LUCRI ALPHA NEWSLETTER NR 8

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Dear current and future Lucri members,

Life is still good in the Overberg. Just to remind you that life is not always that serious, let us kick off with a silly question: What is the difference between ignorance and apathy? (I don't know and I don't care.☺)

Risk Indicator

I mentioned in my previous newsletter that I shall monitor the red indication that was provided by my risk indicator in March 2016. I analysed the underlying causes carefully, as this did not occur due to an increase in share prices – on the contrary, the market is basically moving sideways for a period of two years now. The main driver for the red indication was lower earnings for the collection of shares making up the all share index.

On closer scrutiny, I realised that the formulas built into the construction of the index is causing this observation. The index allocates a higher weight to larger companies. The size of the companies is measured via their market capitalisation (number of issued shares times share price). So, when large expensive companies like Naspers and SAB gets even more expensive by share price growth that exceeds the corresponding earnings growth per share, their importance (weight) in the all share index calculation also increases. When this process continues for a long time, the weight of only a few expensive companies can become so large that their high price to earnings ratios can distort the entire index towards a higher price to earnings ratio, or in other words a lower earnings percentage. In the all share index of the JSE, this effect became so strong that it reflected as a decrease in the collective earnings of the index. Also, the recovery in the share prices of large commodity companies before a corresponding recovery in profitability, added to the high price to earnings ratio of the index.

So, the risk indicator which is measuring the risk in the all share index is telling us that the risk is increasing IN THE INDEX. (Index investors should take note). While I need to take this increased investment risk into account, I am still finding good value in the market by excluding a few large expensive companies. In fact, I am uncovering pockets where I can buy great businesses at decent prices.

Due to the weak capital growth of the all share index in calendar year 2015, my calculation process recognises 2015 as a year with negative real growth in capital. This re-starts the timing and growth count in the risk calculation, causing a reduction in the risk measurement. Our risk indicator now hovers just below 60% - still high due to the factors described above, but not in the red zone anymore.

The value investing approach protects us from the risk observed in the all share index, as we are only buying shares when their price is below value. This lower risk will only be visible during and directly after the next market crash. The Lucri Alpha website (www.lucri.co.za) shows the historical performance of the flagship Lucri fund. Please note the movement of the Lucri unit price opposite the all share index directly after 2008, during the credit crunch – this is a good illustration of a portfolio with a risk profile that is lower than the inherent risk of the all share index.

Why will expensive shares get even more expensive over time, until one observes the effects described above? The answer can be found in the following quote from investment guru Warren Buffett: “Nothing sedates rationality like large doses of effortless money.” Low risk businesses can be high risk investments if you overpay on share price (price far above value). In other words, the business model is low risk and the fundamentals of the company is sound, but the investor enters at an overly optimistic price that extrapolates the good news too far into the future.

The risk inherent in the index indicates that value investors, buying companies at prices indicating low future expectations, will most likely outperform the index over time.

Commodity share recovery

Contrary to the expectations of some investors, the recovery in the beaten down share prices of cyclical commodity companies did not fade out quickly. The companies are maintaining their improved share price levels mentioned in the previous newsletter.

You will notice that I have used the opportunity to lighten the weight of cyclical companies in your portfolios, and to investment into new value opportunities.

Brexit

I am sure you have heard and read enough about Brexit. I just want to use the Brexit opportunity to ask you (especially those who felt uncomfortable during the initial market decline): Is your risk exposure in line with your personal risk comfort level? If not, you are welcome to send me an e-mail requesting me to adjust your risk exposure. Market declines can be a wake-up call to check your risk exposure.

Growth in a stagnant economy

Are you aware that companies have the ability to grow their earnings and dividends per share without any share buy-backs (a popular way to grow per share is just to lower the number of shares issued) and without any growth in the economy and even their specific industry?

Company A earns a constant after tax return on capital of 15% per annum and maintains a dividend cover of three times. The company experiences zero organic growth, but still manages to reward shareholders with reliable growth of 10% per annum in earnings and dividends, as follows:

Year	Capital	Earnings	Dividend	Re-investment add to capital	Dividend growth
1	100	15	5	10	
2	110	16.5	5.5	11	10%

3	121	18.15	6.05	12.1	10%
4	133.1	19.97	6.66	13.31	10%
5	146.41	21.96	7.32	14.64	10%

What you are observing above, is the magic of compound growth due to constant savings. Company A saves 2/3 of their after tax profit every year, and add the savings to their capital base (equity or shareholders' funds). If they manages to retain a yield of 15% on capital (quite realistic for listed companies), their growth will be 10% per annum in a stagnant environment. This also explains why the stock exchange investments in any country can constantly grow faster than the GDP of the particular country for decades on end – the amount saved as % of the capital base adds to the GDP growth.

The free Mercedes – or a few

The practical implication of the above statement can be illustrated by looking at the nominal and real growth of the all share index of the JSE over four decades, from 1974 to 2014:

Year	Inflation index (Rand)	All share with dividend (Rand)	Buying power multiple	Buying power multiple, decade on decade
	A	**B**	**C**	**D**
1974	1	1	1	
1984	3.8	7.44	1.96	1.96
1994	13.92	83.5	6.00	3.06
2004	24.88	305.31	12.27	2.04
2014	43.76	1926.61	44.03	3.59

Column A indicates that the buying power of the South African currency deteriorated over the four decades to such an extent that one needed R 43.76 in 2014 in order to buy an equal amount of goods that one bought with R 1 in 1974. So, roughly 40 times the amount of rand in 40 years! No wonder why people without suitable growth investments will complain about rising prices.

Column B indicates that a passive investor investing R 1 into the JSE all share index in 1974 will have a nominal amount of R 1 926 in 2014. This remarkable result can partly be attributed to the constant savings drive of South African companies (described in the previous paragraph) over four decades. It can also be attributed to the fact that listed companies invests into areas of the economy where the reward to risk ratio is the highest, and that these companies maintain sound business models (opposite state owned enterprises in the RSA economy). So, it is no wonder that listed companies outperform South Africa Incorporated (but I am sure you must be surprised at the extend of the outperformance – this is also due to the diversification of South African companies towards overseas opportunities). Column B also gives you an idea of the strict benchmark that Lucri Alpha uses for outperformance, running against column B all the time. You should therefore not expect index outperformance every year (and your fund manager will work for free with a smile some years☺).

Column C indicates how the buying power of the passive investor increased over time – basically column B divided by column A. This column indicates the reward to the investor for postponing gratification – and what reward! Assuming that the price of a comparable entry level Mercedes sedan had increased in line with the South African inflation rate, the investor is rewarded with 44 Mercedes sedans if he or she postponed buying a comparable Mercedes in 1974, and invested the money in the all share index of the JSE instead. With reference to the title of this paragraph – 43 free Mercedes sedans! Or 44 times your initial buying power in 40 years! Or, if the investor cannot wait that long, how about one free Mercedes sedan after 10 years or 5 free Mercedes sedans after 20 years? (Column C indicates 1.96 in 1984, and 6 in 1994.)

Column D indicates the buying power multiple for each decade separately over the last four decades. While we are currently experiencing a low growth period (I have seen periods of up to four years with no capital growth, we have now completed two years with no growth), observing growth over a suitable long time period like a decade does not indicate any loss of growth momentum over the period of 40 years. In fact, the last decade of the four produced the fastest growth.

Rear view investing

Investors are sometimes their own worst enemies, particularly those investors that uses their rear view mirror to make investment decisions. They chase after the best performers AFTER THE GAIN and sell the worst losers AFTER THE LOSS. (Recipe how to go broke: Buy high and sell low – continue until broke.) This is the investors that constantly change lanes in rush hour traffic – just to find that they have made little progress as the fast lane suddenly became the slow lane. A question for those of you working in large metropolitan areas: Why is the time of day with the slowest traffic called rush hour? ☺

Allan Gray told their clients in September 2015 how they can avoid the attitude that get investors into trouble, if they have a value investor as their investment manager: “Warren Buffett famously commented that the share market is a mechanism that transfers wealth from the impatient to the patient. Even if you select a better-than-average manager you should expect to experience periods of meaningful underperformance. Investors need patience to sit through such periods and shun the crowd to benefit fully from the outperformance that an above average value investor may deliver over the long term. For those that have the fortitude, active management can add significant long-term value. History has shown this to be particularly important when specific sectors or segments of the market become over-represented within the benchmark index. We believe this is very much the case today.”

There you have it – if great value investors like Allan Gray asks for patience, I should ask for forgiveness and lots of patience. If you do not understand or accept the concept of value and the difference between value and price, you will find it difficult to be my customer. You will think I am really stupid by missing out on the momentum shares while taking the pain to go through a downwards cycle on an unpopular share. When I keep on buying as the price drops further, you may think that I have lost my marbles. Given sufficient time to see the full cycle, you will understand the logic of staying the course, buying contra the main stream of investors which are selling.

A successful investor must have the ability to endure the discomfort associated with going against the crowd. It is not that I go against the crowd just for the sake of being a contra thinker– the value investment technique produces this outcome naturally. The crowd sells unpopular stocks – I buy them when their price drops below value.

The theory of value investing is easy to grasp, but one should remember the saying: "In theory, there is not much difference between theory and practice – except in practice!" Experience counts.

About 10% of the portfolios under my management is currently under performing significantly. This does not mean that the rest is all beating the index, some perform close to the index. The underperforming accounts are mostly struggling with energy investments in the current prolonged downswing in (fossil fuel) energy related investments.

I hope you are still sleeping well, without (sans) concerns (souci).

Kind regards and Sans Souci investing,

Simon Streicher