

## LUCRI ALPHA NEWSLETTER NR 16

25 JULY 2018

Dear Lucri friends,

The Streicher family has returned from a blessed tour through Israel. So, we are well rested and ready for action! While the Western Cape received relatively good rainfall this year, the Southern Cape region where we live is still experiencing drought conditions. We currently have promising wheat and barley fields, even with very little rainfall.

### A slightly funny story

An elderly man is stopped by the police around 2 am and is asked where he is going at this time of night? The man replies: "I am on my way to a lecture about alcohol abuse and the effects it has on the human body, as well as the adverse effects of smoking and staying out late." The police officer then asks: "Really? Who is giving that lecture at this time of night?" The old man: "That would be my wife."

Whenever I get to Edinburgh, I'm reminded of the definition of a gentleman. It's someone who knows how to play the bagpipes, but doesn't.

Golf: You can hit a two acre fairway 10% of the time and a two inch branch 90% of the time.

42.7 percent of all statistics are made up on the spot.

Investment wisdom from a long-term Berkshire Hathaway shareholder: "The first 150000% really makes the difference." Funny, really funny.

### A sad story

The all share index of the JSE is still moving sideways. The risk indicator remains around 50%, indicating that share prices, inflation and interest rates in South Africa are roughly in balance. After the index had experienced an important change in trend, it managed to stay above 55 000 index points but developed a crablike movement between 55 000 points and 60 000 points. The promising Cyril clouds did not deliver rain – more about this later. You may remember that I mentioned four years as the longest no growth period in the RSA market that I have ever seen. We are now breaking new ground by moving beyond four years, as we have not made real progress since June 2014.

I got the following question: "What need to change in South Africa before we shall experience share market growth again?" In order to attempt a partial answer, let's look at the history of the all share index over the past 10 years up to June 2018:

### Compound growth in earnings, dividends and market prices:

Period	Earnings	Dividends	Market Price
10 years	3.9%	8.6%	5.8%
5 years	4%	8.7%	6%
3 years	0.6%	4%	2.4%

What a sad picture – no double figures at all, and almost no growth in earnings over the past three years. You can see that capital growth in share prices is being determined by fundamental factors like earnings and dividends over longer periods. In the words of Benjamin Graham: “Over the short term, the market behaves like a voting machine, but over the long term it behaves like a weighing machine.” In other words, market prices can swing wildly over the short term due to changes in sentiment and trading volumes, but over the long term the fundamental weight of earnings and dividends will determine the price level. In all three time periods, the index growth is in-between earnings growth and dividend growth – the weighing machines. We have discussed this in the past, and indicated that dividend growth cannot run above earnings growth indefinitely, as earnings are the source of dividends.

It is clear that the origin of the sluggish growth in share prices sits at the earnings level – the slower earnings growth is already pulling dividend growth down. In the table, you can see that capital growth is faster than earnings growth – the P/E ratio of the market is therefore increasing, but this is not sustainable. On the other hand, dividends are growing faster than market prices – the dividend yield of the index is increasing, supporting the index to some extent.

After December 2017, some South Africans thought that every dark cloud has a Cyril lining. The positive Cyril effect was noticeable initially, but is fading quickly now. I am of the opinion that the current plans to change the protection of property rights in the RSA constitution is already causing massive damage to the RSA economy. So, what need to change? International and local investor confidence in the RSA economy need to be restored by investor friendly measures, and consumer confidence and spending power must be enhanced – this is the basic, but crucial underlying forces for growth. This should occur once an investor friendly environment is being created in South Africa, as investment drives almost everything else, including spending power via job creation. On the brighter side, the South African economy proved to be quite robust in the past, even in adverse environments. We need to be patient. Listen to David Allen on this subject: “Patience is the calm acceptance that things can happen in a different order than the one you have in mind.”

### **A boring story**

This story may be boring, but it can make you a lot of money! Now that I have your attention, let's continue.....

Not many people copies Warren Buffett. He explains this as follows: “Nobody wants to get rich slowly.” This is the story about steady, long term compounding. It is boring. How do one capture the magic of long term compounding? Never interrupt it. Do not save after spending, spend after saving. You will experience volatility, but volatility does not need fixing. If you want success, figure out the price, then pay it. This sounds obvious, but it is powerful if you think deeper about it. Volatility and uncertainty is the psychological and emotional price for investment success – you

need to understand it and pay it. People like predictability, but this need does not always fit long term compounding.

Your personal experiences make up around 0.00000001% of what has happened in the world, but probably 80% of how you think the world works! Your current investment beliefs depend on your personal investment experiences. Let us see whether I can influence your investment beliefs a little bit.

The Oracle of Omaha is stating the obvious: "If you do not find a way to make money while you sleep, you will work until you die."

Not that working until and during old age is necessarily a bad thing in my eyes. I only think it is unfortunate if you need to force yourself to keep on working in unpleasant circumstances due to a lack of choice. To work is natural and healthy – but in old age, I hope to have control over the nature and pace of the work.

You need a compounding force upon which you can rise towards financial independence. Even if you do not get there completely, the steady progress will provide satisfaction, comfort and hope while you gain control over your finances.

You may think this all sounds fine on the surface, but where do I (in South Africa) find such a compounding force, especially given the sad story above? So, please continue reading...

### **The boring compounding machine**

Why do I call such a wonderful device boring? Well, in my experience, investment (not speculation) is more prudent and rewarding when it is quite boring. Excitement, adrenalin rushes, impatience and haste are serious investment swear words! In fact, these swear words will most likely alter investment into the most expensive hobby that you will ever pursue!

I believe the investment success of Warren Buffett is well known to most of you – it is the story of steady, real compounding over 75 years and counting. (Warren started at age 12, he is now 87.) After 50 years of steady progress and constant success at the Berkshire Hathaway company, Warren was congratulated. He remarked: "Well, if you give something your full attention, working constantly at it for 50 years, it should eventually amount to something!" That is Warren Buffett humour combined with the Warren recipe for success: 100% focus, all the time.

Now, a logical question: Why do you not join this specific compounding machine? No, this is not a sales speech, no need to worry. You can invest into Berkshire Hathaway without me being in the picture at all. Easy Equities (the company that owes me a lot for advertising in past Lucri newsletters) now allows you to transfer rands from your local RSA account into a US dollar account, the rands being converted into dollars. You do not need to perform a SWIFT transfer via a bank (they do all of that), and assuming that you do not transfer more than R1 million per annum, you do not need tax clearance. This is the way how I am nowadays building a long term savings account that compounds steadily through all economic cycles. (Yes, there will be volatility, but I shield myself against any negative psychological effects due to volatility – sometimes, I even profit from it via increased buying).

Remember, never interrupt long term compounding! So, never try to jump in and out of Berkshire! You just need to know that a reverse transfer from the US dollar account into the local rand account of Easy Equities is not possible at present – you need an international bank account to receive the dollars when you decide to cash out, preferably far into the future. I use the Easy Equities facility, because it allows me to buy fractions of shares in small amounts at high cost efficiency, with no admin fees and with no sweat. See – the Easy guys really owes me for advertising. You can obviously use any other brokerage account like Drivewealth, Sogotrade, or the international accounts provided by the local RSA brokerage houses. Drivewealth also allows you to buy share fractions, but the others only allow the buying of whole shares. Fractions can be valuable for a company like Berkshire, with a price tag of \$190 per share for the B shares. The A shares are at \$ 285000 each.

### **Why do I believe that Berkshire represents such a strong investment case?**

There are basically 5 main reasons:

- Berkshire enjoys free gearing. In other words, for every R100 that Berkshire owns, they have another R25 (for illustration, not precise) available that they can invest. They do not pay any interest on the extra R25, as this is being provided from their long term insurance business – it is called insurance float. Berkshire therefore concentrates the yield of R125 onto each R100 that they own for investment. This also tells us that Warren Buffett will beat the S & P 500 index in the USA even when he does not select superior investments to the S & P 500. Even when he loses slightly on total investment yield opposite the index, he will still beat the index due to this extra R25 that he can invest. How clever is that? He wins, even when he loses. So will you!
- Berkshire has a carefully selected portfolio of value investments. The Berkshire yield on invested capital (the R125) is above the index standard, then concentrates onto the R100. This portfolio has a high ratio of reward to risk.
- Berkshire owns 100% of superior cash generating companies directly. The free cash flow from these companies plus insurance profit provides the steady compounding force in this compounding machine.
- The investment risk is low in relation to the reward. Warren tells us that investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. Risk is the possibility that this objective will not be attained. At Berkshire, you have an abnormally high likelihood for increased personal future consumption.
- True long term thinking and rational investing is part of the Berkshire DNA. This culture is embedded into the company, it will remain long after Warren and Charlie leaves the scene. In Warren's own words, when someone asked when he will retire? "About 10 years after my death." I am sure the Warren investment culture will remain much longer! They have an experienced team of people who thinks like Warren and Charlie. They have sufficient patience to avoid committing too much money to a major mistake.

### **Historical result for South African investors in Berkshire Hathaway.**

The table below compares the total investment yield of investing in Berkshire to the RSA all share index (plus dividends) over different time periods up to June 2018:

<b>Time period</b>	<b>Initial investment</b>	<b>Berkshire result</b>	<b>All share index</b>
10 years	R 1	R 4.26	R 2.21
5 years	R 1	R 2.24	R 1.50
3 years	R 1	R 1.48	R 1.15

So, utilising Berkshire as a widely diversified unit trust provided the following result for South Africans: 93% superior over the last 10 years, 49% superior over the last 5 years, and 29% superior over the last 3 years. Berkshire reached R 2.24 after 5 years, the RSA index took 10 years to reach R 2.21. I rest my case.

Yes, I know the financially sophisticated readers will correctly point out that I am comparing apples to pears, as I am comparing an USA portfolio to a RSA index. My best defence is that I know I am a bit naughty, but I am still comparing rands to rands over the exact same time periods, with both investments being fully available to South Africans. You may also think that rand weakness played a crucial role in the result. It played a role, but the rand also strengthened against the dollar for long periods over the past ten years – please have a look at a 10 year rand/dollar currency graph. The future result will not only be dependent upon rand weakness, but rather more durable fundamental factors that will favour Berkshire. Having said this, I do expect rand weakness to be a tail wind!

My song and dance about Berkshire took a lot of newsletter space. It signals the importance of the message in my eyes. This time, I do not have space to continue the discussion of the items supporting my recipe for outperformance, started in newsletter nr 14. I hope to continue the discussion next time.

Kind regards and Berkshire investing,

Simon Streicher