

LUCRI ALPHA NEWSLETTER NR 24

22 JULY 2020

Dear Lucri friends,

The country side remains a huge blessing during the current virus pandemic – we are grateful to have the opportunity to live in an environment where we are not constantly being confronted with the current unpleasant circumstances.

Risk indicator

Someone coined a new word in the current crazy market: “Bubblicious” – to describe the stock market in the USA, as the Nasdaq hits a new all-time record high while the USA economy experience the worst conditions in 75 years. Another way to describe this anomaly: “It was the best of times, it was the worst of times...”

The recent high in the S & P 500 index is 3232, with the all-time high being 3386. This current rally in the S & P 500 is driven by only 2% of the S & P 500 member stocks. A healthy rally is one with broad participation – so, the current rally is far from healthy.

In South Africa, the situation is quite different. The RSA market risk indicator remains deep in green territory. This can be explained by relatively low inflation and low interest rate levels compared to historic levels.

Robert Rubin’s lesson on uncertainty

Most people are in denial about uncertainty. The only certainty is that there is no certainty. Despite uncertainty, we must decide and we must act. Every decision is a matter of weighing probabilities. A healthy respect for uncertainty and a focus on probability drives you never to be satisfied with your conclusions. We need to judge our decisions not only on the results but also on how we made them. So, we need to manage risk by investing on probabilities rather than possibilities.

On a lighter note

The loyal friend: “I will always be here for you. Unless we run out of beer and someone has some over there. Then I will be over there for you.”

Healthy diet wisdom: They do not make pizza out of celery. And that is all you need to know about celery....

The dumbest thing I have ever purchased was a 2020 planner.....

Now for your regular geography lesson: What do you find in the middle of Japan?

Answer: “The letter p”

Covid 19 wisdom

There is no cure for a virus that can be killed by hand soap.

Stupidity travels faster than any virus.

The longer I stay at home, the more homeless I look.

Many people seem to see washing their hands as a new thing.

Pandemic related quotes

"We are buying companies or stocks for the next 20 to 30 years. I do not believe the coronavirus will have any significant influence over that time span. You should not allow the pandemic to influence your long term investment decisions." Warren Buffett

"Your investment portfolio and your pension fund are like your face right now – don't touch it!" Just One Lap

"Catastrophes typically exacerbate trends already latent." Koos Bekker

My translation: "Bad events make weak conditions worse and strong conditions better."

"As humans, our natural inclination is to simply extrapolate the present. We therefore tend to exaggerate the long term impact (both positive and negative) of current events." Piet Viljoen (In my opinion he is the Warren Buffett of South Africa.)

"Surprise and shock are endemic to the system. People should always arrange their affairs so that they will survive such events. They will end up richer that way than focusing all the time on getting rich." Peter Bernstein

"How do you go bankrupt? Answer: Gradually, then suddenly." Ernest Hemingway.
Let us hope this is not a Hemingway prophecy on South Africa...as we have now proceeded beyond "gradually".

"The majority of your lifetime investment returns will be determined by decisions that take place during a small minority of the time." Morgan Housel

I have experienced this last quote to be on the money. Over the past 40 years, the best profits in Sasol could be achieved during the short period March 2020 to May 2020. Now, let us discuss the recent Sasol price roller-coaster as well as Sasol as an investment opportunity.

No cheery consensus.....

According to Warren Buffett, an investor pays handsomely for a cheery consensus. When everyone agrees with you that a certain company surely represents an excellent investment, you are almost guaranteed to pay a price above value – think Amazon. On the other hand, when almost no-body agrees that a certain company represents even close to a sound investment at a certain point in time (like Sasol in March to April this year), you have a very high probability of buying below value.

Over the past two and a half years, I have performed several transactions in Sasol shares. This can be summarised as follows: Selling phase: December 2017 to August 2018, a period of 9 months. Monitoring: September 2018 to April 2019, a period of 8 months. Buying phase: May 2019 to 26 March 2020, for 11 months. Monitoring with a few transactions: 26 March to 28 April, one month. Selling phase: 28 April to 8 June, a period of 6 weeks.

In each phase, there was no change of direction, meaning that there was only selling in the selling phase and only buying in the buying phase (no quick change of direction, no attempt at being clever to take a quick profit). The end result was most gratifying – I am grateful. While I am careful not to sound even a little bit boastful (I actually despise boasting), in order to keep your attention I do need to mention that the end result of the five phases described above is twofold: A healthy increase in the amount of Sasol shares owned combined with increased cash in the portfolio. One can also summarise the result by stating that I eventually paid a negative price per share for the additional shares. This was achieved by selling some shares to return more than the original seed capital used for the investment.

Now, I shall try to tell you exactly HOW I arrived at the selling and buying decisions: Can you hear the whisper in the background? *“Be fearful when others are greedy, and greedy only when others are fearful.”* (You know who said this)

Yes, you need to know whether others are greedy or fearful at a specific point in time– so, you need to have a yardstick to measure the extent of their greed or fear. As mentioned in an earlier newsletter, I have developed a rough, inaccurate quantification model to arrive at an approximate indication of the value of a particular share, about six months into the future (I use historical financial statements, updated every six months). While I shall be the first to acknowledge the numerous shortcomings of my model, I do want to share the model results for Sasol over the past 14 years with you. This will give you insight into the shortcomings of the model, but I hope it will also signal to you that there are information value in the model, useful for decision making. As described in an earlier newsletter, I actually use the model to screen out about 60% of the investment universe. Then, I use qualitative methods to screen out a further 90% of the remaining 40% - and try to discipline myself to invest only in the remaining 4%. So, Sasol was also evaluated on a qualitative basis. It is very important to note that the model was applied with 100% consistency over the 14 year period, no changes were allowed to the basic model structure. Only the historical financial data input was updated every six months.

Value calculation results for SASOL during the past 14 year period:

Calendar Year	High price, rand	Low Price, rand	Model value, rand
2007	350	214	209
2008	514	221	293
2009	294	249	296
2010	332	275	309
2011	395	308	327
2012	403	338	382
2013	519	363	440
2014	645	392	495
2015	490	369	511
2016	492	358	492
2017	439	360	444
2018	578	390	408
2019	482	252	347
2020 (Jan to July)	318	22	302

You will notice that the value per Sasol share increased consistently year after year for 8 years from R 209 to R 511. The reason for this is that well-managed companies retain a part of their profits and put them back into the business, growing their balance sheets in the process. *“There is an element of compound interest operating in favour of a sound industrial investment.”* John Maynard Keynes.

Then the trend reversed direction and the value dropped consistently for 5 years from R 511 to R 302. So, in 2020 it reached the value that it had achieved a full decade ago. This clearly indicates that the model was sensitive enough to pick up the unfortunate value destruction that occurred during the Lake Charles project – notice how the value destruction accelerated since 2017 when the project started to impact negatively on the dividend and the balance sheet.

It will be easier and more meaningful to look at the Sasol share price range expressed as a percentage of the calculated value for each year:

Calendar Year	High price %	Low price %	Model value, rand
2007	167	102	209
2008	175	75	293
2009	99	84	296
2010	107	89	309
2011	121	94	327
2012	105	88	382
2013	118	83	440
2014	130	79	495
2015	96	72	511
2016	100	73	492
2017	99	81	444
2018	142	96	408
2019	139	73	347
2020 (Jan to July)	105	7	302

Now, in a perfect world with a perfect quantification model and rational market, you will expect that the high Sasol price will always be above 100%, and the low Sasol price will always be below 100%, with the value being indicated at 100% exactly. This will signal to you that the actual market price fluctuates around the value over time – as one will expect if the value was calculated accurately, AND when the market behaves more or less rationally over time. This will place the value at least with-in the actual price range. Now, looking at the bold, inclined numbers in the table above, you will find that 4 out of a possible 28 numbers signals the value being out of range – but never more than 4%. (This surprised me positively, as I know how inaccurate the model structure is by design, using only history, without any future projections). Out of range numbers reflects either inaccuracies in the model, or irrational market prices, or both. I hope you will agree with me that this result is an improvement on “gut feel” or emotionally driven projections – in an imperfect environment with extreme price volatility from time to time.

So, now we can easily identify the years of greed by looking for huge positive deviations between price and value:

2007, 2008, 2014, 2018 and 2019

Similarly, the years of fear can be identified by the significant negative deviations:

2008, 2015, 2016, 2019 and 2020.

We can find greed and fear in the same year, like in 2008 and in 2019.

Looking at the table, we can also identify the years of:

Maximum greed: 2008 (price 75% above value)

Maximum fear: 2020 (price 93% below value)

Now, if you refer to the selling phases and buying phases referred to earlier (selling Dec 2017 to Aug 2018, buying May 2019 to March 2020), you will find that I have sold in greedy periods and bought in fearful periods – this is really not rocket science. The selling since 28 April 2020 was performed below value, but at high profit margins after buying at extremely deep value. It was done to reduce the investment risk to zero (return all seed capital back to cash).

It may surprise you that my timing during selling and buying was actually quite awful – for instance, I started buying at R365 per share and was still buying almost stubbornly at R23 per share – after a drop of about 94%. To keep on buying you need to be disciplined and need to understand the following quote: *“Volatility is not risk, it is the source of future returns”*. Joshua Brown from Ritholtz Wealth.

I do not have fitting words to describe the recent Sasol price roller-coaster – it was utterly extreme, record breaking and unprecedented. I do know, however, that the steadfast, continual long term buyer of Sasol shares found himself/herself in a lonely place during March 2020 with the consensus view heavily against investment into Sasol. “Almost everybody” knew that Sasol was in deep trouble and that the buying of Sasol shares were “pure speculation”. “Everybody, that is, that have not made an attempt to calculate the intrinsic value of the company. See this opinion from Ingham Analytics: “Sasol is a stock for the traders to play on volatility, not for long term.” No, I am not picking on Ingham Analytics – you will find that the majority of analysts and investors shared this opinion. If that was not true, the price would never have reached only 7% of value.

I must admit – I was concerned about the possible massive dilution in value that can occur when new shares are being issued by Sasol far below value, say at 10% of value. That one action can cause permanent, significant damage to the value per share. We have now passed this specific risk to a large extent – although some dilution risk still remains at a share price that is about 50% of value.

I have also prepared longer term model runs on the share price of Curro to indicate how a quantitative model can help investors to fight their own emotions – the plan is to share this with you next time.

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, I promise to answer in a few days.

Kind regards and deep value investing,

Simon Streicher