LUCRI ALPHA NEWSLETTER NR 27

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Dear Lucri friends,

With most share prices recovering and with some reaching new highs, I am sure investors across the world are feeling much better about their stock portfolios this April versus April last year. Lucri friends familiar with value investment principles will know that the inherent investment risk is actually higher this April versus last April, in spite of us all feeling better. In this newsletter, I am addressing the three basic types of investment, investment bubbles and a dividend generous portfolio to address the cash flow needs of people in retirement.

In a large part of the world, we find ourselves in a valuation-agnostic investment universe. Interest rates are negative in some countries – which is trying to convince us that time flows backwards! In this environment, value investors like Lucri needs to work hard at staying the course – you need to have strong investment principles to guide you as a value investor in these interesting times.

Risk indicator

After feeding you with regular discussions on our risk indicator, I thought that a change in reading diet will do you good. I still find value in this indicator and shall monitor it regularly.

On a lighter note

The early days of Facebook is now a few years into the past. You need to think back to those days to appreciate this one:

“Currently, I am trying to make friends outside of Facebook whilst applying the same principles. Therefore, every day I go down on the street and tell a passer-by what I have eaten, how I feel, what I have done the night before, and what I will do afterwards; I give them pictures of my meals, my drinks, my partner, family, friends, my cat, my dog, someone else’s dog and/or cat, my garden, and “selfies” of when I am pursuing my hobbies such as walking on the beach. I also listen to their conversations, and I tell them that I love them.

And wow! It really works! I already have 3 people following me: Two police officers and a psychiatrist.”

A special for women: “When men reach their sixties and retire, they go to pieces. Women go right on cooking.” Gail Sheehy

A special for men: “My wife has a slight impediment in her speech. Every now and then she stops to breathe.” Jimmy Durante

A bicycle cannot stand alone; it is two tired.

9 out of 10 doctors will agree that 1 out of 10 doctors is an idiot.

Quotes

The following quotes are both from William Grey:

"Paying substantially less for an asset than it is worth is a timeless recipe for investment success – even if it means waiting an uncomfortably long time."

"Investment approaches swing in and out of favour. Any approach that makes sense and works long enough will inevitably become so popular and pervasive that it will stop working long enough to convince many investors that it will never work again."

"Value is in the eye of the beholder." Simon Streicher ☺

Well, after feeding you with various quotes through the years, I finally also caught the disease and now I am boring you with my own. This quote is all about assigned or assumed or imputed value versus intrinsic value. Something has assigned value when you THINK it has value – it simply will have the value that you (and hopefully others) think it has. This is irrespective of any hard proof like a future cash flow stream or assets in a balance sheet. Someone used the phrase "the greater fool" before: "I may be a fool paying this high price, but I am only looking for a greater fool that will pay me even more for it." Rising prices create its own excitement.

Asset Bubbles

Now, when you decide on the value of "something" based on what your gut or greed or friends tell you about it, you may be taking part in an asset bubble without knowing it. Bubbles usually are being recognised by most people as such only after the devastating bursting event. Let us look at a few historical bubbles – now being defined as such in hindsight.

Tiptoe through the Tulips…

(Recognition for some ideas below is hereby given to Erik Conley from Zeninvestor.org)

"Double, Double Toil and Trouble

Fire Burn and Cauldron Bubble…" Shakespeare's Macbeth (Act IV, Scene 1)

Is it true that asset bubbles cannot be identified at all except in hindsight? While it is true that asset bubbles can continue to inflate for months and even years after they are first identified, I believe asset bubbles have common characteristics that can be identified to some extent before the catastrophic collapse that follows sooner or later.

1. The Dutch Tulip Bubble: In the 1600's, Dutch tulip prices soared twentyfold between Nov 1636 and Feb 1637 before plunging 99% by May 1637. It was called **Tulipmania**. Tulip speculators based their "investments" on hopes and dreams.
2. The South Sea Bubble: The South Sea Company was formed in 1711 and was promised a monopoly by the British government on all trade with the Spanish colonies of South America. Expecting a repeat of the success of the East India Company, which provided England a flourishing trade with India,

investors snapped up the shares of the South Sea Company. The shares surged from 128 British Pounds in Jan 1720 to 1050 British Pounds in June 1720, before collapsing totally in the subsequent months and causing a severe economic crises.

3. Japan's Real Estate and Stock Market Bubble: The yen's 50% surge in the early 1980's triggered a Japanese recession in 1986. To counter it, the government ushered in a program of monetary and fiscal stimulus. (Does this sound familiar today?). These measures fostered unbridled speculation, resulting in Japanese stocks and urban land values tripling between 1985 and 1989. In 1989, the value of the Imperial Palace grounds in Tokyo was greater than that of real estate in the entire state of California. The bubble burst in 1991, setting the stage for Japan's subsequent decades of stagnant economic growth and price deflation.
4. The Dotcom Bubble: On scale and size, few bubbles match the dotcom bubble of the 1990's. Increasing popularity of the internet triggered a massive wave of speculation in "new economy" businesses. Hundreds of dotcom companies achieved multi-billion dollar valuations as soon as they went public, with-out generating profits. The NASDAQ index soared from under 500 early in 1990 to a peak of over 5000 in March 2000. The index crashed shortly thereafter, plunging about 80% by October 2002 and triggered a US recession. The NASDAQ reached a new high only in 2015, more than 15 years after its previous peak.
5. The US Housing Bubble: US house prices doubled from 1996 to 2006. While house prices were increasing at a record pace, houses were being bought by sub-prime borrowers. US house prices peaked in 2006, and then commenced a slide. The average US house lost about a third of its value by 2009, causing lots of mortgage bonds to end up under water (the outstanding bond was greater than the house market value). The ripple effect on mortgage backed securities resulted in a global economic contraction that was the biggest since the 1930's Depression. This period became known as the Global Financial Crises.
6. Bitcoin Bubble and Tesla madness: On 13 April 2021, Bitcoin reached a price of R 922 499💣, and Tesla shares approached $900 earlier this year. One Bitcoin was equivalent to the price of a small house in some areas in South Africa. Then, shortly thereafter……to be continued☺.

Yes, I am pulling your leg, but only slightly… The phycology of any bubble is actually easy to understand. Warren Buffett compares it to a wonderful party. While the music continue playing and the guests are really enjoying themselves, it is very hard to leave early. Warren described this as follows: "While most of the party goers know that the golden coach will return into a pumpkin at midnight, they are dancing in a room where the clock has no hands."

I attended both parties – the Bitcoin one and the Tesla one. I left early – in hindsight it was way too early. But surely, I am not returning to the party now – I believe it is way too close to midnight. If I was still attending now, I would leave gradually.

Can Bitcoin inflate beyond $ 100 000 and Tesla beyond $ 2000? Anything is possible, but who knows for sure? To a speculator, whether in Tulip bulbs or Bitcoins (both have zero intrinsic value), hope springs eternal. My main concern about Bitcoin is that it is a technology – and we know that technology can be displaced by superior technology.

The three basic types of investment

Let us go back to basics for a short while. Consider this question from the Lucri Academy: *"Please describe the three basic types of investment in broad terms and provide examples of each?"* If you know the answer, you can skip the following section, you do not need any lessons.

The first broad category of investment is investment into fiat currency. This will include fixed deposits, bonds and to some extent also cumulative, non-convertible preference shares. This type of investment has a powerful enemy, namely inflation. I am planning to write about "expropriation with inflation" in a future newsletter. In order to compensate investors for inflation, this type of investment usually carries a high yield in the form of interest (or a preference dividend), but there will be zero capital appreciation. In the current days of massive money printing, value is actually being transferred away from this type of investment.

The second type of investment includes all assets with assigned or assumed or imputed value – see the discussion earlier in this newsletter. It is a hallucinogenic type of investment – you see what you want to see. This includes rare or desirable assets like art or stamp collections, gold and silver, and yes – also cryptocurrencies like Bitcoin. It does not provide any yield – you depend on capital appreciation only.

The third type of investment is the more desirable from my point of view – assets with intrinsic value. Let us call it productive assets. It includes all types of property (also agricultural land), equities/shares and direct ownership of companies. The difference is that this type of investment is producing something of value – it is alive if you want to compare it to the first two types that are actually dead – it does not really do anything. This productive asset provides yield (rental income or dividends) as well as capital growth.

With all of this in mind, let us construct a portfolio limited to the third type of investment, but also suitable for investors already in retirement.

Retirement portfolio

"*Save aggressively, invest cautiously."* Alan Saltzman

Let us assume you have followed the prudent advice of Alan Saltzman during your working career – but you are now retired and you need a cash flow stream to enhance your pension. In the current money printing world, interest rates are low and if you chase a higher yield, it will most probably be at your own peril.

You can invest in fixed deposits – some people born in the first half of the previous century still see this as their main investment opportunity – the first type of investment discussed above. Let's create a fictitious character, Freddy Fiat. He is only investing in fixed deposits – he checked with Absa bank and found that he can get 4.75% on a R100 001 deposit for a 12 month period. Up to R 100 000, the rates are 4.15%, and for shorter time periods the rate is lower. So, he decided to re-invest the R 100 001 every year in April. He will choose the highest interest rate available each year.

Then, we have our fictitious Pat Productive who want to invest in the third type of investment discussed above, because he is a regular reader of the Lucri newsletter and believes that an asset should be "alive", it should produce and have intrinsic value. He further requested Lucri to construct an investment portfolio with R 100 001 that can compete with Freddy Fiat over the next decade.

So, Lucri decided to use the following attributes to construct an appropriate portfolio:

- Only companies with robust business models will be included. Lucri define robust as companies that could continue paying dividends during the past "Covid" year, without increasing their debt load.
- Debt levels should be low or well under control.
- The companies must generate strong free cash flow with a low need to re-invest capital into the business. No capital intensive companies.
- The dividend payments must be generous and sustainable.

Lucri decided to use this opportunity to demonstrate the value of selected high dividend shares for retired investors.

Lucri contructed the following portfolio on 26 April 2021(closing prices) and calls this the 3F portfolio (fascinating, fabulous five☺)

Name	**Share count**	**Price per share in cent**	**Value (Rand)**
British American Tobacco	92	53510	49 229.20
Lewis	411	3037	12 482.07
Nuworld	417	2996	12493.32
Coronation	228	5468	12467.04
Indluplace	31	39900	12 369.00
TOTAL			**99 040.63**

Immediately after the investment has been made, Pat is slightly behind Freddy due to transaction costs. Pat uses an Easy Equities account, so no admin fees will be applicable.

The idea is to re-visit the investments of Pat and Freddy every year in April to compare the results on yield and capital. Lucri readers should take note of the fact that Lucri did not wait for a special investment timing moment with share prices at a minimum. With the exception of British American Tobacco, all the share prices in the portfolio was significantly lower just a few months ago. The idea is not to show the value of investment timing, but rather the value of time in the market as well as the difference between investment types one and three discussed in this newsletter.

Lucri expects the investment portfolio to beat the fixed deposit comfortably over the next ten years on the total investment result (capital plus yield). Even on a cash flow basis excluding capital growth, the Lucri portfolio is expected to be a worthy competitor, even with the highest available interest rate being selected every year. All yield will be compared on a before tax basis. Lucri may decide to adjust the portfolio once per annum – but the changes should be minimal.

As half of the portfolio was dedicated to a single stock, Lucri plans to discuss the merits of British American Tobacco in a future newsletter.

Feedback from the Lucri year-end

Over 2020/2021, 20 out of 86 portfolios created positive alpha, representing a 23% success rate. The environment was highly competitive, as the RSA all share index advanced with 31.2% dividends included and the S & P 500 index in the USA advanced by 29.9% dividends included. Value investors normally lags when market prices grow at a high rate. Given this type of environment, Lucri is grateful for this limited success rate.

Admin fee

As indicated to most of you during the annual personal feedback, Lucri has decided to charge a small admin fee of 0.1% once per annum (only into the future) based on the closing portfolio value at year end. (If you have not received this message with your personal feedback, you fall into a different category, for example missionaries.) Some clients have already indicated their agreement and willingness to pay the admin fee – this was a pleasant, unexpected outcome before discussing it here – many thanks.

All Lucri clients will receive ample time until the end of October 2021 to decide whether they agree with this arrangement or not. Silence will be taken as agreement. As this is a change to our original agreement, clients obviously have the right to vote with their feet. If you decide to leave Lucri, please remember to send me a short message informing me and to change your password.

Just to remind you – Lucri has two models for compensation – one is a pure performance based model that only charge a fee for outperformance (Alpha). The fee is limited to 20% of Alpha. The other model use a fixed percentage of 0.25% of the year end portfolio value. The admin fee will only be applicable to the first model.

While Lucri wants to retain the performance based culture – I believe this is a strong point of Lucri that differentiates us from the competition – the following observations were made during the past years:

- Clients with specific requests like a high cash content or special low risk investments are tying my hands and prevent outperformance.
- Some clients request me to take their existing portfolios and proceed from there – this proofed to be a disadvantage to Lucri opposite a clean sheet.
- Some clients precludes investment into certain industries, or they limit investment to the re-investment of dividends from existing portfolios only –

this is also acting like hand cuffs, making it almost impossible to beat the market.
- Some clients move money frequently in and out of their accounts, increasing the admin effort.

While Lucri surely have investment blunders (and will continue to have them while obviously trying to minimise this sad occurrence), the special requests above are complicating matters. So, the best balance that I could think of, is to charge a small admin fee – for lack of a better word. This may also test whether certain clients are still committed to Lucri. This will avoid a scenario where Lucri has already “lost” a client, but the client is still on the books. It will be better to move forward with a smaller client number and grow again from there.

Obviously, true to the Lucri culture, all fees must be truly earned – meaning that value must be created for clients **after** fees. So, you may find that you receive no invoice for the admin fee when your portfolio is significantly below water. Small portfolio sizes (yes, Lucri do accept small amounts, especially from younger people) will also be exempt from the admin fee, as it will just not be efficient to invoice 1/1000 of a small portfolio.

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 productive investing,

Simon Streicher