

## **LUCRI ALPHA NEWSLETTER NR 14**

**24 JANUARY 2018**

Dear Lucri friends,

The Streicher family still enjoys the Overberg environment very much. We harvested our first almonds (small scale) and the fig trees were also kind to us this year. In harmony with the draught related water restrictions, we initiated our own internal water supply to the garden areas.

We should listen more to previous generations. The middle section of the farm is almost barren due to the high clay content of the soil – it is also sloped and the highest point on the farm. My grandfather remarked about 38 years ago: “That is where your future water supply is – and you will almost get it for free.” He was so correct – due to the soil condition, rain water just runs off that area like from the roof of a house – and due to the elevation, I can now gravity feed the water right to my doorstep. As that area was not seen as any good for farming, it was called “waste” and my father did not pay much for it when he bought the farm.

### **On a lighter note**

To err is human. To blame it on someone else shows management potential.

What’s the best thing about Switzerland? Not sure but the flag’s a big plus.

Give a man a fish and he will eat for a day. Teach him how to fish, and he will sit in a boat and drink beer all day.

### **Risk indicator**

In my previous newsletter, I risked a conclusion that the flat performance of the RSA stock market is behind us. Over the quarter since then, the all share index advanced another 7% towards 59 504, and are trading around 61 500 today. The change in the prevailing trend is gathering momentum. This sharp advance in capital growth was not fully covered by underlying profits – causing the risk indicator to drift higher towards 61%. We are still in the orange band, but the risk has increased lately. As discussed in earlier newsletters, the RSA all share index is heavily influenced by a handful of large companies, like Naspers. In the last two months, since the strengthening of the rand after the ANC elective conference, a much broader recovery can be noticed amongst the shares in the all share index. This is a healthy sign.

### **An art .....or a science?**

Is investing an art or a science? Or both? When one invests over a long period of time, you become more and more convinced that both science (left brain, mathematics) and art (right brain, creativity) are at play. In the words of Seth Klarman: “Value investing is at the intersection of economics and psychology.” I agree that psychology is one of the most important factors in investing – it is also often the least understood. In Warren Buffett language: “Control the urges that get other people in trouble while investing.” Some of the urges is to constantly make changes

to the portfolio to chase after the next most popular growth share, or to try timing the market, jumping in and out.

One surely needs mathematics, statistics and analytical skills for successful investing. But even more importantly, one needs to think independently and have the courage to follow your convictions. You also need to be consistently rational and control your emotions – to stand firm when the tide is against you. This hints towards the art part of investing – it is partially a craft.

## **Value investing**

Have you seen the following newspaper heading in the past: “Investors loose as markets fall.” Let’s now translate it into Warren Buffett language: “Disinvestors loose as markets fall – but investors gain.” If you make this mind shift your own psychologically, you will likely gain if you buy a widely diversified ETF (after the markets has fallen), and you will most likely gain in a spectacular fashion if you limit your shopping list to a narrow 4% opportunity window, selected via the two most important 3 word sentences in the investment world: “Durable competitive advantage” and “Margin of safety”. More about this later in this newsletter.

Peter Lynch also speaks to the rationality and strong mind that an investor needs: “Just because the price goes down doesn’t mean you are wrong.” He then adds, just for effect and clarity: “Just because the price goes up doesn’t mean you are right.”

When you do a value investment, it can take 5 to 7 years for the value proposition to be recognised by the market. Yes, it can be much faster – it took only two years for the Kumba share price to reach R400 after it had moved into deep value territory at R25 in December 2015. 1500% gain was possible, maybe 1000% is more realistic. But...most of the time you need to be really patient.

A value investor may experience poor, even horrendous, performance compared with that of other investors or the market as a whole during prolonged periods of market overvaluation. Yet over the long term the value approach works so successfully that few, if any, advocates of the philosophy ever abandon it. I have learned that value investors often buy too soon, as soon as the price drops below value. One needs to delay the buy decision deliberately to a point in time later than the time when the long awaited green light is switched on and shines brightly in your valuation model. Likewise, value investors tend to sell too early as well. I have learned that I should hold back (just a bit) for additional profit, as price can overshoot value significantly when the sentiment is positive and the momentum is strong. These simple adjustments can improve the performance of value investors tremendously. So, when you see no action in your Lucri portfolios, I am not doing nothing – I am waiting – and believe me, for someone like me that is HARD WORK, as I need to control the urge to make a quick profit or to cut losses.

The Coronation investment team also knows that value investing can underperform over uncomfortably long time periods: “In our pursuit of generating long-term outperformance, we are fortunate that the majority of our clients understand this may, from time to time, come at the cost of underperformance in the short term. While these periods may be uncomfortable and testing, we have endured them many

times throughout our 24 year history. We therefore know that they are an important part of our compelling and proven long-term investment track record.”

Think carefully about the following observations from a group of investors over a long term investment period of ten years: 97% of the eventual top 25% performers stayed for **three years** in the bottom half of performance. 47% of the outperformers stayed in the **bottom 10% for three years**. Clearly, a three year period cannot be used to determine performance. Almost all of the outperformers over 10 years had 3 year periods of under performance in the 10 year period, and about half of them had horrendous performance for three years!

### **So – when do I fire my portfolio manager?**

You may recall that I promised last time to share my own metrics which will determine whether I should fire myself as my own investment manager. With the above insights into value investing in mind, I basically expect from myself to outperform the market over all rolling periods of 5 to 7 years.

This means that I shall frown upon myself if I discover any rolling 5 year period with negative Alpha, but I shall not take any drastic action yet. The uneasy feeling will increase steadily over the next two years if Alpha remains negative over 6 years and over 7 years. If Alpha stays negative in the two separate years following the 5 year period of underperformance, drastic action will be needed. If Alpha turns positive for the two separate years, I shall monitor the progress. Up to this point in time, after measuring performance for 30 years, all rolling 5 year periods in my own Luciri account shows positive Alpha. So, I am still managing 100% of the discretionary Streicher family funds.

In the event that a 7 year period of negative Alpha is discovered, I plan to fire myself and appoint the following investment managers:

**“The market”**. I plan to invest 1/3 of the funds into a range of ETF’s that covers international shares, local shares, international property and local property. I am not planning to invest into bonds at all – bonds are not my forte.

**“Selected investment companies”**. I plan to put 1/3 of the funds into selected investment companies like Berkshire, Reinet, RACP and Remgro. Provided, of course, that they succeeded in generating positive Alpha in the period where I have failed.

**“Selected portfolio managers”**. I plan to entrust 1/3 of the funds to a select group of portfolio managers with a proven track record of positive Alpha after fees. Currently, my shortlist consists of Allan Gray, Coronation, Foord, Prudential and Investec.

So, this is the simple, but hopefully effective plan: When my own investment effort does not produce outperformance anymore, I hope to follow the above approach to still beat the market by a narrow margin. The margin will be narrow due to investment fees and due to the market itself being one third of the portfolio.

**BITCOIN**

After growing 697% over one year, the bitcoin price hit R79 600 at the time of writing my previous newsletter. Since then, some of you surely noticed the price advancing to R 300 000, only to collapse shortly after to around R 125 000 at some point. Highly volatile, to say the least. And yes, I do believe it is a bubble. “Bubble” is not necessarily a swear word, at least, not in my vocabulary. It present great opportunities, but at high risk. One should understand the risk and act accordingly. One method to reduce risk is to reduce your exposed seed capital drastically after a huge gain. Listen to people smarter than myself on this topic:

“There are two times in a man’s life when he should not speculate: when he can’t afford it and when he can.” Mark Twain

Ladies, this was written long before feminine awareness – and most probably ladies did not speculate in his time. To make it current, you are welcome to translate it into the feminine – it will remain so true.

“A pin lies in wait for every bubble. When the two eventually meet, a new wave of investors learns some very old lessons.” Warren Buffett

### **Recipe for outperformance combined with peace of mind: High return and low risk are twins**

Over the years, I have distilled and concentrated investment knowledge from people much smarter than myself. From this, I have selected 10 ingredients to bake an investment bread that is literally buttered on both sides. I believe these ideas can achieve the seemingly impossible heading above.

The 10 ideas can be sorted under 3 headings:

#### **What to buy?**

1. Say no to 96%: Wait for the fat pitch
2. Durable competitive advantage = Quality
3. Diversify seed capital: I cannot be 100% correct 100% of the time
4. Go where the gain is going – not where it is. Look ahead.

#### **When to buy?**

5. Margin of safety = Value
6. Profit from fear and folly: Markets divorce from reality from time to time
7. First quality, then value. But not quality at all cost.

#### **What then?**

8. Give it time: Buy (selectively) and hold. Be patient.
9. Concentrated winners are wonderful.
10. Lethargy can be lucrative – if you own wonderful companies.

In this newsletter, I shall discuss the first idea in more detail. I hope it will whet your appetite for the future detail on the rest.

### **Say no to 96%: Wait for the fat pitch**

Hendrik Bessembinder, a finance professor at Arizona State University, has studied the US stock performance over a 90 year period to December 2016. He made the following stunning discovery: The entire gain of the USA market in the 90 year period over and above the gain from Treasury bills could be attributed to **just 4%** of all the listed stocks! The other 96% collectively just matched Treasury bills. The lesson? Real quality is **SCARCE!** Focus is needed. Now you know why Warren Buffett believes in concentrated portfolios selected from a narrow window. "Wait for the fat pitch" is also Warren language, taken from baseball.

In order to beat the market, one needs to say no to 24 opportunities out of every 25. It is more important to avoid dragons than trying to slay them. (For South-Africans, we now know that a good translation for dragon is "Steinhoff". No, I need to disappoint you – my models could not avoid this dragon entirely due to cooked books. On the other hand, I am thankful that the value investment technique did prevent me from paying a high price for the share, and in certain portfolios I reduced exposure due to a high price).

From a universe of 100 opportunities, filter out 60 immediately based on instability of profit, lack of growth, high debt load, low yield on capital and unsustainable dividends. This can be done with a simple valuation model based on history. Then, do detailed analyses on durable competitive advantage into the future and filter out 90% of the remaining 40 to remain with 4. The window for outperformance is extremely narrow. Superior quality is scarce. Know what NOT to buy. Charlie Munger: "Winners bet selectively."

To be continued.....

### **Lucri year-end**

The Lucri investment books will close on Friday, 23 February this year to allow sufficient time over the week-end to value all accounts for evaluation purposes. This must be performed before the market opens again on 26 February. Provided that the JSE all share index yardstick and the S & P 500 index yardstick are measured over periods identical to the Lucri period, the measurement stays pure and accurate, even if the period is a few days shorter or longer than previous periods.

I hope you found sections of this letter informative and worthy of your limited reading time.

Kind regards and Sans Souci investing,

Simon Streicher