

## **LUCRI ALPHA NEWSLETTER NR 23**

**27 APRIL 2020**

Dear Lucri friends,

We are currently living in a strange, temporary new world – dictated by the flu of 2020. Yes, I know the flu originated earlier, but for the world at large, the real pain only came in 2020. There are obvious advantages in this new world if you live on a farm – but I shall stop right there as I do not want to make you totally green with envy....

### **Risk indicator**

During March 2020, the risk indicator dropped deep into the low risk area – it is now projecting a bright green light for the first time since I started this newsletter more than 5 years ago. This is to be expected as it was close to green just before the crash. This indicator only reflects the magnitude of a market crash, it does not provide any information on the timing of a market crash – see newsletter no 1. So, it merely indicates that, after the March 2020 market crash, the magnitude of a further crash is limited. In fact, from that time, for the last weeks, the market actually recovered a lot of lost ground.

So, you may well tell me that the risk indicator is only stating the obvious. This time around it is true – but you must keep in mind that some market crashes only take the risk from bright red to a rosy tint, or to a bright orange. It is also possible that the indicator can turn green over time without any market crash, due to continuous growth in company profits. So, the risk indicator has some utility in different scenarios.

I must warn at this point that the full financial effect of the 2020 flu is still an unknown – the market in the USA in particular has recovered over the last weeks in a typical “V” pattern, probably due to the massive quantitative easing effort by the Federal Reserve. It looks like asset bubble conditions to me, I am not trusting this rapid recovery at all. If we look at Warren Buffett’s thinking, we should only be greedy when others are fearful – others were a bit fearful at a S & P 500 index of 2200 in March, but are they still fearful at a S & P 500 index at 2800 only four weeks later? I almost see a bit of greediness, a FOMO (fear of missing out) effect, where investors seem to rush back into the market now. Maybe they have not seen a bull-trap before? (Bull market trap, where investors are lured back into the market too soon)

### **On a lighter note**

I asked you last time what the capital of Zimbabwe is. This time I am asking you: Where is the capital of Zimbabwe? “In a Swiss bank account!”

Some animal wisdom:

Which side of a dog has the most fur? “The outside.”

What do you give an elephant with an upset stomach? “Plenty of room...”

What do you call a sleeping bull? “A bulldozer.”

Mothers and children: Jimmy, did you take a bath? “Why, is one missing?”

More wisdom....

Bills travel through the internet a twice the speed of income.

A clear conscience is usually the sign of a bad memory.

I plan to be spontaneous tomorrow.

### **No 2020 flu here...**

Regular readers of this newsletter will know that I often sing the praises of Berkshire Hathaway as a sound investment, especially for investors in South Africa, as they gain gradually over time due to rand weakness opposite the dollar.

So, how did the rand based price of Berkshire Hathaway performed over the past year, and especially during the market scare last month when the 2020 flu damaged investor confidence worldwide? The short answer is to look at the rand price of Berkshire a year ago, and compare it to the price now, on 27 April 2020. The rand price of Berkshire INCREASED from R 3019 a year ago to R 3518 now – a growth of 13.8% in rand terms over the past year. No 2020 flu here! Compare that to your own portfolios, or to your pension fund growth. I refer you to newsletter nr 19, the last sentence under the heading “Testing your investment and financial knowledge”: “So, a rand investment in Berkshire should yield about 13% compounded growth on average at the lowest risk available.” Do I earn a pat on the back? No, unfortunately not – on closer scrutiny you will find that my dollar growth expectation and my rate of rand weakening projection was way out – in contrast to the old saying, in this case two misses did make a right! I am just joking a bit with myself, indicating an accurate expectation while being way out on the underlying factors. But....I still maintain that on average, it is quite reasonable to expect a compound growth of 13% per annum in Berkshire on a rand basis over the long term.

A more complete answer will be to look at monthly prices over the past year, and use 6 monthly moving averages to indicate the smoothed movement in the Berkshire price in rand:

<b>Berkshire 6 month rolling average price, Rand</b>	<b>Time period, beginning of month</b>
3027	May 2019 to Oct 2019
3051	June 2019 to Nov 2019
3110	July 2019 to Dec 2019
3137	August 2019 to Jan 2020
3205	Sept 2019 to Feb 2020
3230	Oct 2019 to March 2020
3252	Nov 2019 to Apr 2020
3300	Dec 2019 to end Apr 2020

Talk about a steady increase in rand terms – definitely NO negative 2020 flu effect here! Berkshire is behaving like a well-oiled, steady rand machine. I think you know why – the rand started falling faster against the dollar as soon as the dollar price of Berkshire took a hit from the virus – with a remarkable stable result. Now you know why I call Berkshire Hathaway the lowest risk stock that I know in rand terms.

The experienced investors among you will tell me you are not really impressed, as the S & P 500 index had also reached a fresh new high this month, calculated in rand terms. This is true – but I am very cautious about the risk imbedded into the S & P 500 index at present – while I sleep well in the case of Berkshire. More will follow about the risk of indexes when I discuss the positive feedback loop later in this newsletter.

### **Various quotes**

*“The way to stop financial joyriding is to arrest the chauffeur, not the automobile.”*

US President Woodrow Wilson

Yes, the best guarantor of financial success is to look at your own behaviour – especially around credit cards!

*“Hone your communication skills, both written and verbal. If you cannot communicate, it is like winking at a girl in the dark – nothing happens. You can have all the brainpower in the world, but you have to be able to transmit it. Communication is that transmission.”* Warren Buffett

### **Smart margin**

We discussed smart margin three months ago. It is therefore very interesting that Warren Buffett decided to borrow money in Japan while his company is sitting on a lot of cash. True to the smart margin principles, it is long-term money at extremely low interest rates. It is also clear that Warren believes that the yen will stay constant opposite the dollar, or that it will weaken opposite the dollar into the future. (he wants to pay back less dollars than received).

### **Recipe for outperformance**

This time, we are discussing the last outstanding items 8, 9 and 10. I refer you to newsletter nr 14, written in January 2018.

Item 8: **Give it time.**

Buy selectively and hold. Be patient. *“The big money is not in the buying and selling – but in the waiting.”* Charlie Munger

*“The key to making money in stocks is NOT to get scared out of them.”* Peter Lynch

Remember our previous quote, *“You only get hurt when you jump off a roller-coaster.”*

*“Time is on your side when you own shares in superior companies.”* Peter Lynch

*“We just try to add to fundamental earning power every year.”* Warren Buffett

*“Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections than has been lost in corrections themselves.” Peter Lynch*

*“You can have the top 10% and the bottom 10%, I will take the 80% in the middle.”*  
Baron Nathan Rothschild

Therefore, do not try to time the market, do not try to be smart.

Allow time for the full development of gain, it may take 5 to 7 years for the value to be realised in the market. Wait, because time is the friend of the wonderful company. Do not lose focus on value: Stocks surge and swoon, seemingly untethered to any year-to-year build-up in their underlying value. In value investing, the following is true: *“A willingness to look foolish for a sustained period is essential.”* Warren Buffett

Item 9: **Concentrated winners are wonderful.** (This seems to contradict item 3, which dealt with diversification – but it actually provides balance to that argument.)

Again, I need to tell you a little story to illustrate this point. A young man inherited a mountain of money from his father. So, the bank manager of their local bank was eager to provide sound financial and investment advice to the young man. Amongst others, the bank manager elaborated on the virtues of diversification as an investment strategy. The young man replied: “If my father followed your advice, he would not be able to leave me this inheritance, as he would have been the bank manager in the local bank.”

Allow concentration of companies in a portfolio. But...this concentration should develop without committing more seed capital. In other words: **LET YOUR WINNERS RUN.** Hold, do not take profit. This is opposite to the instinct to take profits in the winners, and to leave the losers under the assumption that they will also get their day in the sun.

The great personal fortunes were not built on a portfolio of 50 companies. They were built by someone who identified one wonderful business – think Microsoft, Amazon or Apple – in all these cases, the “someone” is almost a household name now.

Concentrated portfolios often, but not always, carry higher risk due to concentration. Too wide diversification can also lead to losses, as you focus is being diluted.

*“Owning stocks is like having children – do not get involved with more than you can handle.”* Peter Lynch

Remember: Diversification preserves wealth, but concentration builds wealth.

Item 10: **Lethargy can be lucrative – if you own wonderful companies.**

Inactivity can generate gain by avoiding trading costs and taxes. Activity also increase the likelihood of wrong moves. The stock market moves money from the active to the patient. It is more fruitful to think about the likelihood that a specific company product will sustain itself and its economies over time than to jump in and out of the market. To continue doing the correct thing (in this case, very little) under severe headwinds and the tide against you, takes courage and a certain amount of

stubbornness, even arrogance. Again, we need to learn from Warren Buffett: *“Focus unendingly on investment opportunities.”*

### **Feedback from the Lucri year-end**

The past year was a mildly successful one for Lucri, measured by the portion of portfolios that managed to beat the market – portfolios that generated positive alpha.

Over 2019/2020, 46 out of 86 portfolios created positive alpha, representing a 53.5% success rate. The previous 5 years looked as follows on % with positive alpha:

2018/2019: 18 out of 89, or 20%

2017/2018: 20 out of 88, or 23%

2016/2017: 61 out of 85, or 72%

2015/2016: 35 out of 65, or 54%

2014/2015: 22 out of 37, or 59%

In summary, 4 of the 6 years produced a result where more than half of the portfolios produced positive alpha. I know – this is not a highly successful result. Without looking for excuses, I would like to elaborate a bit on my own understanding of the main factor that had driven the stock indexes in the world to become very competitive and difficult to beat.

I identified a strong positive feedback loop in almost all the stock market indexes in the world. In simple terms, a positive feedback loop exists when the factor that drives a certain result, utilises that result to gain momentum - in order to drive the result higher. The cycle then feeds on itself. The factor drives the result, the result drives the factor, and the cycle repeats. Index investing is the factor that had driven the prices of shares in the index higher – as the index products need to physically buy the underlying shares in the index when more money pours into the index investment product. I think you get the picture – as index investing became more popular, more money flowed into the index products. This money started driving the share prices of the underlying shares in the index higher, causing the index to increase. This in turn encourages investors towards index investing – they took the increase in the index as confirmation that index investing is a low risk, high gain strategy.

During the same time period, a negative feedback loop (working just like a positive feedback loop, but in the opposite direction) developed amongst portfolios based on value. A portion of the money that is pouring into index products, comes from the selling of unpopular stocks (read: value stocks). The prices of the value stocks are therefore reduced, and driven deeper into value territory. As the majority of investors look at price momentum, they took this as confirmation that the value stocks should be sold. This cause the value stocks to further decrease in price – while they may increase in value. The cycle then also repeats, driving prices lower and lower.

So, it became increasingly challenging for value investing techniques to beat the market over the past years. Now, during a severe stock market crash, value normally becomes more visible – with the result that value stocks become more popular,

driving the prices higher. So, we should monitor the relative performance of value investing opposite index investing with more interest over the next few years. If my analysis holds any water, value investing should start to outperform again. It obviously depends on the breaking of the positive feedback loop in index investing. We do not see many signs of that yet, but there was a brief shock to the system last month.

### **Sasol**

I have prepared an analysis on the price of the Sasol share opposite value over the past 14 years – but it shall have to stand over for the next newsletter. In short, the Sasol share price dropped from 105% of value to just 7.3% of value in year to date 2020, it is now sitting at 22.5% of value after it started a recovery since 23 March. Even at the current price, this share is the lowest opposite value that it has ever been over the past 14 years, and it may well be the lowest opposite value since listing 41 years ago. This is true even with the value dropping constantly since 2015, to reach the value prevailing about a decade ago.

### **Lucri housekeeping**

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.

Kind regards and concentrated investing,

Simon Streicher