LUCRI ALPHA NEWSLETTER NR 34

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Dear Lucri friends,

In this newsletter, we talk about frauds, growth bombs and value traps. We shall also compare the Lucri Flagship investment with the All Share Index of the JSE over the past 29 years to highlight the value of continuous investment focus over long periods. We are also revisiting the discussion on asset bubbles that we had in April 2021.

On a lighter note

Do you know why the skeleton gave the dog a bone? He had a spare rib….

John: “My friend Peter has 56 chocolates. He ate 45. What has he now?”

John’s friend: “11 chocolates?”

John: “No, diabetes.”

What did one plate say to the other? “Lunch is on me.”

Quotes

“*Changing your mind based on new evidence is healthy, but changing your mind because the share price has influenced your mood can be fatal.”* Jacques Plaut

Lucri agrees. You should NEVER allow any market price to influence your evaluation of the true value of any investment.

“*Climate experts and economists think they are smarter than they really are*.” Charlie Munger

“*Artificial Intelligence experts are not as smart as they think they are*.” Elon Musk

If Charlie Munger and Elon Musk are correct, we can expect trouble in the world economy and in the Artificial Intelligence field.

“*Warren, if people were not so often wrong, we would not be so rich!*” Charlie Munger

Yes, markets are not always efficient – prices do crazy things in relation to value often enough for patient value investors like Warren and Charlie to get a huge advantage in investing.

“*Investing is currently (October 2022) like licking the honey off a razor blade*.” Hugh Hendry

“*A reasonable probability is the only certainty*.” EW Howe

This is true – investing is all about the probability and the magnitude of each outcome. So, the prudent investor will multiply the probability (that a specific event may occur) with the magnitude (of the specific event when it occurs) to get the effect of any event: Effect = probability X magnitude.

Tiptoe through the Tulips….

In newsletter nr 27, April 2021, after discussing several market bubbles, Lucri dared to add a 6th market bubble example: "*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*."

Since April 2021, we had the following result:

The Bitcoin price dropped to R 456 600 on 16 July 2021, recovered to R 986 212 on 12 Nov 2021 and dropped to R 281 371 by 30 Dec 2022. Yes, I shall admit to the Bitcoin die-hards – the price recovered to R 391 700 today. Surely, the price was in bubble territory in April 2021 – you cannot accumulate wealth from the high base above R 900 000 that formed in April 2021.

The original Tesla shares had a share split, but taking this into account, the share price dropped from about $240 in April 2021 to $133 today – after reaching $400 in Nov 2021. In my books, both are good examples of market bubbles in April 2021.

Frauds, growth bombs and value traps……plus a lollapalooza

According to investment manager Piet Viljoen, there are three ways towards a permanent capital loss in investing.

The first one is obvious – you invest due to "healthy" fundamental value, but the accounting reflects a fantasy based on outright fraud. You are conned, like in the case of Steinhoff. The best defence against fraud that Lucri knows about, is to carefully watch the actions of management, like repeated stock issues and constant borrowing. One should also be careful when the CEO make charismatic and bold statements. Even so, Lucri will sometimes get caught by the bad guys, but I am grateful to state that it gets more difficult to catch me nowadays – twice bitten, you know….

Then, an investor may be lured into a position due to turbo-charged growth prospects. The immediate past of the company is fantastic, and the future looks even better. This optimism and excitement is quickly reflected in a stock price that bursts upwards with great momentum. Piet Viljoen calls these situations "growth bombs", as they tend to explode with a **silent** bang, leaving the hopeful investor with a permanent loss. You can recognize these "bombs" by their high P/E ratio and exponential growth in the share price. The risk is high due to a high price although the quality may also be high.

Then, you have the so-called value trap. In this case, the P/E ratio is extremely low – which is normally an advantage. But – the business model is weak, as reflected in a low yield on capital and/or low gross and net margins. There are no durable competitive advantage and strict cost control may be lacking. In short – although there are value currently, the value may be stagnating or even being eroded away slowly over time. This is a very frustrating kind of investment – you pay a price below value with a good margin of safety (from the school of Benjamin Graham), but you wait until the cows come home with absolutely no closure between price and value. If anything, the discount between price and value just opens up further and then the value starts evaporating to follow the price lower! You bought into low quality, which can dish up a nice permanent loss for lunch. So, avoid opportunities with weak balance sheets and weak margins. The risk here is in the low quality of the business model.

If you are starting to think that the golden middle ground between a high P/E and a low P/E represents fertile investment ground, I have hope for you as an investor. You will normally find the lowest overall risk in the intermediate P/E ratio opportunities.

Now for the good news. Sometimes, very seldom, when you keep on searching diligently, you stumble across a low P/E company one fine day with an excellent balance sheet, decent margins in the income statement and steady growth prospects. You buy this company and just never look back. You have absolutely no negative surprises, only positive ones. The price was that of a dying company, but this company is anything but dying. This is what Charlie Munger calls a lollapalooza effect – you make money in the re-rating of the P/E ratio, and the E (earnings) is also exploding upwards. You can then get a ten bagger investment, using the language of Peter Lynch – your investment is increasing by 10 times (1000%) with-in a few years. You bought high quality at a price reflecting low quality. BINGO!

Lucri flagship track record

On 1 March 1994, Lucri started tracking the Lucri flagship portfolio against the All Share Index of the JSE. The so-called unit trust approach is being applied in order to measure the investment performance of “old money” and “new money” correctly – otherwise, we shall not be able to separate the savings drive (buying additional units) and the investment performance (growth in the unit price).

The serious investor needs to compare his or her performance with an appropriate benchmark – in this case the All Share Index of the JSE was chosen as the widest possible benchmark for South Africa.

In the comparison that follows, Lucri will also give you a mechanism for the proper evaluation of investment performance against a benchmark – you need to change the baseline used for comparison at least every year – to reduce the effect of a single year of outperformance or underperformance. In this way, the “one trick pony” type of investment manager will not be able to ride the wave of one lucky break decades ago!

So for the period of almost 29 years (28.87 years exactly), we shall have 29 investment periods, with 29 different baselines. We shall have the following baselines: 1 March 1994 for 28.87 years, 1 March 1995 for 27.87 years, 1 March 1996 for 26.87 years……until 1 March 2022 for 0.87 years. You can think of an investor that initiates a new investment with Lucri every year on 1 March – and each investment is then being evaluated against the All Share Index of the JSE for a similar investment period:

Time period in years (rounded to a whole number)	**R1 invested in All Share JSE index, dividends excluded**	**R1 invested with Lucri, dividends excluded**
29	16.36	23.51
28	15.17	20.90
27	11.60	16.86
26	10.98	13.30
25	12.08	12.67
24	13.27	15.85
23	9.82	11.04
22	8.71	12.58
21	7.26	11.63
20	9.34	14.02
19	7.20	10.11
18	5.82	7.97
17	4.11	5.63
16	3.04	4.58
15	2.55	3.62
14	4.25	4.74
13	2.93	3.47
12	2.43	2.76
11	2.29	2.38
10	1.97	1.94
9	1.65	1.51
8	1.47	1.23
7	1.59	1.34
6	1.53	1.22
5	1.34	1.22
4	1.40	1.42
3	1.53	1.60
2	1.18	1.32
1	1.06	1.03

You will immediately notice periods of over performance as well as under performance. Now, if I was employed as the marketing manager of the All Share Index, I shall highlight the following track record:

Time period in years	**R1 invested in All Share JSE index**	**R1 invested with Lucri**
10	1.97	1.94
5	1.34	1.22
1	1.06	1.03

But, if I was employed by Lucri, I shall highlight the following:

Time period in years	R1 invested in All Share JSE index	R1 invested with Lucri
28	15.17	20.90
24	13.27	15.85
20	9.34	14.02
16	3.04	4.58
12	2.43	2.76
8	1.47	1.23
4	1.40	1.42
2	1.18	1.32

It is clear from the above why you should always pay attention to the baseline that an investment manager chooses when he or she compares against a benchmark.

For the period 1 March 1994 to 11 January 2023, the consumer price index of South Africa moved from 20.5 to 107.2. This tells us that, according to the official inflation rate, R5.23 will buy today what R1 bought on 1 March 1994. You should keep this in mind when you look at the 29 year performance above – the All Share index increased buying power by a factor of 3.1 times without dividends, and Lucri increased buying power by a factor of 4.49 times without dividends.

Conclusions:

The value investment approach used by Lucri added value over very long periods – and the value becomes clearer as the timeline moves out further. Over the past decade, with popular growth stocks influencing the All Share Index of the JSE to a large extent, the value approach was lagging. That trend reversed again over the past 4 years.

In newsletter nr 14 we discussion the question: “When do I fire my portfolio manager?” In that newsletter, we discussed the timeline for evaluation purposes to be at least 5 years, but only for closer scrutiny – the performance over the next two years after the 5 years should be monitored closely. If you study the Lucri performance above, you will find that a 5 year period, and even a 7 year period may be misleading in some cases – especially if particular market conditions (like low interest rates) prevails over periods longer than 7 years.

So, was it worthwhile to do all the research that was required in order to apply the value investment approach? In order to answer this question, I need to remind you about the effect of investment fees (you cannot buy the All Share Index, you need to buy an ETF product with fees attached), and I need to inform you that the value type portfolio produced dividends comfortably above that of the All Share Index.

The combined advantage of lower fees (after taking brokerage costs into account) and the difference in dividends was at least 2% per annum on average. So, the true comparison over the full time period actually reflects the following:

Lucri: R23.51 X (1.04)^28.87 = R 72.94

Please refer to the inflation calculation above. The buying power of Lucri therefore increased by 72.94/5.23 = 13.9 times over the almost 29 years.

All Share Index: R 16.36 X (1.02)^28.87 = R 28.98

The buying power of the All Share Index increased by 28.98/5.23 = 5.5 times over the similar period.

The actual outperformance over the 28.87 years was therefore 151% - which is sufficient to pay me for the hours invested into research (which is my passion and pleasure anyway).

Lucri housekeeping

The Lucri year-end for this year will be end of day on Friday, 17 March 2023. Due to personal circumstances I had to move the year-end out a little bit, but as the comparison against the benchmark uses a continuous, cumulative approach, the measurement will stay pure as long as no time gaps are being introduced into the continuous timeline. I am also announcing the year-end in advance, so that an opportune time cannot be chosen in hindsight for comparison purposes.

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 enjoy your lollapalooza investing,

Simon Streicher