LUCRI ALPHA NEWSLETTER NR 19

25 APRIL 2019

Dear Lucri friends,

The agricultural season in the Overberg is much quicker out of the blocks (thanks to rainfall) this year in comparison to the previous two seasons. So, if the Afrikaans saying is true that a strong start ensures half of your success, I have hope for this year being above average.

In the previous newsletter, I elaborated on the virtues of a long term mind-set and low transaction frequency. This however does not equate to resting on your laurels for long periods. A low frequency of transactions does not imply a low frequency of thorough, fundamental economic analyses or that only a few shares should be analysed. The more shares that you follow and analyse frequently, the better.

"*The person that turns over the most rocks wins the game.*" Peter Lynch

A low transaction frequency will be the result if you screen out 96% of all opportunities and concentrate your funds on the 4% excellent opportunities. If you add the discipline to only invest at low prices, it will translate into no action for long periods while you wait for the fat pitch. Transactions will be further reduced if you allow time in the market.

Thought for the day: There is a general expectation that investors must always be active (doing trades), but the greatest investors are low on trading, high on learning.

On a lighter note

Have you ever asked the following WHY? questions:

- Why is "abbreviated" such a long word?
- Why is it that doctors call what they do "practice"?
- Why is the man who invests all your money called a broker?
- Why is lemon juice made with artificial flavouring, and dishwashing liquid made with real lemons?
- Why do they sterilize the needle for lethal injections?
- Why do we leave cars worth thousands of rand in our driveways and put our useless junk in the garage?

I was in a job interview today when the manager handed me his laptop and said: "I want you to try and sell this to me." So I put it under my arm, walked out of the building and went home. Eventually he called my mobile and said: "Bring it back here right now!" So I said: "$1000 and it's yours."

Just to illustrate low activity: I walked into an organization where mr Jones is the CEO. I asked him: "What are you doing in this organization?" He replied: "O, I am doing nothing." So I walked into the first office where a friendly young man was sitting behind the desk. I asked him: "What are you doing in this organization?" He replied: "O, I am helping mr Jones."

Charlie Munger has coined a new word to describe low trading activity: "*Assiduity – the art of sitting on your …., doing nothing.*"

We have not insulted lawyers and economists for a long time. So, let's immediately correct the situation: "*New York has more lawyers than people*." Anonymous – for good reason! "*People who believe in perpetual growth in a finite world, are either lunatics or economists.*" Charlie Munger

Risk indicator

The risk indicator reduced even further to 35% in March 2019, the lowest risk level since I started the Lucri newsletter in October 2014. The risk indicator dipped briefly into green (below 33%) in January 2019. Currently, it is orange with a strong green glow. A low inflation rate, modest growth in earnings and a stagnant price index over the past 5 years is causing this result. As discussed last time, earnings growth without a corresponding price increase lowers investment risk.

I know……the risk level in South Africa does not FEEL low at this point in time, it actually FEELS quite high. Maybe I forgot to tell you that the emotions around risk needs to be quite negative in order to drive prices low enough in relation to value before the actual risk will be low. By the way, if this is as clear as mud, you are quite normal. In rational value investing, you must override your emotions, they are your enemy.

Testing your investment and financial knowledge

Easy question: What is the reading of the all share index of the JSE today, 25 April 2019?

A bit more difficult: What was the reading of the all share index of the JSE 108 years ago, at the beginning of 1911?

Answers: 58798 and 12.

You may at first glance be impressed by the growth of 489883%, or 4535% per annum calculated on a straight line basis without dividends included. (489883 / 108 = 4535). However, when calculated on a compounded basis, this translates into compounded growth of 8.2% per annum without dividends. With dividends included, the compounded growth will be around 11% (this number is my own rough estimation).

We are learning two important facts: Straight line calculations are not suitable over long time periods, and we should limit our compounded growth expectations towards 10% per annum over long time periods, dividends included. The high double figure growth numbers (closer to 20%) that we have experienced for some time after the year 2000 is not sustainable.

We are also learning that the power of compounding is under appreciated. Compounding is so big you can barely wrap your head around it. People tend to think about exponential growth in linear terms. So – keep your hands still and wait!

We all know that the rand is depreciating against the USA dollar over the years. The theoretical depreciation rate should be equal to the difference in the inflation numbers between the two countries.

Question: What was the average rate of annual rand depreciation (on a compounded basis) against the dollar since 1980?

Answer: 7.1%

So, although the rand sometimes strengthen against the dollar for years on end, and in certain decades the rand even ended the decade stronger against the dollar than at the beginning (for example 2001 to 2011), the long term trend of the rand is to weaken at a rate of 7% compounded.

In my opinion, the theoretical depreciation rate of rand to dollar going forward will most likely be closer to 3%. So, if you are in South Africa, you just need to find a low risk investment in the USA that grows at about 8% in dollar terms (dividends included) to be equal to the long term number of 11% above. My analyses indicates that Berkshire Hathaway will most likely achieve compound growth of 10% in dollar terms over long time periods in the future. So, a rand investment in Berkshire should yield about 13% compounded growth on average at the lowest risk available.

Lowest risk stock investment in the world

Yes, I believe that Berkshire Hathaway provides investors with the lowest risk equity investment in the world for a single share. Berkshire offers the lowest chance of having a lasting, permanent impairment of your capital. If you also have the discipline to buy it at a price obviously below value, you reduce the risk even further.

Why do I focus on risk? The answer is simple: Capitalism is brutal and it kills most companies sooner or later.

Let us look at four different sources of risk at Berkshire:

Competitive risk: This risk increases due to technological disruption, more intense competition, regulatory change and a reduction in demand, amongst others. Berkshire reduces competitive risk through wide diversification – Berkshire does not have to win in every business. A change in the competitive environment in one specific industry will not have a large effect on the long-term results.

Execution risk: Any company can be mismanaged to the point that its value is severely damaged. Berkshire cuts out the biggest controllable factors that negatively affect performance by compensating managers like owners, and by measuring the correct factors (profit drivers) over the long term.

Capital allocation risk: This risk increases due to the misallocation of earnings to opportunities. Capital allocation is a skill that can be taught and retained over time. The culture at Berkshire ensure a laser sharp focus on the best risk adjusted returns, based on opportunity cost. The culture praises discipline with shareholder funds. Sober assumptions are encouraged. In the words of Charlie Munger: “*The math is not that hard. The discipline is.*”

Capital structure risk: Can the company run out of cash or borrowing capacity? Leverage is an easily overlooked risk that can be a killer. A six foot person can drown in a river that is five feet, on average. You usually wins with leverage, but occasionally you get killed. Berkshire minimizes this risk with low debt levels, long-term debt as opposed to short-term debt, strong and consistent earnings and low levels of any other financial liabilities, matched with appropriate liquid assets.

The punchbowl is spiked with debt

USA share prices float on a punchbowl heavily spiked with debt. Last year it was a decade since the initiation of quantative easing. The cumulative excess returns for active managers reached 7% from 2002 to 2008 – the excess is calculated opposite passive investing in indexes. Then, the trend of active management beating benchmarks reversed and dropped steadily from 7% to reach -3% at the end of 2017. This represents a massive loss of 10% in 9 years! With the current slowing and reversal of quantative easing, the million-dollar question is: Will active management regain its superior, excess returns? I believe it will, as QE has distorted the share market, to the disadvantage of cash rich companies and to the advantage of companies using (abusing) debt as an artificial stimulant to buy back shares and increase dividends.

In this environment Lucri and other value investors like Allan Gray is suffering. Listen to William Gray on this topic: "*Today, prices move sharply as broadly adopted approaches buy or sell for reasons either independent from fundamental value or for reasons that few really understand. Investors that are transacting for reasons other than a fundamental view of a company's prospects now account for 85% of trading volume, according to a recent report from JP Morgan. This produces short-term variability but long-term opportunity for skilled investors who focus on the fundamentals. While this market environment makes our approach difficult to stomach, it bodes well for what we do. As it becomes harder to sustain a focus on fundamental value through the shifting tides, managers who seek to do so might either get themselves fired, capitulate or change their stripes – perhaps at the worst possible moment. As share prices ultimately reflect long-term business results, it will be all the more rewarding for those left standing.*"

I am fully under writing this approach. I am not planning to change my stripes to another investment style at all – but I am totally committed to continual learning.

"*The benefit of focusing on intrinsic value is that the pain of an acute share price decline is more often than not accompanied by greater conviction in future returns*."
William Gray

Feedback from the Lucri year-end

With some of the factors above in mind (without hiding behind any excuses), the relative performance of Lucri opposite the market was again quite weak, to say the least. Only 18 of the 89 portfolios under Lucri management managed to create positive alpha this year. This weak performance is in line with 2017/2018 when only 20 of the 88 portfolios created positive alpha. The last two years are significantly weaker than the previous 5 years (and the previous history since 1994). You can clearly notice this underperformance in the long-term performance of the Lucri flagship portfolio of the Streicher family, available on the www.lucri.co.za website.

Now that I mention the website – you can obtain all past newsletters from the website if you wish to refer back. I have decided to write my own book on investments, but to do it in small instalments via these newsletters.

The lazy portfolio

Please refer to newsletter nr 17. At this point in time, 5% of the decade timeline has lapsed, we have now completed just over 2 km of a standard marathon. The initial investment in each case was R100 000. The four athletes in this race are the following in running order:

1. JSE all share index: R 116 064
2. Lazy portfolio: R 111 512
3. S & P 500 (rand): R 108 019
4. Inflation RSA: R 101 928

In the calculation, all spin-offs in shares and all dividends are accounted for. In the index calculations, all dividends are accounted for. The S & P 500 index is converted into rand initially and at each update, the dividends are also converted into rand. Inflation is currently low in South Africa – calculated from the inflation index provided by Stats SA.

Discussion: Both the lazy portfolio and the JSE index were heavily influenced by the strong price movement in Naspers. Naspers also completed the spin-off of Multichoice (MCG) over the past six month period.

The irrational price movement of Annheuzer Bush discussed in the previous newsletter was reversed when the market came to its senses. Yes, the market does deviate from logic and rationality from time to time – this is the main strength of the value investment approach, namely to exploit such opportunities. As my hands are tied in this race, I cannot exploit such opportunities to enhance performance, but the idea is to demonstrate the value of the "sitting on your hands" lethargic approach to investing. It is early in the race – 95% of the road is ahead of us.

Recipe for outperformance

Out of respect for your limited reading time, discussion of items 6 and 7 will have to wait until next time.

Lucri housekeeping

Please always remember to tell me via SMS, WhatsApp or e-mail when you move cash in or out of your account.

All Lucri communication is only via e-mail. If you send an e-mail to streicher.simonj@gmail.com, I promise to answer in a few days.

Kind regards and low risk, assiduity investing.

Simon Streicher