

## LUCRI ALPHA NEWSLETTER NR 18

24 JANUARY 2019

Dear Lucri friends,

In this newsletter, I shall continue my discussion on the merits of a long attention span, how to focus relentlessly on a long term investment goal for years on end. This is in contrast to a casino action style of investment – which in my humble view only produces lots of adrenalin. A summary of the main message of newsletter no 17 is: “*Stock investing is like a roller coaster. You don’t get hurt unless you jump off.*” Only the people who sell while in the red actually lose any money.

“*Nothing so undermines your financial judgement as the sight of your neighbour getting rich.*” J P Morgan. Stick to your carefully designed financial plan, do not look around anxiously.

### On a lighter note

As is the custom at Lucri, let’s initiate the serious talk with something lighter at first:

“*Money is better than poverty – if only for financial reasons.*” Woody Allen

I called an old classmate and asked what he was doing. He replied that he was working on “*Aqua-thermal treatment of ceramics, aluminium and steel under a controlled environment.*” I was impressed.

Upon further inquiring, I learned that he was washing dishes with hot water under his wife’s close supervision.

If you want a marriage that will really last, what is the one quality that you should look for in a potential spouse? Is it brains, humour, character or beauty?

No – you should look for low expectations....!

Further on the joys of married life: John told his wife: “*The last thing I want to do is disappointing you – but I will get to it eventually.*” So, after a period of work related absence, he returned home. His wife said: “*John, I missed you.*” Then she took aim again....

### Risk indicator

The risk indicator reduced further to 43% in December 2018, back to a point it last reached in January 2016, about three years ago. As discussed last time, investment risk can reduce due to a strengthening of fundamental economic factors, or it can reduce due to the fact that share prices have reduced. While share prices have reduced, I am noticing a humble recovery in earnings for companies in the all share index of the JSE. Earnings growth without a corresponding price increase lowers investment risk.

### Irrational share price movement

The daily price quotation of stocks is an unfortunate distraction.

*“The stock market is similar to watching a person walk up the stairs with a yo yo. People focus on the yo yo going up and down, while the real story is the consistent movement of the person up the stairs.”* Tom Lewis

The daily price movement of shares unfortunately causes short term action and constant transactions. Do not buy and sell constantly: *“Your money is like soap. The more you handle it, the less you will have.”* Gene Fama. Investment fees and transaction costs are the sneaky inhibitor of returns. *“Inactivity strikes us as intelligent behaviour.”* Warren Buffett

### **Long term investment**

*“Life and investing are long ballgames.”* Julian Robertson

*“The real money is not in the buying or the selling – it is in the waiting.”* Charlie Munger

*“All investment managers’ miseries stems from an inability to sit alone in a room and do nothing.”* Mohnish Pabrai

*“The single greatest edge an investor can have is a long-term orientation.”* Seth Klarman. You must never be forced to sell – you alone must determine when you sell. Panic selling during market downturns is likely the single biggest mistake most investors make.

Do not bemoan a difficult event, accept life’s vicissitudes. *“Never allow current circumstances to define you. My job is never to let what’s happening in the moment define me.”* Tony Robbins

### **What is investment?**

Let us quickly revert to the basics of investment. How do the world’s most experienced and successful investors define investment?

*“Investment is an activity with the goal to increase or at least maintain purchasing power over time. Risk is the probability that this goal will not be achieved.”* Warren Buffett

So, you need to postpone current consumption or instant gratification to enable higher consumption at a later stage. Have you noticed the stark difference with the marketing slogan: *“Buy now, pay later.”* Yes, you do pay later in lost opportunities, compound interest payments and for most, financial failure.

### **What is risk?**

Now that we are busy with basics, let’s discuss risk. Warren Buffett has touched on the true definition in his quote above.

The true definition of risk is the likelihood of losing purchasing power over time. Risk is **NOT** price volatility as being defined in the academic world. It is not even the same as uncertainty, as Seth Klarman will tell you: *“Risk is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as*

*the fall of 2008 – drives security prices to especially low levels, they often become less risky investments.”*

Entrepreneurs and investors are not risk takers as most people may think. Both investors and entrepreneurs do everything in their power to avoid risk – they try to minimise risk. The real success lies in low risk, high return – not high risk, high return. Deal with high uncertainty – but do it at low risk (due to low prices).

If you believe, like I certainly do, that risk is all about the likelihood to lose purchasing power over time, you will look differently at the risk involved in a fixed deposit, especially over the long term. While the result may differ over the short term, over a 20 year period, with risk defined as above, you get the following result:

Cash is by far the riskiest asset – it is almost certain to lose purchasing power over 20 years, even if it earns interest.

Bonds are better than cash – the risk over 20 years are lower, depending on the prevailing interest rate.

**Over 20 years stocks are easily the least risky – as it is the least likely to lose purchasing power over the long term.**

This may not fall well on your ear (or eye, since you are reading). The reason for your uncomfortable feeling is that we have been taught that risk has all to do with stability – with stable prices being low risk, and volatile prices representing high risk. No-one bothered to add that stable and constant losses opposite inflation are actually highly risky over time. Just talk to a few older citizens who believed that fixed deposits are the way to save for old age.....

Also, I am not really referring to volatile business fundamentals – yes, a company with volatile fundamentals can be highly risky. I am talking about volatile **PRICE** movements over the short term. The water underneath a wave in the sea is surprisingly calm. Business fundamentals, business value, organic growth, margins, free cash flow and yield on capital are much calmer, by an order of magnitude, actually – than the crazy, volatile market prices that jumps up and down from minute to minute. It also seems that price volatility is increasing as time passes – trading via artificial intelligence may play a large role here. If you trade, you often bet against smart robots – and you should know that highly developed computing beat most humans at complex games like trading.

So – have a long attention span – you can beat the robots with prudence and patience.

### **The lazy portfolio**

In the previous newsletter, I constructed a portfolio for the next decade, with four companies that have 100% or almost 100% of their operations outside of South Africa. Was this a message to Lucri readers? Yes, I do believe it will be prudent for most South Africans to invest more outside the country. My take on the current expropriation drive in South Africa is as follows: Expropriation without

comprehension and compassion, but with complexion, comrades and complications...

It is way too early to comment on the portfolio performance, we have only completed the first 2 kilometres of the down comrades on our way to Durban. At this stage, irrational market forces already penalised Annheuzer Bush after the company halved dividends (without lower earnings or profits) in order to reduce the debt burden as a result of the SAB take-over. This is a prudent, value adding long term development, but resulted in a negative short term price movement.

### **Recipe for outperformance**

I shall now further discuss the items under "What to buy" (Please refer to newsletter 14.)

Item 4: Go where the gain is going – not where it currently is. Look ahead.

Be early on a new trend. Try to look through the foggy windshield, not in the clear rear-view mirror.

Item 5: Margin of safety = Value.

This term was coined by Benjamin Graham. "*The purpose of the margin of safety is to render forecasting unnecessary.*" This simply means that you always need to calculate the VALUE of any investment, and then need to pay a price sufficiently below value. Just compare the known current price to the known (to you) current value – without any forecasting. If you cannot determine the value due to various reasons, you simply do not invest. If you can determine the value with great confidence due to a stable industry with staying power, and the consequences of being wrong is not severe, you need a lower margin of safety – you can pay a price that is closer, but still below, the value. If you have higher uncertainty, or when the consequences of a wrong move can be severe, you increase the margin of safety accordingly.

Allow room for error. Do not overpay. Paying a too high price for an opportunity is one of the main reasons for weak investment performance! If you apply this concept, your losses will be limited, even if you are wrong. You can be wrong to some extent and still come out fine.

Listen to Warren Buffett on this topic: "*The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own.*"

For example: If others increase gearing (increase debt levels) in a low interest rate environment in order to buy shares on margin, we should be even more careful due to the increase in share prices as a result of the increased buying activity. This includes contract for difference trading – at its core it is buying shares on margin.

### **Lucri housekeeping**

The Lucri year-end for this year will be end of day on Friday, 1 March 2019. This will provide me with a weekend to properly quantify the price (not value) of your investment portfolios.

Please always remember to tell me via SMS, WhatsApp or e-mail when you move cash in or out of your account.

All Lucri communication is only via e-mail. If you send an e-mail to [streicher.simonj@gmail.com](mailto:streicher.simonj@gmail.com), I promise to answer in a few days.

Lucri does not provide any advice on market timing. The investor decide when to enter the market, my role is to construct an appropriate value portfolio at that point in time to the best of my abilities.

So, I hope this newsletter will help you to have a long term approach to investing, with a different understanding of investment risk.

Kind regards and low risk, long term investing.

Simon Streicher