LUCRI ALPHA NEWSLETTER NR 12

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Dear Lucri friends,

The dry conditions in the Overberg has improved – we are most grateful. At this point in time, a wide range of outcomes are still possible for this agricultural season, but it does not look like a total disaster. I still believe farmers in general are running high risks relative to the average business person in South Africa. Having said this, agricultural investments can be sound – I bought shares in an unlisted agricultural company (over the counter) in the last month, as my valuation model indicated a valuation ratio that is 6 times better than that of the recently listed Kaap Agri. In the event that this company lists on the JSE, the odds will be in my favour to create a significant capital gain. If it never lists, it is also fine, due to the dividend cash flow plus the low price that I have paid relative to value. There is only one important pre-condition for an investor in this kind of (unlisted) company: You need to be prepared to follow a real long-term approach. Listen to Warren Buffett on this topic: “Our favourite holding period is forever.”

Proof that the share market is not always priced correctly

Value investing, the investment style followed by Lucri, will only be beneficial if it is actually possible to buy shares at a price below their real intrinsic value. This in turn will only be possible if the market allocates a wrong price (too low) to a share from time to time. On 18 January 2016, a sufficiently large volume of Kumba shares changed hands at R25.40 per share – you can check the historical price graphs. A few days ago, on 25 July 2017, about 18 months later, Kumba declared an interim dividend of R15.97 per share – 62.8% of the price 18 months ago. (After tax it will be 50.2%). It is reasonable to assume that the full year dividend for 2017 will exceed 100% of the share price 18 months ago on an after tax basis. If one considers the fact that Kumba paid a dividend for most years during the last decade, a 100% after-tax yield on capital per year for most years into the future surely drives home that the market sometimes gets share prices entirely wrong – to the benefit of value investors!

Yes, I am taking the lowest possible price in hind-sight, and yes, I had no idea on that day that we have reached the bottom. If you refer to past Lucri newsletters, you will find more than one reference to Kumba – including one reference where dividends were specifically used to indicate value for this share. Buying close to those dates would have yielded a smile or two by now, although the result would have been less spectacular than in the example. Remember, while true, the example is only there to prevent you from falling asleep.

Obviously, the market can also allocate a price that is too high relative to value – which will signal that you need to stay far away if you do not own the share, but if you own it, it will shout in your ear: Sell! Sell!

On a lighter note: Investment definitions

Money management: The art of hiding trading losses from a spouse.

Random walk theory: The theory that market prices follow a random walk, much like that of a drunken sailor. The weakness of the theory lies in the fact that very little scientific research has been done on the walk patterns of drunken sailors.

Risk Indicator

The risk indicator of the all share index has now stabilised around 52%, basically in the middle of the range. The sideways movement of the index continues, still testing our patience, resilience and investment mettle. I mentioned in a previous newsletter that I have seen a four year period of sideways movement before – the maximum "getting no-where" period known to me. This was more than 40 years ago, in the early seventies. So, if the past holds true for the future, the likelihood of a continuing sideways trend is diminishing. This is the only consolation I can provide at the moment, plus that you will find the index knocking on the upper end of the side-ways range currently. I am discussing in the following paragraph the significant, but almost invisible tail-wind provided by government (of all entities!) if you are patiently following a long-term investment approach.

Anyone interested in an interest-free loan?

It almost sounds like your mum calling: "Anyone interested in ice-cream?" This must be the four most beloved words in the English vocabulary – perhaps only beaten by "Anyone interested in chocolate?"

Yes, almost all governments around the world that are taxing capital growth are indeed providing interest free loans! These governments are most friendly – they do not limit the time period or the amount of the loan at all, and even better – the time period remains totally flexible - you can decide to cash in on the loan at any moment (like the Sell! Sell! moment above), or to extend it indefinitely. I know it sounds too good to be true, and I also know that no broker will tell you about this (that's why I call it almost invisible) as it is not in their best interest that you should have this knowledge. Activity on your share account is in the interest of the broker, as it produces brokerage fees – while this knowledge lead to inactivity and basically no brokerage fees for decades.

Allow me the pleasure to introduce you to two ladies – Long-term Lara and Frequent Fanny. Just to keep the interest of the men, let's assume that both of them are beautiful models. Now, Long-term Lara invests for the extreme long-term, for a full 40 years. By most standards Frequent Fanny, who transacts once per year, does not live up to her name, but relative to Long-term Lara she surely do.

Both ladies start with R5 million (this may get some interest from ladies and definitely increase the interest from men), both achieves investment growth of 15%, both pays capital gains tax at 18% (45% marginal rate times 40% because they are rich) and the cost to transact from cash to shares and back to cash is 1.2% for both. Both also gets the first R40 000 of capital gains tax on a tax-free basis each year. So, their investment parameters are identical.

The only difference is that Long-term Lara invests once and then hold her investment for 40 years without any buying or selling activity. She cashes in after 40 years, pays her capital gains tax of 18%, gets R40 000 tax free and incur investment cost of 1.2%. Frequent Fanny takes her 15% investment growth every year by selling her whole investment, pays her 18% capital gains tax, gets R40 000 tax free every year and incur investment cost of 1.2% in the process. (For those of you with taxation knowledge: Yes, I am giving Fanny a huge benefit here by assuming capital gains tax only – in the real world she may be taxed at her marginal tax rate of 45% due to the short holding period, being less than 3 years. In spite of this benefit to Fanny, she still loses by a huge margin to Lara.)

After the 40 year period, Long-term Lara owns nett capital after taxes and cost of R1085 million, while Frequent Fanny has nett capital after taxes and cost amounting to R320 million – only 29.5% the amount of Long-term Lara. To some men, Lara now really looks stunning – even after 40 years!

How is this possible, after both ladies had enjoyed identical investment growth and after Frequent Fanny had enjoyed the benefit of a R40 000 tax-free allowance for 40 times and Long-term Lara had this benefit only once?

Yes, a part of the answer lies in the cost savings enjoyed by Long-term Lara – she paid the 1.2% brokerage fee only once, and Frequent Fanny paid it 40 times. But this is surely not the only reason – can you see the effect of the invisible tail-wind that Long-term Lara enjoyed? The interest- free loan from government had a massive effect – and partly explains why the rich in this world are constantly getting richer!

Let me summarise the difference between the two investment cases in table format:

Time period (years), if shorter than 40 years	Long-term Lara Capital nett (Rmillion)	Frequent Fanny Capital nett (Rmillion)	Fanny ratio to Lara %
5	9	8.4	93.3
10	17.3	14.2	82
15	33.9	23.9	70.5
20	67.2	40.2	59.8
25	134.3	67.5	50.3
30	269.1	113.4	42.1
35	540.4	190.5	35.3
40	1085.9	319.9	29.5

The data in the table are telling us that Long-term Lara is constantly outperforming Frequent Fanny over time. (Just think how enormous the out-performance would have been if Frequent Fanny was trading every month, like many impatient investors (speculators, rather) do!)

The table explains clearly why Lucri Alpha does not transact frequently – you will notice that the transaction activity in your accounts will be low relative to accounts managed by brokers. Obviously, brokers make money from transacting, while Lucri Alpha needs to outperform on growth, dividends AND cost. (Lucri does not measure

the gain on an after tax – but, it should be clear from the table that all Lucri customers ultimately benefits directly on an after tax basis as well.)

Let's play devil's advocate. What if Frequent Fanny knows what she is doing, and she manages to increase her investment gain beyond 15% due to her annual transactions? Yes, I admit, this will surely change the picture. But you should also realize that Frequent Fanny makes 80 decisions (buy and sell) during the 40 years for each share in her portfolio, while Long-term Lara only makes two decisions, one buy and one sell for each share. So, the risk of a wrong, low quality decision on Fanny's side is much larger than a similar risk for Lara. Remember also, that Lara knows she is in for the extreme long-term – her investment choices must be good for 40 years. Surely, she will make 100% sure and check her own reasoning many times over (also with others) before she makes a "till death do us part" type of investment choice? I therefore believes that Lara will most probably have the upper hand in terms of investment risk. (Lara can still diversify widely – she does not buy a single share, but she holds the portfolio for 40 years before selling.)

Also, according to John Bogle: "The return of a typical investor in the USA in individual stocks lags the market by about 2.5% per annum." If one looks deeper into this, you find that the main reasons behind the lag is based on trading cost and an increased risk of bad decisions as the trading frequency increases. So, the odds are not in Fanny's favour if one look at the numbers. This is also the main reason why I believe I should discuss the benefits of passive, index style investing in a future newsletter. This is important, as it may well be your best possible alternative the day when Lucri does not exist anymore or you decide to move away from Lucri – while still remaining true to the low cost principles of Lucri. So, in favour of index style investing that provides you with the average yield the following must be remembered: "Half the people you know are below average." So, Fanny can just as well reduce her investment gain below 15% via the 80 sell and buy decisions per share!

Let us have a look at the different factors at play in the Lara and Fanny example:

- The effect of transaction cost (or investment fees)
- The effect of a R40 000 capital gain that is tax free every year
- The "invisible" interest-free loan from government

Cost can kill

Someone more eloquent with words than myself once remarked: "Cost are like fingernails – they need to be cut constantly." This is quite true for companies, but also for investors and even applicable to your own cost of living.

In the example of Lara and Fanny, Fanny pays 1.2% every year for a period of 40 years. Due to the wonders of compounding, the effect of this cost is significant and can be shown as follows:

Growth of R5 for 40 years at 15% compound growth: $(1.15)^{40} \times 5 = R1339$.

Now, with 1.2% cost subtracted: (1.138)^40 X 5 = R880, which is only 66% of the previous number. The cost effect of 1.2% yearly was a 34% reduction in total capital!

The mathematical reason for the rather large effect is that the cost is being compounded over a long timeframe.

R40 000 tax-free capital gain every year

This effect will be significant at smaller investment amounts – for example, if the annual 15% capital growth in the example was below R40 000, the whole result would have been different. The cost effect will outweigh the effect of tax-free capital gain to still ensure a stronger finish for Lara, but the difference will be less spectacular. Naturally, there is nothing stopping Lara to limit capital gains every year to exactly R40 000 to balance this advantage that Fanny enjoys. In fact, this is exactly my recommendation to each of you: Take your R40 000 tax-free capital gain every year – because if you don't, you cannot catch up on it later – the opportunity will be lost forever. Governments are not that friendly after all!

In the example, Lara and Fanny are two rich individuals, with the result that the effect of the tax-free capital gain of R40 000 each year will be negligible.

The effect of the interest-free loan from government

Fanny loose out by a not-so-trivial 70.5% compared to Lara – and we already know that 34% can be allocated to the cost effect. The effect of the tax-free portion of R40000 is negligible due to the large amounts in the example – so, let us ignore it completely in the interest of simplification. The rest of the difference can then be allocated to the interest-free loan:

Lara is at R1085.9 million due to low cost and the interest-free loan. After accounting for the 34% effect of cost, Fanny will have R716.7 million. Therefore: The difference between R716.7 million and the end result of R319.9 million can all be allocated to the tail-wind provided by the interest-free loan from government!

As I believe my readers are probably quite familiar with the effect of investment cost over long periods at this point in time, I would like to elaborate on the effect of the interest-free loan. Can you see where this effect is being hidden, and why I call it an interest-free loan? In order to understand it, you need to understand the effect of deferred taxation. This is a tax liability in your books, but you do not pay the tax immediately. Capital gains tax is only payable when you realise your capital gain by actually selling an investment. Before that point in time, you only will have an unrealised capital gain on your books. The important fact to grasp is this: While you carry an unrealised capital gain in your books, you are allowed to enjoy growth on this "loan from government" for your own benefit. You do not pay any interest at all on this "loan" for the full time period until you actually realise the capital gain by selling the investment! In other words, the largest portion of the yield on the unrealised capital gain (82% with capital gains tax at 18%) will benefit you directly. But: If you realise the gain every year, you will be liable for capital gains tax. This tax will need to be paid physically each year – it is actual cash that will flow out of your portfolio, and you lose out on the opportunity to enjoy growth on this amount forever!

Can you see where the benefit is being created? The compounding effect of keeping all growth in the portfolio, enjoying growth on growth, is a very strong tail-wind especially because you pay no interest charge at all on this capital for the full period that you keep it for compounding growth purposes – 40 years in the Lara example.

Yes, you will pay your share of capital gains tax eventually, and you will pay quite a large amount due to the compounding effect. But the point that I want to drive home is that you will retain 82% of the additional yield and outperform significantly due to the so-called interest free loan.

Interesting question

Due to the investment results of four people that I have introduced to you in newsletters 11 and 12 (Re-balancing Ronnie, Passive Paul, Long-term Lara and Frequent Fanny) you may want to pose a most interesting question: "I understand why Ronnie beats Paul and why Lara beats Fanny, but who has the ultimate investment technique: Ronnie or Lara? Ronnie transacts (re-balances) every year and Lara transacts only once in 40 years. While Ronnie performs very well in a tax-free savings account, how will Ronnie perform opposite Lara outside such an account?"

To be continued…….

New Satrix ETF products

For those of you utilising ETF's in your tax-free investment account (I strongly recommend that you do and follow the Ronnie approach – you can do this by yourself even if you have limited investment knowledge), it will be worthwhile taking note of the low cost ratios of the Satrix ETF's that were launched today. The Satrix product tracking the developed MSCI world index is quite competitively priced versus the DBX WD product, soon to be renamed under the Itrix brand. The same is true for the Satrix product tracking the S&P 500 index in the USA – the cost is lower compared to the existing S&P 500 Coreshares product. As you do not pay tax on profits after switching in the tax free investment account, you may want to switch to Satrix. Or, you may decide to buy your future ETF products from Satrix and wait with your current ETF's to see whether the competitors will start lowering their fees. In a capitalist system, this is precisely what you can expect.

Kind regards and Sans Souci investing,

Simon Streicher