

LUCRI ALPHA NEWSLETTER NR 4

30 JULY 2015

Dear current and future Lucri members,

The Streicher family has enjoyed the first 8 months on our Overberg farm. When a family friend from Sasolburg asked my wife recently how long I took to adapt to the new environment, she answered: "About 10 minutes!" We attended a three day practical course on organic farming last week. So, we are looking forward to nutritional, organic veggies in future.

Risk indicator

Our risk indicator lost its rosy tint, and dropped below the mid-point again, to 44.3%. Remember, this is not a timing tool, but rather an indirect indication of the magnitude of a future fall in share prices. The drop was mostly due to a small reduction in share prices, and not due to growth in underlying profits (the latter being the more healthy way to reduce risk).

The all share index of the Johannesburg Stock Exchange has moved sideways over the last 12 months, indicating zero capital growth for the past year. As indicated in my previous newsletter, the bull market is getting tired indeed.

PSG and REINET – from previous newsletters

While PSG shares dropped a little, it moved mostly sideways, following the market as a whole. Reinet performed well, stronger than the market. At some stage during the last month, the market placed a negative value on the Reinet international portfolio, while the portfolio actually grew strongly to a value of R 11 per Reinet share. The negative value was calculated by looking at the market value of the British American Tobacco shares in the Reinet portfolio – it exceeded the market value of Reinet slightly, indicating that the international portfolio was not accounted for at all in the Reinet share price. This situation represents a good margin of safety. Most of you will find Reinet in your portfolios.

Diamonds are a (value) investor's best friend.....an example of deep value

Deep value can be found in the obscure, and the downright UGLY. Most investors will think: "Juck! I am not touching THAT!"

How does a small diamond producer with remaining life of 1 to 2 years on its existing RSA assets sound as an investment? Most will say you should not touch it with a loooooong pole.....until you delve a bit deeper.

You discover that this company actually has cash in the bank in excess of the market capitalisation – in other words, the cash per share EXCEEDS the price that is currently quoted per share! When you buy this share, you immediately gain in cold, hard cash – your gain will currently be about 20% - you receive 380 cent in cash per share, while you pay 320 cent per share. (I have tested whether the company REALLY has this amount of cash by looking at the interest earned on the income statement – it matched completely.)

The catch (there will normally be one!) is that you do not have control over the cash, unless your name is Warren Buffett – he simply buys the whole company and gets control over the cash. So, how do you know that the cash will be employed wisely to your benefit? You look at the track record of the management team that do control the cash. In this case, they firstly reduced debt and then they painstakingly accumulated this cash pile over years. Normally, people that saves with discipline does not squander money.

If you add a highly successful diamond operation in Angola (one out of three prospecting sites were successful) that already operates at a profit and returns dividends to the RSA, the prospects for this company looks much better.

Then, in October 2014, this company initiated a new diamond mining operation in the RSA on a proven diamond field that they have acquired from De Beers. This compensates to a large degree for the fact that the existing RSA diamond mines have reached end-of-life status. While one can accept that the new operation will operate at a loss for the first year, it should turn cash positive in year two.

Remember, you get the Angola operation and this new RSA diamond mine for free at the current share price.

An indication of current profitability is that this company paid dividends of 60 cent per share (50 cent special and 10 cent normal) over the past 12 months – while increasing the net asset value per share from 520 cent to 630 cent. The cash pile also stayed intact.

By this time most of you may have recognised the company as Transhex – the alluvial diamond miner previously in the Rembrandt Group portfolio.

So, why do the investment public at large ignore/neglect Transhex as an investment opportunity? The following may be possible reasons:

- Due to the small size of the company, large financial institutions are not interested in it – share analysts will therefore not follow it.
- With limited share analysts interested in it, information about the company will not be readily available in financial articles.
- Investors may look at the end-of-life status of the current RSA assets, and overlook the success in Angola or the new mine start-up.

Looking at all the factors above, I believe there is a sufficient margin of safety present to accept the investment risk in this case. This investment has passed my quality and value criteria – now, the only element still necessary will be TIME, which requires PATIENCE. I hope this discussion has provided you with some insight into the world of deep value investing.

Value investing not currently popular

I forwarded you an article a few weeks ago, providing scientific proof that value investing as an investment style outperformed the relevant market indexes historically over long periods of time. Notwithstanding the long-term track record, value investing as an investment style grew increasingly unpopular over the last

years. I believe that this trend has been fuelled by the recent under-performance of value investors.

When unpopular investments (cheap) move to highly unpopular (extremely cheap) over time, value investors will under-perform in the interim, especially when popular investments gets more and more popular (expensive) with time. Pressure to perform in the short term can expose investors to long-term investment risk. This disconnect normally develops up to a breaking point before a rapid correction occurs.

When Textainer, the largest tanker container company in the world trades at a dividend yield of 7% in US dollar terms (higher than interest rates in the USA), the market is certainly a bit skewed. Back home, large, diversified commodity companies also trades at 6.6% and 6.2% dividend yields (Anglo and Billiton respectively).

With my style being mostly value oriented, you can therefore expect the same under-performance in my portfolios in the interim. The good news is that you are excused from any management fees if and when this happens.

Energy unpopular – and extremely volatile

My value investment style is currently being tested to the full in the USA. Please have a look at the share price movements of Peabody Energy, the largest privately owned (listed) coal mining company in the world:

\$30.8 per share on 8 August 2005

\$87.7 per share on 23 June 2008

\$18.7 per share on 17 November 2008

\$72.7 per share on 28 March 2011

\$1 per share on 27 July 2015

A real roller-coaster ride! Looking at the numbers, you will understand what Warren Buffett means when he says that price is what you pay, while value is what you get – and they are NOT the same! Surely, the value was never \$87 or \$72, but by the same token the value is surely not \$1 unless you firmly believe that the 40% of total energy sales in the USA represented by coal will drop close to zero in the medium term. Currently, Peabody only needs 3 weeks of coal sales (revenue) to cover the entire price that the market places on the company. I believe the value is about \$ 6 per share – a far cry from the current \$1 market price. I am currently bleeding on this share, as I have bought on the way down – so, my investment mettle and patience are currently being tested!

Four ingredients

The four ingredients of a successful investment cake are:

- **Quality** – as indicated by competitive advantage
- **Value** – a margin of safety

- **Diversification** – you should not be over-confident
- **Time** – time in the market is more important than timing

I can talk more than one hour non-stop on each of the above ingredients, but I shall be merciful☺. I may return to these elements in a future newsletter.

Feedback from Lucri members

You will recall that I have requested feedback from Lucri members in my previous newsletter on their risk appetite. Most members indicated that they have a high risk appetite, while some older members have wisely indicated that they want to reduce their risk exposure. While lower growth is the unavoidable associated “cost” of lower risk, it may be prudent for some, depending on your position in the life cycle. I am not surprised at all that the majority indicated a higher risk tolerance, as the purpose of exposure to shares as an asset class is higher return associated with higher risk.

It is also true that some members will adjust their risk tolerance to low after they have experienced the pain of a share market crash – while this is a normal human reaction to loss, after the crash will be exactly the wrong timing to reduce risk.

While we are experiencing trying times on the stock exchange, I want to ensure you of my unwavering focus on your investments. I remain passionate about (value) investment and will steer away from pure speculative opportunities.

Kind regards and happy investing,

Simon Streicher