

## **LUCRI ALPHA NEWSLETTER NR 13**

**20 OCTOBER 2017**

Dear Lucri friends,

It is now three years since I have issued the first Lucri newsletter. I must admit that the past three years was a challenging investment period, actually the most challenging period in the 37 years since I have initiated my own investment journey.

This does not imply that I am not currently enjoying the investment world – I am just as passionate about investing now as in November 1980 when a new world of investing opened to me. It was a most rewarding journey – intellectually and financially. After introducing a unit trust approach in Jan 1987 in order to measure growth correctly, every R1 invested 30 years ago yielded R240 (including dividends re-invested, but before tax) to end at R241 – 20% compounded growth over 30 years. R127.3 was from dividends and R112.7 was from capital growth. (The Lucri historical performance displayed on my website reflects part of this picture, but it excludes dividends and the initial fast growth period to avoid high expectations.)

The all share index yielded R56 for every R1 invested over the 30 years – R24.7 from capital growth and R31.3 from dividends. I am mentioning these historical figures to encourage people of all ages to save. South Africans as a whole do not save, as all extra savings each year are more than offset by extra borrowing.

So, it was worthwhile investing the additional effort to buy individual stocks versus investing into an all share market related product even if the management fee was for free (a market product was not readily available in the RSA at the time in any case). In other words – over the past 30 years there was no reason to doubt value investing or to fire myself as investment manager. The free investment services, being my own investment manager, obviously helps to secure my position☺. This does not mean I shall never fire myself as my own investment manager – in a future newsletter, I plan to share my own metrics which will determine whether I should fire myself or not, and who to appoint as investment “manager” when I am fired! The investment period to be used for the merit evaluation should not be too short (due to the nature of value investing), but it should also not be too long (as it will cause the manager to rest on past performance for too long, leading to low performance). This may be of interest to you, as this will signal to you when you should fire me, as I surely does not expect to remain your manager after I have fired myself. For now, my position as my own portfolio manager seems to be intact...

### **On a lighter note**

It's difficult explaining puns to kleptomaniacs – they are always taking things literally!

Research shows that 6 out of 7 dwarves are not Happy.

For women: Not all men are annoying. Some are dead.

### **Buffett quote**

As you may have noticed, my newsletters have to contain a quote from Warren Buffett to be complete. This one hints at highly paid consultants and portfolio managers that does not add value: “When a person with money meets a person with experience, the one with experience ends up with the money and the one previously with money leaves with experience.”

### **Risk Indicator**

The difficult three year investment period that I have referred to above is drawing to a close in the RSA. Most of you will meet this news with an enthusiastic outcry: “At last!” As mentioned last time – the longest side-ways market that I know of lasted 4 years in the early seventies. The most recent one lasted for three years – from July 2014 to June 2017. I am sticking out my neck by talking about this period in past tense – why am I concluding that the crab-like market movement is behind us? The following factors help me to come to this conclusion:

- The earnings of the collective group of companies in the all share index of the JSE had grown by 29.5% over the past year. Yes, while RSA incorporated experienced a recession in two quarters out of four!
- After trading with-in a range of 45000 to 55000 for three years, the index broke out of this trading range and closed above 55000 for three consecutive months.

This does not necessarily guarantee fast growth moving forward – but it does signal an important change in the prevailing trend.

The risk indicator of the all share index improved marginally from 52% in June 2017 to 50% in September 2017 while the index increased by 7.7% from 51 611 to 55 579 over the three months. This is a positive signal – indicating that the growth in underlying profits is outpacing capital growth over the past three months. This is healthy, as the capital growth is not driven by possible pre-mature positive sentiment based on hope – it is driven by a fundamental improvement in profitability amongst resource based companies (the likes of Anglo, Billiton, Kumba) as well as companies with large market capitalization on the JSE (Naspers, Richemont).

### **Lucri is lagging currently...**

After sharing the good news above, it will be prudent to warn you about the fact that the companies currently trading below value, typically the companies where Lucri is investing, is still sleeping soundly – totally unaware of the positive movement in the index. These companies are exposed to the local RSA economy where business confidence is still lacking, to say the least.

Over the short term, you should therefore expect temporary underperformance in your Lucri accounts versus the all share index, resulting in no or low Lucri fees most likely to be paid in 2018 – talk about mixed feelings! Most Lucri accounts running for three years or longer are still beating the index by a large margin, even after the most recent period of underperformance. When you compare performance, it will be wise to use the full investment period since you have started with Lucri – the longer the period, the better (up to about 7 years).

## History on All Share Index of the JSE

The following history of the compounded growth percentage in capital, earnings and dividends for the collective group of shares in the All Share Index of the JSE for various periods up to 10 years were firstly introduced to you in newsletter no 6, for periods ending in December 2015:

	<b>1 year</b>	<b>3 years</b>	<b>5 years</b>	<b>10 years</b>
<b>Capital</b>	1.9%	8.8%	9.6%	10.9%
<b>Earnings</b>	-10.3%	-0.3%	7.1%	8.7%
<b>Dividends</b>	8.7%	12.7%	17.9%	14%

I have now updated the exact same information for periods up to September 2017:

	<b>1 year</b>	<b>3 years</b>	<b>5 years</b>	<b>10 years</b>
<b>Capital</b>	7%	4%	9.2%	6.4%
<b>Earnings</b>	29.5%	-0.4%	2%	3.8%
<b>Dividends</b>	9.2%	3.8%	8.3%	8.7%

Scrutiny of the updated numbers reveals that the deviation between dividend growth and capital growth (price movement of shares) varied in a narrow band between 2.3% and -0.9% over all periods. On the other hand, the deviation between earnings growth and capital growth varied in a wide band between 22.5% and -7.2%. From this observation it follows that the movement in share prices of the companies comprising the all share index followed the growth in dividends quite closely over all the periods. We can therefore conclude that share price growth are heavily influenced by dividend growth – the dividend % of the index moved in a narrow band.

Looking at the longer term, it becomes clear that the growth in earnings also plays an important role – with the price movement of the shares almost exactly in-between the dividend growth and the earnings growth for the 10 year period. It is also clear that dividend growth is much more stable and reliable compared to earnings growth – although earnings is the source of dividends.

Dividends growing at 8.7% compounded over 10 years while earnings grow at 3.8% compounded over the same period is clearly unsustainable. The good news for investors like myself that makes a living from dividend income, is that the earnings growth is currently catching up with dividend growth to correct the situation and ensure sustainability.

The other good news is that the standard of living for people with dividends as their main source of income is constantly rising over the past decade as dividend growth outpaces inflation – the trend over the past century on this measure is still intact. (The global average annual return for equities over the past 117 years has been just over 5% above inflation. Out of 23 countries, South Africa was the best performing stock market at 7.2% above inflation per annum over 117 years.)

Dependence on capital growth to provide the same protection against inflation was on an uncertain footing over the past 10 years – explaining why true investors are

not that interested in the price movement of shares, except when they want to buy. Dividend growth (and long-term earnings growth for sustainability) are the true drivers of prosperity for investors – please also refer to the contribution of dividends in my own investment journey mentioned earlier.

## FOMO – BITCOIN AND NASPERS

Do you know that bitcoin (BTC), the first blockchain based cryptocurrency and Naspers, the extremely successful international media and e-commerce related company listed in South-Africa, has something in common? Both cause people to experience FOMO – the fear of missing out.

According to the questions that I am receiving from friends and customers, both are attracting widespread interest. The following historical price trends will explain the interest:

### BITCOIN PRICE HISTORY

Date	Bitcoin price in rand	Price movement
Initiated in 2009	1 (slightly lower, 0.06 \$)	
22 Oct 2015	4087	300% compounded from 2009 to 2015
27 Oct 2016	9982	144 % over 1 year
20 Oct 2017	79600	697 % over 1 year

### NASPERS PRICE HISTORY

Date	Naspers price in rand	Price movement
March 2002	12.3	Loss since listing on 12 Sept 1994
20 Oct 2014	1196	44% compounded since 2002
20 Oct 2015	1953	63% over 1 year
20 Oct 2016	2359	21% over 1 year
20 Oct 2017	3297	40% over 1 year

The above table's show the general trend, but hide the fact that both had been extremely volatile – for instance, Naspers was R100 before it reached R11.90 at its lowest point – 88% of the price just collapsed! Bitcoin also collapsed a few times with about 30% to 80% of the price disappearing almost overnight before recovering again.

This looks like real money to be made really fast – a true “get rich quickly” dream that came true for some people. As “some people” are making serious money, you may experience the fear of missing out. It also looks so easy – rear-view investing and extrapolating the past into the future always looks easy. Again, let's ask Warren Buffett to comment: “Investing seems easy to do when one looks through an always-clean, rear-view mirror. Unfortunately, however, it's the windshield through which investors peer, and that glass is invariably fogged.”

I must now make myself VERY clear: I have no idea at all where the price of either of the two price momentum hero's above will move in future – my windshield is totally fogged up. On the value of the two hero's I do have an opinion, however.

Firstly, as a late baby boomer, it is very difficult for me to place a value on Bitcoin. Having said this, I do (partly) understand the value proposition of cryptocurrencies as I have looked into blockchain technology over the last 18 months – and I have a close to millennial son that can help this baby boomer to see the blockchain light! My interest in Bitcoin is based on my keen interest in money systems – how money has been created over the ages from the use of items limited in supply (certain shells) to precious metals (gold and silver) to paper with a sometimes empty promise attached (fiat currency) to constantly monitored digital ledgers (blockchain based cryptocurrency). I came to the conclusion that our current fiat money system (more than 95% digital in any case) is inferior to cryptocurrencies – inferior in terms of security protection and inferior in terms of cost efficiency and convenience across borders. So, I do believe Bitcoin has value – it is just impossible for me to place an even remotely accurate value on it. The Bitcoin price trend shows classical signs of overheating and wild speculation – but it is interesting to note that the price recovers quickly after each fall.

Naspers, being a listed common stock, is much closer to my field of expertise. I can form a slightly more intelligent opinion on common stocks (and uncommon profits!) – to use a phrase from Philip Fisher. I decided to invert my investment model and started with the current price of Naspers shares. I then increased the growth rate in the model until the value calculation matched the current price. My model needed a growth rate of 51% compounded over 10 years before the value of Naspers was equal to the current price! This means that Naspers needs to become 61 times its current size in the next decade in order to justify the current share price! This is very steep by any standards, and signal that the company (and Tencent) cannot dare to do anything even slightly suboptimal. Also, please note that the historical growth rate of Naspers in the 23 years since 1994 was 24% compounded in book value per share and 18% compounded in dividend payments – this is a far cry from 51%. It seems that the good news (as previously mentioned, Naspers is an excellent company) is priced in to a large extent.

Having said this, I have uncovered a weak form of a “margin of safety” at Naspers, as the sum total of the underlying investments of Naspers far exceeds the Naspers share price – only the 33% stake in Tencent exceeds the Naspers price by 35% already, with all the other e-commerce companies and the African based pay television company totally for free! The catch of this kind of calculation lies in the fact that one uses the **price** of the underlying investments to do the calculation, not the true **value**. For this reason, I call it a weak calculation.

At this point I need to add a disclaimer: I do own a limited amount of Naspers shares for the weak reason mentioned above and yes, I do have an even smaller stake in Bitcoin. I enjoy the raw, unsophisticated nature of the Bitcoin market – it currently has the nature of the stock markets a 100 years ago! Bitcoin also satisfies my interest in money supply systems. As a value investor, I feel I must warn you that

none of them can be classified as true value investments – not even close. Naspers is now so large in the overall weighting of the all share index that it contributes in no small measure to the current underperformance of Lucri opposite the market!

### **Re-balancing Ronnie versus long-term Lara**

I promised last time to look at the two winners, to determine who has the ultimate investment technique. The answer? It depends. Please look at the table below:

Investment of R300 over a 34 year period, passive Paul representing long-term Lara

Re-balancing Ronnie	Passive Paul	Tax situation
R 7664	R 1963	0% tax – Tax Free Investing
R 3533	R 1664	Capital gains tax rate 18%
R1086	R 1664	Marginal tax rate 45%

#### **Conclusions:**

With-in a tax free investing account (TFSA) the re-balancing approach yield the best result by far.

When capital gains tax need to be paid at 18% (40% X 45%), the re-balancing technique is still the strongest. As soon as the marginal tax rate at 45% comes into play, the result reverses and the passive, long-term approach is superior.

Therefore, always re-balance once per year with the funds in your TFSA as indicated in the Re-balancing Ronnie example.

With funds outside of your TFSA, you need to re-balance less frequently at a 3 year interval to ensure that your tax rate will be limited to capital gains tax. Avoid annual re-balancing as this may trigger marginal tax rates as the receiver may see you as a share trader.

I hope you found some of the material in this long-winded newsletter worthwhile of your limited reading time, and may you continue to enjoy the SWAN (Sleep Well At Night) investment style that Lucri is offering.

Kind regards and Sans Souci investing,

Simon Streicher