LUCRI ALPHA NEWSLETTER NR 21

28 OCTOBER 2019

Dear Lucri friends,

As I am writing this newsletter, I realise that a full 5 years have passed since I wrote the first one. Wow – half a decade, gone in the wink of an eye.

In the first newsletter 5 years ago, I addressed the concept of a single, overarching market risk indicator for the all share index of the JSE that does not indicate the timing of a market crash, but rather the potential extent of a market crash at any point in time. It is interesting to note that this indicator moved firmly into green for two consecutive months in August and September of this year. It is the first time for this occurrence (two consecutive greens) since I started the newsletter.

Green indicator periods normally signals a green light to increase investment, as the downside risk from that entry point is low combined with a higher probability for upside. The reward to risk ratio therefore increases. This also signals the extreme negativity of investors towards South Africa – it seems that they have given up on the local market. People now asks whether South Africa is a failed state. In the words of Duncan Artus from Allan Gray: "In my 16 years of investing, I have never seen such negativity around South Africa." I agree with you, Duncan – only in my case, the period covers 39 years.

There is an underlying mechanism that is working steadily at reducing investment risk on the JSE over the past 5 years. Humble, steady nominal growth in per share earnings occurred over the 5 years while nominal share prices essentially moved sideways.

On a lighter note

We have insulted lawyers in this newsletter from time to time. This time, we shall not insult, we shall only mock accountants a little, as I actually likes accountants: The introvert accountant looks at his shoes while he is talking to you. And the extrovert accountant? He looks at your shoes while he is talking to you…..

"*Anheuzer Bush Inbev is one of the best stocks in a beer market*."

To steal from one person is plagiarism – to steal from many is research.

A fool and his money is soon partying.

If you think nobody cares about you, try missing a couple of payments!

Borrow money from pessimists – they do not expect it back.

Socialism quotes

"The problem with socialism is that you eventually run out of other people's money" Margaret Thatcher

"*We either benefit unequally in the prosperity of capitalism or equally in the misery of socialism."* Winston Churchill

Happiness mathematics

How do you increase your happiness? Keep your expectations low: "*Happiness is reality minus expectations.*"

Einstein wisdom

On October 19, 1987, the Dow fell 22.6% in a single day – a 20 standard deviation event. In theory, a 20 standard deviation event should occur once every 4600 million years. But, a Harvard study in 2005 found that a 1987 style one-day crash is actually a once every 104 year event. So, Einstein was correct on another topic: "*There are two things that are infinite – the universe and short-term market stupidity…..but I am not quite sure about the first one.*"

Testing your investment knowledge

Name three purely South African listed companies that outperformed the MSCI Emerging Market index in dollar terms over the past 1, 3 and 5 years?

Answer: PSG group, PSG Consult and Capitec.

Yes, there is growth in South Africa, but unfortunately it is limited to small islands nowadays – in this case, the Mouton magic island.

Warren Buffett quotes

No Lucri newsletter is complete without a Warren Buffett quote: "*You cannot make a good deal with a bad person.*"

So, when you buy shares in a company, the company must have management with talent and integrity – they must be able and trustworthy. Another important Buffett indicator is return on capital. Fast growers that generate low returns on capital can lead to value destruction. When the return on invested capital is low, you should slow down growth. Rather deliver shareholder value by focussing on an increase in return on invested capital. Good capital allocators achieve a high return on retained capital (funds not being paid out as dividends). Great capital allocators with a return on capital above 20% is a rare species.

The South African share market

We experienced a very tough investment environment in the South African share market over the last few years – we had to navigate a rough investment sea with dangerous rocks. We had wrong-doing in companies like Steinhoff, EOH and Tongaat. While the wrong-doing was widespread in Steinhoff, it was limited in EOH and Tongaat. Steinhoff now has no equity value left on their balance sheet – it may be partly due to conservative financial provisions, but the massive value destruction is there for everyone to see. The share price is about R1 per share, with about R12 per share of investment via their interest in Pepkor. Before you get excited and decide to invest heavily, firstly consider the fact that there is also R35 of debt per share on the balance sheet. So, you firstly need to determine and compare the value of the international investments per share to the debt of R35 – and also keep the legal risk and possible historical tax obligations in mind. The jury is still out on Steinhoff's survival.

Then, we had a different group of companies that were a bit too adventurous with large scale international expansion based on debt – Aspen, Famous Brands, Woolworths and Truworths fall into this category. This group has not been mortally wounded, but they have a steep debt hill to climb and the value being created by the expansions is not visible at this stage – to put it very mildly. Please refer to the discussions on debt and margin in the previous two newsletters – the exact same factors that were discussed for investors are at play for investor companies. Listen to Warren Buffett on this topic: "*It is insane to risk what you have and need for something additional that you do not really need."*

Sasol opportunity

I had a few comments on Sasol as an investment in the previous newsletter. Like the group above, Sasol was also adventurous with expansion overseas based on debt. In my opinion, value will be created in the case of Sasol. The annual results of Sasol for the 2019 financial year were released earlier today. I studied the numbers, and were quite encouraged. I had a close look at the debt on the balance sheet, and realised that about R50 billion of the expenditure of about R177 billion on Lake Charles up to 30 June 2019 was already paid via retaining profits from the other Sasol operations excluding Lake Charles. With about R16 billion remaining to be spend on Lake Charles (at most), the worst is surely behind the company. The combined cash flow from Lake Charles and the rest of Sasol seems to be more than sufficient to cover the interest and repay the capital – even while resuming dividend payments in future.

Yes, the final dividend for 2019 will not be paid. I see this is a responsible, logical decision based on the high current debt levels. Anheuzer Bush halved their dividend payment a year ago – and you may remember my positive response at the time – as they also had to deal with high debt levels after the take-over of South African Breweries.

Having said this, the numbers still signal some value destruction – as indicated by my quantitative share valuation model. Based on this, I am adjusting the price range for Sasol as follows: Buy below R330, sell above R460. I continued buying the Sasol share down to R252 per share – my next offer was in the market for R240 per share, but this offer lapsed due to the recovery in the share price today.

The Lazy portfolio

About a year ago, I constructed a concentrated portfolio that we can follow into the future – please refer to newsletter 17. The investment style was active – in the sense that I dared to choose a specific list of shares – and not a shotgun approach via exchange traded funds – by definition passive investing. The investment style was far from active in the sense that there will be many transactions – in fact, I promised to box with my hands tied behind my back for a full decade. There will be no action at all in the portfolio, except for the normal admin of collecting dividends and accounting for share unbundling, share splits or share consolidations.

We invested R100 000 into this portfolio of four companies on 23 October 2018. On 24 October 2019, the value of the R100 000 had grown to R113 608 – a growth of 13.6% in rand terms versus inflation of 4.1% in South Africa over the same period.

The Lazy portfolio on 24 October 2019:

Date: 24/10/19					
Name	**Rand price**	**Share count**	**Dividends**	**Rand value**	**Rand value 23/10/18**
Berkshire B	3085.92	11.80104	0	36417	35000
Anheuzer Bush	1345.96	12.56881	360.97	17278	15000
Naspers	2185.13	9.20515	65.82	20180	25000
Multichoice	124.51	9.20515	0	1146	0
Prosus	1040.7	9.20515	0	9579.8	0
Reinet	271.7	105.50749	340.78	29007	25000
TOTAL:				113608	100000

Comments:

- Naspers was blessed with two "offspring" in the form of Multichoice and Prosus after their planned unbundling exercise to unlock value. As we account for all dividends, stock splits, stock consolidations and unbundling effects, the original 4 shares has now grown to six without any further investment. The Prosus shares will give rise to capital gains tax in South Africa – I am ignoring tax in the calculation to simplify matters a bit.
- Adding the value of the three companies (Naspers, Multichoice and Prosus) in the table above indicates that the initial investment of R25000 had grown to R30906 – the Naspers investment was the star performer at 23.6% growth over one year.
- Reinet gained from closing the gap between share price and value – it was the runner-up performer at 16% growth.
- Anheuzer Bush dropped almost immediately after buying it due to the halving of its dividend. It still ended the year 15% up – after high volatility. (It dropped again a day after this calculation.)
- Berkshire Hathaway – clearly the blue-eyed boy in the portfolio if you look at the huge capital allocation of 35% - was running last by a good margin on price growth, at only 4% growth. I am glad to report that the price growth did not reflect the value growth per share – no disappointment there – which indicates a high probability for price appreciation in Berkshire into the future.

I also indicated that it will be fun to compare this limited, latent and lazy portfolio with the all share index of the JSE, the S & P 500 index in the USA (expressed in rand), and inflation in the RSA:

	23 Oct 2018	**24 Oct 2019**	**Dividend index**	**Rand value**	**Dividend %**
All share index RSA	51500	55614	2091	112047	3.76
S & P 500 dollars	2755.9	3004.5			1.83
S & P 500 rand	39640	43949	804	112900	1.83
RSA inflation index	108.9	113.4	0	104132	

So, at this stage, with only 10% of the road covered, the Lazy portfolio has taken the lead amongst the four athletes in this comrades marathon. Is this a bit deal? No, not at all – 90% of the road is still ahead of us. The only (doubtful) value that we can extract at this point in time is psychological in nature – because we are human, it feels good to be in the lead. The purpose of the Lazy portfolio is to hopefully demonstrate to you that constant buying and selling is not necessary to get respectful (although not optimal) results. We shall see how the marathon develops into the future. It is clear that we had a bit of gain from my favourite game to buy below value and wait for the correction of price towards value. But – over a 10 year period this will not help me very much – there must be growth in value as well to have a respectable result over a 10 year period. I use the word “respectable” as I do not aim for outperformance opposite the indexes in this portfolio – I do hope to have real growth opposite inflation, though.

The latest SPIVA (S&P Indices versus Active) scorecard for local fund managers in the RSA signals how hard it is to beat the market:

Over one year, about 38% of local fund managers beat the local index.

Over three years, about 48% of them beat the local index.

Over 5 years, about 25% of them beat the local index.

The conclusion? A coin flip would do better! Active investment strategies had a horrible performance versus passive products like ETF’s. The picture overseas looked similar when I looked at it a while ago – passive was beating active.

Real Estate Investment Trusts (REITS)

In my previous newsletter, I promised to discuss the benefits of REITS – especially, the strong tax advantage that you can obtain when you superpose a REIT onto a tax free savings account (TFSA) – the TFSA was discussed last time.

Currently, listed property like REITS is one of the worst performing assets classes in South Africa. Being a value investor, you will understand my sudden interest in this asset class.

Most of us have tried our hands on property investments. The most common way will be to buy an additional residential unit and rent it out to someone else – the idea is that your mortgage will (hopefully) be paid by the people renting your property.

In this discussion, I am comparing REITS to direct property ownership by discussing various types of risk.

Liquidity risk: REITS can be traded in a few seconds by the click of a mouse at low transaction cost, around 1%. In direct property, transactions can take months to conclude, at costs north of 5%.

Cash flow risk: REITS are widely diversified with hundreds of properties – ETF's containing REITS will have thousands of properties. In contrast, you can invest into a few direct properties only – one vacancy can hit your cash flow badly.

Management risk: REITS are managed by full-time specialists that enjoy economy of scale. Listed REITS are scrutinised by analysts and regulatory bodies. Compare this with your own efforts during your own limited time.

Leverage risk: REITS use around 35% loan to value ratios – most private, direct property investments use much more.

Permanent loss risk: In the long run, the risk of a concentrated property investment turning bad is much greater than that of a diversified portfolio of REITS.

Now, the "home run" reason why I am buying REITS specifically in a TFSA: REITS are structured in such a way that they do not pay ANY tax to the government. No, the government is not that generous – all the distributable proceeds from the REIT will be fully taxable in the hands of the investor. Now, follow the logic: When you buy a REIT (via an ETF mostly based on REITS) in a TFSA, you escape the tax completely. Remember, proceeds from a REIT is taxed at your marginal tax rate, like other rental income. The value of the TFSA can therefore be enhanced by earning heavily taxed income via the TFSA – tax free.

Recipe for outperformance

Items 8, 9 and 10 will have a stand over until next time – to limit the newsletter.

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 REIT investing,

Simon Streicher