

## **LUCRI ALPHA NEWSLETTER NR 9**

**20 OCTOBER 2016**

Dear current and future Lucri members,

The Overberg is enjoying another excellent agricultural year – we are so grateful. Our thoughts are with the large areas in South Africa that are experiencing severe drought conditions. South Africa is experiencing difficult conditions in general, so let me try to cheer you up. Advice from a wise father to his son: “When you get angry, count to 3. When you get to 2, throw the punch. They won’t be expecting that.”

### **Risk Indicator**

As explained in my previous newsletter, the risk indicator is signalling increased risk in the all share index of the JSE due to the reasons indicated. The situation did not change materially over the past quarter – the indicator is fluctuating between 60% and 62% - just below the red area. While I believe it is still prudent to monitor the all share index risk, I shall limit the newsletter space on this topic as value investors reduces risk by buying below value.

### **Confirmation that diamonds are a (value) investor’s best friend.....**

In newsletter nr 4, I included a discussion on Transhex, with a detailed description of the factors that contributes to the value proposition offered by this investment. A consortium consisting of Christo Wiese (known for Shoprite, Pepkor, Brait and Tradehold) and Piet Viljoen (Regarding Capital Management) has now confirmed this value proposition by making an offer for the entire issued share capital of Transhex– they are clearly in the know. Unfortunately, they are value investors – like me. They want to buy below value before the value of the new diamond mine becomes apparent!

While an independent valuation by Snowden (independent body appointed by the Transhex board to perform a formal valuation) set the value of Transhex at 800 cent per share (midpoint of an evaluation range), the current offer from the consortium is 394 cent per share. So, my reaction to this one is: “Thank you, but no thank you.” While I believe 800 cent is a bit rich, the 394 cent was derived from a sale by Northam platinum who needed cash desperately (most platinum producers need cash currently). I am prepared to listen to offers around 600 cent per share. So, when you receive e-mails or requests from your on-line broker about this offer, just ignore the offer or decline it for your Lucri portfolio, please. If you do not reply, the default option is that the offer will lapse.

In the words of Warren Buffett, value investors are realists who buy from pessimists and sell to optimists. This is a concise description of any value driven transaction. In the case of Transhex, I am not a pessimist and the consortium are not optimists. We are all realists – so, at the current offer we shall not have a transaction.

In a take-over bid like this one, the new owners can bring an application to delist the share if they own 75% or more of the shares, but they cannot force the rest of the shareholders to sell. The moment that they succeed in getting 90% or more of the

shares, they can force the rest to sell – but not at any price. So, we are running the risk that they may succeed in delisting the share. This sounds quite scary to speculators, as they need the market action to make money. Patient value investors do not need a market at all for long periods on end – it is not the market action that makes money for them, but the fundamental value of the company itself – the company profits and dividends. In the case of Transhex, I am now more convinced than ever that we have a strong value opportunity here. We shall be patient and hold out for a better price – in the meantime, time is in our favour as the company is unlocking value day by day – time is the friend of the wonderful company. (In this special case we have a bit of power – Lucri controls about 8% of the Transhex shares that the consortium does not own.)

### **Resilience testing mode**

A number of share markets all over the world are currently in “resilience testing mode” – they are basically just moving sideways since July 2014, testing our investment mettle and resilience. In my own investment career, which was initiated at this time of year 36 years ago, this is one of the most difficult periods I have ever seen. If one defines a share market crash not by the negative movement from top to bottom, but by the amount of time needed to recover back to the top, we are currently experiencing a severe share market “crash”. In the case of South Africa, the notorious share market crashes of 2008 and 1987 recovered with-in 12 months to 18 months. To have a period of 27 months with no capital growth can therefore be classified as more severe than 1987 and 2008, if one uses the yardstick of time needed for the recovery.

While we have not experienced the classical super-exponential growth of a bubble just before July 2014, the aftermath which resulted in a long sideways movement tells us that low interest rates inflated asset prices too far at the time. Not all bull markets end in market crashes – one third of bull markets end into a sideways movement, just like the one we are currently experiencing. Looking back into history, I can find one period in South Africa in the past 42 years with a four year sideways movement – if this repeats, we have another 21 months to go! (Hopefully not.) If you measure the 1929 stock market crash in the USA in the same way, your mouth will be dry – it took more than 18 years. The stock market crash in Japan in the late eighties is even worse – the Nikkei index has not recovered fully after more than 27 years and still counting..... What is the common theme between 1929 USA and 1989 Japan? The belief that buying excellent companies with wonderful growth prospects **at any price** will deliver excellent investments.

Nobody knows how long this sideways movement will last, but I know one sure fact: Those who hang in there, will reap the benefits, provided that you have not bought when prices were in the stratosphere (like 1929 USA and 1989 Japan.) With-in a few years, when you look back, you will ask: “How is it possible that both Reinet and Trencor were trading below R28 per share in 2016?” In markets like the current one, a combination of value investing and a Rip van Winckel approach works very well – if you buy quality below value and sleep for 20 years, you will most probably awake with a positive capital growth surprise.

## **Reduce investment risk**

When you evaluate a company as a potential investment, you need to carefully consider factors like quality, value, cyclicalities and popularity. Quality can be measured indirectly by looking at various factors – I can write a paragraph or two on quality in the future if you believe you can benefit from that. The concept of value has been described in detail in these newsletters – the more tricky part is how to quantify the value. Cyclicalities need to be considered, you need to look through the economic cycle in order to normalise profitability (you want a realistic base to work from). Popularity indicates whether a company may be overpriced. According to Warren Buffett you pay a high price for a cheery consensus. In general, share investment risk can be reduced significantly via diversification, time in the market and a disciplined approach where you only buy below value. Howard Marks summarises what I want to tell you much clearer and to the point: “When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it is not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price.”

## **Value investment cycle**

It is important for Lucri members to understand the concept of a value investment cycle. When a value investor uncovers a value opportunity, he or she does not know how long the investment will stay below value, and even more critical, he or she has no guarantee that the investment will not move deeper and deeper into value territory (price moving lower) after it had been added to the portfolio. Due to the reasons above, it is quite common for value investments to continue losing money for a while, or to stay in an anaemic growth phase for an extended period. A value investor may be correct in the quantification of value, but still lose money temporarily as the share price firstly move lower before slowly recovering and eventually performing.

The best result that a value investor can hope for, is that a value share recovers so dramatically that it changes character to become a growth share. In this case, the value investor buys below value and sells far above value – while the value itself grows exponentially. I had a few of these in the past – this is when you have a “ten beggar” in Peter Lynch language – you sell at more than 10 times your original purchase price, with-in a few years.

If you construct a portfolio of value investments, the different investments may be in different phases of the value investment cycle if you are lucky, but most probably they will be in the early phase, since they have most probably appeared on your value radar screen shortly before. While a collection of value investments in different phases of the value investment cycle will produce a smoothed portfolio bottom-line performance, a freshly constructed portfolio may provide a temporary terrible performance if the majority of the investments are in an early stage of the cycle. The value portfolio performance will therefore depend on how far each share in the portfolio has advanced through the cycle. New members that has not experienced Lucri growth over longer periods should bear this in mind.

Expected returns rise as actual returns fall.

### **Investment Olympics: Century Olympic medal for South Africa**

With the 2016 Olympics still fresh in our memories, let us look at the performance of the various international investment athletes over the true long-term. I got hold of the following research, showing the nominal and real investment growth (in percentage, compound annual growth rate) for different countries over a period of 108 years, from 1900 to 2008:

Position	Country	Nominal Growth	Real Growth
1	Australia	11.1	7.2
2	Sweden	10.8	7.2
3	South Africa	11.9	7.0
4	USA	8.9	5.9
5	Canada	8.9	5.8
6	UK	9.0	5.0
7	Netherlands	7.6	4.6
8	Denmark	8.5	4.6
9	World-Median	8.9	4.0
10	Switzerland	6.4	4.0
11	Japan	10.9	3.7
12	Norway	7.4	3.7
13	Spain	9.4	3.4
14	Ireland	7.8	3.4
15	France	10.4	3.1
16	Germany	7.8	2.8
17	Italy	10.4	1.8
18	Belgium	7.1	1.7

Yes! You find South Africa on the podium, in the third position on real compound annual growth rate if you use the inflation adjusted yardstick as you should. On a nominal growth basis, South Africa has the highest score – but we all understand that we should only consider real growth, as inflation levels are so different in the different countries – we should compare apples with apples.

You must agree, South Africa is blowing in the necks of the winners over 108 years. I think we should award South Africa a gold plated silver medal for this performance – a bronze medal will not be fitting in this case! Are you surprised at the outcome? You will notice that the first three countries are all resource rich countries – this may be a significant observation. Considering how well the South African banking industry weathered the 2008 credit crunch induced storm and the subsequent strong relative performance in the South African stock market from 2008 to 2014, it is just possible that South Africa has improved into pure gold territory over 116 years, from 1900 to 2016. So, we should not complain too much in South Africa, and we should think twice before we invest large portions of our capital abroad. (Just for the record: I am in favour of investing overseas – I am referring to the portion of the savings)

It is also interesting to see that it is not only South Africa that was hampered by large inflation rates – look at Japan (currently in deflation) and the European countries!

I refer you to my “free Mercedes” discussion in the previous newsletter, where I indicated that you would have earned 43 free Mercedes sedans in 40 years on the JSE. This research indicates that you would have earned 1586 free Mercedes sedans over 108 years in South Africa – this mind-blowing result is made possible by the power of compounding over long periods. (With 43 in 40 years, 1849 Mercedes sedans should be possible in 80 years at the same growth rate – this indicates that the growth rate over the 40 year period was faster than the average growth over 108 years.)

When we look at the World-Median real growth of 4%, it delivers a much more humble 68 free Mercedes sedans over 108 years – it is perhaps better to use this more humble example to shape your own expectations. It is amazing how the mathematics of compounding works over long periods – an innocent looking 3% difference in real growth provides a massive difference in the end result – 1586 versus 68. (To those of you that is mathematically strong: Yes, the 7% is actually in-between 7% and 7.1% in order to deliver the 1586 result)

When one looks at growth over extremely long periods like 108 years, it can become meaningless for the investor of today unless you also look at the growth decade by decade over the full period – to determine whether the growth rate for a country like South Africa had tapered off through the decades or not. As I am running out of airtime in this newsletter, I am planning to do just that in my next newsletter – real growth in South Africa over 108 years to be continued....

Let's end this newsletter on a less serious note: **“I bought shares for my old age – and it worked! With-in six months I felt like an old man!”** 😊

I hope you are still sleeping well, without (sans) concerns (souci).

Kind regards and Sans Souci investing,

Simon Streicher