LUCRI ALPHA NEWSLETTER NR 11

2 MAY 2017

Dear Lucri friends,

It is planting time in the Overberg. This year's agricultural cycle is starting amid a dry spell. The capital intensive machinery is planting Barley, Canola and Wheat in large clouds of dust. At an annual cost approaching R 6000 per hectare, the dry land Overberg farmers must have nerves of steel – I think it is safe to state that the risk tolerance of these farmers are way above that of the average investor in common stocks, which is already at the high end of the risk continuum. Talking about stress levels…real stress is when you wake up screaming and you realize you haven't fallen asleep yet!☺

Poor lawyers

I have written 10 newsletters without insulting any lawyers. This unacceptable state of affairs must be rectified immediately. We all know that 99% of lawyers gives the rest a bad name, right? I called my lawyer and said: "Can I ask you two questions?" His reply: "Of course. What's the second question?"

Risk Indicator

The risk indicator of the all share index dropped below 50% (the midpoint) in March 2017 after hovering above 60% for the six month period July 2016 to December 2016. This is good news, as it signals a reduction in investment risk. You will remember (newsletter 1) that this does not indicate the likelihood or timing of a share market crash, but rather the extent of any crash if one is initiated now, at this moment. So, a crash occurring now should produce less red ink versus one during July 2016 to December 2016. With the all share index (price) moving no-where for almost three years, even modest growth in company earnings over time is lowering the rating (P/E ratio) of the index due to an increase in the denominator. While popular stocks are still expensive and have a high weight in the index, the risk indicator signals that the insane ratings are gradually returning to normality.

Feedback on Lucri financial year end

As indicated to you, Friday the 24th of February was used as the financial year end to provide sufficient time over the weekend to value all the portfolios. This year we had a significant improvement on positive alpha relative to the previous years. One of the main reasons can be found in the strong price recovery of unpopular commodity stocks that was bought below value earlier. (Please refer to the tables presented in newsletter no 10). The flagship Lucri fund experienced a positive alpha of 5.8% last year. You will find the updated historical performance of this fund on the www.lucri.co.za website.

Overall, 61 out of 85 portfolios produced positive alpha last year. I separated the 85 portfolios into the following three groups:

- Portfolios that was started from a clean sheet, investing time more than one year, group A
- As above, but investing time less than one year, group B
- Portfolios that were taken over from clients and restructured, group C

The following table provides a concise summary of the results:

Group	Positive Alpha	Negative Alpha	Total
A	49	6	55
B	8	13	21
C	4	5	9

What can we learn from these results? Firstly, it is obvious that the result improves over time. 89% (49 out of 55) of older portfolios beats the market while only 38% (8 out of 21) of portfolios with a running time less than one year could achieve positive alpha. So, if you are a new Lucri member and your result was negative, you can take heart by looking at group A. The value investing approach asks for patience due to the length of the investment cycle – companies does not move from unpopular to popular within months – it rather takes years for the ugly duckling to develop its Swan-like feathers.

The relative poor performance in group C is mostly due to an initial weak hand of cards that was not restructured with sufficient aggression (it is safe to assume that most portfolios that are handed over to me are not aligned towards positive alpha) or it can be due to restrictions placed on the portfolio by the owner.

The most valuable learning can be taken from the 6 portfolios that was started from a clean sheet of paper, was in play for longer than a year, but still underperformed relative to the market. I take full responsibility for the underperformance in these 6 cases, and shall work without any fees until we have positive alpha (or until I am fired☞). In some cases the underperformance was due to a concentrated investment that went bad. You only need one bad concentrated investment in a portfolio for the entire portfolio to underperform the market. The value of diversification should not be underestimated – it is the only free lunch in the investment industry. In some cases the lack of diversification over different time periods contributed to the underperformance. If the investor invests one lump sum at one point in time only, there will be a lack of diversification over different opportunities – this can be positive or negative, depending on the reward to risk ratio of the initial portfolio.

Peabody – an example of a bad investment decision

I shall now discuss one of my failures – I believe an investor needs to discuss and learn from past failures. I have referred to my investment into the largest listed coal producer in the world in earlier newsletters. The common shares of Peabody, a fortune 500 company, were cancelled last month. This is a nice way to state that shareholder value was completely destroyed – to zero. Peabody is an example of world class operating excellence and maintains an excellent safety record. The company has abundant high quality coal reserves (low sulphur content) and the reserves are being extracted at a most competitive cost base. The share moved into

unpopular territory when international coal prices dropped three years ago. The reason for buying the stock was mostly due to an unsustainably low coal price. (This part of the investment idea worked out very well, by the way – the coal price recovered.) With about 35% of all electricity in the USA being generated from coal, and given the fact that Peabody had the lion's share of the coal market in the USA, a significant portion of the power in the USA is being generated from coal mined by Peabody.

With a strong market share, low cost production, excellent coal quality, a secure market due to power generation and abundant reserves that can be extracted at low cost this looked like an appropriate reward to risk ratio investment. Based on the technical quality of the asset, the size of the company and the operating excellence of the extracting process, it certainly was a superior investment.

What went wrong? I overestimated the quality of the balance sheet, it is that simple. Even after the coal price improved dramatically (certain metallurgical/coking coal types produced by Peabody in Australia increased 50% in price) and after the company decreased its cost of production significantly, Peabody could not keep up with the interest payments on loan agreements that it accepted in order to take over an asset in Australia. So, the learning point is that the size of the company does not count. It is the ratio of financial liabilities to equity that must be limited in order to ensure sustainability during a brutal, prolonged downswing in product prices. Peabody will survive, it had been restructured successfully and is emerging from chapter 11 bankruptcy at the moment, but the holder of common shares will not receive any value. While it is true that wealth concentrates onto the holder of common stocks, it is sobering to remember that almost all the investment risk is ultimately carried by the common stock holder as well.

The lesson: The size and operating quality of an investment cannot rescue the investor in the event that the balance sheet is of low quality (too much debt). During a brutal, prolonged downswing in product prices the contractual interest payments will kill you notwithstanding a strong recovery in product price – if the recovery occurs too late.

How do you think the unthinkable? With an itheberg. In Peabody's case, the iceberg is called DEBT.

Investment Olympics: Gold for South Africa

Just a quick update: After introducing the international investment athletes to you over a period of 108 years (1900 to 2008) in newsletter number 9, I have learned that South Africa indeed received pure gold over a 114 year period (best performer for 1900 to 2014). Yes, South Africa took the Olympic honours on real investment growth based in USA dollars over a 114 year period.

President Zunkma

You may quickly remind me that the 114 years are past tense, what about the future given the political moves that we are currently experiencing in South Africa?

Yes, South Africa reached so-called “junk” status on dollar denominated debt recently after two rating agencies had decided to downgrade our dollar debt. Our rand based debt (90% of our debt) has not (yet?) been downgraded officially as only one rating agency decided to perform a downgrade. The downgrade followed unnerving political moves in South Africa. As investors, you may wonder how all these developments will impact your nest egg in South Africa and what actions you need to take towards protection. If you ask me, one should definitely not listen to any predictions. The poor track record of political experts over the last year (think Brexit and the US elections) should tell you something about the usefulness of predictions. It is better to focus on the valuations of your investments and very important: Take advantage of opportunities that present themselves from short-term market moves in response (over reaction) to political or other negative news headlines. You can hear the Warren Buffett mantra in the background: “Be fearful when others are greedy, and greedy only when others are fearful.” Remember that value investors are buyers when an industry is struggling and sentiment is poor and sellers when the cheery consensus is positive and an industry is booming.

Dealing with uncertainty

Looking back at 2016, certain unexpected or low probability events came to pass. Brexit and Donald Trump as president-elect was both thought of as long shots in January 2016. Unlikely things happen – and likely things fail to happen – all the time. This is not news to you – we all know the future is not predictable – but we still love listening to predictions because we have a basic need to know more about the future. The message here is that not knowing what is going to happen does not mean one cannot manage investment risk. Diversification over different industries, business models, asset classes and countries/currencies reduce investment risk. Buying below value reduces investment risk tremendously. Diversification over time by investing in stages at different time periods and circumstances is also most helpful in risk reduction. After Peabody, let’s also add: Low debt to equity ratios reduce risk!

Periodic Capital Re-balancing

In the 105 year period from 1900 to 2005 the USA stock market returned a compound growth rate of 9.6% per annum. The following factors contributed to this growth rate:

- Earnings growth per share: 5% (range 4% to 7% most decades, -5.6% in depression decade)
- Dividends: 4.5% (range 6.9% to 1.1% per decade)
- Rating changes, change in P/E ratio: 0.1% (range 9.3% to -8% per decade)

The combined growth on earnings and dividends showed a steady, consistent performance of 8% to 13% per decade over the full period to deliver 9.5%. The moment one adds rating changes or speculative growth, wild variations are introduced as the P/E ratios wax and wane through the decades. The total growth range was 20.1% to -1.2% to produce the 9.6%. For example, in the 1980’s, the P/E ratio of the market rose from 7.3 to 15.2 times, an increase of 108% or 7.7% per

annum. In 1999 the market P/E reached 32 – you will remember the term “irrational exuberance” coined by Allan Greenspan, at the time chairman of the Federal Reserve. Decades of weak speculative return was immediately followed by decades of positive return from rating changes – and vice versa. This is an excellent example of reversion to the mean – basically a return to sanity after unprecedented P/E ratios.

Why am I high-lighting these historic figures and factors? **Because you can profit from it!** Now I have your attention again, right? There IS a magical formula that can be applied towards getting rich surely and gradually. I call it “Periodic Capital Re-balancing”. If you invest in shotgun-type baskets of shares like ETF’s and take care to invest into different asset classes and currencies, you can benefit from this technique at negligible risk.

I developed and quantified an over-simplified case to illustrate the point: An investor, Passive Paul, decided to invest equal amounts of money into three ETF’s, namely A, B and C. Each ETF goes through the following three year growth cycle: +40%, +20% and -30%, but the cycles are out of phase by one year exactly for each ETF. With +40% growth at A, B will experience +20% growth and C will suffer a 30% loss in the same year. The next year will look as follows: A +20%, B -30% and C +40% and the year thereafter: A -30%, B +40% and C +20%. Then the whole three year cycle repeats itself. Passive Paul invests R100 into each of the three ETF’s and hold the investment for 34 years. Re-balancing Ronnie invests the exact amount of R100 into each of the three identical ETF’s at the exact same starting point in time. The ONLY difference is that Re-balancing Ronnie lives up to his name and decides to re-balance the capital of A, B and C **once** in a year in such a way that the three ETF’s carries equal amounts of capital – in other words, after each year each ETF will have 1/3 of the total invested capital. This means that Ronnie will add to the looser (buy more) and subtract from the winner (sell some) to balance the investment capital in each.

In this over-simplified example, Ronnie will always buy and sell in the correct direction. Ronnie also keep the investment for 34 years – with 34 re-balancing acts over the 34 years. The following table present you with the result:

Time period	Passive Paul (rands)	Re-balancing Ronnie (rands)
Year 1	330	330
Year 3	353	399
Year 5	412	483
Year 10	569	856
Year 15	742	1378
Year 20	925	2018
Year 25	1207	3250
Year 30	1517	5235
Year 34	1963	7664

Remember, the two investors started with the exact same amount (R300), at the same time and invested into identical ETF’s. See that the performance after one year is identical – as can be expected. The only difference is that Ronnie re-balances

after year 1, and repeats the exercise each year – it only takes him a few minutes to perform the re-balancing. After 18 years the calculation shows that Ronnie is 100% ahead of Paul, and the end result indicates that Ronnie is 3.9 times stronger than Paul financially (290% improvement relative to Paul.)

Can you see how the value is being created? In this example, the ETF with an increasing P/E that is in a growth phase, is partially switched to a different ETF with a lower or declining P/E that is in a downswing. When this occurs, we gain in E overall. Then, when the cycle reverses (reversion to the mean), value is being created from the gain in E when P/E recovers and we gain in P (basically a capital gain, as you sell at P).

Yes, you will be correct if you indicate that reality will look different to this example where the cycle is rather severe and repeats itself conveniently every three years. In theory, theory is a good approximation of practise except in practise☺. The point I want to drive home is this: If you accept that different asset classes and currencies move in cycles, that these cycles are out of phase with one another most of the time and that reversion to the mean is more fact than fiction (as indicated over 105 years in the USA market where the market P/E started at 15 in 1900, fluctuated between 7.3 and 32 just in the 80's and 90's and ended at 18 in 2005), you can surely gain form the often wild swings in sentiment that drives investment ratings. Think about rand/dollar volatility in South Africa – you just need to buy the S & P 500 index EFT (CSP 500) and a South African ETF with less rand hedge shares (like ASHMID) to gain from the cycles in the rand/dollar ratio. If you add a different asset class like listed property as your third ETF (PropTrax 10 or GLPROP), you will surely have three ETF's that will move out of phase often enough to gain form it, and where the likelihood of a reversal in the relative movement is also quite high – so that you can gain form reversion to the mean. Yes! - you can benefit from "Periodic Capital Re-balancing" at very low risk, investing only a few minutes per year to perform the re-balancing.

I believe this technique is especially well suited for a Tax Free Investment or a Tax Free Savings Account. If you (South African citizens) utilise your R40 000 of tax – free capital gains each year and use it to fund your Tax Free Investment (maximum R33 000 per annum) AND utilise the technique above, I can (almost) guarantee you investment success defined as real after tax investment return over decades, even while accepting that unforeseen events will occur (unlikely things will happen).

Let's end on a less serious note, just to remove those $$ signs from your eyes: For those of you who love flying: If flying is so safe, why do they call the airport the terminal?

I hope you are enjoying the investment journey with Lucri amid the uncertainty of the market environment. Volatility driven by fear provides us with mispriced opportunities – which is essential for value investing.

Kind regards and Sans Souci investing,

Simon Streicher