LUCRI ALPHA NEWSLETTER NR 22

27 JANUARY 2020

Dear Lucri friends,

The drought conditions in the Overberg were broken recently by a six day rain – we are thankful. During the six days, we never saw the sun, it was heavily overcast all the time. In the middle of it, our Eskom power supply went down for 52 hours. So, we tested the solar power supply to the utmost – it managed to power one fridge and one freezer all the time, but we had to eliminate almost all other electrical consumption.

Risk indicator

The risk indicator, which was discussed in detail last time, remained stable at a low risk point on the border between green and orange. The slight recovery in the stock market was almost balanced by the low growth in company earnings in the RSA.

On a lighter note

During the past summer holiday period, I was again reminded of the following comical truth: Why do you ALWAYS find what you are searching for in the VERY LAST place where you look? Because…you stop searching after that!

This one is for people with adult children in the house: “We childproofed our house….but they are still getting in!”

Down under….

What’s Australia’s most popular drink? “Coca-Koala”

How do you describe an exhausted kangaroo? “Out of bounds”

Africa…

What is the capital of Zimbabwe? “Z”

I went to the grocery store and saw a sign in the window: “No food or drink inside.” So I went home.

Various quotes

“No matter how great the talent of effort, some things just take time. You cannot produce a baby in one month by getting nine woman pregnant.” Warren Buffett

“*Some companies cannot fall into bankruptcy – as you cannot fall off a pancake.”* Charlie Munger

“*Your net worth is a lagging measure of your financial habits. Your weight is a lagging measure of your eating habits. Your knowledge is a lagging measure of your learning habits. Your clutter is a lagging measure of your cleaning habits. You get what you repeat.”* James Clear

Performance versus cost in unit trusts

A total of 139 general equity unit trusts were analysed by Financial Express Analytics over the three year period 30 Sept 2016 to 30 Sept 2019.

Over this period, they found the following:

- 85% of the 139 unit trusts underperformed the market
- 95% of all the assets under management underperformed the market
- 97% of all fees paid were towards underperforming funds

Therefore: The 15% of the funds that over performed the market, attracted only 5% of the capital! Also, the fees per rand invested was about 40% LOWER in the over performing unit trusts!

So, it is clear that it is totally wrong to expect or assume that the most expensive fund managers will also be the best performing fund managers. I admit that the recent trend towards passive investment (or index investing) versus active investing had something to do with the result above – as passive investing is cheaper and the performance over the last few years was superior to active investment.

Having said this, I believe that a study into active portfolio managers as a group may yield the exact same result – a high fee structure does not guarantee over performance.

The successful portfolio manager

What is the best quality of a highly successful portfolio manager? Is it intellect? No, intelligence will not help much beyond a certain level. A successful portfolio manager keeps his/her head and just do the average thing while everybody else are losing theirs. **You should look over the valley while others are staring into the abyss.**

Smart Margin

Now, longer term readers of this newsletter will know that the idea of using borrowed money to invest into stocks have almost always received negative press in the Lucri newsletter. I just want to balance the argument slightly in this message.

Margin (debt) is not necessarily evil, it is merely a powerful financial tool that must be used with extreme caution. Warren Buffett use interest free insurance float as leverage – it is a critical component of his success over 50 years and more. So – the first principle to smart margin is to use non-callable, low-interest loans. Also, you should limit the gearing to a very conservative level of 10% to 20%. Lastly, always use margin counter cyclically, in other words, only use it AFTER a stock market crash of 30% or more. Do not use it in a hot market with high upwards momentum – only use it when investors are fearful.

The value of patience

During the last month, the value of patience was again illustrated in one client account that I am managing. The client wanted to consolidate accounts, and instructed me to sell all the holdings in one particular broker account about a year ago. This account contained, amongst others, shares in Impala platinum – bought at a price of R55 originally, a few years ago. The Impala share price dropped to R20 per share, and was still extremely depressed, far below value when the client wanted to sell. After a short discussion, we decided to wait a bit – just sell the winners, and keep the “losers” for a while. During the last year, the Impala share price increased strongly towards R150 per share, and I manged to sell at R150. This one share then changed the fortunes of that account meaningfully.

I admit…. R55 to R20 to R150 is the kind of volatility that is not good for the stomach of most people, it is also a bit more than what I usually enjoy (I must tell you, I normally welcome volatility for the opportunities that it brings to buy below value).

It just reminded me again that it is ONLY the beginning (buy price) and the end (selling price) that determines the capital gain in any investment, NOT the mad price movements in the middle. This investment turned out to be quite lucrative for the client – but it could have been a disaster if the customer was scared out of the investment one year earlier!

REINET

I believe it is fair to state that, out of the group of shares that were discussed in detail in past Lucri newsletters, Reinet was discussed most often. From the very first Lucri newsletter, I referred to this company quite a few times, usually talking about the huge difference between the value of the underlying Reinet investments contained in every share of Reinet and the Reinet share price. I noticed that some of you indeed had a braai with Johann Rupert (Newsletter 10, under the heading “Rupert insult”) and tipped him off on the prospects of a Reinet share buy-back.

Over the past year, Reinet initiated four buy-back cycles and bought about 6% of their own shares, then cancelled the shares. Of utmost importance is the fact that they bought their own shares for the correct reason: The share price was way below value per share. Some companies try to create artificial demand for their shares and support their share price by buying at any price. No, Reinet was extremely disciplined and only bought at prices FAR below value. In this manner, they increased the value per share even further!

About two years ago, the overseas listing of Reinet was changed from the Luxembourg Stock Exchange (low volume trading) to Euronext Amsterdam. We also have direct Reinet shares listed on the JSE for the past two years instead of the previous depository receipts.

In order to understand the real value proposition behind Reinet, I need to tell you a little story. Forty years ago, the proud father of a new-born son instructed his stock broker to immediately open a new brokerage account in the name of his new-born son. He then instructed the stockbroker to transfer the rand value of all the dividends that will be generated in his own brokerage account in the future, into this new account for investment, but no other funds will be invested into the new account. After forty years, the father was surprised to find that the rand value of the account in the name of his son exceeded the rand value of his own account. He took care to preserve his capital, no capital funds were extracted from his account.

Well, he should not have been surprised – we have mentioned the value of dividends in this newsletter repeatedly. Since the new account enjoyed the inflow of ALL the dividends, also the dividends being generated from the dividends – the new account was growing exponentially over time.

Back to the Reinet share: In Reinet, the broker account of the father in the story is being represented by the Reinet investment in British American Tobacco, and the broker account of the son is being represented by the international portfolio of Reinet. All dividends from the tobacco investment is being transferred into the international portfolio, while the international portfolio keeps all dividends that it generates internally (except for the small amount of dividends being paid out by Reinet).

Now, you should not be surprised to learn that the international portfolio of Reinet, which started from zero about 12 years ago, surpassed the value of the Reinet investment in tobacco. In this case, some tobacco shares were sold and the proceeds were also transferred into the international portfolio – this obviously speeded up the whole process:

The numbers below refers to ONE share of REINET:

Date	**Reinet share price**	**Value of Reinet international portfolio**	**Value of British American Tobacco investment**	**Sum of the parts of all Reinet investments**
	Rand	Rand	Rand	Rand
18 November 2015	299	110	312	422
25 January 2019	197	160	150	310
24 January 2020	304	254	227	481

The table above tells us the following:

- During the last four years, Reinet was transformed from a primarily tobacco company to a primarily diversified investment company. The international portfolio represented 37% (110/299) of the Reinet share price four years ago, but this number has now increased to 83% (254/304). Can you see the significant effect of the dividends being transferred into the international portfolio? The dollar price of the tobacco investment reduced, the rand to dollar exchange rate was almost constant (14.24 R/$ four years ago, now 14.33 R/$), and the amount of tobacco shares reduced only slightly. The dividends and the growth in the international portfolio were the main factors at play here.
- During the past four years, the international portfolio was growing at 23% per year compounded, from R110 to R254. During this time, the Reinet share price moved nowhere – from R 299 to R 304, with lots of volatility in-between (R197 a year ago).
- The Reinet share price increased by 54% (304/197) over the last year, while the sum of the parts of the Reinet investments also increased by 55%

(481/310) over the same period. The discount between the Reinet share price and the underlying Reinet investments per share therefore remained almost constant (36% a year ago, 37% now).

- Since the Reinet investment into British American Tobacco only represents about 2.8% of British American Tobacco, Reinet can sell all its tobacco shares in a short time frame without distorting the market price. It is therefore correct to assume that the value that can be realised from the tobacco investment will be very close to the value reflected in the table. Keeping this in mind, one can subtract the value of the tobacco interest directly from the Reinet share price to determine the price that you actually pay for the international portfolio: In Nov 2015, you paid R299 – R312 = -R13 for the R110. One year ago, you paid R197 – R150 = R47 for the R160. Today, you pay R304 – R227 = R77 for the R254. While you got the international portfolio for free in Nov 2015, you will still buy the international portfolio at a discount of 70% today! (The discount was 71% a year ago.)
- It is clear that the price of Reinet shares did not reflect the underlying value of Reinet correctly in the past, and it is still not reflecting the value correctly now, even after a significant increase in the Reinet share price of 54% over the past year. The share price just followed the underlying investments, but the huge discount to the underlying investments remained intact.
- While the value of the international portfolio was completely ignored in Nov 2015, the market is slowly but surely taking notice of the international portfolio, as the “price” increased from –R13 four years ago to R47 one year ago and to R77 now.

Recipe for outperformance

Items 8, 9 and 10 will have a stand over until next time (again!).

Lucri housekeeping

The Lucri year-end for this year will be end of day on Friday, 28 February 2020. This will provide me with a weekend to properly quantify the price (not value) of your investment portfolios.

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 REINET investing,

Simon Streicher