LUCRI ALPHA NEWSLETTER NR 32

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Dear Lucri friends,

At the risk of boring you with repetition (something that Lucri wants to minimise), let us look again at the definition of investment and risk as expressed concisely by Warren Buffett: "*Investment is an activity whereby consumption of today is postponed for greater consumption tomorrow. Risk is the probability that this goal will not be achieved."* We shall refer to this quote again later in this newsletter.

This is so true. We are investing in order to increase buying power into the future. Ultimately, we are saving not to accumulate a number that signals "wealth", but we want to protect and increase our future consumption. Risk is not volatility – it is a mathematical expression to indicate whether the odds are in our favour or not. Buying power has moved to the forefront even more nowadays – due to a hurting level of inflation that increases our cost of living. We shall therefore spend a bit of airtime on inflation in this newsletter.

On a lighter note

John, testing new AI technology: "Sirri, please check my bank balance and tell me which Apple product I can afford?"

Sirri instantly replied: "Apple Juice!"

John (with a sly smile): "Is a zebra white with black stripes, or black with white stripes?"

John's friend: "It is red, with white and black stripes!"

John: "Uuuuh…….right!"

After one bee discovers a fine patch of flowers, a whole army of worker bees arrives at the scene shortly thereafter. How is this possible?

Answer: Easy – they just arrange a zoom meeting.

John: "The Highveld winter in South Africa is now really getting out of hand!"

John's friend: "Why – what happened?"

John: "When I went to the ATM early this winter's morning, I immediately got a message: Account frozen."

Quotes

"*Gravity is NOT responsible for making people fall in love."* Albert Einstein. See – he had a good sense of humour!

"How many legs does a dog have if you call the tail a leg? Four. Calling the tail a leg does not make it a leg." Abraham Lincoln

The lesson: Calling an investment product (like bonds and bank deposits) safe and superior does NOT make it safe and superior! Unfortunately, our society today is suffering from chronic truth decay.

"To say that derivative accounting in America is a sewer, is a grave insult to sewage." Charlie Munger

Poor old Charlie does not mince his words, does he?

Warren: "*Charlie is good at lowering expectations*."

Charlie: "*Absolutely! That's how I got married – my wife had to lower her expectations."*

"*If you are not willing to own a stock for ten years, do not even think about owning it for ten minutes."* Warren Buffett

I think Lucri friends understand what Warren is telling us here – we should not speculate.

"*Rule number one: Most things will prove to be cyclical. Rule number two: Some of the greatest opportunities for gain and loss come when other people forget rule number one."* Howard Marks

"An investor faces a constant stream of regrets. When the position is profitable, he regrets the fact that he did not buy more. If the position turns into a loss, he regrets buying too many or buying at all. The investor is always kicking himself until he finds some method in the madness. Then, he regrets that he did not find it earlier." Sensei

Those of you that are investors yourself will know how true this quote can be. Lucri has learned to remove emotion completely from the investment equation, as emotions can be strong and powerful enemies to rational thinking. Find an approach that works for you and then stick to it – but make sure that you remain a constant student of new ideas as well. The cartoon character Poko has discovered a most valuable truth: "*I discovered who the enemy is – he is us."*

Expropriation with inflation

People in South Africa are familiar with the political drive towards expropriation without compensation – but they too often ignore a much more widespread kind of confiscation, namely expropriation with inflation. Inflation confiscates future spending power – it is acting like a stealth tax. Just look at the following quote from an unknown, sharp person: "*Bonds and bank deposits are contracts of guaranteed confiscation."* Does these "investment" products provide risk-free return as is so boldly claimed, or rather return-free risk? Lucri firmly believes that the latter is more applicable – especially in the current environment where the interest that you earn is being outpaced by the rate of deterioration of the buying power of the principle amount. Surely, this will leave you poorer at the end of the investment period than at the beginning of it. Please refer quickly to the Warren Buffett quote in the introduction to this newsletter – can you see that bonds and bank deposits does not pass muster as investments in the current environment?

“Bonds are carrying triple risk to investors right now.” Doug Casey

Let us expand on this quote a bit more. Why does bonds carry a three-ply risk to investors?

Number one: Inflation risk. With international bonds providing 3% to 4% interest, it is a sure loss with inflation eating away at the purchasing power of the underlying principle at double that rate.

Number two: Capital loss. When interest rates are rising like in the current environment, the capital value of the bond reduces (if not held to maturity). Interest rates and bond prices are inversely related (except for inflation linked bonds, perhaps).

Number three: Default risk. With the current harsh economic conditions, some bond issuers will not be able to honour their commitments. Even sovereign bonds are not safe in this regard – as investors in Russian bonds discovered with much pain and regret last month.

You have surely noticed the current inflation in energy prices, food costs and many of the primary costs of living. This has come simultaneously with a deflation in asset prices covering the whole range from bonds to equities. Even the modern “superman” asset, namely bitcoin, are suffering together with all other crypto. Sooner or later, deflation will filter into the real estate market as mortgage rates have already spiked significantly over the past months. In New Zealand, property prices are already deflating by about 1% per month as they were early in the interest rate hiking game. When it comes to the world economy and international politics, we are living in interesting times indeed.

We also have the argument that the CPI number in most countries is not being calculated correctly. Lucri is firmly in that camp – I calculated that over the past three decades, inflation was under-reported in the RSA CPI number to the tune of about 2% per annum. (This is not a thumb suck number – I have calculated the inflation rate of my own household carefully over the past three decades and compared it to the national CPI number. I know my household is not representing the average South African household, but I believe it is close enough. Yes – our household keep track of EVERY rand spent every day over the past 30 years – this is more than a hobby, this is how we calculate our contribution to well fare and other worthy causes).

If my calculation is just roughly true, it actually means that the poor South African real growth rate around 1% lately actually signals a slow deterioration in real growth at a rate of 1%.

You also have people like Rick Rule that argues that increases in government tax should be included into the cost of living calculation – and I cannot find grounds to disagree with him.

So, where should investors hide and invest when cash is trash due to high inflation and all other asset classes are deflating? Lucri does not have all the answers, but this I do know: If an investor behaves like a true investor and focus on real investments, he or she should do just fine over time. Ok, so what is this so-called "real investments" exactly, you may be asking.

In my mind, a real investment is one where you initially gets more value than you are giving away via price when you enters the position. A real investment is also one where the potential reward to risk ratio is far above average due to a high potential reward boosted further by low risk. (Remember – risk is a probability). Lastly, a real investment produces lots of cold, hard cash – the cash flow stream must be strong, reliable and continuous due to a high yield on capital and strong free cash flow. By free cash flow I am referring to cash profit that can be extracted from the business without hurting the productive base of the business. A company that needs a high rate of re-investment of profits due to forced replacement of assets (due to wear and tear of expensive equipment, for example) will struggle to generate much free cash flow. Therefore, it pays to stay away from capital intensive businesses during periods of high inflation – the available cash flow will be absorbed by the much needed replacement of equipment at ever increasing prices. If this is postponed, you end up with a 2022 version of Eskom, not a 2000 version. Most South Africans did not think about Eskom until 2008, but nowadays Eskom has changed into a swear word in South Africa due to reliability issues as well as electricity price escalation far ahead of inflation – yes, even ahead of official inflation plus 2%.

A capital intensive business cannot pay out a generous dividend without hurting itself – or even worse, without borrowing more or issuing new shares to afford the equipment replacement. So – Lucri will keep on searching for value in capital light businesses with low debt, a high yield on capital and strong gross as well as nett margins which signals a strong competitive advantage.

Increasingly, new age "investors" into memestocks, crypto currency and high momentum growth stocks are learning old investment lessons again. The first lesson being that the buying of zero yielding instruments like bitcoin is NOT investing – it is speculation. As mentioned before in these newsletters – speculation is not a swear word – but it surely is not real investing either. An investor does not need to sell anything in order to earn a cash flow – he or she can just sit there (Charlie will say, just sit on your ass) and do absolutely nothing while a modest cash flow stream enters their bank accounts steadily and continuously.

A speculator, on the other hand, needs to find a buyer that are prepared to pay a price higher that the price the speculator initially paid. If no willing buyer can be found, or buyers can be found that are only willing to buy at a reduced price, often lower than the initial price paid, the speculator will be in trouble. He or she will wait, hoping for a change in fortunes – but eventually, with prices moving even lower, he or she may start to panic and accept a much reduced price. This is surely not the way to financial freedom.

Social media reports that previously boldly declared that "prices are moving to the moon" or that "prices will dramatically crash upwards" suddenly disappear and are replaced with doom and gloom type reports. This is the time that the probability of finding true investments below value will increase dramatically. Investments will go on sale, but buying interest will be muted.

The R1 million iPad that we got for free

Let me close this newsletter with a personal story. During 2016/2017, I speculated (see, it is not a swear word☺) with about 2 bitcoin for the fun (the price was around R5000 per bitcoin). In those days, the price doubled quickly. So, I sold one bitcoin to cover the cost and hold the other one at no risk.

Yes, I was so clever – I reduced my risk to zero by removing all my seed capital from the table. Then I decided (in my superior wisdom) to buy an iPad for my wife with this free bonanza bitcoin. So, I sold the bitcoin for about R 11 000 and we had a free iPad. Right?

Wrong! My wife now owns an iPad which in fact costed us one bitcoin – which at some point in time translated into R1 million – today it translates into "only" R383000. Depending on my mood, I think about that iPad as being free, or….the R 1 million iPad! The lesson? Never buy free iPads – they can get very expensive! And: When you are in the extremely blessed position to reduce investment risk to zero, you can and should hold on to the remaining portion of that investment for a very long time. Yes, I know……wide awake Lucri friends will tell me that bitcoin is NOT an investment according to the definition of an investment – you are fast learners! But you know what I mean – if and when you are in this favourable position with a true investment – you hold and do what Charlie recommend – you just sit on you know what☺.

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 "real" investing,

Simon Streicher