

LUCRI ALPHA NEWSLETTER NR 31

18 April 2022

Dear Lucri friends,

In this newsletter we shall re-visit Freddy Fiat and Pat Productive and check on their investment progress one year later. We shall look at the increasing success of value investing versus other investment styles that also partly explains the positive feedback that I am sharing from the Lucri year-end.

Later in the letter we are dissecting a quote from Charlie Munger to unlock some of the hidden wisdom.

On a lighter note

Life through John's eyes.....

John: "I really have a very nice boss."

John's friend: "Why do you think so?"

John: "Well, I was tired so I called him early this morning and asked if I could come in a little late. He then gave such a considerate and positive response."

John's friend: "What did he say?"

John: "He immediately replied: Dream on."

The Afrikaans speaking son asks his father (in Afrikaans, translated): "Why do I need to learn English?"

His wise father replied: "Well, my son, let me explain it to you in detail: You are attending a party and you spot this gorgeous English girl. You immediately find her highly attractive. So, you almost fainted when she walks up to you and whispers in your ear: "You're cool." And what is your eager reaction? "You are not so hot either!"

This embarrassing disaster could have ended quite differently, but unfortunately you earlier resisted learning the English language."

The son replied in English: "Teach me! Please teach me!"

Quotes

"True investors can exploit the recurrent excessive optimism and excessive apprehension of the speculative public." Benjamin Graham (the father of value investing)

The same message as above, just with a bit of humour added:

"The stock market is the only market where things go on sale and the customers run out of the store." Cullen Roche

"A team can reach almost any goal if the team members are not too concerned about who gets the credit." Charlie Munger

“Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. Risk is the probability that this objective will not be attained.” Warren Buffett

The following quote is a reminder that no-one can tell you when market declines will occur:

“We spend a lot of time looking for systemic risk; in truth, however, it tends to find us.” Meg McConnell (New York Fed)

“It’s said that hard work never killed anyone, but I say why take the chance?” Ronald Reagan

“It is easier to mislead someone than to convince them that they have been misled.” Mark Twain

Continual learning

“Be a life-long learning machine” Charlie Munger

Lucri is serious about the idea of continual learning. For example, Lucri has learned that one red light starts burning brightly when the debt of a company exceeds 50% of the equity value of that company.

Also, when the management of a company is arranging repeated new stock issues, one red light is switched on.

But – when both occurs – high debt and repeated new stock issues, a massive signpost is fired up with bold red letters that shouts: STAY AWAY!

While on this topic of learning, we can ponder the following wisdom that was shared in a presentation by Charlie Munger: *“Determine value apart from price; progress apart from activity; wealth apart from size.”*

Freddy Fiat and Pat Productive

One year ago, in newsletter nr 27, Lucri friends were introduced to Freddy Fiat and Pat Productive. You may recall that Freddy only invests in fixed deposits, while Pat only invests in productive assets, the third type of investment described one year ago under the heading “The three basic types of investment.”

It was mentioned that we shall re-visit the investments of Pat and Freddy every year in April to compare the results on yield and capital.

We need to look at two quotes from that newsletter:

Quote 1: *“Lucri expects the investment portfolio to beat the fixed deposit comfortably over the next ten years on the total investment result (capital plus yield).”*

Quote 2: *“Even on a cash flow basis excluding capital growth, the Lucri portfolio is expected to be a worthy competitor”*

It is now roughly one year later. Pat Productive converted R 100 001 to an initial portfolio valued at R 99 040.63 after broker fees. The portfolio can now be summarised as follows:

| Name | Share count | Initial price per share in cent | Initial value (Rand) | Dividend received past year (Rand) | End price per share in cent | End value dividend included (Rand) |
|--------------------------|--------------------|--|-----------------------------|---|------------------------------------|---|
| British American Tobacco | 92 | 53510 | 49229.20 | 4065.48 | 62623 | 61679 |
| Lewis | 411 | 3037 | 12482.07 | 1602.9 | 4670 | 20797 |
| Nuworld | 417 | 2996 | 12493.32 | 1038.33 | 3250 | 14591 |
| Coronation | 228 | 5468 | 12467.04 | 1071.60 | 4299 | 10873 |
| Indluplace | 3100 | 399 | 12369.00 | 871.10 | 315 | 10636 |
| TOTAL | | | 99040.63 | 8649.41 | | 118575 |

It is clear that investment in productive assets is not always plain sailing without volatility. Two of the five investments produced negative returns even after taking dividends into account. The complete portfolio, however, produced satisfactory growth.

Freddy Fiat invested the R 100 001 in a fixed deposit at Absa, earning 4.75% interest. This was the highest interest rate available for amounts more than R 100 000 and for a period of one year. This resulted in a total amount of R 104 751.10 today.

Referring to quote one, we should compare the R118 575 of Pat Productive to the R104 751.10 of Freddy Fiat. After the first year, Pat is comfortably ahead. We should re-evaluate again in one year's time.

Referring to quote two, we should compare the R8649 of Pat Productive to the R4750 of Freddy Fiat. Also on a pure cash flow basis, the dividend income is outperforming the interest received. You will recall that tax charges will be ignored for both investors in the comparison – but normally interest can be taxed heavily above the allowed threshold, while dividends will be taxed at a 20% flat rate. So, even after subtracting 20% tax, the after tax cash income of Pat is beating the before tax cash income of Freddy.

Freddy checks with Absa, and is quite glad to learn that he can re-invest the R104751.10 at an increased interest rate of 6% for the next year. He immediately invest in a one year fixed deposit.

Pat decides to keep his portfolio basically unchanged, but to invest the total dividend of R 8649 into Nuworld at 3250 cent each. After broker fees, he buys 263.57 additional Nuworld shares. His Nuworld share count therefore increases from 417 to 680.57.

The new portfolio therefore looks as follows:

92 British American Tobacco

411 Lewis

680.57 Nuworld

228 Coronation

3100 Indluplace

Glamour growth darlings: End of the bubbly time?

Over the past decade, it was difficult for value investors to out-perform the market. Internet based companies and other popular growth stocks were growing rapidly, reaching high price to earnings multiples and valuations. After a few years of fast growth, the market value of these fast growers accounted for a significant portion of the total market value. The market index was therefore driven by these fast growers to a large extent.

This phenomenon can be tracked by following the ratio of the S & P 500 index to the price of a large value based company like Berkshire Hathaway that behaves like a value based share index. This ratio increased over many years to reach a peak in June 2020. Since then, the ratio decreased by 8.6% over an 18 month period towards the end of 2021. Since the start of 2022, the ratio decreased by a further 18.9% over a period of four months to April 2022.

This is a clear signal that value investing is getting relatively stronger opposite other investment styles.

Feedback from the Lucri year-end

Over 2021/2022, from 1 March 2021 to 28 Feb 2022, 68 out of 84 portfolios created positive alpha, representing an 81% success rate. This compares favourably to the 23% success rate of the previous year. One explanation can be found in the discussion above, as Lucri utilises a pure value investing style. Also, after strong market growth, the market tends to grow slower from the higher base – this was the case over the past year. Lucri is grateful for the results of the past year, but need to warn against too high expectations for the new investment year. Careful optimism will be in order.

Charlie's quote dissected

I thought it may be of value to Lucri friends if I take a quote from Charlie Munger and then analyse and explain the quote as I understand it. It is quite possible that you may understand it differently or may want to add your own interpretation – I am well aware of the fact that I am not the only investor that studies the mind of Charlie Munger.

“Our experience tends to confirm a long-held notion that being PREPARED, on a FEW OCCASIONS in a lifetime, to ACT PROMPTLY IN SCALE, in doing some SIMPLE and LOGICAL thing, will often DRAMATICALLY IMPROVE the financial results of that lifetime. A FEW MAJOR OPPORTUNITIES, CLEARLY

RECOGNIZABLE as such, will usually come to one who CONTINUOUSLY SEARCHES and WAITS, with a CURIOUS MIND that loves DIAGNOSIS involving MULTIPLE VARIABLES. And then all that is required is a willingness to BET HEAVILY when the ODDS are EXTREMELY FAVOURABLE, using RESOURCES available as a result of PRUDENCE and PATIENCE in the past.”

I think most readers will agree with me that this is quite a mouth full. The quotes from Charlie are loaded with wisdom to the brim. Let us now try to dissect it into smaller chunks by using the words in capital letters. I shall endeavour to add my own understanding, gained from other teachings by Warren Buffett and Charlie Munger:

prepared – opportunities comes to the prepared mind, opportunities can only be identified by those who are prepared. Prepare yourself mentally and accumulate cash resources by underspending your income.

few occasions – transact infrequently. Stay inactive for long periods of time. Do not trade just because it is easy and possible.

act promptly – you must recognize the opportunity and act with conviction. When you decide to act, do it without delay, do not procrastinate.

in scale – go in boots and all – you must take a really big bite.

simple – great opportunities are very often straight forward – you do not need a complicated mathematical model.

logical – be rational, without any emotions influencing you. See the world the way it is, not as you like it to be or hope it to be.

dramatically improve – it will make all the difference.

few major opportunities – high quality opportunities are scarce, like precious stones.

clearly recognizable – the benefits must be in your face, they should scream at you – it must be clear and obvious.

continuously searches – you must have a long attention span, covering 50 years or more. Be mentally present all the time.

waits – do nothing for 90% of the time, this is the difficult part. Resist the human bias to act.

curious mind – you must have a desire to understand how the world works.

diagnosis – frequently ask why and try to get to the bottom of events – develop a broad understanding.

multiple variables – use a wide range of mental models and only focus on important, knowable information.

bet heavily – you must have the power of your conviction, when all indicators are shining brightly green, you climb in boots and all.

odds extremely favourable – you must be sure, the probability for success must be very high. The possible future outcomes must be in a narrow band, all significantly above average.

resources – use your own resources, do not borrow.

prudence – underspend your income, delay gratification.

patience – do not jump at the first opportunity. The stock market is a mechanism that moves wealth from the active to the patient.

I hope this analysis sheds more light on the loads of wisdom in Charlie's mind – his quotes deserves to be read carefully, and the reading should be followed by thorough, deep thinking.

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 Munger investing,

Simon Streicher