

LUCRI ALPHA NEWSLETTER NR 7

25 APRIL 2016

Dear current and future Lucri members,

I am not sure whether you are aware that Swellendam, our home town in the Overberg, had recently been crowned as the top municipality in South Africa after all municipalities had been evaluated. I know it is all relative, and that the competition was not severe ☺ - but I can tell you that I have noticed shortly after our arrival here that the team at Swellendam are doing something right. So, the Overberg was on the map for a short while.

Risk indicator South Africa

Our risk indicator remained in the upper orange zone for January and February, but moved into the red zone in March 2016. This increase in risk was driven by a stubborn trend of lower average earnings for the shares in the All Share index while inflation and interest rates also moved higher. This recent move into the red zone differs from past experience, as it was not accompanied by significantly increased share prices, but rather driven by an imbalance between earnings growth, inflation and interest rates. I am in uncharted waters here and therefore hesitant to conclude immediately that the risk is too high. I shall monitor the situation.

Over-simplified table

You may recall that I have discussed the following table in my previous newsletter:

“The following over-simplified table helps me to keep the correct perspective while markets are volatile. **A** represents the % fall in the price of a share from a certain base, and **B** represents the % increase on the new base when the share price recovers fully.”

A	B
10	11
20	25
30	43
40	67
50	100
60	150
70	233
80	400
90	900
95	1900

The last three months provide us with a beautiful example on how the recovery from a low base (I called it shares with capitulation price levels in my previous newsletter) plays out. I simply used the date of my previous newsletter as the starting point for a tracking period until today's date. This is therefore not an indication of bottom to top

recovery. As no-one can accurately call the bottom or the top, this is a more realistic indication of the recovery:

Share name	Price 25 Jan 2016	Price 25 Apr 2016	% Increase
Anglo	5419	14695	171%
Assore	8600	18899	119%
Kumba	2911	11851	307%
African Rainbow	4587	10482	128%
Exxarro	4830	8876	84%

This group of 5 delivered an average recovery (not growth) of 162% in just 3 months. It illustrates the investment cycle for a value investor: The value investment cycle can be described as drawdowns initially with significant repricing at an uncertain point in the future. The initial drawdowns will occur as the value investor almost never buys at the bottom, but on the way towards the bottom, suffering paper losses initially. The golden rule is that a value investor should never fear a declining share price while the share value holds water – you should refuse to change your mind when you remain JUSTIFIABLY confident in your investment choice. Warren Buffett’s wisdom mentioned in the previous newsletter was on the money again!

Most Lucri members own a combination of the five shares mentioned in the table – so, most of you will notice a positive movement in your portfolios over the last three months, after an initial drawdown. I referred in the past to Lucri customers that had improved their reward to risk ratio by continual cash injection into their accounts during a down cycle. Those investors have reason to smile.

It is interesting to note that this significant repricing occurred BEFORE there was a significant improvement in the commercial prospects of commodity producers – the repricing was purely based on improved sentiment, just like the last vertical drop in commodity share prices was purely based on overly pessimistic sentiment. This may signal that the recovery is not based on a solid foundation – but it is also true that most share price recoveries occurs months before the financial results of the companies start to improve.

I have also mentioned in my previous newsletter that it was impossible for me to buy popular, expensive shares while staying true to the investment principles of a value investor. I have specifically mentioned two shares with heavy weighting in the All Share index, namely SAB and Naspers:

Share name	Price 25 Jan 2016	Price 25 Apr 2016	% Increase
SAB	98200	88131	-10%
Naspers	182000	197119	8%

The two popular shares basically moved sideways as a group over the three months, cancelling each other out over the period. From the above, it should be clear that portfolios light on popular stocks and heavy on unpopular resource stocks have created positive alpha over the last three months. As mentioned before, we are not looking for a flash in the pan over just three months, but rather long-term performance. Investing is a marathon, not a sprint. So, the results above are not meaningful unless the total investment cycle provides positive alpha. Having said this, I must admit that I am grateful for this kind of repricing, as it contributes towards long-term alpha. Value investors need shares that are priced “wrongly” relative to value in order to find opportunities to outperform the market. “Wrong” share prices on the low side occurs when bad news are extrapolated too far into the future. In the event that this repricing continues, value investors will once again gain the upper hand over time.

I am a trustee for a trust created for the benefit of the widow and children of one of my best friends that had passed away. Around December 2015 the portfolio manager of the trust sold Anglo for R 62 while the share was bought earlier at a substantially higher price. I squealed like a wild boar (like when Asterix and Obelix are rapidly catching up with it!) – I think you can understand my agony. While I did not know that the recovery towards R 146 per share was so close, I surely knew that Anglo was FAR below value – and in my books it is a cardinal sin to sell a share when it is trading substantially below value. You should not lose heart and sell just because “everybody else is doing it”.

Feedback on financial year end for Lucri

As indicated to you, I chose Friday the 26th of February as the financial year-end date this year to provide sufficient time to process results over the weekend. While this was a challenging year for Lucri, just over half of the portfolios under management (35 out of 65) still produced positive alpha last year. The alpha was rather small, and sometimes only produced due to a down market (portfolio falling less than the market index). So, not a good year overall.

The 13 month period towards the end of March looks drastically different, due to the repricing mentioned above. As our Lucri system is cumulative, it only means that my portfolios will have a strong start for the new financial year. Looking at the spread in the performance over 65 portfolios, I realised that the investors only starting with Lucri in December 2015 may perhaps think that I am a genius, as their portfolios took off like rockets, providing huge alpha over merely two months – thanks to the repricing above.

My customers that have been with Lucri for two years or more took the full brunt of the initial downswing in commodity prices before the subsequent recovery – so their portfolios only recovered red ink. They may think that I am alet’s just say “not much of a genius”. As always, the truth is somewhere in-between! This is a classic case of “the last will be first”. My current customer base has a huge spread in performance, while I am using consistent investment principles and techniques. The reason for the huge spread can be found in the starting point of the investment opposite the recent commodity cycle. These differences should reduce over time.

Finding the bottom

While the price of a share or a commodity is in decline, it is almost impossible to call the bottom correctly (some investors may get lucky once or twice, but I have not seen consistent performance). So, I have developed a simple, but effective technique to help me find the bottom. You need patience combined with sufficient cash resources in order to apply the technique to your advantage.

While the price is decreasing, you invest equal amounts of cash in several phases. Each investment will be followed by subsequent investments after the price has decreased by a further 10%. Repeat until you hit the bottom. The equal cash amounts ensure that you buy more shares as the price decreases – pulling the average purchase price per share below the arithmetic average of the purchase prices. (This is nothing new – it is known as rand cost averaging.) Upon recovery, you may sell the most expensive purchases at a break-even price – decreasing your average purchase price per share even further.

I have recently used this technique to buy West Texas Intermediate crude, but I adjusted the formula to buy after a 5% decline in price each time. (I adjusted to 5% as I was convinced that we are already close to the bottom.) I performed 6 transactions, and could sell my first, most expensive entry point at break-even after a temporary recovery. The other 5 transactions all show profit at this point in time, with the latter investments showing must larger gains due to buying at the (perhaps temporary?) bottom. If the decline commences again, I shall follow the crude oil price lower and lower until it reaches a bottom again.

You should take note that this technique should only be applied in cases where you are pretty sure that the price will recover – while I have no idea on timing, I am quite sure (based on my study of crude production cost) that the rand price per barrel of oil will recover over the medium term.

Price versus Value

I mentioned in my previous newsletter that I would like to expand the price versus value discussion. Firstly, we need to share an inconvenient truth: **No one can forecast the future.**

Not knowing what will happen in future is particularly inconvenient when you are investing for the future 😊. How should we reduce our future risk and improve our probability of success, given this particular inconvenient truth?

Maximum gain and minimal risk are (Siamese) twins

This may sound like a dichotomy – but I shall endeavour to convince you that maximum gain and minimal risk are indeed joined at the hip. We have learned that you should be willing to accept higher financial risk in order to reap a higher financial reward. While this most probably holds water for most commercial endeavours, it surely is not true in the case of value investing.

When shares prices are in equilibrium (when the market is efficient, share prices are quoted “correctly”), risk and reward also points in the same direction as you would expect – higher risk provides higher reward.

The strength of value investing lies in the ability to spot mispriced opportunities, when price is far below or above value. In these special circumstances, where the share market is not in equilibrium, risk and reward points in opposite directions. In this special case, the highest possibility for a price increase (reward) co-insides with the lowest possibility for financial loss (risk). This occurs when the price is at its maximum deviation from value towards the low side. Just think about the scenario for a while: At the point where the price is FAR below value, the possibility for an upwards correction towards value is at its highest – maximum gain potential. This is exactly the same point where the possibility for further price decline is at its lowest – minimal risk. Therefore, maximum gain and minimal risk are joined at the hip!

Obviously, one needs to make sure that your value calculation is as accurate as possible, but it does not need perfection, an approximate range is good enough. The only missing ingredient for investment success that is then still needed, is patience – to wait until a mispriced opportunity occurs. You do not need to know when it will happen in future, you only need to be able to recognise the opportunity when it crosses your path. So, the inconvenient truth mentioned above is not so inconvenient after all – we know that the market will supply us with opportunities at an uncertain point in time. Normally, value investors have sufficient time to act and buy at their leisure, as most investors does not follow this style of investing and does not believe that an investment opportunity exists in the first place – even when value investors tell them directly!

Friendly request

Please inform me each and every time when you add cash to your brokerage accounts? A quick e-mail or SMS is sufficient – just three words “I added cash” will do ☺.

During the past year, some investors forgot to inform me that they have added cash to their accounts. Others are most faithful and never fails to inform me – you can ignore this request – I do not want to preach to the converted!

The reason for this request is that I do not access the brokerage accounts of all investors every day or even every week (I have a schedule to monitor accounts, but my investment style does not require constant monitoring). If you recall the unit trust approach that Lucri is using, you will recognise the importance of units being issued timely and correctly to measure investment performance accurately.

A late recognition of additional cash may work for you or against you depending on share price movements, but the first price surely must be consistent accuracy.

Kind regards and Sans Souci investing,

Simon Streicher

