LUCRI ALPHA NEWSLETTER NR 20

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Dear Lucri friends,

The Overberg is really beautiful at this time of year – the whole area is a patchwork of yellow, various greens and brown with occasional Encalyptus trees and the Langeberg mountain blue in the distance. We have bright yellow patches due to the Canola blossoms.

In the previous newsletter, I briefly mentioned the dangers associated with leverage. Charlie Munger puts the same message across with much more flair: "*There are 3 ways a smart person can go broke: liquor, ladies and leverage.*"

With leverage you usually win, but occasionally you are taken to the cleaners. Debt add additional strain to already complex financial decisions. Debt (margin) amplifies financial gains and losses – but it also amplifies emotions. Keep in mind that emotions are the Achilles' heel of most investors – it usually results in terrible market timing that hurts long term results badly. So, for most investors not using margin at all is the right approach.

Margin is a powerful tool, which like fire, can be used wisely or it can burn your portfolio to the ground if used incorrectly.

Market volatility gets a lot of air time in the media, but it does not really matter for long term income investors. Why? Because volatility affects prices, not dividends. Dividend paying stocks are one of the best ways to invest your assets to create a growing income stream. "*A chicken for its eggs, bees for their honey, a cow for her milk and a stock for its dividend.*" John Williams

On a lighter note

"*A meeting moves at the speed of the slowest mind in the room. In other words, all but one participant in the room will be bored, all but one mind underutilized.*" Dale Dauten

Why do you call your original language your mother tongue? Fathers do not get much opportunity to use their tongue….

Why do they call it "fast" when time passes so slooowly when you are hungry?

I used to be indecisive, but now I am not so sure anymore….

On a lighter note, with a lesson

How much did Andrew leave? "I think he left it all." (You cannot take your money with you when you die.)

If something can't continue forever, it will eventually stop. (To be applied to bull markets as well as bear markets.)

An empty sack cannot stand up straight. (There must be value in an investment.)

Diversify your portfolio, do not diworsify it. (Additions must strengthen your portfolio.)

War does not determine who is right, only who is left…..

Risk indicator

The risk indicator remains low at 41%. It increased slightly since the previous quarter, but the risk for a huge drop in the JSE all share index (in the event of a market meltdown) remains subdued.

This result can be expected due to the fact that the JSE all share index only had crab-like movements in the last years. In this environment, we should remind ourselves that winners are not people who never fail, it is people who never quit.

"*Never give up! Never, ever give up!*" Winston Churchill. I think this speech has achieved a world record on motivational value per second – and that record still stands today. This speech, one of the most powerful ever, had seven words and lasted about 4 seconds. It speaks about our resilience and emotional stability. People get smarter but they do not get wiser. They do not get more stable emotionally. When they are scared, they are scared! For this reason, we can buy statistical bargains with a huge ratio of reward to risk.

Sasol opportunity

Talking about reward to risk…..with such a large number of Lucri friends previously or currently associated to Sasol, I thought it will be fitting to comment briefly on Sasol as an investment opportunity at this point in time. Is Sasol a buy opportunity at present? The short answer is "yes" – the price was below R310 per share when I looked earlier today. (I know a lot of Sasol colleagues will currently be in a closed period – unfortunately their hands are tied.) The current lack of investor confidence in Sasol is not without good reason, but the current price indicates that the pendulum had swung too far towards extreme negativity. My quantitative investment model and a few rules of thumb like share price in relation to equity per share and the Sasol share price in rand in relation to the prevailing rand/barrel oil price all indicates that Sasol is currently trading below value.

I should just add that Sasol is not in my opinion a typical "buy and hold" long term investment. It is a cyclical investment – with wide swings around value. Over the last years, I have used an oversimplified formula for buying and selling the Sasol share: Sell above R500, buy below R360 – and repeat. You still need patience and discipline to succeed, even with a simple formula. This formula is deducted from the share value – it will not be valid forever. But, during the last 5 years it was remarkably successful. So, the current price being below R360 with a good margin explains my short answer above.

I believe the negative news (and more) is now fully priced into the share – it is my take that positive news (like beneficial operation on the rest of the Lake Charles production complex) will shortly start turning the investment sentiment around Sasol.

Berkshire Hathaway price history

In my previous newsletter, I introduced you to the "lowest risk stock investment in the world". This time, I want to indicate that the historical reward from this low risk investment was very pleasing – providing an extremely high reward to risk ratio:

I prepared the following table for Berkshire B shares. The price was deducted for past periods when only Berkshire A shares were available:

Date	**Price in Rand**	**Time period to present in years**	**Compounded growth to present**
June 1980	0.31	39	26.4%
June 1997	144	22	14.6%
June 1999	256	20	12.9%
June 2004	356	15	15%
June 2009	492	10	19.4%
June 2014	1335	5	16.8%
June 2016	2122	3	11%
June 2018	2510	1	15.6%

In June this year, the Berkshire share traded for R2900 (dollar price converted to rand). From the table it is clear that the 10 year period June 1999 to June 2009 provided a relative low compounded growth (about 6.7%). It is interesting to note that the price movement in dollars was quite strong over these 10 years, but the rand strengthened opposite the dollar, providing low rand based growth. Overall, the growth was more than satisfactory, especially in comparison to the low risk that I elaborated on last time.

South African investors will also look with envy at the mouth-watering compounded growth of 16.8% since June 2014 to June 2019 – as the JSE index was basically moving sideways over that time frame. This reminds me of the following wisdom from John Maxwell: "*The pessimist complains about the wind. The optimist expects it to change. The leader adjusts the sails*." One way for South Africans to adjust the sails will be to invest more offshore – Berkshire is a prime example.

A history lesson linked to investment

Aesop was a slave in ancient Greece – he was also an excellent story teller – stories with lots of learning points included. I am sure you are familiar with fables like "The Tortoise and the Hare" as well as "The Boy who cried Wolf." Did you know that these fables were written about 2600 years ago? (Aesop died in 565 BC).

Now, Aesop is also known to be the originator of the quote "*A bird in the hand is better (worth more) than two in the bush*." This perhaps speaks of the value of certainty in an unsure economic environment, but we can look at this quote from a value investment and fundamental analysis viewpoint as well and ask the correct questions. At its core, it is an investment quote. All investment is about capital outlay (the bird in the hand) and a future, unsure cash flow stream that the investor hope to earn on the capital.

- What are the prevailing and future level of bird interest rates? For example, at a 12% interest rate, it will be better to have two birds in 6 years' time than one bird now – but at a 13% interest rate, it is better to rather take the one bird now than two after 6 years.
- How many birds are currently in the bush in total? How many will probably be there into the future?
- How many birds will you be able to get and when? In other words, how will the "bird flow" look like over the years?
- How far is the bush away from you?
- How will the bush look like in 10 to 20 years from now?
- How many hunters are interested in that bush?
- How many snakes are in the bush – snakes that eat birds' eggs?

O well – now I have messed up Aesop's quote for good!

Tax Free Savings Accounts (TFSA)

In these newsletters, I strive to provide you with information that you can apply outside Lucri as well – it is not limited to investing with Lucri at all. This time, I would like to sing the praises of a South African investment vehicle that I believe is still being under estimated and underutilised, maybe due to a lack of proper understanding. It is also true that the commissions that your financial adviser can earn on this kind of investment is very limited – maybe explaining the lack of enthusiasm that some advisors demonstrates for a tax free savings account.

Basically, every natural person in South Africa can invest in a TFSA – this excludes trusts and companies. There are only three limits that are linked to a TFSA, namely the rate of contribution should be lower or equal to R 33 000 per year, the total contribution should be limited to R 500 000, and the life span of the investment cannot exceed your own life span. This means you can invest R 50 per month – it will take you 833 years to reach the R 500 000 overall limit, but if your name is Methuselah, nothing stops you from doing exactly that!

It is important to understand that there are NO other limits – the account value can increase to several million rand – there is no limit to the eventual, total account value. The resulting tax saving is also not limited at all. It will be determined by time in the market, basically your life span, and your investment skill. The funds in the TFSA is also fully available for withdrawal at any time – you can empty the total account in one go if you need to. But – if you think carefully about it, you will realise that your very first investment rand should enter a TFSA, and when you enter retirement, you should firstly deplete all other sources and get to the TFSA last. In other words, first in, last out – to provide for maximum investment time, which translates to maximum growth and maximum tax advantage.

Now, the true reason for investing in a TFSA is that almost ALL gain from the account (dividends, capital gains and speculative short term gains) will be totally tax free (you will still pay offshore withholding tax – but it is a relatively small tax expense). You need to invest with after tax money, but thereafter all gains are tax free. On capital gains, you will not pay tax outside the TFSA on the first R 40 000, and you will not pay tax if you are below the tax threshold. Speculative gains outside a TFSA are normally taxed at your marginal tax rate. If you are young with your whole life ahead of you, a TFSA is the ideal vehicle to start investing – for the simple reason that time in the market is such an important ingredient in investment gain. Older people can still gain – limited to time in the market.

Some people may think they are not earning enough to pay taxes according to the SARS tax tables – why should they invest in a TFSA? The short answer is that EVERYBODY (natural persons) pay 20% tax on dividends in South Africa – irrespective of your income level (except if you are exempted from dividend tax, but individuals are rarely exempt). So, obviously, everybody stand to gain in a TFSA. (The tax saving can be substantial over time, and will grow exponentially as time passes). This also explains why you should get your husband, wife, father, mother, grandfather, grandmother, son, daughter and even that toddler onto a TFSA – in each account, you can invest R 33 000 per year up to R 500 000.

Yes, I practise what I am preaching here. (except for the toddler!) Right from the start, when the legislation allowed for a TFSA, my wife and myself each started investing into our own TFSA. The TFSA legislation was passed about 5 years ago – we could invest R 30 000 per year into the account during the first two years, and R 33 000 per year for the subsequent three years – R 159 000 in total. So, R 341 000 to go for each! At this point in time, the value of the accounts are as follows:

My own TFSA: R 190 000 – the compounded growth was 9% per year

My wife's TFSA: R 185 700 – the compounded growth was 8% per year.

In both cases, the compounded growth was calculated taking the different time lines for the 5 investments (over 5 years) into account. What can you deduct by looking at the two growth figures – that I am a slightly better investor than my wife? No, I have managed both accounts. You find that we can already reap R 57 700 tax free – but as explained above, we shall rather earn tax free income on that money as long as possible.

The growth is not spectacular – but given the market conditions in South Africa over the past 5 years, I am more than satisfied – remember, the growth is tax free, and the future growth on this growth will also be totally tax free. By the way, the growth came from the international ETF's in the portfolio – sadly the South African ETF's provided nothing but red ink. So, the growth in the international ETF's was quite strong to make up for the South African losses. This is another benefit of the TFSA – you can invest 100% overseas, with no limits on the offshore portion. Other advantages of a TFSA:

- Total relief of the admin burden to declare share transactions to SARS.
- Due to the fact that only ETF's (basically baskets of shares) are allowed, the risk of being wiped out by a Steinhoff or an African bank is negligible.

With a TFSA, the playing field is totally level for all South Africans – we can invest exactly at the same maximum rate up to exactly the same overall limit of R 500 000. So, maybe I should challenge my Lucri friends to see who will be first to reach a value of R 1 million in their TFSA? The first prize will be a week-long free vacation in the Overberg on my farm. (Obviously so that I can pick your brain)

REIT's (Real Estate Investment trusts)

In my next newsletter, I plan to discuss the benefits of REIT's – especially, the strong tax advantage that you can obtain when you superpose a REIT onto a TFSA.

Recipe for outperformance

In this newsletter, we shall discuss items 6 and 7.

Item 6: **Profit from fear and folly.**

Markets divorce from reality from time to time. Though markets are generally rational, they occasionally do crazy things. Disregard mob fears or enthusiasms and focus on fundamentals. "*From time to time, dark economic clouds gather and rains gold."* Warren Buffett. People do silly things due to fear and greed. Look for a marvellous business with a solvable problem. Widespread fear is your friend, as it serves up bargains. (Personal fear is your enemy.) "*Fear is the foe of the faddist, but the friend of the fundamentalist.*" Warren Buffett.

"*If you can keep your head when all about you are losing theirs….*

If you can wait and not be tired of waiting….

If you can think for yourself….

If you can stand firm when everyone doubt you….

Yours is the Earth and everything that's in it."

Kipling

Item 7: **First quality, then value. But not quality at all cost.**

Qualitative analyses is more important than quantitative analyses. But – do not overpay for quality. What is smart at one price, is stupid at another. You cannot buy what is popular and have superior returns on the high baseline.

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 tax free investing,

Simon Streicher