LETTER TO ANANDA INVESTORS
NOVEMBER 2021

#4

"UNSEEN"

Dear Fellow Investor,

"Friends Don't Let Friends Become Chinese Billionaires" is the title of a 2011 Forbes article. According to the author Ray Kwong, 72 billionaires had died over the previous eight years in China. 15 murdered, 17 suicides, 14 executed and 19 from illness (at an average age of 48). They were not that many Chinese billionaires at the time (today they are 1,100, by far the largest cohort in the world, ahead of 700 in the US): only 115 "happy" few. A lot has changed since, and correlation is not causality, but becoming a billionaire in China in those days could have some seriously unpleasant unintended consequences.

Death is the most serious unintended consequence – one people forcefully try to avoid. Most are less spectacular, more insidious, and therefore less fiercely opposed. But unintended consequences are a serious problem. We live in systems larger and more complex than at any time in history. As governments and regulations expand to accommodate these systems, and technology enables centralization and control, unseen consequences are on the rise.

In this letter we will discuss **why the things we do not see matter so much, sometimes more than those we do see.** And how unseen and unintended consequences have existed since time immemorial (entrenched by human biases). How the monetary policies pursued by Western central bankers foster the unseen on a totally new scale, reducing feedback loops, maintaining unhealthy equilibriums, and boosting imbalances. We hope to find wisdom by reviewing some of the worst offenders, and inspiration from how top organisations combat this pernicious phenomenon. We discuss how we find the feedback of financial markets can be helpful, but only through patience, experience… and, quite frankly, a lot of pain.

As with many things, acceptance is the first step to recovery. For politicians, managers, investors, and parents alike, paying more attention to the unseen is a helpful tonic. A nudge ever so slightly toward progress, growth, and harmony.

If only we could all take the Hippocratic oath: modest and wise enough to pledge to "*first, do no harm*"!

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They say the road to hell is paved with good intentions. And indeed, no one sets out to implement unintended consequences, by their very definition. They arise from failures to achieve intended goals, or from unforeseen side-effects. But their very real impact can bankrupt companies, hurt economic growth, and weaken the social fabric of societies.

They are inherent to any system conceived by humans, a result of our species' well-established biases. The most basic one being overconfidence, sometimes named the Dunning-Kruger effect after two psychologists who studied the phenomenon. Put simply, humans tend to wildly overestimate their own competence for any given task. Countless studies show most people believe they are "better than average" drivers. I know I am, but please don't ask my wife! Asked specifically about biases, 85% of participants in a Princeton study rated themselves less susceptible than "the average American" and less susceptible than their own peers.

Combine this with the tendency to oversimplify (sometimes called the fallacy of the single cause), to see patterns where none exist (fallacy of correlation), or to focus on unimportant data (information bias) and you have a raft of blind spots and a fertile environment for unintended consequences. It also doesn't help that humility and self-awareness are often unrewarded by society and are only rarely election winners or CEO promotion material. The impulse towards misjudged, rushed or unnecessary activity is exactly what the precept "first, do no harm" tries to restrain.

Add the fact that humans are excellent at optimising for the environment in which they find themselves, or phrased differently, at gaming the system. And you go a long way to explain why unintended consequences have occurred ever since humans started organising themselves. By oversimplifying with overconfidence, we are often seduced by the idea that we can design the "perfect system" which cannot be gamed. Unfortunately, history is littered with evidence to the contrary. When Soviet Russia incentivised nail factories via the weight of production, producers focused on the largest nails which were heavy but useless. Noticing this, they tweaked the system to incentivise via the number of nails. Output immediately switched to tiny tacks. Attempts to incentivise via monetary value encouraged the most expensive materials. By manhours, the hiring of unnecessary staff. Eliminating unintended consequences is extremely hard to do, as anyone who has played whack-a-mole or tried to remove bubbles from wallpaper will know.

It is easy to grasp the visible drawbacks of the Soviet nail factory – the wasted materials, the unnecessary wages. The unseen costs are harder to grasp, condemned to a shadow world of the "might-have-been." Useful nails could have built new factories, the expensive iron formed new tools, the unnecessary workers founded new businesses. And the opportunity cost does not stop there. Those missed projects would themselves have generated further projects. **An entire chain of potential compounding growth is chopped off at the root.**

The economist Frédéric Bastiat was a historian of opportunity costs and unintended consequences, describing them in his brilliant 1850 essay "*What Is Seen, and What Is Unseen*", which included the parable of the broken window:

Jacques, accidentally breaking a pane of glass, is consoled by a friend: "It's an ill wind that blows no one good. What would become of glaziers if windows were never broken?." Jacques pays the glazier 6 francs for the repair. The glazier spends his earnings, perhaps on a pair of boots. This is ***seen****. What is* ***unseen*** *is the 6 francs that Jacques no longer spends, the boots he no longer buys. The transaction has not created economic growth or a net purchase of boots. Society is poorer to the tune of one broken window.*

Whilst readers may think this remark obvious, the question of opportunity cost, or worse, collateral damage, was not universally accepted back then. In mid-19th century Europe, much debate centred around the role governments should play in influencing commerce. Perhaps not widely known, Bastiat was a member of the French National Assembly and considered the most brilliant economic journalist who ever lived by Joseph Schumpeter. History has shown how right he was to argue that every action comes with its corollary, opportunity cost, and that sometimes it is the unseen leg of the pair which is most important.

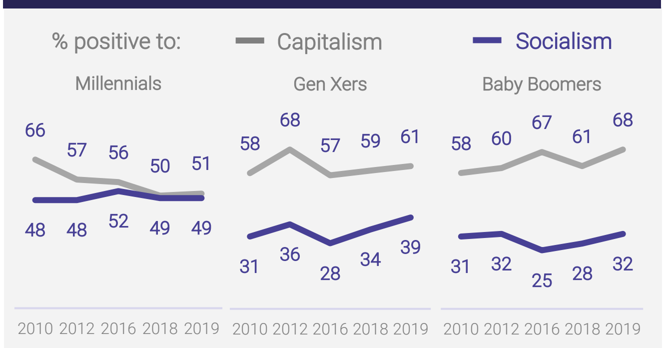
Speed limits are sometimes offered as a banal example of the seen/unseen trade-off. Almost all fatal road accidents could be avoided if we set the limit at 15mph. However, the development of rapid transport is linked to GDP, to the reduction of poverty and its attendant death and disease. The total toll on human lives would be terribly negative if we decided to "save lives" using such policy.

Another popular example is rent control. It is tempting for politicians to fight rent inflation by putting in place control mechanisms. While it usually works in the short-term, and is a sure election winner, the unintended consequences of such policies are severe: disincentivising landlords to maintain and invest in new properties, leading to a reduction of the supply and therefore exacerbating the issue.

While those two examples may sound obvious, at least to our audience, sadly most trade-offs are more complicated and less clear cut, a fact Covid-19 has made abundantly clear. Bastiat argued that almost every decision could be framed with seen/unseen. Unintended consequences tend to arise when the unseen is discounted, unexpected, or hard to quantify.

For a long time, the Western world had the dubious benefit of a real-life example of centralisation gone wrong. It could observe socialist economies severely underperforming on its doorstep. But the memory of the bankruptcies of such systems and the unintended consequences of bad incentives is slowly fading away. Given the younger generations seem to view Socialism and Capitalism as equally (un)attractive propositions (Figure 1), it might be time to dust off those old textbooks.

Fig. 1:
View of Political Systems, By Generation

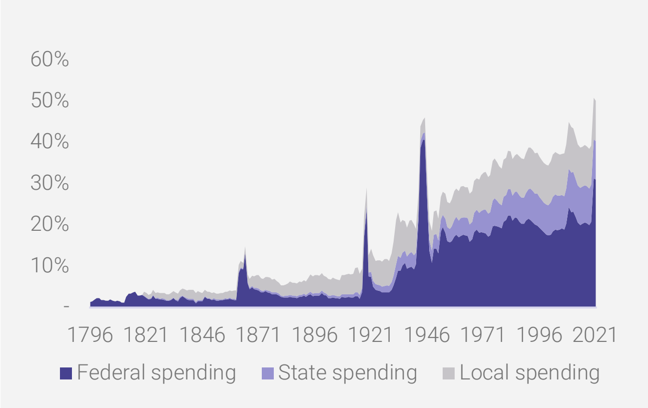


Source: Gallup

Looking at history, certain conditions foster unintended consequences. And it seems the direction of travel is for those conditions to increase.

The first aggravating condition is size. The larger and the more centralised the organism, the more difficult it is to regulate. What is seen becomes ever more remote from what is unseen. Information is harder to disseminate, and it takes longer to implement change. As the feedback loop loses its intensity, accountability decreases. **Eventually no one knows who is making the effort, and usually by that stage, no one really cares**. The default position of large governments tends to be to keep growing, especially during crises. When they face constant calls to act, situations where "first, do no harm" feels like an insufficient response. And act they do, as shown by the giant step changes in activity during wars, and lately during Covid-19. The Figure 2 below shows the situation in the US – not the worst offender. Notice how those periods of growth are not reversed. It seems systems just keep on growing if no one pushes them back.

Fig. 2:
US Government Spending % GDP



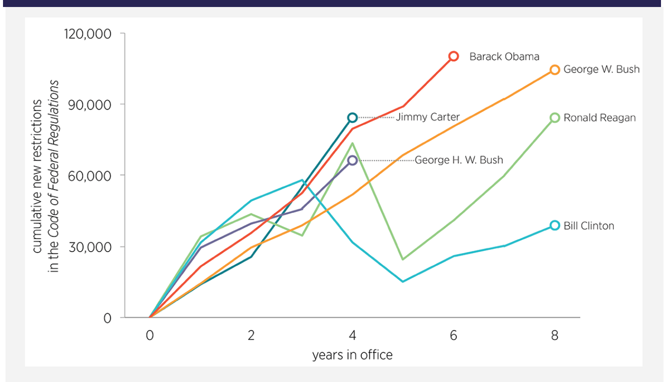
Source: US Census Bureau

The bias to action is aggravated nowadays by **technology and media**. Near instantaneous communication tends to encourage hasty decisions. Social media can have the unintended consequence that extremes receive a greater share of voice, and polarisation is rarely constructive for decision making.

One area this has manifested in recent years is the criticism of Big Tech in the US, which has faced mounting accusations of monopolistic practices. We will not wade into the debate here, aside from noting that it has merit, but is a complex issue, ripe for unintended consequences. The political imperative to act recently found some expression following the appointment of the new FTC chair – 32-year-old Lina Khan. A recent article Bloomberg stated she "has gained the support of politicians across the ideological spectrum, from progressive… Bernie Sanders to hard right conservative… Josh Hawley." When a **coalition of the extremes is misrepresented by the press as consensus building** across the aisle, it can lead to counterproductive populist decisions. One of Khan's most visible first actions has been to scrutinise the acquisition of the distressed movie studio MGM by Amazon. Big Tech may or may not require scrutiny for monopolistic practices, but the unintended consequence here could be to jeopardise the creation of a new and well-funded competitor in the streaming wars, one which might have shaken up the historically tight-knit US media industry.

Regulation of course is a tricky domain, if only because it tends to be easier to add than to remove. Niall Ferguson notes that eight US presidents have declared 70 states of national emergency since 1976 and that 40 remain in effect to this day. Writing recently, "let's face it, there are hundreds of thousands of people employed for the sole purpose of generating new rules, and almost none whose job it is to scrap them." Increasing regulation is one of the few areas of consensus across the political spectrum. President Trump famously pledged to cut regulations during his term, initiating a "one in, two out" policy. However, critics point out this was partly achieved via sophistry (the Trump administration enacted plenty of regulations which were technically defined as "deregulatory" and are therefore excluded from the official numbers). And of course, his executive orders, trade restrictions and various other shadow regulations further complicate the picture. At the end of the day, all flavours of US political administration seem addicted to regulation (Figure 3), and the EU is not particularly restrained in this regard either.

Fig. 3:
New Restrictions Added Under US Presidents



Source: Mercatus Centre, George Mason University

While there is no question that **good regulation is desirable, it is also the case that bad regulation is often worse than none**, and often hits small businesses and entrepreneurship disproportionately. We should approach the exercise with humility, given our collective track record.

Take for example the Great Financial Crisis. To quote Steve Schwartzman "Historians of the financial crisis will tell you that in the insanity of the housing markets, two connected sets of government actions stand out. The first was politically encouraging home ownership before the crisis, even by people who could not afford it. In the aftermath of the crisis, the government initiated its second set of disastrous actions by clamping down on banks and requiring them to tighten their lending standards. In both the housing boom that preceded the crisis, and the bust that followed, the government's policies exacerbated the situation. When the market was going too fast, they slammed the gas. When it was grinding to a halt, they hit the brakes. The poor American consumer suffered whiplash in the passenger seat."

During those dark days, Citigroup – one of the most regulated entities on planet earth – required total government funds reaching an astounding $500 billion. An extravagant amount, which contrasts sharply with more lightly regulated asset classes like private equity or hedge funds where not a single dollar of public money was necessary.

At a micro level, the defence of Wirecard by the German regulator which prosecuted the Financial Times whistle-blowers, suggests at best that regulations designed over the last few decades are still not optimally implemented.

These are isolated examples, and **plenty of regulations do work well**. But what is unseen is the impact on everyday commerce. The two financial crises of the 21st century resulted in the Sarbanes-Oxley and Dodd-Frank Acts, designed to regulate capital markets and prevent future disasters. The reporting requirements involved in running a publicly listed company have become significantly more onerous as a result. Entrepreneurs have responded by staying private for longer. The median age for companies at IPO for the period 2001-2020 was 11 years, compared to 8 for 1981-2001, and the trend seems to be accelerating. Enormous private companies like Stripe, TikTok, SpaceX are becoming the norm. They have turned to private equity to meet their financing requirements, with the result that retail investors and pension funds have less opportunity to invest in some of the most innovative and fastest growing companies. As a result, rules enacted to protect retail investors end up hurting them. Clearly not intended.

GDPR (General Data Protection Regulation) in Europe is an interesting example of a noble ambition to protect personal data. The intention is as commendable as the subject is complicated. But is GDPR a net positive, and how can we estimate the liability side of the equation? Estimating 400m European internet users, each visiting 10 websites each day, most flashing a GDPR privacy consent message. We are collectively spending more than 300 lifetimes EVERY YEAR granting consent (or not). If like us, you indiscriminately click "I Agree" to all those pop-ups, then the noble ambition has turned into quite a waste. We suspect Bastiat might ask whether a better solution could be found if European society allocated 300 lifetimes to considering the problem. We are being flippant, but sadly it doesn't stop there. As the entrepreneurs amongst you will likely know only too well. Whilst protecting user privacy is vital, the major beneficiary of all this regulation has been large tech companies: the very people regulators are seeking to constrain. Companies must devote substantial budgets to ensure they are compliant with the rules – something easily afforded by the largest companies, less so by SMEs and start-ups. Ernst & Young estimated that US Fortune 500 companies spent over $8bn simply preparing for GDPR. There have been various surveys suggesting that most small businesses have hired new staff and spent thousands of man hours, with half of them still not fully compliant, leaving them vulnerable to fines of up to €20m. Is it really a surprise therefore that Mark Zuckerberg makes public statements suggesting more rules should be introduced?

Any such move would further entrench Facebook's competitive advantage: **the incumbents risk "pulling up the ladder behind them"** so that new companies may not be able to compete. A pretty serious unintended consequence.

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Monetary Policy – the mother of all unintended consequences

These examples suggest we are not much better at managing the unseen since the days of Bastiat. In fact, we would argue that things have gotten worse. Particularly in Western societies, where central bankers are exposing us to the mother of all unintended consequences.

In our letter #2 (Debasement) we alluded to the importance of the risk-free rate in the capitalist system. Every asset – and therefore every risk – is priced in relation to it, making it the price of all prices. **The one supposed to allow the proper allocation of resources and capital.** One to tamper with only in exceptional circumstances.

Having thought long and hard about prices and markets, Adam Smith was well aware of the power of the unseen. In *The Wealth of Nations,* he writes about the "invisible hand" of the market, the unrivalled power of market prices to optimise allocations. In the capitalist system the risk-free rate is on its own the equivalent of the whole *Goskomtsen team* (State Committee on Prices) in the former Soviet Union. For the last 20 years, Western central banks have manipulated this rate on a scale never seen before. First by supressing interest rates. Then by ever more creative forms of quantitative easing.

This has been pleasing for investors and market participants since asset prices have risen. Companies have benefitted from boosted demand. Governments have enjoyed lower financing costs. Harder to see are the numerous unintended consequences of manipulating this most important price, the distortions impacting many feedback loops and safeguards across our economies.

Some examples:

- The proliferation of zombie companies, which would otherwise be unable to service their debt, keeps people and resources tied up in unproductive enterprises. This keeps **overcapacity in the system**, reduces economic potential, and **penalises the best players.**
- The explosion of moral hazard. The reduction in the risk of failure encourages decision makers to make ever riskier decisions. Setting bad examples and penalising the wise and prudent. To quote Warren Buffett (in Berkshire Hathaway's 2000 Annual Report) "the line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money." This is highly **detrimental to the quality of capital allocation, and therefore to future underlying economic growth.**
- Price inflation housing markets, which transact on extremely low yields because 30-year financing is available sometimes below 1%. Great for Boomers and above who are selling assets at record prices. But it penalises generations of **frustrated young actives** who face the steepest property ladder ever and who **develop an unhealthy resentment toward the current "system."**
- Record high demand for cars, kitchens, or sofas, with manufacturers selling a huge part of their production thanks to record availability of credit or outright stimulus cheques. How can companies plan capex and future investments when they suspect they are selling more than the real underlying demand, but don't know by how much? **Buybacks become a simpler answer than capex in such an unhealthy environment.**
- Art, collectibles, and digital assets hitting record valuations, especially when accepting crypto. Pockets of the market are desperate to protect their purchasing power whilst avoiding exposure to fiat currencies. This has driven many traditionally taxed transactions into unregulated markets, reducing tax revenues and **further weakening the credit of fiat currency[1].**
- Governments able to increase spending through massive borrowings without needing to convince the debt markets of their ability to ever repay that debt. How can they ever **embark on necessary, but painful, structural reforms when money seems literally to be growing on trees?**

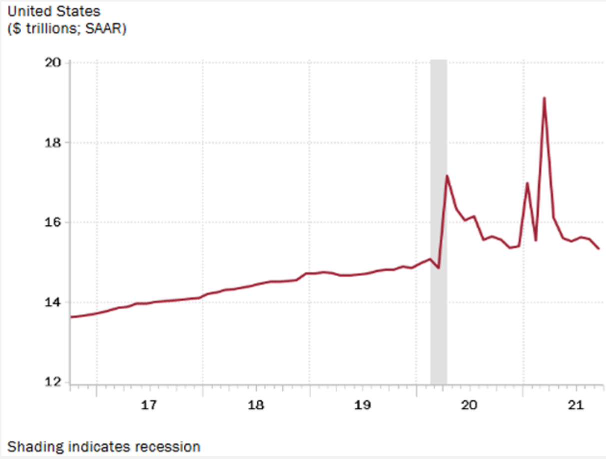
We could go on. Everywhere you look nowadays, one can see imbalances fuelled by ultra-aggressive monetary policy, and looking further, the attendant unintended consequences. With all decisions slightly off, with all investments slightly wrong, is it really a surprise that underlying economic growth has been trending down ever since we started implementing those policies at the end of the 1990s? **We have been compounding opportunity costs for decades.**

Trends have only accelerated with the Covid-19 crisis. The dramatic silencing of the bond markets by central bankers – close to 50% of all US dollars ever created have been printed since the start of the pandemic for example – has allowed governments to distribute unprecedented amounts of money across the globe.

An unemployed couple in the US with two children could have received up to c$95k (pre-tax) in stimulus and unemployment benefit since March 2020 (the US median household income in 2019 was c$70k, and the median bank balance around $6k). A level of support the government could never afford with its own resources. So much so that real disposable personal income did not go down during the crisis but actually massively increased, reaching levels never seen before (Figure 4), and going a long way to explain the boom in certain industries.

[1] Fiat currency is legal tender whose value is backed by the issuing government. This approach differs from money whose value is underpinned by some physical good such as gold or silver, called commodity money.

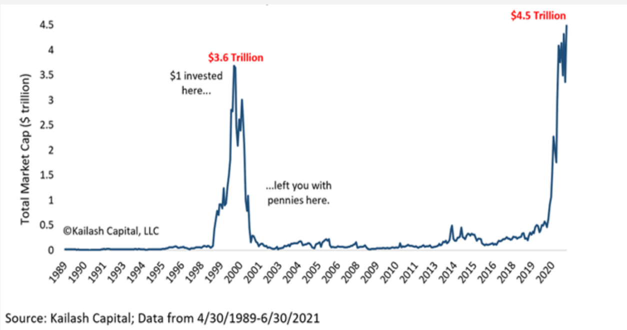
Fig. 4:
Real Disposable Personal Income



Source: Haver Analytics, Rosenberg Research

While the direct and immediate consequences of such policies (avoiding human suffering, short-term boost to the economy) are very pleasing, the unintended consequences have already been quite dramatic (severe labour shortage in certain industries, disincentivisation of work, moral hazard, epic speculations reminiscent of 2000 in certain asset classes, see Figure 5) and could prove long lasting.

Fig. 5:
Total Market Cap of Stocks with Price/Revenue>20x



Source: Kailash Capital, data to 30th June 2021

The unprecedented debasement also has an enormous impact on asset prices, sending them to all-time highs. As wages fail to keep up – despite robust growth – it further expands the wealth gap and understandably drives populist sentiment. This in turns creates political polarisation and degrades governance: not what we need given the starting point.

Central bankers seem secretly to be hoping for a benign deleveraging via inflation. It is clearly a possible path: letting inflation run a little hot for a while to erode liabilities, while keeping financial conditions benign to support the economy, whilst calling inflation transitory. The narrative is working so far, and given the situation, it is no doubt a desirable outcome. However, it is a tight and risky path. To quote Jean Claude Trichet at a time when inflation was considered a scary phenomenon rather than part of the solution: inflation, like toothpaste is "easy to get out of the tube, and very difficult to put back in." Things could escalate quickly and in a disorderly fashion.

Deflation, the alternative facing central bankers is even scarier. Leaving the economy and markets without support would risk triggering a liquidation phase, leading to a severe economic crisis. This would have dramatic economic, social, and **possibly political consequences, especially in a world where populism and political extremes on both sides of the spectrum are on the rise.**

So here we are, 20 years of ever more aggressive monetary policies have placed the Western world in a true **hostage situation**. And while unintended consequences are becoming clear for all to see, we are left hoping they right the ship and avoid the catastrophes that those policies achieved when pushed too far or for too long (be it in Venezuela, in Zimbabwe, or with the Assignats during the French Revolution!).

To return to those old history books for a second. Perhaps an unlikely commentator, but Copernicus warned that printing generated unintended consequences as far back as the 1400s, writing:

Although there are countless maladies that are forever causing the decline of kingdoms… the following four… are the most serious: civil discord, a high death rate, sterility of the soil, and the ***debasement of coinage****. The first three are so obvious that everybody recognizes the damage they cause; but the fourth one, which has to do with money,* ***is noticed by only a few****… since it does not operate all at once and at a single blow, but* ***gradually overthrows governments, and in a hidden, insidious way***

And who better to discern the unseen than Copernicus, the man who discerned the Earth's rotation around the sun!

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How to best protect against unintended consequences?

It seems there are a few clear 'Don'ts.' Most at risk are organisations or companies that lack accountability mechanisms. Or those which are unable to undo mistakes and change course. This makes feedback loops extremely important. Everything should be done to protect them, though many organisations end up doing the opposite for convenience. Short-term thinking is another as it tends to encourage clientelism and taking the easy route. Humans are most at risk from their biases when thinking about the short-term.

But enough doom and gloom, it is always more constructive to focus on the 'Dos,' and here there is plenty of hope.

It seems the simplest way to limit unintended consequences is **to reduce complexity and the size of a team** or an organisation. We have professed our admiration for Mark Leonard's Constellation Software in a previous letter. A company designed to reduce what Leonard calls the "communication overhead" exacted on large teams. Constellation tries to limit teams to 10 or less. Leonard has a theory that by limiting yourself to small teams you may sacrifice margins in the nearer term, by not capturing the maximum economies of scale. But that this is more than offset by the superior execution of small teams. They will create better products, serve customers better, and eventually capture a larger share of a larger market. Another great operator, Jeff Bezos, famously applies a two-pizza rule to internal meetings at Amazon. If you can't feed the team with two pizzas, you should probably split it up.

Next step is to **maximise feedback loops**. And here there is great news. Technology and the explosion of data are allowing the multiplication of feedback loops at an exponential rate. Helping managers to optimise and adjust in ways that were unimaginable just 20 years ago. Take an industry like video games. Products used to be designed, written onto discs, and shipped to retailers. While the publisher would launch an advertising campaign, hoping the game would be a hit rather than a flop. Imagine the number of things that could go wrong, with a limited ability to change course once the game launched. Today video games are distributed digitally, when they are not consumed directly in the cloud. Most of the time built on past successes through small incremental improvements. They offer the possibility for subscriptions, or in game buying, rather than a large upfront cost. And with real time usage data, the studio can continuously refine and optimise the gaming experience. This revolution has made game companies easier to run, more profitable, and less volatile. Although it is fair to say their stock prices have retained some of the volatile old habits.

Natively digital sectors are not the only ones benefiting: Direct to Consumer (DTC) is now reaching all corners of the economy. Take Nike or Adidas, which used to sell their merchandise through wholesalers, not knowing if a product would hit or flop, with a limited understanding of their customers, and no way to communicate with them beyond advertisements. Today more than 30% of sales go through the DTC channel at Nike, allowing them to be more reactive, less promotional, and have a clearer vision of the end demand. This makes sense from a margin standpoint, as you internalise some of the distribution margin, but even more importantly, it makes the company easier to run, more data centric. This ultimately results in higher returns on capital and less volatility.

And things are only accelerating. The emergence of blockchain applications, and the numerous experiments in decentralised autonomous organisations (DAOs) open amazing possibilities for organisations and ecosystems to grow and develop in ways which would have been impossible before the emergence of those technologies.

Through the introduction of feedback loops, numerous unintended consequences inherent to the old way of doing things (think discounts out of Nike's control offered by an overstocked wholesaler) are slowly disappearing, allowing the quality of businesses to improve dramatically.

After multiplying feedback loops, the logical next step is **to focus on incentives**, and therefore the response to feedback loops. To quote Charlie Munger "never ever think about something else when you should be thinking about incentives." In particular if they reward durable and long-term performance. This is easier said than done as the long-term is a succession of short-terms. Our experience meeting companies is that it is nearly impossible to create effective long-term incentives overnight. It is a process. A succession of sound shorter term decisions, hoping to foster a culture focused on the long-term. The Constellation Software stock plan for example runs over 3 years – probably shorter than most programs – but the way it is designed encourages total commitment and long-term decision making. Senior employees must invest a significant portion of their compensation into stock bought on the open market, with a vesting over 3 years. Such a plan is tough to implement as you can only do it if employees are convinced the system (and the stock price!) will work for them. If not, you must either pay above-average wages, which is not great for business, or you attract people who did not have other choices than coming to work for you, which is even worse. But once up and running, it is tough to beat.

Last but not least, perhaps the best guarantee to limit unintended consequences is **humility**. Being, as Jerry Seinfeld put it nicely on a recent podcast, "aware of our own mediocrity." Designing processes which work despite our human biases, rather than designed for an all too theoretical perfect human.

Think about something as mundane and universal as internal meetings. It is preferable if every participant has prepared and read the materials ahead of a meeting. As an organiser you certainly hope they do. And maybe even instruct them to if you are so inclined. It works in theory, but in practice, as they say, theory and practice can be two very different things. So why not invert the problem and design a process which makes sure everybody is on the "same page."

This is the road followed by Amazon, one of the most thoughtful companies on the planet when it comes to organisation and execution. Amazon meetings start with 15 minutes of silence in which the attendees read a 6-pager on the discussion subject. Where most companies would encourage people to prepare in advance, Bezos accepts that "humans will be humans," and that they may or may not make the effort, at least not every time. Amazon also bans the use of PowerPoint, probably recognizing the danger of the human bias to be influenced by broad-brush storytelling over detailed analysis. If a message relies on fancy slides to be convincing, an alarm bell should ring.

Internally we have taken a page from the Amazon's playbook for our research meetings. We don't write 6-pagers as (sadly!) our internal research documents usually run longer, which makes them impractical to read collectively in a meeting. But to make sure everybody has thoroughly read the documents and dignified the quality of the research, the analyst presenting an investment idea starts the meeting with a 5-question quiz. Those questions recap the most important points of the memorandum, with a few curveballs. Everybody takes the test, publicly. We find it has increased the overall quality of our meetings, as well as given them a more playful atmosphere.

The reason we think so much about the unseen, feedback loops, and incentives at Ananda is that they are at the core of our way of investing.

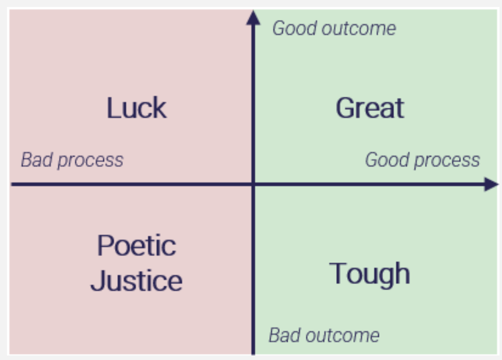
Unintended consequences and the unseen can offer investors some of the best contrarian opportunities. The market is a fantastic discounting mechanism, and prices generally reflect most of the information available at any given time, as the efficient market theory would have it. This is particularly the case for what you see, what is advertised. The unintended consequences, by being less intuitive, not advertised, more remote, and sometimes distanced from their cause, open all kinds of opportunity to investors, especially those with a long-term horizon.

When it comes to **feedback loops**, the market is also rather unique. It provides perfectly clear feedback. In the shape of a simple number, as brutal as it gets, daily. But it is feedback you can only trust to your detriment. Daily feedback is feedback for the day, not a reflexion of the long-term quality of a portfolio. A collection of prices, not of values, and therefore one that can at times be of the "precisely right but directionally wrong" nature.

Because the market's job is to humble us, and because it does a very good job of it, it forces participants to retest their hypothesis and confront their biases fully and forcefully. It is impossible to ignore, and a valuable risk monitor. But dignify it too highly, and you risk embracing the index, making the market your master, when it should be your servant, to paraphrase Warren Buffett and Benjamin Graham.

In the long-term prices will follow the earning power of assets, and therefore their value, making the market a proper weighing machine one can rely on. The short-term is a different story. Prices nowadays are driven by so many external factors, that the market is at best a loosely calibrated voting machine. This makes the performance analysis of investment recommendations difficult. And is the reason we put so much effort into building more adapted feedback loops, with varying timeframes and offering the possibility to adjust for different factors. It is also a reason we spend so much time trying to differentiate the process from the outcome when reviewing live or past investment recommendations. If a lucky mistake is preferable to an unlucky correct view in its short-term impact on the bottom line, in the long-term it is not.

Fig. 6:
Process vs Outcome



This ties up nicely with **incentives**. Whether it is about portfolio companies, or internally, our experience is that poorly designed incentive schemes are the biggest source of unintended consequences. And that nothing matches a well-defined and simple incentive scheme.

The history of capital markets abounds with examples of improperly incentivised managers harming good businesses by pursuing reckless M&A or vanity project investments. Conversely, incredible shareholder returns have been achieved by businesses in traditionally mediocre industries who have a properly defined and incentivised framework for capital allocation. Just look at the 20-year total returns of CarMax (14x), Next Plc (16x) or NVR Inc (28x) – solid results standalone, all the more impressive for used car sales, commodity retail or homebuilding (respectively), businesses not reputed for their attractive moats.

Even if unintended consequences are daunting and scary, the good news is that humans can perform miracles under the right circumstances, and that technology is today providing us the tools to organise ourselves into more efficiently self-correcting units.

Compounding allows small improvements to produce gigantic returns. The great unseen is that in a good environment, with the right incentives, healthy social justice, and the freedom to build, millions of people and actions around the world are compounding to achieve great things 24/7.

From all the team at Ananda, we wish you a Merry Christmas, and a fantastic 2022!

- Louis Villa

Historical Performance	
Period	**ALTO L Class USD[1]**
Jul-19	1.0%
Aug-19	2.4%
Sep-19	0.9%
Oct-19	7.2%
Nov-19	3.0%
Dec-19	1.8%
Jan-20	3.4%
Feb-20	-5.2%
Mar-20	-11.0%
Apr-20	11.7%
May-20	10.3%
Jun-20	-0.4%
Jul-20	3.8%
Aug-20	5.4%
Sep-20	-0.1%
Oct-20	-0.2%
Nov-20	10.9%
Dec-20	4.7%
Jan-21	-5.1%
Feb-21	1.3%
Mar-21	4.8%
Apr-21	5.8%
May-21	-0.4%
Jun-21	1.3%
Jul-21	-0.1%
Aug-21	-0.3%
Sep-21	-3.2%
Oct-21	2.1%
Inception to date	**74.2%**
Inception to date Benchmark[2]	**42.5%**

1 L class, net performance in USD; 2 Benchmark is calculated as 2/3 of the Eurostoxx 600's and 1/3 of the S&P500's total return.

Montpelier House
106 Brompton Road
London SW3 1JJ

ANANDA
ASSET MANAGEMENT

+44 (0) 207 590 1835
info@ananda-am.com
www.ananda-am.com