LUCRI ALPHA NEWSLETTER NR 6

25 JANUARY 2016

Dear current and future Lucri members,

During the summer holiday period of 2015 we experienced a high influx to the coastal resorts of the Overberg and Western Cape region. My observation (no scientific proof) is that more South Africans are discovering the beauty and tranquillity of this region.

Correction

Newsletter no 5 mentioned “Sance Souci” while it should have been “Sans Souci”. I realised my error a few minutes after I had hit the “send” button. Nobody corrected me, maybe out of courtesy. (or ignorance?☺)

Risk indicator

Our risk indicator jumped to 60.4% in October last year, less than 6% away from the red zone. The indicator hovered around 60% for most of the time and dropped slightly to 58.8% at the end of December. The increase in risk was driven by lower average earnings for the shares in the All Share index while inflation moved slightly higher as well. After the current (January 2016) market correction, the risk indicator should drop to more acceptable levels again.

Market volatility

The current market conditions reminds me strongly of the well-known quote from Warren Buffett: “Be fearful when others are greedy and greedy only when others are fearful”. What are you reading on the internet and news bulletins right now? What are the TV and your friends telling you? You can almost touch and smell the fear!

So, Warren tells us that we should be thinking about getting “greedy” and pick up our pace of buying. This asks for courage. Another famous quote: “The best time to buy shares is when the blood runs in the streets – even if it is your own!” It takes great courage and conviction to increase buying while you are bleeding. It does not mean that you should storm into the markets like a mad bull and buy every share that has at least halved in price.

Investment principles

At times like these, you should be disciplined and stick to your investment principles. Another bit of wisdom from Warren Buffett: “We don’t have to be smarter than the rest. We have to be more disciplined than them.” I am calm and relaxed about the markets, but I do acknowledge that some of you (maybe most of you?) might be very concerned and afraid. Especially those that are close to retirement have reason to be afraid, as they run the real risk of locking their losses into a pension scheme that will not share in the subsequent market recovery. (They might consider a living annuity for a portion of their savings to reduce this risk.) While I feel for those people, the rational approach for most of you should be to become a little more “greedy” at this point in time. Some of you has done exactly that! Congratulations on your improved reward to risk ratio. (Remember risk reduction in newsletter no 1). While I cannot guarantee your success, you have surely improved your statistical probability of ultimate success. Quote from Seth Klarman: “Value investing is risk aversion.”

The following over-simplified table helps me to keep the correct perspective while markets are volatile. **A** represents the % fall in the price of a share from a certain base, and **B** represents the % increase on the new base when the share price recovers fully:

A	B
10	11
20	25
30	43
40	67
50	100
60	150
70	233
80	400
90	900
95	1900

While the likelihood of a full recovery for a share which had fallen by 95% is very low, this kind of share only needs to recover half-way to its previous base to yield 900% on the new base. So, continued buying at the new base with equal amounts of money can outperform your initial loss by far – providing an investment break-even point long before the share price has recovered fully. This is an over-simplified table, but it strongly signals the asymmetrical nature of the recovery hidden in the mathematical formula. Lucri members know that I am not looking a past prices, but rather at past and current value per share. So, if you find a share far below value after a vertical drop in price, you should remember this little table. This will give you the courage that we spoke of in the beginning of this newsletter. I need to add a strong health warning at this stage: You always need to understand the fundamentals of the company to understand the likelihood of a recovery versus the likelihood of insolvency. For example, after its vertical fall, LONMIN will not be a candidate for this kind of recovery due to weak fundamentals combined with a 1 to 48 dilution factor in the original shares.

History on All Share Index of the JSE

During the past quarter, I have distilled the historical compounded growth percentage in capital, earnings and dividends for the collective group of shares in the All Share Index of the JSE for periods up to 10 years. The following table provides you with a summary of my findings for periods ending in December 2015:

	1 year	3 years	5 years	10 years
Capital	**1.9%**	**8.8%**	**9.6%**	**10.9%**
Earnings	**-10.3%**	**-0.3%**	**7.1%**	**8.7%**
Dividends	**8.7%**	**12.7%**	**17.9%**	**14%**

From the table it is clear that share prices (capital growth) follows both earnings and dividends over all the periods. You find that the % growth in the capital index falls in-between the boundaries formed by earnings on the lower side and dividends on the higher side. While sentiment and short term news headings can move share prices temporarily, this table provides strong proof that you should look at earnings growth and dividend growth as the main drivers of share prices over various longer time periods.

You will notice a steady drop off in company earnings growth from the 10 year period (which includes all the periods) to the most recent year. This signals that we should expect lower growth going forward (discussed in newsletter no 5).

The historical growth rate in dividends shows robustness and resilience for all the periods. While this cannot continue indefinitely if the earnings growth does not recover in the long-term, it proofs that investors living off a constant stream of dividends (including myself) could increase their standard of living over all the periods. This is also one of the reasons why I mentioned earlier that I am calm and relaxed about the markets. If you are a true investor, the constant cash flow stream from your investments (like dividends in this case) is much more important than the movement in the capital value (prices of shares). You are not dependent on the price movement at all, as you are not planning to sell any shares.

Commodity shares

Some commodity shares have now reached capitulation price levels (to the Afrikaans speaking Lucri members – capitulation price means “gatvol prys”☺) – where all investors buying the share over the last three years has lost money (on paper, at least!). When this happens, investors are fearful and do not think rationally about a share – they give away value due to emotional reasons with no sound, rational thought process involved.

Regarding Capital Management, a pure value investing investment house, expressed themselves strongly in favour of commodities: “We still regards the resources sector as a once in a generation investment opportunity at current prices. Now is precisely the time to be accessing compelling value opportunities. This commodity cycle has been far more severe and protracted than we anticipated.”

Flagship Lucri portfolio

The “flagship” Lucri portfolio (historical graph on www.lucri.co.za website) which I manage on behalf of my own family as well as wider family members will most probably show negative capital growth (not negative dividend growth) for the first time in many years. I also expect negative alpha this year ending 29 February 2016 for the first time in many years, while the three year and longer rolling periods should still show positive alpha. The main reason for this deviation in performance can be found in the unprecedented long and deep downswing in commodity prices that the world are experiencing currently. More specifically, the severe downswing in energy related investments has subtracted from portfolio performance the last year.

Alpha is not only being determined by the investments that you include in a portfolio, but also by the investments that you exclude on purpose. This year, the take-over of South African Breweries by Anheuser-Bush add handsomely to the all share index while I excluded it from Lucri due to a hefty price tag relative to value. I also excluded Naspers, another star in the all share index, on the same grounds. It should be no surprise to you that I added selected commodity investments including energy related investments to the core Lucri portfolio, while I steered away from SAB and Naspers.

This just provide proof that I am practising what I am preaching – namely, that you should stick to your investment principles, be rational and disciplined. Value investing is in my DNA, it is what I stand for. So, when commodity investments showed value, I added it to the portfolio. As long as the commodity investments stay unpopular, my portfolio will underperform. I have created “delayed alpha” – I bought unpopular shares below value. The prices dropped further, but the value of the investments are holding water. So, while the monetary “value” of the portfolio calculated via prices quoted on the stock exchange has dropped, it is pleasing to note that the VALUE of my portfolio has steadily increased.

This also explains the underperformance that many of your portfolios will reflect over the year ending 29 February 2016 – I am consistent in my investment choices over all portfolios under my management. So, you should not expect a good alpha result this year (I shall unfortunately not be issuing large invoices☺).

Individual shares from previous newsletters

I know some Lucri members were disappointed when I sold some of their high price momentum shares like PSG. While I made it clear in past newsletters that I admire the fundamental company performance of PSG (I still do), any share can get ahead of itself – and PSG was no exception. The share stormed ahead on its own momentum, defying gravity, to about R 270 per share while the sum of its parts were about R 220 per share at the time. Since then, the share experienced a strong gravity pull to about R 178 per share on 18 January. Guess who is taking modest buying interest in PSG again?

While I am still patiently waiting for the new diamond mine at Transhex to show its true colours, the cash in the Transhex bank account mentioned previously acted as an important stabiliser during the January market volatility – the share did not follow the market lower, but initiated a slow recovery instead. The share price is being supported by the share value.

In America, the shares of Peabody energy went into a further nose-dive to the point where every dollar of market capitalization is being covered by 122 tons of coal in reserve and 2.25 tons of coal being sold every year around the world.

Performance feedback

At the end of every financial year running from March to February, I provide each Lucri member with more detailed performance feedback. This year 29 February will fall on a Monday. As I need sufficient time to value all portfolios before the market opens again, I shall end the performance measurement period on Friday, 26 February. A slightly shorter or longer period does not influence relative performance at all, as long as one compares with the chosen benchmark over an identical time period with no overlap or lost time between subsequent time periods. For example, I could have chosen 2 years or three years as time periods for comparison – but shall stick to one year periods as this is more the norm. The trading day of 29 February will therefore be added to the following financial year for comparison purposes.

Price versus Value

I actually planned to expand more on the issue of price versus value in this newsletter, but I am running out of my usual newsletter length. You can expect more discussion on this topic in my next newsletter.

In the meantime, I hope you continue to sleep well through all insane movements on the stock exchange. We should not fear stock market volatility, but rather recognise and appreciate it as a wonderful opportunity.

Kind regards and Sans Souci investing,

Simon Streicher