LUCRI ALPHA NEWSLETTER NR 40

11 July 2024

Dear Lucri friends,

I am writing a little ahead of schedule this time due to the prolonged stormy conditions in the Western Cape – in this way, I can reserve the sunny days ahead for outside activities!

In this newsletter, we talk about long term compounding without tears, the difference between uncertainty and risk, reversion to the mean as applied to Sasol shares and we celebrate our investment into Lewis.

On a lighter note

What do you call a girl who stands in the middle of a tennis court?   "Anette"

Knock, knock….

Who's there?

Boo.

Boo who?

I'm so sorry…..!

What does a polite monster say when he meets you for the first time? "Pleased to eat you!"

Life through John's eyes….

John: "I think I would like to go to the concert."

John's friend: "Good! I shall make the reservations immediately."

John: "On second thoughts….I am not too sure. Maybe I shall just stay home."

John's friend: "You know, you have now changed your mind three times on this!"

John: "Yes, I know – but what is the good of a mind if you cannot change it?"

Quotes

"*I want to be average for a time period far above average.*" Morgan Housel

Morgan refers to investments here. He believes in taking low risks, he resists the fear of missing out (FOMO) and is not bothered at all if his neighbour is getting rich much faster than himself. He knows that he must just stay in the game, and never allow the slightest possibility for him to be knocked out of the game permanently (to be declared bankrupt after taking on too much debt, for example).

He therefore aims for a slightly lower rate of compounding, but he is increasing the possibility that he can continue compounding for many decades into the future. He

believes that this strategy will help him to accumulate wealth that can propel him into the top 10% of investors in the world.

So, Morgan invests into index funds and keep adding to them steadily for very long time periods.

"*Investing is a game of extreme patience AND extreme decisiveness.*" Monish Pabrai

Monish is teaching us about patience – regular Lucri newsletter readers have heard this many times before. Monish is also telling us that you need to step up to the bat when the opportunity arrives – Lucri agrees fully. Warren Buffett also teaches that we should not run outside with teaspoons when it rains gold, we should use buckets at least…

Monish was a good friend of Charlie Munger – he visited Charlie many times over the last decade, they played bridge together and he learned a lot from Charlie.

"*The difference between stupidity and genius is that genius has limits.*"
Albert Einstein

No comment from Lucri – I believe this guy was qualified to talk about genius status.

"*Try to compound a little faster than the market at a risk a little lower than the market.*" Chuck Akre

Chuck explains how we can compound a little faster:

Buy companies with a return on equity that is a little higher than the market average – because return on equity approaches the growth rate of the investment over long periods of time.

Chuck also explains how we can ensure that the risk is a little lower than the market risk:

- Buy companies with a balance sheet a little stronger than the average balance sheet in the market.
- Buy companies with a rating a little below the average market rating (PE ratio).
- Buy companies with management that has skill and integrity – that ensure that per share performance matches the company performance.

Long term compounding without tears

Guy Spier, the author of the book "The education of a value investor", has excellent advice for investors. His ideas are closely related to that of Morgan Housel above.

According to Guy, you need to construct your portfolio to do reasonably well in various different scenarios. If you set it up to outperform significantly in a specific scenario, but this portfolio will completely blow up in a different scenario, you are gambling – not investing. Ben Graham also stressed the fact that safety of your principal should be ensured while you strive for a reasonable return.

Rather make sure that you stay in the game – even if you do not have outstanding results every year. In this way you ensure that you will reap the benefits of long term steady compounding without tears.

A practical example of uncertainty

In the previous newsletter, we discussed an investment process where the odds are in your favour – for example, when somebody gives you 2 to 1 odds on the tossing of a coin. The probability of being right is only 50%, but the odds are strongly in your favour. Provided that you can repeat the process many times, your risk will be very low. Uncertainty is not the same as risk – you are uncertain at each tossing of the coin – but the overall risk is low.

I have performed a quick practical test to illustrate the role of probability, the role of a specific outcome connected with a certain probability and the portion of your wealth that you can place at risk.

I flipped a coin 20 times, with odds of 1.5 to 1 in my favour. Heads will provide me with R1.50, but tails will cause me to lose R1. I was not lucky at all – I got 14 tails, and only 6 heads. The outcome was a loss of R5 calculated as (R1.5 X 6) minus (14 X R1) = -R5. Does this mean that I should stop the process – as I am loosing after 20 repeats?

No, not at all. The odds are in my favour. So, I continued, and flipped the coin another 20 times. This time, I got 14 heads and 6 tails. So, in total, I got 20 heads and 20 tails, with a final result of a R10 gain, calculated as (R1.5 X 20) minus (R1 X 20) = +R10. Due to the odds not really strong, I needed 40 repeats, not only 20.

With odds of 2 to 1, the first 20 repeats will still provide a loss of R2 calculated as (R2 X 6) minus (14 X R1) = -R2.

Only with odds of 3 to 1, the first 20 repeats provided a gain of R4 calculated as (R3 X 6) minus (14 XR1).

So, in conclusion: You can bet 5% of your wealth (20 repeats) only if you have very strong odds, like 3 to 1. With odds of 2 to 1, you should decrease the size of your bet to 2.5% of your wealth (40 repeats). The lower the odds, the smaller the size of your wealth that you should place at risk.

Reversion to the mean

A large portion of processes in the world moves in cycles. Now, in any cycle, if you found a parameter or a measurement very close to one of the extremes in the cycle, you have a high probability to experience reversion to the mean. This means that the measurement will return to a value closer to the midpoint in the cycle. I once read a book on the subject – all I can really remember of this book, is that the author convinced me with mathematics and many examples that reversion to the mean should not be ignored in any cyclical movement.

Now, just to get your attention, let us apply this to the movement in the share price of Sasol shares.

"*Energy is the currency of life.*" Art Berman

Sasol is mainly an energy company, and the energy market is very cyclical in nature. Currently, a significant portion of the turnover of Sasol is due to petrochemical sales. If we account for the high energy intensity of the chemical process industry, it soon become clear that Sasol does not need to sell mainly fuels and gas to be classified as an energy company.

Now, regular readers of the Lucri newsletter may recall that Lucri does not regard Sasol as a sound long term investment, mainly due to the low free cash flow generation of the company. Due to the high capital intensity of Sasol, a huge portion of the cash flow needs to be invested into maintenance or equipment replacement – leaving a small portion available for dividends to shareholders, or share buy backs.

So, we shall concentrate on the question whether Sasol may be a sound cyclical investment – not for the long term, but only to ride the cycle.

Over the past 21 years, we found the following cycles in the share price of Sasol.

Low point no 1 will be indicated by L1, high point no 1 by H1 etc:

L1: R78.60 on 15 Aug 2003

H1: R496 on 23 May 2008, upwards leg duration 4 years and 9 months

L2: R245 on 24 Oct 2008, downwards leg duration 5 months

H2: R619 on 11 July 2014, upwards leg duration 5 years and 8 months

L3: R392 on 12 Dec 2014, downwards leg duration 5 months

H3: R547 on 28 Sept 2018, upwards leg duration 3 years and 9 months

L4: R27 on 20 March 2020, downwards leg duration 1 year and 6 months

H4: R417 on 3 June 2022, upwards leg duration 2 years and 2 months

L5: R110.40 on 4 June 2024, downwards leg duration 2 years??

Now, looking at this data, we can clearly see the huge cycles in the share price of Sasol over the past 21 years. It seems that the duration of the upwards leg are growing shorter over this period with a weaker high price, and that the duration of the downwards leg are growing longer resulting in more extreme lows.

I am inserting the question marks on L5 due to the fact that nobody will be able to determine that turning point with high accuracy. On 9 July 2024, the Sasol share price closed at R142.60 – which is already 29% above R110.40 on 4 June 2024, only one month ago. This may increase the likelihood that L5 was indeed at R110.40, but we do not know for sure.

We can use additional, alternative measurements to enhance our understanding of the cycles in the Sasol share price.

If we compare the Sasol price to the Rand per barrel price of Brent crude, we find the following:

H1 was reached at a Sasol price equal to 47% of the Brent crude price per barrel

H2 was reached at a Sasol price equal to 53% of the Brent crude price per barrel

In the period 2000 to 2014, the ratio of the Sasol price to the R/bbl price of Brent crude moved between 40% and 60% for most of the time.

After the massive capital investment in the Lake Charles chemical complex in the USA, the ratio of the Sasol price to the R/bbl price of Brent crude moved between 10% and 25% for most of the time. This indicates that fuel sales had less influence on the fortunes of Sasol.

L4 was reached at a Sasol price equal to just 4% of the Brent crude price – but this was a short lived, extraordinary occurrence when the market feared for the solvency of the company due to a high debt load combined with a weak oil price. The covid crash also exacerbated the situation.

On 4 June 2024 (the possible L5 above), the ratio of the Sasol price to the R/bbl price of Brent crude was 7.8%, which is lower than the usual range of 10% to 25% for the time period after 2020.

We can also look at the percentage of the time since December 2004 that the Sasol share price was trading below R110.40 – the price reached on 4 June 2024. Using the long term price trend of Sasol shares, it is a quick and simple exercise to determine that Sasol was trading at or below R110.40 for only 1.73% of the time since December 2004. While price is no indication of value, if we use the reversion to the mean kind of thinking, it becomes clear that the Sasol price can adjust upwards as it seems to be close to an extreme level in the cycle.

Before we decide to buy Sasol as a short term cyclical investment, we should calculate the current value of the share.

We can do this using the Lucri model that has quantified the value of Sasol shares with "sufficient" accuracy in the past. I am using this term, to signal the inherent weaknesses of the Lucri model. The model places a value of R216 on a Sasol share. This is lower than the current net asset value of R310 per share, due to the low yield on capital that Sasol is currently earning. This value is also much lower than the current replacement value per Sasol share – which I am estimating very roughly to be about R900 to R1000 per share. Maybe one of my readers that have higher quality information and more updated Sasol related knowledge than myself can help me to quantify the replacement value with improved accuracy. In any case – the value from the Lucri model seems to be quite conservative in nature.

So, if you accept the concept of reversion to the mean and if you believe L5 was on 4 June 2024, you have additional indicators in the form of value, % of time and the ratio of the Sasol price to the R/bbl Brent crude oil price to inform your cyclical investment decision.

Lewis investment

Lucri sang the praises of Lewis as an investment in newsletter 26. Towards the end of this newsletter dated 20 Jan 2021, Lucri mentioned that the so-called nett-nett

value of Lewis was R40.66 per share, while the share price was trading at R24 (after it had already recovered from the covid crash).

From then until now, the nett-nett value of Lewis has increased to R56.11 per share – a gain of 38% over the 3.5 year period. Over the same period, the share price has closed most of the discount to the nett-nett value to trade at R55.48 (11 July 2024). So, it is now clear that the R24 price tag was a "black Friday" sale of Lewis shares!

Lewis also paid generous dividends as follows since 20 Jan 2021: 195 c in July 2021, 195 c in Jan 2022, 218 c in July 2022, 195 c in Jan 2023, 218 c in July 2023, 200 c in Jan 2024 and has now declared 300 c to be paid on 29 July 2024.

This provided R9.77 after dividend tax of 20%, excluding the last 300 c dividend. So, the total yield after purchasing Lewis on 20 Jan 2021 will be (((R55.48 + R9.77)/R24) X 100) – 100 = 171%, or 33% per annum over the 3.5 year period.

We have reason to celebrate – but it is crucial that we should understand WHY we are achieving this result. This happy result came about due to the growth in the nett-nett value per share, the re-rating of the stock price to remove the discount to the nett-nett value and the generous dividends that was paid each semester. This in turn was enabled by the strong share buy-backs over the period and the strong free cash flow generation. The quality of the management team has a lot to do with this performance, as Lewis is operating in a very competitive environment.

Currently, you cannot bargain on the re-rating of the share price anymore, but you still have a generous dividend of 9% before tax (R5 per share before tax, R4 per share after tax) plus the expected slow growth in the nett-nett value per share.

Lewis is returning more than the earnings per share to investors every year. If you add the cost of the share buy-backs each year to the dividend payment and calculate this on a per share basis, you will find that the resulting number per share exceeds the earnings per share. Normally, this will not be possible without incurring debt – but in the case of Lewis, they only loan money to support their debtor's book. You can compare this to a bank that loans from the reserve bank to support their own money supply to banking customers. Lewis calculates their earnings per share in a most conservative manner – they reserve for bad loans far in excess of their historical bad loan experience. The result is that their cash flow per share far exceeds their declared earnings per share, which already provides a 14% earnings yield (it used to be around 20% before the re-rating).

We have already discussed the difference between Sasol and Lewis as investments. While I am prepared to keep Lewis for long periods of time, my investment into Sasol will be short to medium term – just to allow sufficient time for the cycle to play out and for reversion to the mean. Lucri also regards any investment into Sasol to be at higher risk relative to Lewis, and will therefore allot a much smaller % of my portfolio to it.

Lucri housekeeping

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 investment without tears,

Simon Streicher