

LUCRI ALPHA NEWSLETTER NR 5

20 OCTOBER 2015

Dear current and future Lucri members,

Can you believe that a full year has passed since I wrote my first newsletter? The Streicher family is still enjoying the Overberg very much – we have now experienced all the seasons here – the early summer season is really beautiful. It is currently harvest time in the Overberg.

Risk indicator

Our risk indicator is currently lingering just below the midpoint of the range at 49.5%. The JSE is still moving sideways with muted growth in South Africa as well as the rest of the world. I am noticing strong, persistent deflationary forces in the world economy for the first time in my life. We are so used to inflationary forces, that deflationary pressure is at first difficult to notice and to understand.

Governments want a little inflation, as it helps them with tax collections and debt management. Have you ever seen a government that can tax an increase in the standard of living due to falling prices while salaries remain stagnant? No, they surely need increases in salary payments. So, most governments are printing money at an alarming high rate to stimulate growth (actually inflation). While this kind of money creation out of thin air normally will lead to inflationary pressure, it now barely produces inflation around 2% in the USA and elsewhere. This is a strong indication of deflationary pressures at play.

You may be surprised to learn that the 165 companies whose shares make up the All Share index of the JSE as a collective had experienced a DECREASE of 6.2% in their collective profits over the past 12 months starting at the end of September 2014. This sheds new light on the sideways movement of the JSE over the past year. At the same time, the collective dividend payments of the 165 companies were INCREASED by 11.2% over the same period. This indicates lower growth opportunities or lower confidence to invest amongst these companies – as they are paying a larger portion of profits in the form of cash to investors with less internal investment. Again, the reduction in profit indicates deflationary pressures at work. As investors, it seems that we should prepare ourselves for lower growth moving forward. Low inflation supports high price to earnings multiples – so, our markets may not be as pricy as indicated via PE multiples in comparison to historical PE multiples that is derived from periods with higher inflation.

PSG/Reinet/Transhex/Textainer/Peabody

The “Mouton Magic” at PSG that I mentioned a year ago is still at play – it was sheer pleasure to work through their latest financial statements and profit performance. “Rupert Risk Reduction” at Reinet has not changed a bit over the past year – but you will notice a steady outperformance from Reinet opposite the All Share Index – AND this outperformance came at a risk much lower than average. Transhex, which I introduced to you in newsletter nr 4, has moved lower while the value indicators

mentioned are all still applicable and holding water – say no more! As mentioned before, TIME and PATIENCE should produce results there.

In the USA, Textainer shares were driven so low that the annual dividend of \$1.88 expressed as a percentage of the share price reached 11% while the company faithfully continue to pay a dividend every quarter without fail. As expected, the share price started recovering lately.

Peabody energy, the volatile “wild card” introduced to you last time, recovered strongly from \$1 to reach \$2.7 with-in a few weeks, currently sitting at \$1.5 (due to a 15 for 1 share consolidation, \$1.5 now translates to \$22.5 per share). This confirms that the value of the company exceeded \$1 (\$15) per share – the verdict is still out on my estimate of \$6 (\$90) per share. My bleeding on this one has stopped.

Model portfolio

You surely have noticed that I can react swiftly and buy shares almost immediately when you add cash to your accounts. The method in the madness here is that I constantly update a model portfolio in the background. When you add funds to your account, I simply compare your portfolio with the model portfolio and adjust towards the model portfolio – all analyses were already complete before buying commences. I am also using an overall “Lucri protocol” to avoid placing too much weight into certain market segments – the protocol will cover diversified industrials, high quality shares, cyclical shares below value and non-cyclical shares below value.

The Chameleon’s eyes turn and turn....

Enough serious stuff, it is time for a bed-time story! Please allow me a bit of “nature fiction” – based on a true life story☺.

I had the privilege to find a wild Chameleon on the farm earlier this year. As a child, I loved to watch Chameleons in the veld.

But firstly, a dry and boring quote from the Lucri philosophy write-up that you will find on my website, www.lucri.co.za

“The Lucri Alpha philosophy results in infrequent trading as deep value does not occur frequently. This should not be seen as inactivity, as constant analyses need to be applied behind the scenes in order to immediately recognize value when it appears. When this happens, swift and decisive action is needed before the market recognises the value and share price correction commences.”

This translates into the following if you loves nature:

The Chameleon stands motionless...no, not entirely motionless...the eyes are moving constantly: Forewords, to the sides and even backwards. The immediate environment is being scanned thoroughly and completely – a 360 degrees continual scan, with small, rapid eye movements.

The body remains absolutely still, or sometimes moving slowly and cautiously forward. Then, suddenly, the yellow tongue lashes out in a flash!.....and disappears immediately again. It seems as if nothing had changed....until you notice that the fly

on the leaf nearby had disappeared. So much for the belief that Chameleon's are slow! The jaws of the Chameleon moves slowly up and down and slightly to the sides as well – and a grin of satisfaction appears at the corners of its mouth.....(ok, you need to apply a bit of imagination to notice the grin, only lovers of nature can notice it!)

The Chameleon is teaching us a few valuable investment lessons:

- You need patience and discipline – no greed, no fear. The Chameleon scans the environment for hours and hours on end before a fly moves with-in shooting range.
- Stay calm and relaxed – the Chameleon is NOT chasing flies frantically – quite the opposite. Remember the Chameleon's motto: No motion or emotion!
- You need to do your investment homework consistently and thoroughly – scan the investment environment consistently with Chameleon eyes – cover a full 360 degrees angle.
- Only lashed out when your target is comfortably with-in reach. I have never seen a Chameleon missing its target or lashing out too soon – it waits for the perfect moment.
- The distance from the fly to the Chameleon's mouth represents the ratio between investment price and value – you ONLY acts swiftly when this ratio (distance) is with-in your reach and you are almost sure of success.
- A few high quality catches are sufficient to put you ahead of the market – the Chameleon stills its hunger with a few flies only.

I hope this little nature fiction story help you to understand the Lucri philosophy better!

Wisdom from (value) investors

Seth Klarman: "If the general tendency is for buying to beget more buying and selling to precipitate more selling, investors must fight the tendency to capitulate to market forces."

Louis Lowenstein: "Do not confuse the real success of an investment with its mirror of success in the stock market."

Jan van Niekerk at RECM: "Ultimately the only protection is to own assets where the current prices imply very low expectations, and to use times of uncertainty in markets as an opportunity".

Rob Dower at Allen Gray: "Our job is to diligently dig for opportunities that provide you with the best chance of growing your wealth over the long term, without taking on undue risk in the process." My comment: AMEN!

Simon Brown: "If you are stressing during the current market cycle, your risk appetite is not as high as you might have thought. Reduce your risk and your stress – simple.

Lucri calculation of unit prices

I am realising that some members of Lucri do not fully appreciate and understand the unit trust approach that Lucri uses to calculate investment performance. As this approach is so central to the measurement of investment performance, I am using this section of my newsletter to explain it in more detail.

Two investors, Bull and Bear, decided to invest with Lucri. Bull decided to invest four amounts of R 25 000 each with Lucri, at different time periods. The market were in an upswing while Bull invested, and the market increased 20% in-between each of the four investments. Bear also decided to invest four amounts of R25 000 each with Lucri, at different time periods. But, in this case, the market were decreasing and decreased by 20% in-between each of the four investments.

Result:

The total investment value of Bull's account amounted to R 134 199 after his last investment. He performed a straight calculation and concluded that his investment increased with 34.2% from R 100 000 to R 134 199. A unit price calculation, where the savings drive is totally separated from the investment performance, indicated that the initial unit price of 2500 c per unit had increased to 4320 c per unit – an increase of 72.8%. The unit price was not affected at all by subsequent investments – it stayed unaltered during a subsequent investment.

The total investment value of Bear's account amounted to R 73 800 after his last investment. He performed a straight calculation and concluded that his investment had suffered a loss of 26.2% from R 100 000 to R 73 800. A unit price calculation, however, indicated that the initial unit price of 2 500 c per unit had reduced severely to 1 280 c per unit – a decrease of 48.8%.

From the above it is clear that both profits and losses can be underestimated with a huge margin when a straight calculation is used to measure repetitive investments over time. It is therefore a Lucri imperative to use a unit price approach to measure investment performance accurately. You need to do this for your own personal investments too – before you can make any meaningful comparison between your own investment performance and a specific index or your pension fund performance or any other investment performance.

Easy Equities

You might have noticed that Easy Equities was crowned as top broker in South Africa in a recent broker survey performed by clients of more than 15 different brokers. Standard Online was second and PSG third. I have investigated Easy Equities since the beginning of this year, due to the lowest brokerage charge in the RSA at 0.25%, no admin costs at all and no fixed minimum for brokerage fees. This means that you can now help your minor children (over the age of 7) to open their own brokerage accounts, and they can buy shares with their pocket money of R50, or R10 – whatever, in a cost effective way! You can empower your gardener to start investing in this way too – the opportunity is now available for the first time in the RSA to invest cost effectively with small sums. (No, I do not get anything from Easy Equities for this advertisement☺)

Tax Free Savings Accounts

If you have not opened a tax free savings account with as broker yet, I want to strongly recommend that you give it serious thought. While you are limited at R30000 per annum on the inflow side, you are not limited at all on withdrawals. All gains are tax free – dividends, interest, capital gains and even speculative gains if you sell immediately at a profit. Especially young children, with their life still in front of them, can gain a lot via this type of account. Also, property investments, where the REIT rental income is normally taxable at your marginal tax rate, can be quite attractive via a TFSA (Tax Free Savings Account). The account will be opened at your current broker without another FICA admin pain, if your FICA status is up to date. (No, I do not see any advantages or profit for Lucri in the TFSA space – as you need to buy ETF's only in a TFSA, and I cannot outperform the market with the market. But I am quite willing, due to my love for the investment game, to provide you with my own ETF choice to mimic a complete pension fund with international, local and property content.)

Investing Sance Souci

I hope you are still investing without (sance) concerns (souci). I had the privilege to visit Sance Souci in Europe – it is a most beautiful country estate, in fact so beautiful that the original owner named it "Sance Souci". If you exclude the market noise and ignore the constant volatility, your chances to reduce investment stress improves dramatically.

Kind regards and sance souci investing,

Simon Streicher