

LUCRI ALPHA NEWSLETTER NR 15

2 MAY 2018

Dear Lucri friends,

The drought conditions continues in the Overberg area, and I am sure you have noticed that the drought on the stock exchange in South Africa is also continuing, but with promising rain clouds on the horizon. Despite the drought, we enjoy the Overberg – likewise, I enjoy investing despite the headwinds.

On a lighter note

As you know, there are always a correct and a wrong approach in life. How should you NOT argue with your husband/wife?

“If I agree with you, we shall both be wrong!”

Rather use this one: “If you think about it a little bit, you will agree with me, because you are bright!”

Knowledge is knowing a tomato is a fruit. Wisdom is not putting it in a fruit salad.

If you can take only one thing with you to an isolated, lonely island.....you should not go.

Risk indicator

In the last five months after the ANC elective conference, a mild, but broader recovery is developing amongst the shares in the all share index in South Africa. This is evident if one monitors the movement in the all share index in comparison with the movement in the share price of Naspers, the share with the largest weight in the index. The all share index is still trading above 55000, while the Naspers share price has reduced from about R4000 per share to R 3000 per share. Shares with a smaller weight than Naspers is supporting the index.

Our risk indicator has improved again to a level just below 50%. The risk level is improving due to a lower inflation rate and lower interest rates in South Africa. For those of you that make use of P/E ratios to decide whether a share is expensive or cheap: Paying attention to the prevailing inflation rate will add value to your approach. I have learned that, while a P/E ratio of 15 may be fine for a specific company at an inflation rate of 5%, it is no longer true when inflation runs at 10% or higher. Low inflation environments can sustain higher P/E ratios without increasing risk.

Talking about inflation, according to Sam Ewing inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair!

Steinhoff and Naspers

No, you do not need to worry – the two companies above do not have anything in common. I just need to comment briefly on them due to questions from several Lucri investors.

The price of Steinhoff shares has now dropped below R2 a share – does it therefore represent a buying opportunity? My best answer to this question is that, without any access to un-cooked books, nobody really knows the answer. Yes, you can use your gut, you can make a wild guess, but without correct company statements you cannot calculate the value of the company at all. When the price of Steinhoff shares drops like a lead balloon from R60 to below R2, this information in isolation does not tell you that the share is below value. Remember, price is what you pay and value is what you get - the two are not the same. This does not mean that somebody paying below R2 now will not make a killing – it simply means that any purchase of Steinhoff shares without information based on the corrected company statements is speculation at an extremely high risk level.

Many of you have seen Naspers appearing in your Lucri portfolios in the last few months. In the past, I always viewed Naspers as a high quality investment with excellent management, but the price was too high relative to value. The price also demanded a growth rate that I believed was difficult to sustain. So, what changed? The Tencent investment owned by Naspers continued to overshadow the whole Naspers company, but this was also true in the recent past. After selling 2% of Tencent in a book building exercise, the remaining 31.2% of Tencent that Naspers owns is still 145% of the total Naspers market capitalization – in other words, for every R100 that you pay for Naspers shares, you are getting R145 of Tencent shares. In addition to this, you are getting a portfolio of promising internet start-up companies – like the “Amazon of India” for example. These start-ups were burning cash at an alarming rate – until about November last year. Now, the older start-ups are starting to return cash, and the negative yield on capital has improved from -30% to -20%. When the Naspers share price dropped below R3500 per share, with Naspers basically debt free, the factors above caught my attention. So, it is the portion of Naspers excluding Tencent that made me change my mind. It is still an expensive buy – but the investment risk is now much lower in my opinion, mainly due to an increase in the company value. The value increase is driven by the Naspers start-up companies excluding Tencent.

Feedback from the Lucri year-end.

This year the relative performance of Lucri opposite the market was weak in comparison to prior years. Only 20 of the 88 portfolios under Lucri management managed to create positive Alpha this year.

As we are running against the all share index in South Africa and the S&P 500 index in the USA, competition heats up when the index has a strong year. In South Africa, the index returned more than 15% last year with dividends included while the majority of individual shares were stagnant. As explained in my annual reporting, a large portion of the index growth was from one share, Naspers, with a weight of about 20% in the index.

The main reason for the underperformance was share prices of value positions that did not (yet) reflect value. As indicated in newsletter nr 14, it can take 5 to 7 years for a value opportunity to fully reflect value. However, as the value positions are all in

different phases of the “returning to value” cycle, a full portfolio of value positions should not deviate from value for the full indicated period.

A high percentage of rand hedge stocks in Lucri portfolios also contributed to under performance, as the rand strengthened over the past year.

History on Lucri flagship portfolio

In newsletter nr 14, I was talking (typing) too fast when I claimed the following: “Up to this point in time, after measuring for 30 years, all rolling 5 year periods in my own Lucri account shows positive Alpha.” On closer scrutiny, I did find 5 year periods with negative Alpha. I decided to zoom in on those periods, in the first place to correct the record, but also to facilitate our learning. In particular, the advice in my previous newsletter on when to start monitoring closely – after a 5 year period with negative Alpha - and when to take action – after the two years immediately following the underperforming 5 year period also shows negative Alpha – will be tested against the Lucri history. From newsletter nr 14: “If Alpha stays negative in the two separate years following the 5 year period of underperformance, drastic action will be needed.”

Time periods with positive Alpha in the Lucri flagship:

If one invested R1 in the Lucri flagship at the beginning of year 1, then again invested R1 at the beginning of year 2, and continued like this for several years, you will have portfolios running over different time periods, each starting at a different baseline. This will ensure that past performance (one lucky year) does not influence the total performance of the track record. (I am sure you have noticed how portfolio managers can project positive track records if they are allowed to choose the baseline. Though accurate, they do not show their performance from several repeating baselines, one year apart like I am suggesting above. This will show their true colours quickly.)

Since the start of 1994, 24 different portfolios can be created using the method above, the first running for 24 years, the second for 23 years, etc. For the Lucri flagship, 21 of the 24 portfolios thus formed, created positive Alpha. More meaningfully, the 21 portfolios that created positive Alpha are the longer term portfolios without fail – the 21 portfolios with running times from 24 years to 4 years ALL created positive Alpha. (This is the reason for my oversight – I wrongly assumed that this translates into all 5 year periods with positive Alpha.) Negative Alpha were created in the last three portfolios, from 3 years to 1 year. Without looking at the rolling 5 year periods since 1994, you may deduct from the above that I have lost my touch over the last three years. However, the rolling 5 year periods since 1994 reveals that periods of underperformance occurred in the past, but that the longer timeframe created sufficient opportunity for subsequent over-performance to more than just make good for the underperformance. Also, the last 5 year period is showing positive Alpha.

Now, let us take a look at the rolling 5 year periods:

Rolling 5 year periods	Alpha
1994 - 1999	20%
1995 - 2000	22%
1996 - 2001	0.5%
1997 - 2002	-24%
1998 - 2003	-30%
1999 - 2004	-15%
2000 - 2005	-18%
2001 - 2006	5.5%
2002 - 2007	6.2%
2003 - 2008	6%
2004 - 2009	26%
2005 - 2010	15%
2006 - 2011	21%
2007 - 2012	45%
2008 - 2013	44%
2009 - 2014	23%
2010 - 2015	42%
2011 - 2016	35%
2012 - 2017	31%
2013 - 2018	7.5%

So, what can we deduct from this history?

Firstly, the last 5 year rolling period still produces positive Alpha, even with underperformance in the last three years.

Then, most importantly, we have 4 consecutive 5 year rolling periods with negative Alpha. Despite this, all longer term portfolios that includes the underperforming periods have positive Alpha! If we now look at each underperforming 5 year period and the two years immediately following the 5 year period, we find the following:

1997 to 2002: Year 6 positive Alpha, year 7 positive Alpha

1998 to 2003: Year 6 positive Alpha, year 7 positive Alpha

1999 to 2004: Year 6 positive Alpha, year 7 equal to market

2000 to 2005: Year 6 equal to market, year 7 negative Alpha, year 8 positive Alpha

The first three 5 year periods were followed by mostly positive years – it was easy to remain patient. The last 5 year period, however, was initially followed by average to weak years, only the third year turned positive. Now, did the patience (to avoid drastic action) paid off?

In the decade following this difficult period, from 2008 (after year 7) to 2018, the Lucri flagship created positive Alpha of 51%!

So, what is our main conclusion from all the number crunching above?

If I did not exercise patience and restraint and changed my investment philosophy or fired myself to buy index funds, I would have missed out on the subsequent over performance of 51% - and, the worst of all – I would not have known this (as I would stop running my own portfolio).

This is the strongest case I can make against abandoning an investment philosophy too soon.

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

In newsletter nr 14, I started a discussion under the heading above. I am now elaborating on the second item under “What to buy?”:

Durable competitive advantage = Quality

A durable competitive advantage and a quality investment is associated with:

- A dominant business franchise
- Wide, sustainable moats (Warren Buffett language) that protects a high return on capital
- Growing sales
- There must be a strong likelihood that the business model will continue generating a high return on capital for many years
- Tremendous staying power
- Honest and able management that think like owners
- Opportunities for internal growth at attractive returns
- Low debt levels – no artificial stimulants
- Cash rich
- Cost control discipline

Look out for the presence of the above factors in a company in order to identify a quality investment.

I hope you could extract some learning points from this newsletter. I know I am addressing the whole spectrum of investors from the most experienced to the beginner in these letters – it is therefore quite a challenge to cater for everyone. One size does not fit all.

Kind regards and Sans Souci investing,

Simon Streicher