

## LUCRI ALPHA NEWSLETTER NR 29

25 OCTOBER 2021

Dear Lucri friends,

In this newsletter, we shall re-visit the principles of value investing and discuss a brief history of investing over the last century. The margin of safety of a secret company will also be discussed – to investigate why this company can be regarded as a “pedigree” value investment with a large margin of safety.

Now that investments into commodity companies are so popular on the JSE, I feel the need to introduce readers to the commodity investment trap. Be very careful when you practise value investment techniques on commodity companies. Due to the cyclical nature of commodities, the PE ratios of these companies look very low and the dividend % look very high at the very top of the commodity price cycle. So, these investments LOOK cheap exactly at the point in time when they are actually expensive! You need to normalise the earnings and dividends through the full commodity cycle to create a true picture.

### **On a lighter note**

Life through John’s eyes.....

John: “I have excellent news! I won a huge lottery prize, close to R 5 million!”

John’s friend: “Congratulations! And what are you going to do with all that money?”

John: “I shall pay my creditors.”

John’s friend: “And what are you going to do with the rest?”

John: “They shall just have to wait.”

Another one....

John: “I have decided to buy stocks for my old age.”

John’s friend: “And is it working well for you?”

John: “Absolutely! I had only started six months ago, and I am already feeling like an old man....”

The wisdom that comes with age: “I decided to stop calling the bathroom the “John” and renamed it the “Jim”. I feel so much better saying I went to the Jim this morning.”

*“Help someone when they are in trouble and they will remember you when they are in trouble again.”* John Wayne

*“I checked the actuarial tables and found that six year olds have the highest survival rate. So, I decided to change to the diet of a six year old, namely ice cream, hamburgers and Coke!”* Warren Buffett (By the way – the last part of this is true – Warren is one of the few 91 year olds that still gets away with this junk food diet. His

concept of a balanced diet is a Coke in one hand, nicely balanced with an ice cream cone in the other!)

## Quotes

*“If I was a business teacher, I would present an internet company as the final exam and ask the students to put a value on it. I would flunk anybody that provides me with an answer!”* Warren Buffett during the dotcom bubble.

*“In all domains, we are searching for the best explanation. That explanation represents reality in some way, but it is never the final answer. That means we should continue making progress.”* David Deutsch

*“There is a principle which is a bar against all information, which is proof against all argument and which cannot fail to keep man in everlasting ignorance. That principle is condemnation before investigation.”* Edmund Spencer

So... let us investigate and re-visit the principles of value investing, and search for the best explanation. This will also provide Lucri friends with the opportunity to evaluate the Lucri investment philosophy critically☺.

## The principles of value investing (Acknowledgement to Piet Viljoen from RECM)

- Keep an open mind – avoid dogmatic thinking.
- All investing is value investing – growth and value are joined at the hip. Growth and value are not mutually exclusive, as growth creates value.
- The driving forces for undervalued assets have remained constant for the last century and longer:
  - a. Extrapolating depressed conditions
  - b. Underestimating future potential
  - c. Forced selling due to leverage
  - d. Excessive selling due to fear
  - e. Neglect due to negative emotions or impatience
  - f. Lack of recognition for a valuable business model
- Low returns reduce business investment (read competition), increasing prospective returns, and vice versa.
- Scarcity is valuable. Navigate uncharted waters, where few others fish. Fish where the fish are.

## A brief history of investing over the past century (plus an admission of guilt)

- Early in the twentieth century, it was difficult to get hold of data, information and charts.
- Stocks were seen as gambles, and bonds were the only investment seen as fit for purpose.
- Graham and Dodd published “Security Analysis” in 1934. Their insight was that equities could be safe investments. You just had to buy stocks that were really cheap – very few made the effort of getting fundamental value information. A low PE and low price to book were the revolutionary metrics. Warren Buffett made tons of money on so-called “cigar butt” equities.

- 30 years later, cheap stocks were rare. The nifty-fifty growth stock craze took off, and collapsed spectacularly. Value investors hardened their dogma that one should not pay up for growth.
- Charlie Munger then came with the insight that certain businesses had sustainable barriers to entry, and one could expect those companies to grow profits at a high rate for a long time. The revolutionary metrics change to “moat” and “return on equity”.
- In the run-up to the millennium, growth stocks became popular again and internet related stocks took off – this was the co-called dotcom bubble. Buying cheap stocks was out of favour. Then, the internet stocks collapsed spectacularly early into the new millennium – Buffett and Munger were heroes, as they believed tech is “too hard” to invest in.
- Then certain investors realised that the network effect combined with scale and the internet can create huge benefits. This was missed by value investors (myself included) as the market exuberance and intangible assets of internet companies reminded us of the nifty fifty era and the dotcom era. Great bonanzas for value investors normally came in periods of panic following the bursting of market bubbles. So, most value investors missed most internet-enabled businesses who were benefitting from increased scale. However, some shrewd value investors did buy FAANG stocks based on their belief that the market was underestimating future potential – which is a value investing principle.

So, how do we look at the future from here? I believe we should stick to the principles of value investing. For example, one key insight for the future, given the fantastic historical returns of the FAANG stocks, will be: “High returns attract business investment (competition), reducing prospective returns.” I would therefore fish where few others fish – one example being tobacco related companies – because low growth/returns reduce investment (competition), increasing prospective returns while neglect due to negative emotions and extrapolation of depressed conditions have created very attractive entry points. These are all principles of value investing. (Please refer to newsletter 28 for a discussion on British American Tobacco.)

In newsletter 28, I asked: “*Now, how would you like to receive the BTI investment totally for free as part of an investment portfolio where you only pay for the non-BTI portion of the portfolio?*” I hope regular readers of the Lucri newsletter could get to the secret right away (some succeeded) – yes, I am talking about an investment that was mentioned many times in the past, namely Reinet, from the Rupert stable.

### **Reinet – where you pay negative portfolio fees**

As I have written extensively on Reinet in the past, and I really do not want to bore you with repetition, I shall try to introduce you to a different angle of Reinet this time around.

You know by now how devastating the effect of the portfolio management fees charged by many portfolio managers can be to the long term growth potential of your

investment. In the past, we have discussed “cost can kill” and tried to sensitise you to the effect of a regular annual management fee of 1.5% for example - taking mathematical short cuts, we can show that eliminating a 1.5% fee will add 56% to your portfolio over a period of 30 years:  $(1.015)^{30} = 1.56$

Now, if you can do even better, and get a NEGATIVE fee of 3.7% each year (there is a payment of 3.7% from external sources into your portfolio each year), you can add another factor of  $(1.037)^{30} = 2.97$  over 30 years! So, the difference between paying 1.5% per year and getting 3.7% per year is staggering: It is  $1.56 \times 2.97 = 4.64$  – which translates into 364% in addition. Putting it differently: Investor A pays 1.5% portfolio fees over 30 years and have a total portfolio of R 10 000 at the end of the period. Investor B invests identical amounts at identical time intervals compared to investor A, and enjoys identical investment growth, but he gets 3.7% per year into the portfolio from external sources and avoid paying any fees. Investor B will then have R 46 396 at the end of the period.

Now – how on earth is it possible to pay a negative portfolio fee? In the case of Reinet, it helps to know that Reinet is an investment holding company with two major components in its portfolio – British American Tobacco and an international portfolio of investments that nowadays consists mainly of Pension Insurance Corporation – a British insurance company that manages and insures pension payments on behalf of many pension funds.

On 8 July 2021 (this is not a special day, I could have picked any day over several months) the SOTP (*sum of the parts, where you just add the value of the underlying investments*) of Reinet was as follows: R165 of BTI shares and R 328 worth of the international portfolio to reach R 493 for each share of Reinet. On that day, Reinet traded for R279 each – also nothing special, this was close to the prevailing price range for many weeks. So, we can reach the following conclusions:

- Reinet need to increase by 77% in price to reach its own SOTP value – this is already a strong margin of safety
- You pay R 279 to receive a R 328 international portfolio – at a discount of 15% - which is reasonable value
- AND on top of this discount, you receive R 165 of BTI shares for free
- As the BTI portion of the Reinet portfolio pays a dividend amounting to 4.7% of the Reinet price and Reinet charges about 1% as a management fee, you in effect receives a 3.7% bonanza every year from an external source, namely BTI. I see it as external, as it is my argument or assumption that I have not paid for it when I bought Reinet – do you follow my line of thinking?

Now, obviously, you surely are able to think for yourself and you may reach a different conclusion – you are most welcome to do so. But I think I have stated my case that, in the highly likely event that the investment performance of Reinet in the international portfolio will be roughly equal to another active investment where I will pay a fee of 1.5% every year, I have a high probability of beating this other investment by 364% over a 30 year period. I rest my case 😊.

**Newsletter nr 19: “Lowest risk stock investment in the world”**

I shall be the first to acknowledge that I certainly still have much to learn about investment, and that I do get some investments wrong. To indicate that Lucri are learning, I want to refer you to newsletter nr 19, especially the following: *“My analyses indicates that Berkshire Hathaway will most likely achieve compound growth of 10% in dollar terms over long periods in the future. So, a rand investment in Berkshire should yield about 13% compounded growth on average at the lowest risk available.”*

I started analysing this prediction shortly thereafter, from 1 May 2019, and updated the numbers every month. The result at the start of this month, 1 October 2021, looked as follows: Berkshire should have appreciated from \$216 to \$272, and the rand should have weakened from R14.3/\$ to R15.36/\$. The real world numbers were \$277.29 (versus \$272) and R15.13/\$ (versus R15.36). If you multiply the two numbers to get to the Berkshire price in rand, you find that the prediction was for Berkshire to be at R 4183 while the real world number was at R 4195. Impressive?

No, I think you are smart enough to spot the flaw in presenting the end number only. The correct question will be: How widely did the two numbers fluctuate around the prediction in the period from 1 May 2019 to 1 October 2021? When you look closer, you will find that the Berkshire price fluctuated between \$177 and \$289. The rand fluctuated between R18.68/\$ and R13.77/\$. So, the Berkshire price in rand also fluctuated wildly, but it is interesting to note that the two numbers, namely the dollar price of Berkshire and the Rand to dollar exchange rate, almost always moved in opposite directions, keeping the rand price of Berkshire close to the rand price prediction MOST of the time. Now, you can spot the buying opportunity here: If the rand price of Berkshire adheres to the prediction MOST of the time, surely the odds are in the investor’s favour for the small window in time when the rand price of Berkshire deviates momentarily from this prediction?

Well, so far so good: Lucri bought Berkshire on each such occurrence (until now, the deviation was downwards each time), resulting in quick recovery back towards the predicted price. The probability clearly was in my favour at each buying opportunity. I believe this helped Lucri to lower the risk even further, buying the “lowest risk stock investment” at specific points in time when the rand price dropped significantly from a predicted price, given that the predicted price was accurate most of the time.

### **The Lazy portfolio**

Three years ago, I constructed a concentrated portfolio on certain principles to hold for a 10 year period – please refer to newsletter 17. We are now 30% into the time period – or to stay with the Comrades marathon analogy, we have covered 30% of the full distance.

On 22 October 2021, the value of the original R 100 000 investment had grown to R131 489, a growth of 31% in rand terms over three years versus inflation of 12.6% in South Africa over the identical period.

Name	Rand price	Share count	Dividends Cumulative	Rand value 22/10/2021	Rand value 23/10/2018
Berkshire B	4295.21	11.80104	0	50688	35000
Anheuser Bush	831.08	12.56881	754.28	11200	15000
Naspers	2665	9.20515	163.44	24695	25000
Multichoice	123.57	9.20515	104	1241	0
Prosus	1352.54	9.20515	20.97	12471	0
Reinet	284.18	105.50749	1210.61	31194	25000
			Total:	<b>131489</b>	<b>100000</b>

It has become the custom to compare the lazy portfolio with the all share index of the JSE, the S & P 500 index in the USA (expressed in rand), and inflation in the RSA:

	23 Oct 2018	22 Oct 2021	Dividend index total	Rand value	Dividend %
All share index RSA	51500	67050	6726	143254	4.1%
S & P 500 dollars	2755.9	4545			
S & P 500 rand	39640	67491	2562	176723	1.25%
RSA inflation index	108.9	122.6	0	112580	

At this stage, with 30% of the road covered, the lazy portfolio is running in the third position, 8% behind the RSA all share index. The S&P 500 is now taking the lead in two consecutive years, but the low dividend % of the index signals that this athlete may just be running too hard this early in the race – time will tell.

The all share index of the RSA has recovered strongly from a year ago to take the second position. The dividend % of 4.1% signals on the surface that this index has legs to run.....but, please look again at my warning about the commodity value trap early in this newsletter.

Also, it is worth noting that in the Lazy portfolio, Naspers (including the Multichoice and Prosus off-spring) is still the best performer (R 38 407 versus R 25 000 invested, 53% growth), even after the market losses of Tencent in China. I think most readers will know about the negative effect of regulation by the Chinese Communist Party on the listed prices of technology companies like Tencent and Alibaba, to name a few. It is also clear that Berkshire is performing stronger as each year passes – using marathon analogy again, Naspers is hearing the steady footsteps of Berkshire as the distance between them closes with each step.....

The weakest performer at this point in time is the RSA inflation index – but this may be signalling that inflation is not being measured accurately. This is a discussion for another day (another newsletter).

## **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](mailto:streicher.simonj@gmail.com), I promise to answer in a few days.

Kind regards and Reinet investing,

Simon Streicher