LUCRI ALPHA NEWSLETTER NR 38

17 January 2024

Dear Lucri friends,

Lucri Alpha was initiated 12 years ago, in January 2012. The newsletters only kicked off more than 2 years later in October 2014. As you can see, we are now at nr 38 already.

In this newsletter, we spend airtime on Charlie Munger, who passed away since our previous newsletter. We also look at a "simple portfolio" and the ideal PE ratio in relation to expected future growth.

On a lighter note

The two accountants sit opposite each other in the prison cell. "*You know*", the one says to the other "*I have discovered that in accounting it is better to think inside the box!".*

Knock, knock

Who's there?

Hatch

Hatch who?

Bless you!

Doctor, doctor! I feel like a clock!

Doctor: "You are too wound up…"

Now for your regular biology lessons:

Where are monsters found?

They are hardly ever lost…

Why are giraffes so slow to apologize?

It take them a long time to swallow their pride…

On a heavier note

In the previous newsletter, we discussed the heavy fact that the South African government borrowed money at a rate of R30 million per hour over the past three years. On 1 November 2023, the medium term budget of South Africa was presented by the minister of finance. He projected that R1100 000 million needs to be borrowed over the next 2 years. So, the new projected rate of borrowing will be R63 million per hour. The lesson? If it is unsustainably high, you just double down!

Charlie Munger

Charlie Munger, previous vice president of Berkshire Hathaway, died peacefully in his sleep on 28 November 2023, just 33 days before his 100th birthday. As his quotes and wit have been used quite regularly by Lucri, we shall devote a portion of this newsletter to him.

Did you know that Charlie read roughly 40 000 books over a period of 80 years at a rate faster than one book per day? This astonishing fact was recently mentioned by Mohnish Pabrai, one of his friends and close followers. Charlie integrated the knowledge of these books and build a mental lattice work in his head that helped him to make sound, rational decisions. We should mention here that Charlie did not read books like most people do. He scanned them quickly, and only took the golden nuggets that are interesting to him or that he found valuable. If a section of a book was interesting to him, he will read every word – but only in that section.

An example of golden nuggets will be the following:

There are three golden nuggets in the book “The intelligent investor”, written by Benjamin Graham:

- Always think of share investments as pieces of a real business. Do not think about it as something with a price that moves up and down on a chart. Think about the fundamentals. This tells us that a share has intrinsic value.
- Never allow the market to instruct you – the market is there to serve you. The market is your servant. Do not allow current price movements to influence you.
- Always apply a margin of safety, because it is impossible to calculate the intrinsic value with high accuracy.

You can see that Charlie practised what he preached, look at the following quotes from Charlie:

“*The game of life is the game of everlasting learning. At least it is if you want to win.*”

“*In my whole life, I have known no wise people who did not read all the time – none, zero.”*

“It is not the smartest, not even the most diligent people that gets ahead in life. It is the people who go to bed a little wiser every day. They are learning machines.”

Charlie loved to teach. You have not taught unless somebody have learned. If we measure Charlie on this yardstick, he really was a magnificent teacher – I can also testify that I have learned a ton from Charlie indirectly through his interviews and the Berkshire Hathaway annual meetings.

I have written the bulk of my investment thesis in 1993, 30 years ago. So, in December 2023, I read the whole thesis again, and added a lot of notes and comments as I progressed through the 297 pages. Constant focus on this field has helped me to continue learning over the last 30 years, from Charlie and others. In the investment field, you need a long attention span and constant focus.

Charlie was a very direct and honest person, who called a spade a spade. For example, listen to this remark from him: "*There are business leaders who do not have one true friend in this world and rightly so!"* He made this remark when he discussed the fact that life is so much more than just making money – how you make money is more important that the money itself.

I have learned to appreciate the wit and wisdom of Charlie. There are three kinds of people in this world that starts with an I, but they are vastly different: Innovators, imitators and investors. Charlie Munger will disagree, he will insist that there are 4 kinds – he will surely add "idiots" to the list☺. There are two groups of people that influences us all that starts with a F: Friends and Family. Yes – you got it! Charlie will insist there are 3 groups – he will add "fools" to the list.

About one month before he passed away, David and Ben of "Acquired" interviewed Charlie and alluded to the fact that it is hard to make money. Charlie: "*Why should it not be hard? Why should it be easy?"* He also added: "*It is crazy not to put the bulk of your money into your very best investment ideas – because life changing ideas are extremely rare – you only get 5 to 6 opportunities like that in your lifetime." "But…the beauty of it is, you only have to get rich once!" "It helps to get your very best opportunities early in your life and then live to a ripe old age to get the benefits of compound growth."*

You can hear that Charlie's mind was still very sharp, even at close to 100 years of age.

Charlie always taught on the subject of patience. "*Wait – without growing tired of waiting. The real money is not in the buying and selling, it is in the waiting."*

The people from Simply Wall Street have also learned from Charlie: "*Think in decades, not months. Reach your own conclusions. Be a lifelong learner."*

Charlie got the following question: "*How do you know when to exit an investment*?"

He answered as follows: "*I am trying never to exit a stock. I am no good at exits. I do not like even looking for exits. I am looking for holds. Think of the pleasure I have got from watching Costco march ahead. Such an utter meritocracy and it does so well. Why would I trade that experience for a series of transactions that make me a little more? I would be less rich after taxes, and it is a much less satisfactory life than rooting for people I like and admire."*

Ok, before you grow tired of Charlie, we shall move on – but you can be sure that Lucri will refer to Charlie in future. He mentioned that people that has passed away can be good mentors via their teachings – so, he shall remain one of the Lucri mentors.

The simple portfolio

"*Anything should be made as simple as possible, but not any simpler*." This quote is often used by Warren Buffett, but he is not responsible for the original. With this quote in mind, Lucri decided to develop a portfolio that is super simple, but still effective with a superior reward to risk ratio. Lucri calls this the "simple portfolio".

This portfolio is a solid starting point for a more elaborate portfolio, because you may find it hard to beat! My advice to you that are also investors in your own right – compare your own portfolio performance to this simple portfolio and do not hesitate to convert to this one if you have a hard time beating it.

This portfolio only has two components, namely 50% invested into Berkshire B (brk.b) and 50% invested in the Satrix 500 index fund (STX500). This portfolio provides a very efficient balance between the active and passive investment styles. This portfolio is also quite tax efficient, as the holder will not pay significant tax until the portfolio is sold – preferably only in the distant future.

Berkshire does not pay any dividends – excess cash are returned to shareholders via share buy-backs only. No tax will be paid until the investor decides to sell in future. Also, the unique feature of the Satrix500 index fund is that it capitalises any dividends from the S&P 500 index in the USA – so, the dividend will be retained and will provide an enhanced capital growth. No dividend will be paid out.

To calculate the value of this portfolio will be super simple – just use the dollar price quotation of brk.b, the R/$ exchange rate and the rand price of STX500. No dividends need to be accounted for at all.

We shall invest R 100 000 today in this portfolio, at the current prices which looks quite steep due to the weak rand. We shall buy R50 000 of brk.b and R 50 000 of STX500, assuming total transaction costs of 0.6% via Easy Equities:

Brk.b dollar price: $361.10

Rand to dollar exchange rate: 19.04 R/$

Brk.b rand price: R6875.34

Price quotation on STX500: R94.11

So, we can buy 0.994 X R50000/R6875.34 = 7.228 brk.b and 0.994 X R50000/94.11 = 528.11 STX500.

The simple portfolio therefore consists of 7.228 brk.b and 528.11 STX500. Lucri shall refer to the performance of the simple portfolio from time to time, but this will not occur on a fixed time basis at all. Lucri hope to illustrate that, over time, this portfolio will proof hard to beat, especially on a reward to risk ratio. The risk in this portfolio is very low for a 100% equity portfolio.

Theoretical PE ratios versus growth rate

While working through my investment thesis written in 1993, I was reminded about a formula that I developed for the price of a share relative to free cash flow, a specific discount rate and a specific future growth rate in free cash flow.

The future free cash flow stream of any company can be illustrated as a series of perpetual annual cash flow items into the future until judgement day. If you discount this cash flow stream back to today, you get the intrinsic value. I used these cash flow items and transformed it into a mathematical series that can be quantified mathematically through a short-cut method.

Now, those of you with unlucky memories from a mathematical class or exam in the past, may develop stomach pains if I publish the formula here☺. So, I shall be merciful and just publish the end result. I am sure my readers can enjoy a happy and successful life without performing too much mathematics.

Now, those of you that are well versed in accounting, will tell me that earnings per share and free cash flow are two different things. You are quite correct, but in companies with a high quality of earnings, the free cash flow per share will approach the published earnings. As Lucri are focused on companies with a high quality of earnings, we shall make the assumption that free cash flow are identical to earnings.

In order to illustrate the effect of interest rates on the PE ratio, we shall discount at 8% over 15 years for a low interest rate environment, and at 12% over 15 years for a high interest rate environment. The result is as follows:

PE ratio for different scenarios

Growth rate %	**15 years, 8% discount rate**	**15 years, 12% discount rate**
0%	8.6	6.8
1%	9.1	7.2
2%	9.8	7.7
3%	10.5	8.2
4%	11.2	8.7
5%	12.1	9.3
6%	13	9.9
7%	13.9	10.6
8%	15	11.4
9%	16.2	12.2
10%	17.4	13
11%	18.8	14
12%	20.3	15
13%	22	16.1
14%	23.8	17.3
15%	25.7	18.7
16%	27.9	20.1
17%	30.2	21.7
18%	32.7	23.4
19%	35.5	25.2
20%	38.6	27.2
21%	41.9	29.4
22%	45.5	31.8
23%	49.5	34.4
24%	53.8	37.2
25%	58.5	40.3

We can immediately see the effect of the interest rate on the PE ratio. Warren Buffett said that the effect of interest rates on share prices are the same as the effect of gravity on physical things.

We can also see that the theoretical PEG ratio (ratio of PE to growth) is above one in all cases. Value investors always look for a price that is in their favour – so, value investors want to buy at a PEG ratio of 1 or below 1 – especially for the higher growth stocks.

Due to the extremely low probability to grow consistently at a rate above 15% for long time periods, we shall restrict ourselves to growth rates of 15% and lower.

How can you utilise this table? To be conservative, we shall focus on the 12% discount rate column. You identify an opportunity that is growing at 15% consistently, but it is priced at 10% growth with a PE ratio of 13. You buy this stock, and allow 5 years for the market to re-rate the company due to consistent growth at 15%.

With this in mind, you can expect the following share price growth after 5 years: $(1.15)^5 \times 18.7/13 = 2.89$. You will receive total growth of 189%, which is 23.6% compound growth. You received 15% growth from earnings, and an additional capital growth of 8.6% per annum due to the stock re-rating from a 13 PE to the correct 18.7 PE.

You are most welcome to invent your own system around this theoretical framework.

I hope the mathematics did not give you too much stomach cramps☺.

Lucri housekeeping

The Lucri year-end for this year will be end of day on Friday, 1 March 2024. I am always 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, Telegram or e-mail when you move cash in or out of your account.

All comprehensive 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 “Munger style” investing,

Simon Streicher