestanding properties on a triple-net lease basis. Tenants are therefore responsible for taxes, insurance and maintenance of the property. Consequently, the rental is almost full "profit" or described differently, the operating margin is almost 97%. Leases are long-term, with a current weighted average remaining lease term of 8.8 years as of June 30, 2022. The chart below shows the Adjusted Funds From Operations (AFFO) per share. In simple terms, you can read it as the "rental income after accounting adjustments" per share. Realty Income's high-quality tenant portfolio has helped maintain its robust and stable AFFO visibility, despite worsening macro headwinds even in previous slow economic cycles. One can look at that chart and wonder where the Covid impact is. The strength of the company's fundamentals also lies in its occupancy rate. No one wants empty buildings. Over the last 10 years, Realty's occupancy rate has averaged 98% which compares favorably to other S&P REIT companies that could only achieve an average occupancy rate of 94% over the same period.

AFFO PER SHARE

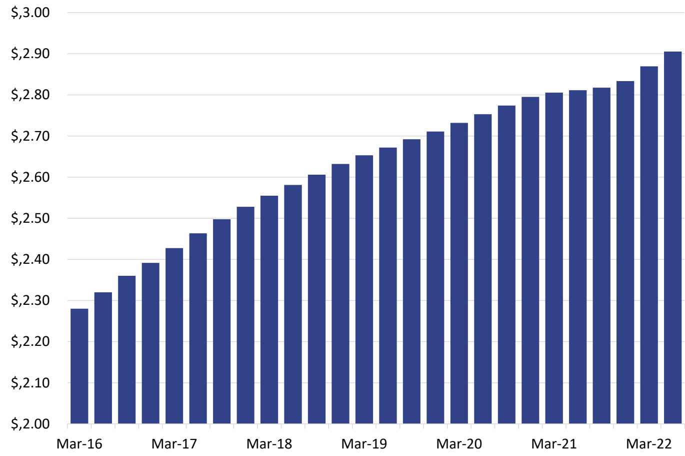


Low vacancies, long leases and favourable lease clauses have generated a steadily rising income profile.

Let me make a point on diversification. That does not just apply to the offshore vs local theme we covered in our recent Insight presentation. Realty's customers are spread over 72 separate industries. They cover all the states of America and have ventured into mainland Europe and the UK. Although 84% of their tenants are from the retail environment, not one is bigger than 4% of the overall client exposure. Grocery stores (as a grouping) make up 10% of the exposure. The rest comprise convenience stores, pharmacies, restaurants (quick and casual dining), and health and fitness clubs. Some familiar tenants are Starbucks Coffee, Sainsbury's, FedEx, 7-Eleven, Tesco, The Home Depot, and even Amazon and for those who have travelled the US and struggled with a headache, there is a CVS pharmacy or Walgreens almost everywhere.

At the end of the day, Harvard House comes back to the same story on dividends. Realty Income declares quarterly dividends (but actually pays them out monthly.) The chart highlights quite clearly how dividends have grown over time, despite the volatility of the share price above.

REALTY ROLLING 12M DIVIDEND HISTORY



Realty Income and Harvard House – our philosophies are perfectly aligned.

We hope this has once again shed light as to why we continue to sing the same philosophy song. Sometimes it may be a Waltz, other times a Rap, but we will sing the same words - every time.

Realty Income favours grocery stores. The portfolio is not situated exclusively in America but includes other geographies, including the UK, where leading supermarket Sainsbury's is a client.

Topic: The World in 2023

The world and financial markets have lurched from one crisis to the next over the past few years.

Will 2023 be any different?

Join us as we look ahead to what the new year may hold.

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Natal Midlands	
Date:	24th of November 2022
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	6th of December 2022
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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Performance figures quoted for the portfolio is from Morningstar, as at the date of this document for a lump sum investment, using NAV-NAV with income reinvested and do not take any upfront manager's charge into account. Income distributions are declared on the ex-dividend date. Actual investment performance will differ based on the initial fees charge applicable, the actual investment date, the date of reinvestment and dividend withholding tax. Performance fees do not apply to any funds managed by Harvard House. The manager does not provide any guarantee either with respect to the capital or return of the portfolio. A schedule of fees, charges, and maximum commissions are available on request from the manager.

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