LUCRI ALPHA NEWSLETTER NR 26

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Dear Lucri friends,

I am sensitive to the fact that 2020 was a horrible year for most people, and that 2021 did not start well for people infested with the flu of 2020. So, a bit of good news may be welcome, but I give it with caution. In contrast to most economic performances during 2020, the Overberg area had a bumper agricultural year. The farmers could plant their crops with lower priced fuel, and could sell an above average yield at above average prices. At long last, the profit margin on small grain farming opened up. We are most grateful.

Risk indicator

We have learned something new about the risk indicator over the last year. You may remember that the risk indicator does not provide any clues on timing, whether a market crash is approaching or not. It only provides us with information on the magnitude of a crash if it should happen at that point in time – a green indicator indicates limited downside. Now, after 2020, we also know that a green indicator provides information on the magnitude of a re-bound or recovery – the recovery will most likely be very strong if it occurs in a period with a green risk indicator. (It is logical, but now it is confirmed.) Green signals a high probability for an above average upside. Since the time of writing newsletter 23, when the risk indicator moved into green for the first time since starting the newsletters, the all share index of the JSE expanded with 31% (It recovered with 69% from the low point in March 2020). Since March 2020, the risk indicator increased from 11% to 26% - since 33% is the cut-off point for green, the risk indicator does not have a deep green tint anymore, but it remains green. Some prudent Lucri investors rushed to me with open purses from March to June last year – it was such a pleasure to invest their added funds at rock bottom prices. For example, I could buy the Arrowhead B REIT (real estate investment trust) for one investor at 95 sent each. He received a 32,9 sent pay-out this December (34% before tax) plus a capital yield of 142% over a seven month period. Once again, we have confirmed the Buffett wisdom: "*Be greedy only when others are fearful.*"

On a lighter note

Five blokes in an Audi Quattro arrived at the ferry checkpoint in Harwich, Essex. Tracey, in her brand new uniform, stops them: "*I can't let you on the ferry. It is illegal to have 5 people in a Quattro. Quattro means four. One of you will have to get out and stay behind.*" "*Quattro is just the name of the car!*" the driver replies disbelievingly. "*Look at the papers. This car is designed to carry five people.*" "*You can't pull that one on me. This is Tracey from Basildon you're talking to here,*" she replies with a smile. "*Quattro means four. You have five people in your car and you are therefore breaking the law. So I can't let you onto the ferry. It's more than my job's worth to let you all on.*" The driver is now very cross: "*I've had enough of you.*

Call your supervisor over. I want to speak to someone with more intelligence!"
"*Sorry,*" responds Tracey, "*but Sharon is busy with those two blokes in the Fiat Uno.*"

A new product is now available for people living in the Highveld (and other cold) areas of South Africa. The product is especially useful in winter months. It is an alarm clock with a build-in thermometer. The alarm clock will only go off at the set time if the external temperature is above the set point chosen by you…

The tortoise and the hare….(Adopted from Aesop)

I am sure all my Lucri friends remember the great lesson from the race between Ted the tortoise and Harry the hare. (The names are a free bonus from Lucri.) You see, what Lucri friends may not know, is that Harry is still feeling a bit sore after losing a race against a slow tortoise! What humiliation! And it is not helpful at all that Ted has developed a bit of a "holier than thou" attitude lately. To make matters worse, parents have been using the race as a moral lesson about the dangers of over-confidence – and he, Harry, was and still is the subject of much laughter and ridicule non-stop for 26 centuries! No, it is high time that children learn a more realistic lesson: The fastest always wins! Period. So, when Harry and Ted was in the veld one day, far away from home, Harry asked for a re-match, and Ted agreed. Harry proposed that they should run back home, the first to arrive will be the winner – Ted agreed. Harry was pleased and shortly shouted: "Go!" Ted immediately pulled in his head and feet and shouted: "I'm home!"

Now that the presidential election in the DSA (divided states of America) is in the news, we should listen to the wisdom of Warren Buffett. People asked him what the first thing will be what he will do if he is elected president of the USA? He replied: "I shall immediately ask for a re-count!"

What do you get when you say "fund managers" quickly? You get "fun damagers" – how true, you might say….

Investment wisdom

A man had a model horse – good looking, good mannered and totally obedient for most of the time. But, once in a while, this horse gets totally out of control and then wreaks havoc. So, the owner took the horse to the vet and ask what he should do? The clever vet replied: "The next time your horse behaves, sell it!" The lesson to investors: Make sure you know a company inside out over the full economic cycle before you buy it!

Quotes

"Teach your kids the tricks of vendors and lenders." Charlie Munger

This is so true – it will put your kids light years ahead of others if you do.

"*If crooks knew how much money can be made by being honest, they will change their behaviour.*" Classical Munger wisdom on integrity.

"*Take the high road – it is less crowded*". Classical Buffett wisdom on integrity.

“*The whole trick of the investment game is to have a few times when you know something is better than average or better than your best other opportunity. You invest ONLY when you have that extra knowledge. If it gets you only a few opportunities in life, that’s enough.”* Charlie Munger

“*Heads: I win.*” “*Tails: I also win*.” Seth Klarman. This is an excellent explanation of the “margin of safety” principle. Should I expand on it in a future newsletter?

Charlie Munger was asked about three years ago what his opinion about Elon Musk is? He replied: “*Never underestimate a man who overestimates himself*.” Looking at the current news about Elon being the richest man in the world, Charlie was spot-on as usual – we should have bought Tesla shares. (I did – but sold far too early.)

Sasol

Yes, I know…you are getting tired of me talking about the Sasol share price every time. This time I shall try to be short and bitter (for those that did not buy). Last time I mentioned that Sasol was trading around R87 per share, and that I started buying again. The buying continued until R72 per share. With the price now around R170 per share, I could manage to take back more cash than the initial investment with shares to spare. Again, in this buying cycle, I am grateful to report a negative buying price per share.

To take instructions from the market or not….

Should you take any hints about the value of a share from the market price? No, a thousand times no – Benjamin Graham taught us that the market is not our instructor, giving us insights about value. He taught us that the market is your servant – it serves you in the way you want to be served. “Mr Market” was manic depressive about Sasol in the latter half of March 2020 and at one time yelled: “*Sasol is for sale at R25 per share! I have a lot that must be sold immediately*!” How many takers were there? Not too many – as the price dropped even further. Many people were hiding (some literally!). Now, mr Market is not pessimistic nor optimistic, and is yelling: “*I want to buy Sasol at R170 per share*! *Any sellers*?” It is not totally insane to expect that an overly optimistic mr Market may yell in future: “*I want to buy Sasol at R400 per share*!” You see, mr Market is psychologically unstable – how can you ever take investment clues from such a person? But – I am sorry to report – many speculators do – they wrongly call themselves investors. (I have a small confession: I lied about being brief on Sasol.)

My answer

One of my Lucri friends (he is a good friend, a previous colleague and very frank as you will see) asked me to explain why I bought Lewis shares for his portfolio, as he was convinced that Lewis must be a bad investment. “*What were you smoking when you decided to buy Lewis Stores?*” I know some Lucri friends rarely enters a Lewis store. So, instead of only writing to him alone motivating my investment decision, I thought it best to include the whole Lucri community (this sounds great) into the discussion:

Dear friend,

Since I do not always motivate my investment decisions, I shall provide you now with more background on Lewis as an investment opportunity.

- The listed Lewis entity consists of 5 separate retail brands (one being a new start-up on-line retailer named Inspire) with the well-known (but maybe unpopular to you) Lewis stores only one of the five. There are also two financial operations, namely a credit provider and an insurer embedded into the listed entity – so, in total seven operations.
- The quantitative model, which I love to refer to in my newsletters, put a first round valuation of R42 per share on Lewis. The current share price is R24, 43% below the rough value evaluation. This is a good starting point for investment interest.
- Coronation Fund Managers, a respectable fund manager using a value based approach, has increased their direct interest in Lewis to 27% at the end of Oct 2020. This is a good sign.
- Over the past three years, Lewis bought back 15% (13.6 million) of their own outstanding shares. This increased the effective stake of existing shareholders by 17%. This is the opposite of dilution caused by a rights issue – it is a concentration of shareholder interest. The highly successful Apple operation in the USA is also buying back massive amounts of their own shares.
- In contrast to most companies buying back shares, Lewis have no debt. They buy their own shares with cash generated internally – a very good sign.
- Lewis have not missed a dividend pay-out since listing 20 years ago – before that, they were part of the listed Foshini group.
- They continued paying a dividend through the covid lockdown period – one of only a few retailers that could manage this. Lewis paid a dividend of 198 sent during 2020 – 8.25% on the current share price (16% on their low price point of 2020).
- They bought an upper class retailer, UFO (United Furniture Outlets) a few years ago with cash generated internally – no debt were used for this transaction. They therefore got exposure to the higher income market.
- They bought selected Beares stores from the insolvent Ellerines – yes, you got it – all on a cash basis, no debt.
- They continue to revamp existing stores and open new ones in a measured fashion with caution and restraint – yes, on a cash basis.
- They increased their ratio of cash sales transactions to credit sales transactions to have about 50% of 2020 transactions in cash. This lowers their credit default risk profile. This may be a surprise to people who regarded Lewis as an exploiter of poor people by charging high interest rates. If this is true, they are steadily working towards less exploitation.
- They manage their business utilising 26 business metrics that they publish ahead of each reporting period – they display remarkable transparency and excellent management.
- They funded an on-line retailer as a start-up business with internally generated cash.

The whole picture reflects a highly profitable operation with a strong cash generation element. The Lewis operations are managed with care and skill, without accepting undue risk. To buy back shares, pay out a most generous dividend, buy competitors, open additional stores, revamp existing ones and start a new on-line retailer all on a complete cash basis is a rare accomplishment indeed. If you find such a company at less than 60% of value you should buy without delay. (It was actually available at 30% of value at one point in time.) Good investment opportunities are perishable – they disappear quickly. Nothing in life is certain, but if you do your homework and find such a gem, you surely have the odds in your favour. This is the essence of prudent investing – to have the odds stacked heavily in your favour. You wanted to know what I smoked when I made the Lewis decision – I was smoking a rare brand, which my belated financial mentor used to call “profit instinct”. He coined that word, but it never caught on, as most people did not understood his language. I understood him quite well – hopefully the Lewis explanation above honour my mentor’s legacy.

There is another most important measure that points towards Lewis as an excellent investment……please continue reading!

Classic Benjamin Graham

I first learned about the father of value investing, Benjamin Graham, in 1987. Around 1993 I investigated his investment techniques in more depth. He was interested in shares that sell below their nett nett value. Graham defined the nett nett value of a share as follows: You take the current assets on the balance sheet and subtract the current liabilities to get the nett current assets. Then you subtract the long-term liabilities from the nett current assets to get the nett nett value. (For those of you with accounting background: Graham basically subtracted ALL liabilities on the balance sheet from the current assets to get the nett nett value. Or, you can subtract the fixed assets from the equity to get the same result – mathematically.) You then just divide the nett nett value by the amount of shares issued to arrive at the nett nett value per share – to some of my readers this may be boring, I know. For those that are bored, please refer to “On a lighter note” on page one ☺. The calculations are not that important – I just need to give the background.

Graham argued that shares that are selling below this nett nett value per share is basically risk free, as the investor is fully covered by assets that can be liquidated into cash over the short term – the liquidation value. I initiated a massive search in 1993 to find such shares listed on the Johannesburg Stock Exchange – but could not find one – not even one. This reminded me of the tooth fairy, santa or an honest politician – you only hear about them, but cannot find any of them in your lifetime! Now, at the beginning of 2021, I suddenly found two companies on the JSE that are classic Benjamin Graham nett nett shares.

The skilled negotiator

Imagine you are negotiating to buy a furniture business. You manage to ensure that the value of the stock on the floor has been written down due to any stock damage, and you asked for all slow moving stock to be written down to zero value. You negotiate that the goodwill of the organisation should be valued at zero, although there must be a loyal customer base (you are a ruthless negotiator, shame on you). You also negotiate for all fixed assets of the business to be valued at zero value. Then, you demand that ALL liabilities of the business must be subtracted from the reduced value of the stock on the floor. Finally, you offer to buy the business at a price equal to 60% of the remaining reduced stock value on the floor. Your reasoning is that, in the event of an unforeseen risk factor, you can liquidate the business at 80% of the reduced stock value and still make a profit of 33% on your purchase price. Do you think it will be possible for you to conclude your buy transaction successfully under such conditions? Definitely not – no-one in their right state of mind will sell at that price to you. But the funny thing is – I found two businesses listed at the Johannesburg stock exchange where the owners of little pieces of the business, called shares, are willing to sell their shares happily to me under the exact stringent valuation criteria described above. Yes, you are correct – the one is Lewis – I have already spilled the beans on Lewis, but now you have an even greater motivation to look at Lewis very closely. The nett nett value per Lewis share can be calculated as described in depth above to be R40,66 per Lewis share – while the share is trading at R24. The other opportunity is even slightly better – the nett nett value is R50 per share, and the share is trading at R28. I am in the market for this share, both for Lucri clients and for myself – so it is a huge secret at this point in time…..

Lucri housekeeping

The Lucri year-end for this year will be end of day on Friday, 26 February 2021. This will provide me with a weekend to properly quantify the price of your 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 nett nett investing,

Simon Streicher