# *Selected Past Buzzes*

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# Contents

# Selected Buzzes

## Introduction

The purpose of this section is to gather ideas from various sources to improve your understanding of portfolio management.

### Retirement Planning

Some basic questions one should ask when preparing a retirement plan are:

1. How long will you live? You can't afford to live too long or you will become a burden on society! Smoking, a poor diet and a lack of exercise will come in handy here.
2. When will you retire? Can you really afford to take early retirement?
3. What investment returns will you generate? Your best investment is the skills you possess: don't lose your income earning capacity!
4. What will inflation be?
5. What are your expenses? Keep your costs down; you don't really need that flashy car, do you?

### Know When to Sell

The mistake investors often make is not knowing when to sell. Here are some pointers:

1. Forget what you paid for the shares. The question is, would you pay today's price to buy the shares.
2. Be alert to fundamental shifts; i.e. recognise when the story has changed.
3. Check the fundamentals. A fall in the price of a share does not mean that the share has lost real value.
4. Ignore the day to day swings in the share price. Technical analysis should not replace fundamentals if you are long-term investor.
5. Consider the tax benefits of taking a loss. If you have built up a tax gain, you could reduce the CGT by realising a tax loss (sell at the present price and buy back at the lower price) more than 45 days later.
6. Consider selling down gradually (the opposite of Rand cost averaging).
7. Don't look back when you sell a share. You have not made a loss when the price rises after you have sold it.

### The Power of Focus

I have read many a book on personal management but "The power of focus" by Canfield, Hansen and Hewitt must rank in the top best three I have ever read. Here are the ideas I got from it – to get the full benefit from this book read it! The ideas here are relevant to investing as well.

1. Identify habits that inhibit success, choose to change, create an action plan (affirmations) and work on changing.
2. Focus on what you are brilliant at and dump, delegate or defer other activities.
3. Develop a clear vision of what you want to achieve – specific, personal, meaningful, challenging and realistic goals that can be measured – and get your priorities right.
4. Create an optimum balance – make time to think, plan, act, learn, exercise and relax.
5. Build excellent relationships – avoid toxic people, focus on core clients and build strategic alliances.
6. Develop winning attitudes – a confident belief in yourself.
7. Ask for help when needed.
8. Consistently and persistently pursue your goal with total integrity.
9. Take decisive action – think, get facts, consider options, priority rate, visualise outcome and focus on performance.
10. Create a purpose for being and live that purpose.

### A Bunch of Loonies

"Pension plans can overlay an equity market-neutral fund with equity index futures to create a synthetic long equity portfolio. To the extent that the hedge-fund component outperforms its funding cost, the alphas may be transferred back to a long-only equity portfolio via derivatives. In theory, one can reverse this process to form a pseudo hedge fund; that is, an equity long-only manger's alpha over an equity index can be transferred back to an absolute return fund by shorting equity futures." Can you just imagine the fees they charge for this insanity?

### Stock Picks

I found the following comment in Finance Week, 26 November 1999, page 44: "PSG Online dealer Willie Greenen says that now is the time investors should be going for blue chips such as Dimension Data, Datatec, Comparex and Old Mutual." Had "investors" taken this advice they would have lost 90% of their money on the three IT shares recommended at the time of writing!

### Index Tracking

Index-trackers in the US outperform roughly 60% of active managers, mainly because of their lower costs. After adjusting for risk, only a handful of active managers beat the index. And, they do not seem to be able to repeat this feat in the next period. For active managers to win:

1. Markets need to be inefficient.
2. They (the managers) need superior skills.
3. Their fees need to be low.
4. There should be little competition for the same investments.

Clearly, active management is a no win situation. So what is the solution, index tracking? Vanguard, the US index-tracking giant, has worked out that its total costs are 3.1% p.a. (R100 000 invested at 12% p.a. for 30 years = R3.0 million. At 8.9% p.a. it comes to R1.3 million. Who wins with tracking? You get R1.3 million and the tracker company gets R1.7 million. So what is the solution? Intelligent DIY investing!

## Some Guru Investment Advice

1. The unthinkable can always happen and you have to run your affairs accordingly. Survival in this game begins with humility. (Peter Bernstein)
2. Look at every stock as part of a business rather than things that go up and down. Have the right attitude to fluctuations. Prosper from the actions of the business rather than from the actions of the stock over the short term. The Investment Professionals Industry is the only industry I know where the professional's efforts subtract value from what the layman can do himself. (Warren Buffett) (Don't you just love this man?)
3. Focus on long term investment and not on short-term speculation. Base the assessment on a steady, sophisticated enlightened, analytical approach rather than on the public appraisal of the price of the share. (Jack Bogle)

## The Madness of Crowds

Sir Isaac Newton said that he could predict the motion of planets but not the madness of crowds. The market emotion cycle goes something like this: Optimism, excitement, thrill, euphoria (peak) anxiety, denial, fear, depression, panic, capitulation despondency (trough) depression, hope, relief, optimism (go to start).

## Maverick Risk

Maverick risk is the risk of being wrong and alone. When agents invest other people's money, it is more acceptable to fail conventionally than to succeed unconventionally. A contrarian view is not accepted until it has been shown to be correct and has, therefore lost its relevance. It is easier to tell people what they want to hear, even if it is wrong, than to tell people what they do not want to hear.

## Behavioral Aspects of Investing

1. Cognitive bias is the tendency of intelligent, well-informed people to do the wrong thing.
2. Attention grabbing stocks do not outperform the market.
3. A stock is not necessarily a good buy just because the company is sound. The price of the stock may be inflated.
4. Familiarity bias is where we believe that things that are familiar to us are better and less risky – this is why so many people put so much of their money into the stock of the company they work for, e.g. the staff of Enron.
5. We tend to hold onto loss making shares as we do not want to admit that we made a mistake.
6. We tend not to like boring companies when they can be sound investments.
7. We tend to be overconfident in our decisions (overconfidence bias).
8. We focus on information that confirms our beliefs and ignore inconsistent information (confirmation bias).
9. We tend to place too much emphasis on similarities (representative bias).
10. We tend to anchor estimates to salient numbers even if the figures have little or no relevance to the estimates (anchoring bias).

## The Cost of Outsourcing

The total sum of all the advisory fees, marketing expenditures, sales commissions, brokerage commissions, transaction costs, custody and legal fees and securities processing expenses come to $300 billion a year in the US. This is nearly 3% of the total capitalised market value of $12 trillion. So the mutual fund industry confiscates nearly 50% of the historical real rate of return earned on the market. (It would be interesting to compare this in RSA where we do not have the same economy of scale as in the US.)

## Tiger 21 (The Source of Hedgehog)

Tiger 21 is a fascinating idea! A group called The Investment Group for Enhanced Results was formed. They meet periodically to dissect and deconstruct the investment portfolios of the members of the group. They are highly critical of each other, have fun but importantly pool knowledge for enhancing their investments. Some of the ideas that were thrown about when Fortune attended one of the meetings were:

1. Why is your portfolio so complicated? Get rid of the small stuff.
2. Are you trying to be a portfolio equity manager?
3. Why don't you have any real estate in your portfolio?
4. Why don't you think about opening your own business?
5. What are you really looking for in life?

This is not an investment club where each person puts in money and watches ten other clowns vote to invest it in rubbish. It is also not handing your investments over to someone who has their own interests at heart, e.g. churn to generate brokerage income. It is a pooling of knowledge to help each other make better investment decisions.

## Extracts from "How Companies Lie"

"The odds in Las Vegas and the odds of making money by investing in companies have two major differences. In Las Vegas, one can compute the odds of winning or losing. These days, the way publicly traded companies are behaving, you cannot. The dealers usually do not insert or remove a couple of aces during the game, but on Wall Street and among many of the publicly traded companies, they do."

"Managed mendacity, systematically applied to the investing public, has become the new science of publicly traded corporations."

Examples given in this book are:

1. Cendant allegedly booked $500m in fictitious revenue over three years
2. Waste Management became the most frequently sued company in 1998 due to accounting scandals
3. Sunbeam shifted $231m from reserves to income
4. Global Crossing used Enron-like accounting fraud and inflated revenue

5. Tyco International was investigated for hiding debt to make revenues look better
6. The Korean unit of Lernout & Hauspie Speech Products funnelled bank loans through third parties to make it look like customers were paying for sales that never took place

If investors cannot validate the factual basis of revenue reporting, return on capital and reports of cash flows, logically they should not invest. But with all this deception and deliberate concealment, there is no way to validate all the reporting.

Warren Buffett commented that if he could not understand an annual report, perhaps the company did not intend for him to understand it.

78% of corporate financial executives said that they had been asked to use accounting rules to cast reporting in a better light and 38% had complied.

It takes moral courage to tell it like it is.

In The Continental Vending case in the US (1968) the judge ruled that adherence to GAAP did not exempt auditors from liability if the court found that there was a need for further disclosures. This ruling opened the door to further litigation against auditors (71 cases in 1970, 140 in 1971 and 200 by 1972).

## Dirty Tricks

The Pension Funds' Adjudicator, Mr Vuyani Ngalwana lists ten dirty little pension fund tricks that undermine pensions:

1. Poor investment decisions resulting in poor returns.
2. Hidden costs.
3. Sneaky interest charges.
4. Incestuous relationships.
5. Funds not sticking to the spirit of the law.
6. Trustees who don't use their brains.
7. Trustees who surrender their fiduciary duties to service providers.
8. Penalties charged for pulling out.
9. Plundering the funds.
10. Employers pocketing savings for themselves.

[If you are forced to join a pension fund as part of your employment contract, see the contributions as an expense and not as an investment. Make your own provisions for your retirement.]

## The M&M Concept Debunked

Modigliani and Miller received the Nobel Prize for their assertion that the split between equity and different forms of debt and its dividend policy make no difference to the total value of the entity. [I have battled with this idea for the past 35 years! I fought many a student in the past who had this rule drilled into them by their lecturers.] The Economist says that this principle is not wrong but is only true in circumstances so rare that it is the exception rather than the rule and says that structure does affect the value of the firm. [When I was merchant banking we structured companies to increase shareholder wealth.] The Economist says that this idea set back the study by economists of corporate finance for a generation.

## Precious Wisdom

Mr Laurie Dippenaar, gives us some of his precious wisdom regarding investments:

1. Think long term, not short term
2. Buy and hold – churning undermines wealth
3. Do not hold poor assets for the sake of diversification
4. Invest in what you understand – a solid Warren Buffett principle
5. The market does not talk, it is there to serve us, not to instruct us
6. Avoid investing in companies if you do not trust the management – watch for creative accounting tricks
7. Invest in companies that are owner managed where the management is passionate about the business
8. Value the shares as you would value a business – my valuation models are based on this philosophy
9. Buy on fundamentals, not on technical movements – act rationally
10. Avoid investments that don't pay dividends
11. Focus on a few good ideas, do not spread yourself too thinly
12. Ridicule fads

## Pearls of Wisdom from WB

1. When being presented with growth rates achieved, be wary of the start point and the terminal points for calculating the growth. Spectacular growth can be achieved if the start points and terminal points are carefully chosen.
2. When a company issues its own shares to acquire assets what it is really doing is to give away part of what the existing shareholders own.
3. Be nervous about derivatives: they are little understood and pose a serious threat to the global financial system.
4. Buy companies that have as their goal customer satisfaction rather than shareholder satisfaction. If you treat your customers with indifference your business will wither.
5. Try to buy businesses that do not require huge capex and can price in inflationary increases.
6. It is dangerous to project high growth rates. Not many companies can exceed 10% p.a. for any length of time.
7. The problem with derivatives is that people do not think of the consequences of the consequences.
8. Investing does not require enormous intellect. It requires enormous discipline.
9. Diversification is madness. The best way to minimise risk is to think. (Why then is his portfolio so well diversified?)
10. Using brokers to advise you today is equivalent to kings in ancient times using fortune tellers. You will get the same result.
11. EVA is one of many fads used by companies (as an excuse for thinking!).

12. Calculate all variables fairly conservatively and then make a provision for a margin of safety.
13. Some people are very stupid when they know something is wrong but do it anyway.
14. Stock buy backs are often motivated by management wanting to increase the price of the shares.
15. Investing is a life-long game. You keep learning. The two most important ingredients are temperament and common sense.

## Absolute Return Myth

A brilliant article written by M Barton Waring and Laurence B Siegel considers the myth of the absolute-return investor. This article helped me clarify my thinking on beta and alpha. Please read on: it will crystallise your thinking as well. Here is a summary of the points made:

1. The return on any portfolio consists of a market part and a non-market part. In the jargon of finance the market part is called "beta" and the non-market part is called "alpha".
2. The beta part results from the exposure to market returns.
3. Any portfolio's return has a beta component and an alpha component.
4. To achieve a beta return requires no skill and one should not pay an asset manager for producing such returns – you can do this yourself.
5. To achieve an alpha return (a return in excess of the market) requires unusual skill and is expensive to achieve. It is unlikely that the cost of producing an alpha return would be less than the alpha return.
6. Most investors will have a benchmark that they want to achieve. Such investors are relative-return investors. The only way that value can be added to such a portfolio is to add alpha.
7. The concept of a hedge fund is that it earns no beta return, i.e. its returns are not relative to some benchmark. It's goal is to only earn an alpha return, i.e. a return that is unrelated to the market.
8. Investors who believe that managers can earn absolute returns either believe in magic or they believe that these managers have super-human skills. Do not be taken in by the media hype that absolute returns will beat relative returns.
9. In a perfectly efficient market the expectation for manager alpha is zero.
10. Beating the benchmark is the only thing worth paying high fees to achieve. [But will the additional return compensate for the high fees?]

## Messaging Earnings

Of 401 companies surveyed in the US, 78% stated that they would reduce spending on research and development, maintenance, advertising and other discretionary areas to manage profit. Another 55% stated that they would delay starting a new project. Booking revenues in advance and postponing taking expenses were other favoured activities. Managers felt that they had a duty to manage earnings. The survey found that earnings received three times the ranking of revenue and cash flow as a measure of value. Analysts need to focus on the areas that give management most opportunity to manage earnings such as inventory valuation, provision for doubtful debts, pension fund accounting and depreciation rates [not mentioned]. Those who focus on the cash flows are probably not aware of how easy it is to manipulate this statement, e.g.:

1. Stretch out payables
2. Getting a financial institution to pay vendors and then paying them back later
3. Securitising debtors
4. Buying shares to fund staff options (not shown as operating cash flows)

In a book "How to Detect Accounting Gimmicks and Fraud in Financial Reports, Howard Schilit identifies seven broad areas where companies are likely to manipulate their numbers:

1. Recording revenue too soon or of questionable quality
2. Recording bogus revenue
3. Boosting income with one-time gains
4. Shifting current revenue to a later period
5. Shifting expenses to a later or earlier period
6. Failing to record or improperly reducing liabilities
7. Shifting future expenses to the current period as a special charge

Here are some other things to watch for:

1. Deferred tax: If they are not paying real taxes, maybe they are not making real profits.
2. Sale and leasebacks to generate profit on sale of assets.
3. Changes in focus in presenting the results – they may be trying to hide something.
4. Serial acquirers – a way to grow without effort.
5. Frequent non-recurring expenditure – really recurring.
6. Taking the big bath – make profits look good in future.

Here are some ideas to avoid getting fooled:

1. Become familiar with the company's business so you can anticipate trends.
2. Speak with people who have the answers.
3. Focus full concentrated energy in understanding the financial statements.
4. Ask tough questions at the presentation of the results of the company.
5. Nurture a curiosity about how companies work.
6. Stay alert and sceptical.
7. Do not abandon fundamentals – do reality checks on the values.
8. When you cannot understand why the stock is so pricy, time to bail.
9. Determine the portion of the value of the stock that is reliant on future growth.
10. Do not take short cuts (such as EBITDA) – have a holistic approach to analysis.
11. Free cash flow is the goal of analysis – but start with the balance sheet and the profit profile.

12. Work at it – do not be lazy.

## How to get sold a pup

Jonathan Clements gives advice in the Wall Street Journal on how not to be taken in by financial advisors. Their secret is to win your confidence and trust. This is what they do:

1. They feign friendship by asking all about you and pretending to have things in common with you.
2. They will look for your hot buttons, e.g. greed, fear, goals, etc. This is known as "putting you under ether" so that you can't think straight.
3. They will tout an investment's scarcity to make it seem more valuable. Alternatively, they will point out that the bargain price will not last. Or they will state that others are clamouring to get into the deal.
4. They may exploit your good-natured tendency to return favours by giving you something up-front, such as take you out to lunch.
5. They will then hit you with what is known as the presumptive close by suggesting a high figure and then lowering it to make you feel more comfortable.

[I was sold insurance in my first year at varsity by the maths teacher who played the above tricks on me. For something like 30 years I paid premiums of 10% of my salary. The total sum the policies will pay out when I die is less than one month's salary today.]

## Professional Method

Four different people consult four different doctors in four different countries complaining of the same symptoms. In all cases the doctors will ask the same questions, conduct a similar battery of tests and will come to the same diagnosis (appendicitis). They will most likely arrive at the same conclusion as to whether or not to operate and when they operate they will follow a similar procedure. This is called "Professional method." There is no such universally accepted professional method for establishing investment policy.

## Trust but Verify

Phillip Lawton gives the following advice to investment professionals who want to protect themselves from scoundrels. It is based on the Russian proverb that Ronald Reagan quoted in the disarmament negotiations with the former Soviet Union: "Trust but verify." When he left office he said: "It is still play, but cut the cards. It's still watch closely. And don't be afraid to see what you see." (My policy is clear: I do not trust!)

## Simple as That

The co-founder of "The Motley Fool", David Gardner, wrote an article saying that the greatest secret to investing of them all is: "Find good companies and hold those positions tenaciously over time to yield multiples upon multiples of your original investment."

## New Issues as Investments

Between 1997 and 1999 230 new companies were attracted to the JSE. More than 200 of these companies gave negative nominal capital returns and more than 110 lost more than 80% of their capital over the following four year period. Had R100 been invested in these new listings at the time, they would have been worth a mere R40 four years later. Warren Buffett says that the only day you should buy a new offering is on a day without a "y" in it. Clearly the sellers of these shares will squeeze the last cent out of these new offerings.

## Think Long Term!

Daniel Broby says:

1. The investment process is everything: it is the process that produces alpha.
2. At some point a portfolio will under-perform – you need to think long term.
3. Do not think short term – the long term strategy is what delivers results.

## Crowd Behavior

Tony Plummer says that work being done by scientists, who are mapping brain activity using sophisticated technology, have found that rational thought is impaired if emotions are high and attention is focused. In these circumstances, the subconscious mind is not able to do the job it was designed for. The result is poor decision making. However, placing people in a trance-like state makes them vulnerable to indoctrination, which triggers mindless crowd behaviour. Belonging to a group gives individuals security and relieves them of the burden of making difficult decisions. [What he is really saying is: Take a group of hypnotised zombies, indoctrinate them as to the fact that the market is going up or down, and you have crowd behaviour. Somehow you have to get all the facts and let your subconscious do the work it was cut out to do.]

## Alpha v Beta

Many investment strategies are now calling for separating the alpha returns from the beta returns. When assessing portfolios, beta is the return achieved by being in the market and alpha is the return achieved in excess of the market return due to good stock picking or luck. Many clients cull investment managers who are unable to produce alpha.

## Fund Managers

The business of fund management involves other people being given your money to look after and to get paid handsomely to do so even if they are hopeless at the job. Investors select funds on the basis of past performance even though there is little evidence that this is a good predictor of future success. The average fund manager inevitably underperforms the market. Over the past 25 years the S&P returned an average of 12,3% p.a. Over the same period the average equity mutual fund returned 10% and the average mutual fund investor earned just 7,3%.

The way performance fees are structured in this industry is resulting in a new class of billionaires. The balance between the industry and its clients will not be redressed until investors learn that higher fees do not guarantee higher returns. [The problem is that the average investor has no idea how to calculate the return made on his investments but accepts the propaganda published by the fund managers! This is why I am on a mission to help investors do it themselves.]

The alpha delivered by the average fund manager is negative **before allowing for costs**: the average fund manager is doomed to under-perform the market. Some mangers will outperform the market but it is impossible to identify them in advance.

## Peter L Bernstein and Risk

PLB defines risk as: "More things can happen than will happen." This really means that we do not know what will happen, but we need to think about it.

## Paul Samuelson on Investing

The famous economist, has this to say about investing:

1. Investing should not be fun. Fun is going to Las Vegas and getting the gambling urge out of your system.
2. If you re-think your portfolio every month you will be tempted to churn, which serves no purpose other than to reduce your wealth.
3. There is no need at the age of 50 to start changing your risk profile by going into "safer stuff".
4. Warren Buffet achieved what he did because he has a broadly diversified low-turnover fund that is shareholder oriented.

## Analysts Should Stick to the Knitting

Arjuna Sittampalam says that when activists stop protecting the shareholders and start influencing the way companies are run, they become dangerous. Such people are not qualified to run companies, but they tend to believe that their judgement is superior to that of company management. For example, they often insist that the company over-gears to increase short term profits, at the expense of long term risk.

## Returns from Financial Products

One of the benefits you get from doing our workshop is that you start questioning the returns being produced by your preservation fund, provident fund, life annuities, etc. Below is a story sent to me by one of the participants:

The asset managers in charge of our provident fund wrote a letter to us telling us that our investments yielded an effective return of 28% p.a. over the past six months. My account reflected:

| | |
|---|---|
| Opening balance at beginning of six months | R432 000 |
| Invested per month | 7 167 |
| Balance at end of six months | R520 000 |

My calculation of my return was:

| | |
|---|---|
| PV = | -432 000 |
| n = | 6 |
| PMT = | -7 167 |
| FV = | 520 000 |
| i = | 1,60254% |
| Annual effective | 21% |

One wonders what happened to the 7% p.a. that went walkies. [Different method of calculating returns.]

## Manipulating Cash Flow

There is a common belief that the statement of cash flow cannot be manipulated if it is in compliance with "GAAP". Here are some tricks used by Tyco:

1. They would acquire a subsidiary and ask management of the subsidiary to make advance payments to suppliers so that for a short period after consolidation cash flow would look good.
2. They made loans to staff and recognised them in investment activities. They then converted the loans into salaries (no cash flow) so that the salaries never hit operating cash flows! [Really ingenious!)
3. They bought customer contracts from dealers totalling $800 million, which they treated as an investment activity. When they collected the revenue from these contracts, they treated the cash flow as from operating activities.

Want some more?

1. Add back depreciation in operating cash flows and then recognise replacement of property, plant and equipment in investing activities (required by IFRS).
2. Capitalise leases. Previously, rental would have gone to reduce operating cash flows. Now repayments of lease liabilities go to reduce financing activities. And, IFRS allows one to treat interest paid as a financing activity!

And then we get the really crude one where the company debits property, plant and equipment and credits operating expenses. The "increase" in PPE is then shown as an investing activity (Worldcom).

## Effectiveness of Defined Benefit Funds

Gerhardt van Niekerk of Sasfin says that only 5% of defined benefit funds are able to meet payout expectations of their members. People expect that these funds will replace 75% of their final salary. The actual outcome is closer to 30%. He says that fund managers are not always disclosing to members the total expense ratio.

All private underwritten funds with assets exceeding R6m or contributions exceeding R350 000 p.a. now require a full audit. This adds to the costs of administering the fund. [All the more reason to do it yourself. You can be your own auditor for free.]

## A Top 10 Life Skill

Please read the following quotes six times and ensure that they are embedded into your mindset:

WK Clifford, a distinguished mathematician: "It is wrong always, everywhere, and for anyone to believe anything on insufficient evidence."

Thomas Henry Huxley, eminent biologist: "It is wrong for a man to say that he is certain of the objective truth of any proposition unless he can produce evidence which logically justifies that certainty."

## Finweek 29 May 2008's Advice

It is always fascinating to look at investment professional's predictions backwards. For example, Deanne Gordon of J P Morgan was quoted in this magazine as saying that one should avoid banks and go for Sasol, MTN, Implats, Exxaro and Murray and Roberts. Let's see how these recommendations panned out:

| Share | Price May | Price Nov | Gain/Loss |
|---|---|---|---|
| Sasol | R473.00 | R281.32 | -41% |
| MTN | R152.19 | R104.60 | -31% |
| Implats | R325.01 | R124.00 | -62% |
| Exxaro | R157.50 | R 71.40 | -55% |
| M & R | R 88.00 | R 48.90 | -44% |
| Average | | | -47% |
| Alsi | 31 841 | 21 209 | -33% |

The two banks in my portfolio performed as follows over this period

| Share | Price May | Price Nov | Gain/Loss |
|---|---|---|---|
| Absa | R85.50 | R103.50 | +21% |
| Standard | R83.10 | R86.58 | + 4% |

Conclusion? **Nobody knows nutting!**

## Stanlib's Advert

Some sound advice from Stanlib in times of turmoil:

1. Do not try to time the market.
2. Stay invested for the long term.
3. Invest in a diversified portfolio.
4. Invest on a regular basis.

## Bryan Hirsch's Wisdom

1. The desire for instant gratification is the foe of your investment strategy.
2. Wealth isn't created overnight.
3. The real art of investing (other than diversification) is to identify value before others do and then be patient. Rewards will then be reaped over the long term.
4. Forget about trying to time the market. Develop and stick to a sound investment strategy, ignore sentiment and stick to the fundamentals.

## Summary of 2008 Crash

The American consumer overspent, under-saved and piled up huge debts. The government ran unsustainable budget deficits and neglected massive trade deficits that required copious foreign financing. Politicians pressed Fannie and Freddie to heedlessly expand home ownership, distorting incentives and diminishing discipline in the mortgage markets. Banks handed out generous consumer loans and exotic mortgages of all flavours. Wall Street firms, egged on by generous compensation schemes, packaged these loans into complex products that were distributed worldwide. The rating agencies debased the AAA rating and regulators lost sight of the forest for the bark on the trees. The Fed shrugged and abetted all of this with cheap money and deregulatory bias. It all hit the fan when the consumer rolled over and began to default on the mortgages. For reasons only history will judge, Lehman Brothers was allowed to fail. This shocked the system and credit markets screeched to a halt and asset markets crashed globally. Consumers reduced spending, businesses had to scramble to reduce costs and layoffs became commonplace. And that, dear reader, is how the economy plunged into recession.

## Another Scam

When will investors learn that there are no free lunches. If you are promised wonderful returns, there is clearly something wrong. Conmen/women feed off the greed of fools. The Tannenbaum saga looks like it could go as high as R10bn or even R15bn. There is talk of this scam being used for money laundering and SARS has said that it is going to investigate those who invested in the scam for tax avoidance. "Investors" seem to be running shy. It will be interesting to see what comes out of this woodwork.

## Richard Bernsteins's Lessons

The well-known strategist of Merrill Lynch, Richard Bernstein, gave the following investment guidelines learned during his twenty year stay with the company:

1. Income is as important as capital gains.
2. Most stock market indicators don't work.
3. Investors need to have a long time horizon – day trading is based on luck.
4. Diversification does not depend on the number of assets in a portfolio but the correlation between the assets.
5. Balance sheets are more important than income statements and cash flow statements.
6. Investors should focus on GAAP accounting and not unaudited pro-forma accounting.
7. Investors should research financial history.
8. Leverage gives the illusion of wealth. Saving is wealth.

## Retirement Planning

I was approached by a family whose father had just retired with a nest-egg of R4m. He was adamant that he was not interested in investing on the JSE so approached a financial advisor who proposed various financial products, insurance policies and annuities. The annual returns fluctuated from just under 5% p.a. after tax to 9% p.a. before tax. The proposals were all made on a pre-tax basis with a comment: "You must get a tax expert to work out the tax payable on the various proposals." I would have thought that these advisors would have done an elementary course on how to calculate tax on interest income. SARS's tax booklet is all you need for this calculation.

He needed a monthly income of R18 000 p.a. after tax. Based on these proposals, he would be fine for the first five to ten years and then he would have to consider moving to a nice little plot in Reitz or Heilbron.

I find it fascinating that old people will not invest on the JSE but will give their money to institutions who, guess what, invest on the JSE. It is like someone refusing to eat fresh meat but will happily eat bully-beef out of a can.

## A Lesson Learnt

In retrospect, could we have seen the 2008 crash coming? On 30 June 2008 I popped over to my 93 year-old friend Gilbert and advised him that, being a short term investor (he had dying on his mind) he should get out of the market. The index on that day was 30 413. He took my advice and immediately sold all his shares. Here is what he received for the shares after selling expenses compared to the values on 28 February 2009:

| Share | Sold for | 28 Feb 2009 | Fall in Price |
|---|---|---|---|
| Resources | | | |
| Anglo | 538.16 | 141.28 | -74% |
| Billiton | 293.83 | 156.40 | -47% |
| Exxaro | 139.39 | 67.50 | -52% |
| Kumba | 317.40 | 161.00 | -49% |
| Implats | 318.71 | 118.59 | -63% |
| Sasol | 463.90 | 252.00 | -46% |
| Financials | | | |
| Standard | 73.16 | 65.00 | -11% |
| First Rand | 13.02 | 12.05 | -7% |
| Discovery | 20.58 | 24.15 | 17% |
| Lib Hold | 219.15 | 63.99 | -71% |
| Metropolitan | 10.75 | 10.92 | 2% |
| Lib Int | 130.48 | 48.00 | -63% |
| Industrials | | | |
| AECI | 62.23 | 43.99 | -29% |
| Astral | 88.81 | 87.35 | -2% |
| Aveng | 56.47 | 25.75 | -54% |
| AVI | 12.93 | 16.30 | 26% |
| Barlows | 79.88 | 30.19 | -62% |
| Bidvest | 96.79 | 83.00 | -14% |
| Freeworld | 6.87 | 9.69 | 41% |
| Mittal | 226.70 | 73.95 | -67% |
| PPC | 28.99 | 29.70 | 2% |
| Reunert | 48.80 | 37.24 | -24% |
| SAB | 161.95 | 144.00 | -11% |
| Spar | 47.94 | 53.29 | 11% |
| Tiger | 140.24 | 126.50 | -10% |

The total proceeds came to R4,2m. Had the portfolio been liquidated on 28 February 2009 it would have realised R2,5m after selling expenses but before dividends received in the interim. In August (the index had fallen to 27 000) I asked him how he felt about being out of the market. He said: "I am sad as I lost my only hobby." He died in October. This was when I vowed never to give financial advice again.

## Jack Ciesielski's Important Indicators

Jack Ciesielski lists some important things to watch for when analysing annual financial statements:

1. Defined benefit pension obligations – with the market downturn, the company may be heavily exposed to such liabilities.
2. Security valuations – identify the basis used for such valuations and how gains and losses are accounted for.
3. Goodwill impairments – if the company is writing its goodwill down, it means that prospects are not looking good.
4. Off balance sheet financing.
5. Quality of revenue, e.g. accounting policies for recognition, concentration of customers, level of outstanding debtors, bad debt write-offs, discounts offered to customers, pressures on margins, stuffing the channel, method of allocation of revenue iro long term contracts, etc.
6. Deferred tax assets resulting from tax losses and how accounted for.
7. Selection of policies and estimates that could have an impact on the results.

## When to Sell

Investment managers spend most of their time developing their buy discipline and tend to neglect their sell discipline. Research has shown that selling winners too quickly resulted in a loss of 200 bps (2%) of alpha. This tendency is called the "disposition effect" and is motivated by the desire to lock in gains and avoid losses. Where funds are limited, the desire to buy the next hot stock will lead to selling winners faster.

Refusing to sell a losing stock is a common problem – investors are stubborn and unwilling to admit their mistakes, thereby allowing small losses to go unaddressed until they become serious losses.

One should abandon gut feel and do the sums – if there are better opportunities, dump the old and buy the new.

## Some Behaviors to Avoid

Investment decisions can and are affected by our emotions. Here are some ideas based on an article by Michel Pireu:

1. We tend to become distressed by making losses. This clouds our analytical process so we tend to take on more risk to avoid a loss.
2. We fear regret. If the market price of a share is below what we paid for it, understand why. If research shows that the market is not recognising the potential, buy more. If research shows that we made a mistake, learn from the mistake.
3. We tend to place too much weight on recent experiences rather than looking at the long-term.
4. We get too optimistic when the market goes up and too pessimistic when it goes down so we tend to buy high and sell low.
5. We tend to see order in situations when there is none.
6. We tend to be over-confident in areas where we have some knowledge, e.g. the staff of Enron over-exposing themselves to shares in their company.
7. We tend to trade on what we consider to be inside information when it has already been fully discounted by the market.
8. We tend to see our decisions as rational not realising that there are always two parties to a transaction.
9. We want to satisfy our egos so we tend to gamble.

10. We remember our successes and tend to want to forget our failures which means that we do not learn from them.
11. We tend to overvalue things we have "touched", e.g. if an analyst visits a company he could develop unwarranted confidence in that company.
12. We tend to have our own way of assessing value thereby missing other important inputs.

## DIY

Craig Chambers, deputy MD of Umbono Fund Managers, says that an important aspect to take into consideration when looking at active managers in SA is that they do little more than mimic indices in terms of their portfolio construction. He says that 80 listed stocks make up 96% of the top 11 managers' aggregated holdings in 2008, which is merely an index tracking fund. He posits: "If the tools are available for ordinary retail investors to track their own investments, why should they trust [and pay] the experts to manage their money. [This is what the our workshops teach you.]

## The Higher the Risk?

Many suffer from the misconception that trying to make serious money requires that one take serious risks. In fact, the converse is true. Avoiding serious loss is a precondition for sustaining a high compound rate of growth. [Please read this six times, or seven if you are a little doffer than normal, like me.]

## The Dow Jones Index

Before using an index one should understand how it is constructed. The file AA Sectors and Strata sets out the composition of the various JSE indexes we use to measure the performance of our portfolios.

The Dow was first published in 1896 and represented the average of 12 stocks from important US industries. The only survivor from this date is General Electric.

When the index was first published it was 41 arrived at by adding the prices of the shares in the index and dividing by the number of shares in the index. Subsequently, when a share was split, consolidated, etc. the divisor was adjusted.

Today the index consists of 30 of the largest and most widely held companies in the US. The index is price-weighted and not weighted based on market cap or free float, as are our indexes. The divisor at present is less than one so the index is lower than the average price of the shares in the index.

The largest one-day gain in the Dow was 15,3% on 15 March 1933, during the depression. The largest one-day drop since 1914 was on 19 October 1987 when it fell 22.6%. The third largest one-day fall was on 17 September 2001 when the market opened for the first time after the 9/11 tragedy. It fell on that day by 7.1%. By the end of that week it had fallen by 14.3%.

## Myths by Ricco Freidrich of Sanlam

Ricco (I have had the privileged of meeting him) says that there are various myths we should avoid when taking investment decisions:

1. **There is no free lunch**. He says that there is one free lunch and that is the eighth wonder of the world, compounding. He advises you get started early and save.

2. **Earnings drive share prices**. He says that, in fact, dividends do.

3. **Active managers outperform the market**. He says that this may be the case in the short term but in the long term only about 25% do. He says that what is needed is a detailed, disciplined and value-oriented approach to investing.

4. **You can make money in the long run by investing in initial public offerings**. He says that the companies that listed in 2007 and 2008 have delivered a negative 45% return.

5. **Volatility equates risk**. He says that the variability of returns tells one nothing about the business risk or the balance sheet risk of a company.

6. **Markets are efficient**. Although he admits that the market is pretty efficient, he points out that there are pockets of inefficiency in the market that can be exploited.

7. **We can accurately forecast the future**. He says that many economists, analysts and fund managers really do try but can be horribly out.

What a pleasure it is to read such wisdom from someone at the coalface. I preach every one of these ideas in my portfolio management workshops – it is nice to know that I am on the right track.

## Private Equity Investing

In an article in the Journal of Economic Perspectives, Ludovic Phalippou warns against investments in private equity. He says that fees of 7% p.a. reduce net returns below benchmark indices. He maintains that industry associations report high performance by private equity funds by over representing well-performing funds, using fair value accounting to boost returns and using measuring systems that over-rate performance. He says that expenses not immediately visible to investors include transaction fees, taxes, accounting fees, litigation, advisory and monitoring fees and directors' fees.

## PIC Scorecard

The PIC has developed a matrix to be used to score companies on a range of issues such as BBE, corporate governance, environmental sustainability and social responsibility. Mr Molefe says that the matrix would enable the corporation, which manages assets valued at more than R740bn on behalf of civil servants, to assist companies to correct underperformance and highlight shortfalls. [Surely if the PIC is looking after government employees it should be focusing on aspects such as growth in revenue, margins, gearing, returns on equity, balance sheet strength, etc. Value is created by returns, not by cosmetics.]

## Procedures v Common Sense

In 1986 a company called AES in the US operated without rules and regulations. It did not even have a defined hierarchy. Its policy was: "If we had a procedure, you'd assume we know what we were doing when we wrote it and we didn't. So figure it out and use your common sense." The company expanded at a break-neck pace, bringing electricity to remote corners of the globe. In 2000 its share price topped $70. The number of employees grew to 50 000. The company then hit a liquidity crisis and its share price fell to $1. The company has restated its financial statements no fewer than six times. AES became known as "Always Explaining Something." When the company appointed a new CFO she found that people who were previously meter readers were performing accounting functions. In 2008 the company became Sarbanes-Oxley compliant. Its share price at the time of writing is over $15. The CEO says that the company has now found a balance between doing things right and experimenting with new ideas. He says, however, that he does not want people to come up with new ideas about how to report income!

## More on WB's Investment Wisdom

1. Buy companies with excellent qualities, honest and competent people at sensible prices.
2. Stick to companies you understand.
3. Don't look back. Live from now into the future.
4. Apply a rational approach combined with the right temperament.
5. Exercise patience.
6. Be informed – determine whether the company is over or under valued.
7. The road to success is paved with wrong decisions.
8. Diversification offers protection against ignorance. (He says if you know what you are doing, you don't have to diversify.)
9. Think long term.
10. Profit from the folly of people who run away during market downturns.

## How is this for Logic?

"If your objective is to earn over 15% p.a. over the long term, why not just buy bonds giving this return?" [Show me where you find such bonds!]

## Heard this one before?

"He presented himself as an expert financial and investment advisor and I trusted him like a brother, I trusted him with my heart and soul. He convinced me to entrust more than R10m to him to invest for my advantage. He gave me the impression that he handed the investment portfolios of several doctors and my money would be safe." Need I continue? How many years of this doctor's life were spent saving R10m? This so-called expert actually stole part of the doctor's life. Had the doctor followed rule number 1 in life he would not have lost this money. What is the rule? Do not give your money to others to invest. If you want the advice of others, ensure that the investments are registered directly into your name and the advisor has no access to the cash with your stockbroker.

## How to Get Suckered

Dr Mario Smith, clinical psychologist at the University of the Western Cape, says that education does not guarantee common sense. He says that con-artists associate themselves with eminent personalities or institutions to gain the confidence of victims. And when the victims discover that they have been conned, they are too embarrassed to admit the truth so as to try to protect their reputation.

A former manager at the port in Durban was told that the spirits of his ancestors (eminent personalities) had deposited R90m in a bank account and that the cash was bewitched and would have to be cleansed. He was told to place cash in a suitcase so it could be sprinkled with special "muti powder". He was then told to open an account and place R1m in it and the ancestors would convert it to R90m. He is now suing to try to get his money back.

## Geriatric Gang

Four German pensioners are going on trial for kidnapping, gagging and driving half-way across Germany with their asset manager in the boot of their car. They were not happy with the performance of their investments!

## Extract from Moneyweb

I was sent this analysis from the website of Moneyweb. It compares the performance of general equity unit trusts in SA with the SATRIX 40. I have extended the analysis to compare it with the Alsi.

| December 2009 | 1 Yr | 3 Yrs | 5 Yrs |
|---|---|---|---|
| No. of general equity funds | 86 | 66 | 47 |
| Average return achieved | 26,6% | 4,2% | 16,5% |
| Satrix 40's return | 31,4% | 5,9% | 19,8% |
| Funds underperforming Satrix | 84% | 65% | 89% |
| Return on the Alsi | 33,4% | 6,7% | 20,3% |

## Krion's Scam

Many years ago I was running a workshop at OTK in Bethal when a young CA told me during coffee break about a wonderful investment he had made with a woman from Vereeniging (she "guaranteed" that she would quadruple his money in three years). I asked: How is she able to generate this kind of a return? He told me that she speculated in warrants (a housewife from Vereeniging can guarantee him such a return because she speculates in warrants???). It is amazing what people want to believe when greed overshadows common sense. Marietjie Prinsloo and several family members have been convicted on various charges, including racketeering, money laundering and fraud.

Remember rule 1 of investing: do not give your money to someone else to invest. If you are not capable of doing it yourself, then deal with one of the large reputable financial institutions. And if you are to do so, make sure that the cash is invested directly, i.e. do not give your cash to the intermediary to invest for you.

## Returns on New Listings

David Carte writes in Citibusiness (9 June 2010) that out of the 127 new listings in the past three years, only 11 have given a return of 10% p.a. compounded. Many have given a negative return of 90% or worse. My view on this is that unless it is your full-time job to sift through the haystack looking for the diamond needle, stay away from small caps and new listings.

## Dividends Do Count!

Modigliani and Miller asserted that a company's dividend policy is irrelevant to its share price. John D Rockefeller said that the only thing that gives him pleasure is to see his dividends coming in. This is the difference between a businessman and academics who spend their lives in their ivory towers. Dividends bring discipline to management's investment decisions. Holding onto profits may lead to excessive executive compensation, sloppy management and unproductive use of assets. The more cash a company keeps, the more likely it will overpay for acquisitions thereby destroying shareholder value. The only figure you can truly trust in a company's accounts is its dividends – you can verify them! If a company does not pay dividends, do not waste your money investing in its shares unless the dividend was temporarily suspended for a good reason.

The Dow was initiated in 1896 at 41. By the end of 1998 it had reached 9181. If dividends had been included (which I do in my statistics) the index would have been 636 000 (an annual return of 9% p.a.)! **DIVIDENDS DO COUNT**.

## Measuring Your Portfolio Performance

A few years ago during the presentation of an IFRS workshop in Durban I suggested to someone that he attend my portfolio management workshop. He told me that he did not need it as he had a "fantastic stockbroker". When I asked him what he earned on his portfolio during the previous year he said: "I have no idea." When I asked him how he knew that his stockbroker was "fantastic", he spluttered "Oh, about 15%". I informed him that the market had returned 35% that year. This was me for most of my life! I only started monitoring my investment returns in 2003 when I started our workshops.

I would guess that 95% of investors do not monitor and measure the performance of their investments. They are, for obvious reasons, positively dissuaded from doing so by their investment advisors and fund managers. And being human, it is easier to go through life in denial. I see many cases of shock and disbelief when people reach retirement age to find that they do not have enough capital on which to retire. One of the delegates at our workshops told us that 100% of the top management at his company either support their own parents or the parents of their spouse, or both. Is this what you want when you retire - for your son-in-law to support you?

## Investing a Losing Game?

This comment immediately raised my hackles as I believe that in the long term one can only win from investing on the JSE. However, I decided to continue reading the article only to find tremendous wisdom in what Peter Hupalo says in his book, i.e. one should invest like an intelligent amateur plays tennis: don't look for one big winner but aim for consistency in results. He says that the bulk of an investor's portfolio should be in high-quality larger companies bought at reasonable prices. He says such a portfolio will likely not only beat the market timer's portfolio over time but also a speculative portfolio of actively selected picks. He says one should play the game by taking advantage of long-term compounding, diversification, managing risk and controlling the urge to speculate.

## Savings not enough

Chris Blaine writes that only 6% of South Africans save enough for retirement purposes. An Old Mutual survey found that only 57% of full-time employees belong to a pension or provident fund. Half of fund members don't know who their trustees are, 85% did not vote in the election of trustees and over 60% had no idea how their funds were being invested.

## Gifts v Choices

Jeff Bezos, in his address to Princeton's class of 2010 explained the difference between gifts and choices. He said that being clever was a gift but being kind was a choice. He listed the difficult choices we need to make:

1. Be inert or follow your passions
2. Follow dogma or be original
3. A life of ease or service to others and adventure
4. Bluff it out when wrong or apologise
5. Guard against rejection or act when fall in love
6. Give up when the going gets tough or relentlessly pursue goals
7. Be clever at the expense of others or be kind

## Investing Gems

1. It is much more profitable to sell investment advice and gimmicks than to follow them. (Forbes)
2. Stocks are bought on expectations, not on facts. (Gerald Loeb)
3. Investing is not a race-horse but plough-horse. (Anon)
4. The current price of a stock crystallises all that is now knowable. (Ron Ross)
5. A vision without a plan is a hallucination. (Salome Thomas)
6. Working hard and smart does not necessarily improve investment returns. (Chandan Sengupta)
7. Don't chase the ghosts of past returns. (Anon)
8. The investment business is a giant scam: it deletes billions of dollars each year in transaction costs and fees. (Jack Meyer)
9. Every set of published accounts is based on books that have been gently cooked or completely roasted. (Ian Griffiths)
10. Market forecasters make astrologists look good. (Risk Ferri)
11. Wall Street's favourite scam is pretending that luck is skill. (Ron Ross)

## Ten Worst Crashes in US

Here is something really scary. It is a list of the ten worst market crashes in the US prior to the 2008 crash:

| No. | Fall | Dates | Reason |
|---|---|---|---|
| 10th | 38% | 15 Jan 2000 to 10 Sep 2002 | 1 |
| 9th | 40% | 21 Nov 1916 to 19 Dec 1917 | 2 |

| | | | |
|---|---|---|---|
| 8th | 41% | 12 Sep 1937 to 28 Apr 1942 | 3 |
| 7th | 45% | 11 Jan 1973 to 6 Dec 1974 | 4 |
| 6th | 46% | 17 Jun 1901 to 9 Nov 1903 | 5 |
| 5th | 47% | 3 Nov 1919 to 24 Aug 1921 | 6 |
| 4th | 48% | 3 Sep 1929 to 13 Nov 1929 | 7 |
| 3rd | 49% | 19 Jun 1906 to 15 Nov 1907 | 8 |
| 2nd | 49% | 10 Mar 1937 to 31 Mar 1938 | 9 |
| 1st | 86% | 17 Apr 1930 to 8 Jul 1932 | 10 |

**Reasons:**

1. Tech bubble burst
2. Beginning of the first world war
3. Attack on Pearl Harbour – world war two
4. Vietnam war and Watergate scandal
5. Severe drought in the US
6. First tech bubble
7. Start of great depression
8. Credit crunch in New York
9. Great depression, war scare and Wall Street scandals
10. Great depression (took 22 years to recover)

## Complexity Important to Earn Fees

Finance has turned the simple into the perplexing. The reason for this obsession with needless complexity is that it is far easier to charge high fees for things that sound complex. (James Montier)

## Why People Fail

Jason Zweig, in his book "Your Money and Your Brain", gives reasons as to why people fail in the investing game:

1. Not crystallising their investment goals
2. Taking bets on "sure things"
3. When markets rise, tolerance for risk falls and when markets fall tolerance for risk rises
4. Not reading the fine print in financial statements
5. Trying to be too smart
6. Frenetically jumping from one share to the next
7. Buying high and selling low
8. Really believing they can beat the market
9. Hanging onto every word said and written about the future when no one can predict it

## Some More Investing Rules

Here are some ideas from The Global Investor Book of Investing Rules by Philip Jenks and Stephen Eckett:

1. "It is easy to get a high value for a company – just underestimate the capital investment it will need to make." (Nick Anstill) [EBITDA ignores capex completely!]
2. "Treat any stockbroker who is remunerated with commission as a compulsive liar." (Simon Cawkwell)
3. "Historically, equity investors have overpaid for comfort and excitement." (Jeremy Grantham)
4. "Avoid company visits: they are usually successful promotions." (Dean LeBaron)
5. "The children or designated heirs of a great CEO are about as likely to excel as replacement CEOs as are any of Beethoven's children to write great symphonies." (Robert A G Monks)
6. "If you cannot understand it, don't buy it." (Timothy V Pick)

## Returns on Financial Products

After attending one of our portfolio management workshops, a participant (P) got hold of his father's investment with a large financial institution (a five fund product) and entered the information into our Effective Return Model. The facts were:

| | |
|---|---|
| Opening investment 30 Nov 2009 | R2 558 777 |
| Withdrew per month | R21 187 |
| Balance 30 November 2010 | R2 488 287 |

The return on this portfolio came to 7.5% p.a. compared to the Alsi return of 15.0% p.a. during the same period.

P pointed this out to his father's financial advisor (A) who then showed P "his" investment in the same product which was worth R6m on 1 January 2000 and R13m on 31 December 2010. P then entered this information into our model which calculated a return on the portfolio of 7.3% p.a. compared to 16.1% p.a. for the Alsi during the same period. On seeing this A stuttered: "No but I withdrew R300 000 p.a. from this portfolio." On entering this information P got 11.0% p.a. for the portfolio. Clearly the advisor was lying!!

You are looking at about a 7,5% negative alpha by investing in these products. R10k at 15% for 45 years (my investment history) = R5.4m. At 7.5% it comes to R260k.

## Some John Templeton Investment Rules

1. Invest – don't trade
2. Buy value, not market trends or economic outlook
3. Search for bargains in quality shares
4. Don't invest on sentiment or on a tip
5. Diversify
6. Remain flexible and open-minded
7. Don't be too fearful or negative – there will be corrections and even crashes: over time stocks go up

## Here we go again

The Sunday Times reports that monies were allegedly siphoned from pension funds managed for the South African Clothing and Textile Workers Union in loans to politically connected companies. It appears as if some of the monies found their way into exorbitant "facilitation" fees! We live in a corrupt society. I feel for those who unwittingly entrust their hard-earned savings to pension funds managed by untrustworthy individuals. Stick to the rule: Keep control of your own wealth. DO NOT GIVE YOUR HARD EARNED WEALTH TO OTHERS TO INVEST!!! Do it yourself.

## PIC's Investments

According to the Citizen, 8 September 2011, the Public Investment Corporation is to invest funds from the Government Pension Fund in education and training projects, roads, telecommunications and housing to make workers more productive. [I am sure that the returns from such "investments" will outperform the market??? I predicted that this would happen.]

## Small Caps

Research in the US suggests that thorough fundamental analysis of penny stocks will reveal no more than two or three out of every 100 examined to be potential winners. The benefit does not warrant the effort.

## Prescribed Assets

For years I have been predicting that the Government will make a grab for pension fund assets. In Business Day, 19 March 2012, the following appeared: "The discussion paper on state owned entities and development finance institutions suggests that the state should "regulate a substantial part of retirement and life assurance funds to be invested in state-owned enterprises and/or development financial institution's financial instruments." I am sure you will generate a superb positive alpha from these investments. I feel so sorry for the poor suckers out there who know no better and pile money into pension and retirement annuity funds with the promise of tax benefits. To get employees to take the bait, the government is to offer more tax allowances.

## Financial Advice

Chris Veegh and Steven Nathan say that complexity neither serves the investor nor improves the investor's returns. They say that the investment industry doesn't require advisers to support its complexity; it requires complexity to support advisers.

## Muppets – Are you one?

In case you missed the buzz about the SA guy's (Greg Smith) resignation letter to Goldman Sachs, here is the gist: He was unhappy about the attitude that the management had to its clients calling them "Muppets" and talking about "ripping eyeballs out", i.e. ripping their clients off to boost the profits of GS thereby boosting their bonuses. My only surprise is that others are surprised about what goes on behind closed doors. I have been ripped off five times in my life-time (a slow learner) – three insurance policies, an RA, my broker churning my portfolio to generate brokerage, a front running scam and William Tell. The first five were due to ignorance and the last due to letting my emotions run riot. If you do it yourself and if you are exceptionally vigilant, you can protect yourself from being a Muppet. [I have since read the book: excellent.]

## Risk Literacy

Michel Pireu quotes Gerd Gigerenzwer who says that people should be taught at school what he calls "risk literacy, i.e. learning how to deal with uncertainties in an informed way. He says that people need to be rewired so that they do not blindly trust their financial advisors thereby jeopardising their wealth. People cling to the belief that others can predict the future. He says that people should be equipped to allow them to take informed decisions for themselves. He says that risks and responsibilities are challenges to be accepted and not obstacles to be avoided.

## What Stocks Fund Managers Hold

Patrick Cairns listed the top ten shares in which fund managers in SA invest. They are, in order, with the number of funds in brackets, Sasol (237), Anglo American (236), MTN (228), BHP Billiton (216), Standard Bank (181), Old Mutual (169), BAT (156), Naspers (155), AngloGold Ashanti (145) and Bidvest (141). He says that all of these shares have excellent track records. Really? Did he do his homework? Three of these companies have miserable track records. The funds do not invest in these companies because they have good track records. They invest in them because they have no choice! The sizes of these companies vary between R852bn for BAT to R60bn for Bidvest. Investing in smaller cap companies will have no impact on the performance of these funds. DIY individual investors are not constrained by the size of companies.

## Another Ponzi scheme

It is so easy to separate a fool from her/is money. Another scheme called "The Relative Value Arbitrage Fund" (note the impressive name) attracted 3 000 idiots (R1,8bn – average of R600k each!!) who fell for the scam. When will people realise that by giving their savings to someone else, they will not get rich: the recipients of the money will get rich. There are predators out there after your hard earned cash. It is easy to avoid being taken for a ride. Have a policy and a culture of disciplined execution of that policy. If you have attended my workshops you will know what the policy is (rules 1 to 3). Do not allow greed to affect your decision making process and learn to say "No". Don't allow yourself to be pressured or bullied. And don't be fooled by: "So and so made 30% return in a month – you are missing out big time."

## Ego Driven Investors

Ego driven investors don't invest to create wealth but to gain the admiration of others by talking about their successes. Mr Ego holds onto loss making investments (he won't admit to making a mistake), he won't buy winners (someone else must have made a gain) instead looking for possible turnaround dogs (real bragging rights). When he does get lucky he does not hold onto the winner but "takes his profit" so he can tell the world about it. He buys dogs, sells stars and bails out of winners. [He never tells anyone about his losses so never learns from his mistakes.]

## Bill Gates' High School Talk

He outlined the following that kids will not learn at school:

1. Life is not fair – get used to it
2. The world is not interested in your self esteem – go and accomplish something before feeling good about yourself
3. You will not earn big time straight out of school – you won't be a big shot with a car phone until you earn it
4. If you think your teacher is tough, wait until you get a boss
5. Flipping burgers is not beneath your dignity – your grandparents called this opportunity
6. Learn from your mistakes – don't blame others for them

7. Your school might have done away with winners and losers but in real life you will have to compete
8. Life is not divided into terms – there are no summers off – go find yourself in your own time
9. TV is not real life – in real life you have to go to work
10. Be nice to nerds, one day you will probably be working for one

## Warren Buffett Invests Like a Girl

This book written by Louann Lofton suggests that you should too. He writes that women:

1. Churn and fiddle less than men
2. Accept their shortfalls; men are over-confident
3. Shun risk unlike men who thrive on it
4. Are less optimistic and more realist than men
5. Do the sums before putting their money into a share: men are more impulsive
6. Are not influenced by herds whereas men are
7. Learn from their mistakes, not so men

From my experience in dealing with both men and women investors, I can confirm most of the above.

## John C Maxwell's Mission Test

I recently listened to John C Maxwell's ten step test for evaluating a goal or a mission. He is also the author of the 21 Irrefutable Laws of Leadership, which I have listened to twice on my C.T. trips. He is brilliant. Here is my take on the ten steps. Try it on your mission to develop a meaningful store of wealth.

1. **Ownership**: Is it your mission, i.e. not one imposed on you by someone else?
2. **Clarity**: Have you clarified what you want to achieve, i.e. can you visualise the outcome?
3. **Reality**: Is the mission really achievable, i.e. not just a pipe dream?
4. **Passion**: Do you have the necessary passion to achieve it?
5. **Strategy**: Have you developed a written strategy setting out how you intend achieving it?
6. **People**: Have you persuaded others, e.g. your spouse, to join you in your journey?
7. **Cost**: Have you identified what the cost will be and are you prepared to incur the cost?
8. **Tenacity**: Do you have the perseverance to achieve your goal?
9. **Fulfilling**: Will the mission fulfil you?
10. **Significance**: Will the mission be of help to others, e.g. leave a legacy?

He says that if you score more than 7 out of 10, go for it. When I ran this test on my mission to educate people on DIY investing, I scored 10 out of 10!

## Rockland Targeted Development Investment Fund

Six pension funds invested in this fund which has since been placed under provisional curatorship. According to the Citizen, the fund was not registered with the FSB. How is it possible that pension fund trustees allocate assets to funds not registered with the FSB??? Not that this is always protection, but it is a start. Apparently, the total investment was in a piece of land that was revalued by 2 125% over three years. If the trustees had done our portfolio management course they would not have got past rule five, i.e. never invest in a fund with a name that has more than three words in it!!! Of course they would not have got past rule 1: DIY, do not give your money to others to invest!!!

## Abdicating Responsibility

A workshop participant sent me the following information about his investment in a well-known unit trust: Seven monthly investments of R800 from 31 July 2002 to 31 January 2003 and a R15 000 sum on 31 July 2006 were made. His investment stood at R36 477 at 30 June 2013. He ran the Ten Year App in Map 1 to discover that his investment earned 7,4% p.a. compared to 16,3% p.a. for the JSE during the same period, i.e. a negative alpha of 8,9% p.a. Horrendous!

## Some Lovely Quotes

Ryneveld van der Horst sent me this list:

"The four most dangerous words in investing are 'This time it's different.'" John Templeton

"Quantitatively based solutions and asset allocation equations invariably fail as they are designed to capture what would have worked in the previous cycle whereas the next one remains a riddle wrapped in an enigma." Barton Biggs

"It is absurd to think that the general public can ever make money out of market forecasts." Bengamin Graham

"If you have trouble imagining a 20% loss in the stock market, you shouldn't be in stocks." Jack Bogle

"The stock market is filled with individuals who know the price of everything, but the value of nothing." Philip Fisher

"Investors should remember that excitement and expenses are their enemies." Warren Buffett

"The public buys the most at the top and the least at the bottom." Bob Farrell

"By far the biggest problem for investment professionals is dealing with career and business risk: protecting your own job as an agent. The second curse of professional investing is over-management caused by the need to be seen to be busy, to be earning your keep. The individual is far better-positioned to wait patiently for the right pitch while paying no regard to what others are doing, which is almost impossible for professionals." Jeremy Grantham

"You can't develop a portfolio strategy around endless possibilities. You wouldn't even get out of bed if you considered everything that could possibly happen. You can use history as one tool for shaping reasonable probabilities. Then, you look at the world of economic, sentiment and political drivers to determine what's most likely to happen—while always knowing you can be and will be wrong a lot." Ken Fisher

"The average long-term experience in investing is never surprising, but the short term experience is always surprising." Charles Ellis

"The market does reflect the available information, as the professors tell us. But just as the funhouse mirrors don't always accurately reflect your weight, the markets don't always accurately reflect that information. Usually they are too pessimistic when it's bad, and too optimistic when it's good." Bill Miller

"If investing is entertaining, if you're having fun, you're probably not making money. Good investing is boring." George Soros

"Investing without research is like playing stud poker and never looking at the cards." Peter Lynch

## How is this for Logic?

David Gleason wrote the following about Naspers: "I certainly wouldn't buy at this price (R688), but if I owned the counter, I wouldn't sell either." He clearly does not know the rule for when to sell a share. Good call David. You got it half right. I can also be half right 100% of the time.

## Impairing Assets

The Citizen reported that Telkom was to write its assets down to market value by taking an impairment loss of R12 billion. I have two problems with this:

1. This is not an IFRS concept.
2. When companies take an impairment loss such as this, management are admitting that the profit they reported in the past was smoke and mirrors. Can you trust the reported figures going forward?

Of course going forward profits are going to look good as the depreciation charge on the impaired assets will disappear.

## DIY Living Annuity v RA

An article in the Citizen tells of a holder of an RA who wanted to transfer his investments from one fund to another. He was hit with a 24% penalty for doing this, not by the taxman but by the financial institution. Earlier he ceased paying his monthly premium on the RA. He was hit by another 19% penalty for doing this. No one is going to hit you for changing your investment on a DIY Living Annuity. If you do not know what this is, study some portfolios in Hedgehog (Map 5).

## 25% p.m Month Return

Tempting? Fools and their money are easily parted. If you fall for this, you are a Muppet. "But I know of four other people that are earning this return." "People?" No: "fools". Every month a new scheme appears and fools are relieved of their money. The Citizen reported one of these schemes to the FSB and they said it was not in their jurisdiction to take action. This is why it is so easy to con people in RSA. No one takes any action and if by some miracle, action is taken the perpetrator walks away with a slap on the wrist and enough money to live in luxury for the rest of his (or her) life.

## Selected Gems from LC van der Merwe

1. Price is what you pay, value is what you get WB
2. Before investing, find out what the company does PL
3. The essential characteristics of an investor are patience, discipline and risk aversion SK
4. Any normal person using the customary three percent of his or her brain can pick shares just as well, if not better, than the average expert PL
5. Only buy something that you'd be happy to hold if the market shut down for 10 years WB
6. Be fearful when others are greedy and be greedy when others are fearful WB
7. Know what you own, and know why you own it PL
8. We ignore outlooks and forecasts MW, WB and CM
9. Risk comes from not knowing what you're doing WB
10. We don't have to be smarter than the rest: we have to be more disciplined than the rest WB
11. Cash combined with courage in a time of crisis is priceless WB
12. We try to be consistently not stupid, instead of trying to be consistently clever CM
13. We find a few intelligent things to do, not to keep up with everything in the world CM
14. In the short run, the market is a voting machine; in the long run it is a weighing machine BG
15. Intelligent investing is value investing; acquiring more than you are paying for CM
16. If you don't study companies, you have the same success buying stocks as you do in a poker game if you bet without looking at your cards PL
17. In the long run, it's not just how much money you make that will determine your wealth, it's how much of that money you put to work investing it PL
18. Wide diversification is only required when investors do not understand what they are doing WB
19. If investing is entertaining, if you're having fun, you're probably not making money. Good investing should be boring George Soros
20. If you are not willing to own a stock for 10 years, do not even think about owning it for 10 minutes WB
21. Calling someone who trades actively in the market an investor is like calling someone who repeatedly engages in one-night stands a romantic WB

WB = Warren Buffett, PL = Peter Lynch, SK = Seth Klarmans, MW = Martin Whitman, BG = Benjamin Graham, CM = Charlie Munger

## Warning

Charl Marais sent me a horror story about the trustees (a big four auditing firm) of a deceased estate having to spend three years to get shares held in Old Mutual transferred from a deceased estate to a trust. Numerous forms were required to be completed, various fees had to be paid and nothing happened. It sounds very much like my experience with SARS trying to get a tax clearance certificate. His advice is to ensure that before you or a client dies, move your holdings from Computershare.

## Think – Ask Questions

When "experts" talk about PE ratios and "multiples" (a "multiple" is merely a PE ratio where the person wants to sound intelligent) or they predict a pending "market" crash, don't just accept what he or she is saying. Ask yourself questions. For example, I hear over and over again that the "market" has hit a new high. The Alsi was 150 in 1970. It is, at the time of writing, over 50 000. It must have hit about 40 000 new highs over the past 43 years. And this is news??? The problem is that listeners misinterpret this to be that the market IS high. For the market to hit a "new high" since 2008, it must hit 70 000 points taking a 10% growth rate into account at the time of writing (norm for the JSE over time).

I was sent an article written by a professor from the Cape who commented: "You would have to go back to 1965 to find the JSE Industrial Index as demandingly valued as it is today." I wonder if this guy knows what the PER formula is.

## A Professional Manager's Performance

After attending our workshop a participant ran the Five Year App in Map 1 on her portfolio's history. She had invested R66 000 on 31 May 2008, R30 000 on 31 December 2010, R50 000 on 31 December 2011, R10 000 on 31 March 2012, R10 000 on 31 May 2012 and R9 000 on 30 June 2012 into this portfolio. Her portfolio totalled R218 784 on 30 September 2013. She had earned a 7% p.a. return on this portfolio compared to the market return during that period of 12,8% p.a.. How many people do this exercise? They only do it when they get a wake-up call on attending the workshop. She effectively lost 20% of her total portfolio by not capturing the market return. I invited her to join Hedgehog and she completed the returns to find that for the eight months ended 31 October 2013 she had achieved a negative alpha of 19,4%, an all-time record. When she challenged the asset manager about this the response was: "Don't tell me I don't know what I am doing – I've been in the business for 45 years." Remember that 45 times 0 = 0.

## More Ideas from Warren Buffett

1. You don't need to be an expert in order to achieve satisfactory investment returns. Keep things simple and don't swing for the fences. When promised quick profits, respond with a quick "NO".
2. If you focus on prospective price changes you are speculating. The fact that a share has risen in the recent past is no reason to buy it.
3. Games are won by players who focus on the playing field, not by those whose eyes are glued to the scoreboard.
4. Forming macro opinions or listening to the macro or market predictions of others is a waste of time.

## Learning from the Mistakes of Others

I had the pleasure of meeting a semi-retired engineer in a portfolio management workshop recently. At lunch he suggested that I document the mistakes of others so we can learn from them. It is cheaper to learn from the mistakes of others than your own.

I got to thinking about the blinders I have made in my life so decided to document them for your benefit. By the time you have finished reading what follows, you may get the impression that I am a real idiot. You won't be far wrong. But remember that only fools do not learn from mistakes. I might be an idiot but I am not a fool – I learnt.

1. Trusting others to run my portfolio: During my Q.E. lecturing days I was "too busy" to nurture my own investment portfolio so I gave a mandate to a stockbroker to manage it for me. They churned my entire portfolio twice a year and invested in every new issue coming to the market. It took me some time to realise that they earn brokerage on churn and receive commission on new issues. The estimated opportunity loss due to this mistake is unknown but must be material.

2. Investing in a residential property: When I was young "position, position, position" was drilled into me so I bought a newly constructed apartment within walking distance of Sandton City for R90 000, when the JSE index was 150 (in 1970). Early in 2004, when the Alsi index was 12 600, I sold the property for R475 000 (12 600/150 x 90 000 = R7.5m). Net rental equated dividends over this period. Excluding all the time spent managing this liability the opportunity loss made to date from this mistake is approximately R40m.

3. Apathy: During my lecturing days I was "too busy" to reinvest the dividends generated from my investment portfolio. I rectified this problem ten years ago but the accumulated opportunity loss of this mistake to date is approximately R20m.

4. Greed: I have a policy of not investing in new issues, not investing in small high risk companies, not investing in furniture and the construction industries and yet, when I was offered the opportunity to take up shares on prelisting in a company called William Tell, I jumped at the opportunity. The estimated loss to date is R1m.

5. Blinded by Tax Savings: In 1973 (age 33) I bought a retirement annuity product from Anchor Insurance. After investing R3 447 in this annuity and spending the tax savings, the company converted the RA to another product which promised to pay out R1 990 at age 63, which I never received as the company had no record of the policy. The opportunity loss to date is R5m.

6. Impatience: A while back I lost patience with AECI (sold for R59.50), BAT (sold for R259.29) and SAB (sold for R236.61). The prices at 31 March were AECI R127.00, BAT R587.68 and SAB R525.94. Opportunity loss to date is R2m.

7. Hate Paying Tax: After shutting down my Q.E. preparation activities, I sat with over R0.5m in my company earning 1% p.a. because I did not want to pay secondary tax on dividends. Had I paid the STC and invested the amount in JSE equities I would have been far better off. Opportunity loss to date is R2.5m.

These were the lessons I learnt:

1. Do it yourself

2. JSE listed shares will always trump residential property
3. Creating a store of wealth is a top priority so allocate time to it
4. Keep emotion out of the decision making process
5. Execute your strategy with discipline
6. Do not invest because of tax savings: take them into account in the decision making process
7. Good companies bounce back – have patience
8. Pay the damn tax

## Not So Funny Story

Comair's sponsor issued a statement that two directors had bought R86m of shares in the company. The share price shot up 15%. The sponsor then realised its mistake – in fact the directors had sold these shares. On publishing the correction the shares fell back to where they had been!

## Defencex

After attending the portfolio management workshop, a participant phoned me to get my take on an "investment" called "Defencex". I could not believe this. Males don't listen! I told him to wake up and look at reality. Clearly this was a Ponzi scheme. "But Charles, all my friends are making a fortune out of it."

What I find so amazing is that it took the Financial Services Board a year to close Defencex down. Why?

How do you protect yourself against these temptations? Easy. Say ten times once a week: "I only invest my hard earned money in my low risk portfolio of quality shares on the JSE. The higher the risk, the higher is the potential loss. I use sound strategic approach to investing. I am not influenced by what others do. I do not allow greed to impact my decision making. I do not hand my money over to third parties to invest. I am motivated by my goal of achieving a 3% p.a. alpha over time."

## Economist May 3rd to 9th 2014

"People who sell funds to investors have little incentive to sell cheap ones. Either they work for banks (try to flog their own firm's products), or they are paid commissions by the fund-management firm. The higher the fund's fees the greater the incentive to sell it. In a world of slower growth, low inflation and Treasury bond yields of between 2.5% and 3%, future investment returns are likely to be low, all the more reason for them not to be eroded by fees in an industry with such a lacklustre performance."

## Transnet Pensioners

I have been following this story with interest over the years. Imagine going to work for a company and being told that part of your salary is to be set aside to provide for your old age. You rely on this promise only to find that when the time comes the cupboard is bare.

Transnet has been trying for decades to squirm out of its responsibilities to its pensioners. A class action is now being brought on behalf of 62 000 pensioners claiming R80 billion in assets and interest. What chance do you think they have? None. Learn from this. Do not rely on others to manage your pension assets. Do it yourself.

## A Preservation Fund

The Portfolio Management Workshop motivates some of us to calculate the alphas we have achieved on our past investments – you need courage to do this. An irate past workshop participant ran the lump sum application on her preservation fund and found the following:

| | |
|---|---|
| Invested on 31 May 2008 | R 953 145 |
| Closing balance on 30 Sep 2014 | 1 626 528 |
| Portfolio return p.a. | 8.8% |
| Alsi return p.a. | 10.3% |
| RCH return p.a. | 17.5% |

When the rand cost hedge return (the return on an equal amount invested each month during the period) is substantially higher than the lump sum investment, you know that there is a disastrous initial investment timing problem. The Alsi on 31 May 2008 was at an all-time month-end high of 31 841. By 28 February 2009 it had fallen to 18 465. Had the investment been made on 28 February 2009, instead of on 31 May 2008, the Alsi would have given a return of 22.6% p.a. (instead of the dismal 10.3% p.a.).

One must expect to earn a negative alpha of about 4% p.a. on a preservation fund due to fees, having to invest 25% in monetary investments, etc. (Note that the above alpha was lower than 4% p.a. because 25% of the investment was in monitory assets – when the market falls monitory assets are a good place to be.) If the R953 145 had been invested on 28 February 2009 instead of 31 May 2008, the investment would have been worth R2,5m today instead of R1,6m at a negative 4% p.a. alpha.

This preservation fund was invested in:

| | |
|---|---|
| Allan Grey balanced fund | 21% |
| Coronation balanced plus fund | 22% |
| Investec opportunity fund | 18% |
| Investec Value Fund | 17% |
| Prudential Dividend Maximiser Fund | 22% |

50% was invested in local equities, 20% in foreign equities, 25% in monitory investments and 5% in "other" investments such as property.

## From Bear to Bull

David Bianco, a prominent Wall Street bear, ditched his pessimistic views on US stocks and now sees a "long lasting economic expansion of moderate growth, which should rival the US record of 10 years". The market promptly took a dive. Nobody knows nutting!

## Another Ponzi scheme bites the dust

Business rescue practitioners have concluded that the business model of SuraPure Drinks was fundamentally flawed. It did not take much common sense to see this from the outset, but as our Minister of Finance, Mr Nene says, people are always looking for ways to make easy money, so these schemes will always succeed for a short while. Greed and the lack of common sense are serious impediments to wealth building.

## Fear and Greed v Long Term Resolve

Bob Farrell, who had a front row seat at Merrill Lynch during the market ups and downs since 1987, says that fear and greed are stronger than long term resolve. He does not give a solution to the problem. May I? It is patience and perseverance.

## Quotes from Charlie Munger

1. "One of the key elements to successful investing is the right temperament and preparedness of mind."
2. "Whenever you see 'EBITDA', substitute BS earnings."
3. "Most investors worry too much."
4. "The efficient market theory is roughly right, which means that it is difficult to beat the market."
5. "People have a craving to be told the future. [Don't tell me – I am constantly asked to predict the future movements in the markets or the where a specific share is headed. I DO NOT KNOW. Listening to forecasters is as crazy as kings in the past asking seers to look into the guts of sheep."
6. "All kinds of earnings blessed by accountants are not really earned. When you reach for the money, it melts away. It was never there." [A good example was African Bank]

## Price Book Ratio

Quote from Citizen: "The price book ratio is a good indicator of value. Shares with low price book ratios will tend to enjoy better returns than their peers." The lack of education out there is horrendous. And I pay to receive this newspaper!!

## The Dividend Yield Problem

Recently the month end fell on a Friday and, as Business Day does not publish on a Saturday, I used the information in the Citizen to extract the share prices, price earnings ratios and dividend yields for our database. On the Sunday, I used the Sunday Times to check my extracts. The share prices and price earnings ratios tallied but the dividend yields differed. After scratching my head for a while, I divided the Sunday Times published dividend yields by 0,85 and miraculously arrived at the Citizen dividend yields. On Monday morning I compared the dividend yields in the Business Day and found that they agreed with those in the Sunday Times.

A few months earlier I discovered that the JSE Monthly Bulletin publishes the dividends per share net of the 15% withholding tax. I telephoned the JSE to find out what their reasoning was. I was told that they felt that this would be more valuable to the retail investor. The retail investor studies the JSE MB???

The decision made by the JSE is illogical for the following reasons:

1. Many "retail" investors hold their portfolios in companies to "save" withholding tax so publishing net figures is irrelevant to these shareholders.
2. Any student of accounting will know that it is a cardinal sin to net expenses against income. The withholding tax is an expense of the shareholder and not of the company. One would not disclose one's salary in one's books net of PAYE.
3. The company paying the dividend does not disclose the withholding tax as an expense in its books. If the shareholders do not disclose it in their books, Treasury can increase withholding tax and no one will feel the pain. Maybe this is what motivated them to increase the rate from 10% to 15% recently – where to next, 20%, 25%, 95%? [Now 20%. Next?]
4. The sophisticated analyst assesses the ability of the company to grow by multiplying the return on opening equity by (1 – the dividend payout ratio). Withholding tax is not a cost of the company so does not impact on its sustainable growth rate.
5. The really sophisticated analyst assesses the company's price earnings ratio by dividing the dividend pay-out ratio (dividend per share divided by earnings per share) by certain risk and growth factors. Withholding tax is not an expense of the company so should not impact the PE ratio.

So the decision of the JSE is clearly wrong. However, one thing I have learnt over my lifetime is that organisations such as the JSE will never admit to such a mistake, so we will have to live with it and find other ways to overcome the problem like we do with IFRS stupidities.

## Broker Costs

One of the members of Hedgehog compared his transaction costs with those of other members and complained to his stockbroker that his costs were too high. They agreed to reduce their broker fees, just like that! It is amazing how powerful the little word "ask" is.

## Charlie White

Charlie died an hour after his 109th birthday. I am trying everything possible to extend my working life so that I can be of service to you so searched the article in Time Magazine for his secret. Firstly, my name almost helps but these are the two ideas I found:

1. "If you cannot change it, don't worry about it."
2. "If I let people irritate me, I would be dead long ago."

Thanks Charlie for your two pearls of wisdom. RIP.

## Advice from a Stockbroker

"There is nothing wrong with having a present amount that is used for highly speculative investments, an amount that the investor can afford to lose."

1. Who in this day and age can "afford to lose" hard earned investment funds?
2. Does he (only a male would come up with this ridiculous "advice") really believe that the higher the risk the higher the return?

From his photograph, he appears to be quite an intelligent guy, so why does he give this advice? Who wins when you speculate? What is his occupation? Got it? If you want to get wealthy remember **it is the process that produces alpha, not wild hits at curved balls**.

## Spoofing

The way spoofing works is that you place a series of orders to sell financial futures in a share or an index (i.e. sell now for future delivery). Before the orders are accepted you cancel the orders and place a new series of orders at a lower price. You have to move fast as you do not want your orders to be accepted. When you have pushed the market sufficiently down, you jump in and buy at the lower price. A Mr Sarao operating in London, was able to "flash crash" the American markets by 10% in a few minutes on May 6th. At the time of writing, he was fighting extradition to the US in British courts.

## Stock Picking

Research has revealed that the majority of active fund managers in the American market only beat the index five times in the past 20 years. Fund managers who construct portfolios to mimic the market (tracker funds) are doomed to under-perform due to fees. (The Economist)

## Analysing Write-Offs

The Economist warns users of financial statements not to ignore write-offs. Some analysts think that impairments are merely a book entry so is of little concern. In fact, some even consider this a plus as future profits will not be "burdened" by these charges to profits (bad debt expenses, depreciation, stock obsolesce, etc.). Do not be fooled. If the asset being impaired is, for example, plant or inventory, that asset was paid for in cash, on credit or by borrowings so this is a real loss. If the asset being impaired is a receivable (debtor) (see African Bank), the other side of the entry when the receivable was created was profit (revenue) which you previously thought at the time was real. Never take impairments lightly. Get angry with management.

## Guess

The following paragraph appeared in the Economist: "A country where the rule of law is ignored, where the independence of regulatory institutions is tainted, where companies are pressured through tax penalties and other punishments and where rules on tenders are change regularly, is not a fit country for foreign capital." Do you think this refers to Turkey, Nigeria, Zimbabwe or South Africa? Turkey.

## Reading

I came across a young man in one of our workshops (Danie) who stunned me with his knowledge of matters that count. I asked him to write a paragraph on how he got to where he is. Here it is.

Since the age of 21, I have been reading two to four books a month to help me become a better leader, achieve higher levels of success and to live a life of significance. I am currently 34 and the list of books continues to grow that I would still like to read. This wasn't always the case though. I didn't read a single book until I was 21. I had no vision for my future, lacked self-confidence, and was content to live a life of mediocrity. So what happened that inspired me on this quest to continue growing through constantly reading? Two things: The first is that I realised that we are ultimately responsible for what we do with our potential. Potential has been given freely to us, but it takes a lot of sacrifice to develop it. Secondly I found my "why" in life! I discovered a cause worth living for, which drove me to constantly develop my potential so that I can become more effective at creating a positive impact in this world. I am often asked where I get time to read with my busy life. My suggestion to them is: "Find your cause worth living for (why) and you will prioritise accordingly".

Truly brilliant.

## Money v Time Weighted Return

In our workshops I explain that some financial institutions use the TWR approach. Here is an example I received from a financial advisor assisting someone who is leaving our beautiful country for greener (?) pastures:

| | |
|---|---|
| Invested 18 Sep 2003 | R35 577.50 |
| Deemed disposal 30 Sep 2014 | 52 505.87 |
| Annualised IRR calculated by company | 17.97% p.a. |
| The IRR (MWR) actually works out at | 3.6% p.a. |

This insurance company is on our watch list in Map 3!

I find it so sad that so many cleaver people will not take one day out of their lives to learn how they are being ripped off by financial institutions and how they can create wealth by empowering themselves. Intelligent people do.

## A Week in the Life of an Equity Investor

On Wednesday morning, 9 December 2015, I climbed into my little Bakkie heading for a B&B (Die Herehuis, absolutely delightful owners and not too shabby either) in Beaufort West. While enjoying the glorious day, humming to Mozart, conducting Beethoven and singing with Elvis, my dedicated market watcher phoned to tell me that our No. 1 had fired our capable minister of finance and replaced him with a David (or Desmond or Douglas) van Rooyen. The market went into free fall. My first thought was: "How do I motivate people to invest in the JSE when those in power can cause such utter destruction by their actions? By Wednesday night my portfolio was down by R2.5m on the previous month. On Thursday it fell by another R0.7m. Fortunately some influential people were mobilized over the weekend to undertake damage control. My Saturday workshop was a disaster ("Am I doing more harm than good encouraging people to invest in SA equities?") By the time my Monday workshop started, a degree of calm had been restored to the market and the rest is history. What is there to be learnt from this episode?

1. Don't invest cash in the market that you will need in the next year, or so, as you may panic and sell shares when the market is down, thereby incurring losses.
2. Learn not to panic. Wait it out. Don't get caught in the day to day market turmoil. It will pass. I do not agree with Warren's concept of "Be bold when others are fearful", especially in a country like ours. We were lucky this time. We may not be so lucky next time.
3. We need to build a sovereign risk premium into the pricing of JSE equity shares. This could happen again. I think that the market has now built this premium into its pricing – there has been some permanent damage done.

4. We should understand that every share's valuation commences with a risk free rate. Bond rates went through the roof as a result of this disaster resulting in market values falling.
5. The money that fled the country during the turmoil will not easily return. It will take time for the damage to be undone, lots of time. Permanent damage was caused: we lost a lot of trust among investors. But remember that the market prices reflect all this at present so dumping shares at lower prices is not a good idea.

As I have always said: Don't go out and play in a tornado – hunker down and wait for it to pass. Then assess the damage and take whatever action is necessary when sanity is restored.

## Growth v Value Investing

While studying for my CFA examinations I came across many articles on this concept. Growth investing looks for companies with the potential to grow, usually evidenced by proven performance whereas value investing looks for poor performing companies that have the potential to turn around. For large investors like Warren Buffett value investing makes sense as he can help turn a poor performing company around by investing his own resources, such as management skills, in the company. However, for small investors like us, we do not have such resources so betting that dogs will turn around is akin to gambling.

Value investors look for companies with low price earnings ratios and low price book ratios. A price earnings ratio is the market price of a share divided by the earnings per share. The formula for a price earnings ratio is (ignoring withholding tax):

DP%/((r – g)/(1 + g)) where DP% is the proportion of the earnings of the company distributed by way of dividend, r is the return required taking into account the risks attributable to this investment and g is the expected future growth in dividends

For a company to have a low PE ratio (companies that value investors drool over) they must pay poor dividends, must be very risky and must expect poor future growth.

A price book ratio is the market price of a share divided by the net asset value (or equity) per share. The formula for a price book ratio is (ignoring withholding tax):

(ROOE – g)/(r – g) where ROOE is the return the company earns on opening equity and r and g are as above.

Those who favour value investing, therefore, look for companies that earn poor returns on equity, are highly risky and expect poor future growth.

So for us, the small investors, value investing makes no sense at all.

## CAPM and Beta

At a recent workshop at a certain university a student mentioned the word "Beta". I said: "Beta is Bull". A lecturer overheard this and said that I should not say such things to students as they had to believe in Beta because it is part of their syllabus. They are still teaching the same rubbish that I was teaching 40 years ago with no thought as to the validity of the concepts.

In preparation for the advanced workshop on portfolio management, I bought a book called "The 10-Day MBA". In this book the author quotes an article in Forbes written in March 1992 (25 years ago!) entitled "Bye-Bye Beta" which quoted reliable research showing that beta was irrelevant to the future performance of shares. The book states: "Betas may have fallen into disrepute, but since there is nothing better, business schools still teach this theory". This is an indictment on our education system. It is time to open your minds and start thinking out of the box. The problem is that if you do so, you will probably fail your exams!

## Volatility v Risk

In the book quoted above, the following statement appears: "Volatility is equated with risk". This is one of the biggest misconceptions in portfolio management. Volatility is merely "noise". "Risk" is the probability of permanent loss of capital.

## Definition of an Expert

I was clearing out some old papers recently and came across an advert for Tony Henfrey's Gold Letter. It was dated 28 May 1982 and stated that 13 world class experts were forecasting that gold would reach $4 000 by 1986!

The definition of an expert is a person who is very skillful or highly trained and informed in some special field. Just because you have studied the gold market in the past does not qualify you to be able to project the future. There are so many variables impacting on the price of gold that, unless you are a psychic who can see the future (and I am not too sure that there is a field of expertise in this discipline) it is not possible to predict such movements. Anyone who states that they can do so is a charlatan. This is why I do not give advice because I have not mastered, and never will, the ability to see the future.

## Cost of Smoking

In one of the Cape workshops, a participant kept popping out for a smoke. He spends R40 per day on cigarettes. While he was out of the workshop we did a quick and dirty calculation to establish what R40 per day would accumulate to over his working life (40 years) if invested on the JSE. Assuming a growth rate in the price of cigarettes of 10% p.a. and a return on the JSE of 12% p.a. the amount came to R38m. Using 15% p.a. return on the JSE (our goal) it came to R72m. Do you think that this knowledge will cut the habit? No chance. [Latest buzz – he has quit!]

## The Story or the Facts

Research published in Time Magazine shows that people base decisions on stories rather than on hard facts. One of the policies we follow in our selection process is to buy the performance rather than the story. The conclusion of the research is not to ridicule people who get hooked on stories as this is part of our psychological make-up. We should rather focus on educating people to gather and assess the facts before coming to a decision.

## A Powerful Statement

It's not the unknown unknowns that catch people out but the perceived truths that turn out to be totally wrong. The gap between perception and reality is often very wide."

Perceived truths are ideas based on listening to what others say and one's own emotions. Without researching the facts and carefully considering the evidence, stupid decisions can be made. I have been trying to understand why some members of Hedgehog opted for the alternative to pure cash in the SAB takeover. Not one I spoke to based the decision on research – it was all based on assumptions and perception.

## Busy, Busy, Busy

One of the biggest mistakes I made in my life (and there were many) was that I was always busy. Only later in life did I realise the importance of allocating time to:

1. **Reading**: for fun and to broaden my mind
2. **Studying**: to develop my expertise
3. **Searching**: for new ideas
4. **Strategising**: to improve approach to goal achievement
5. **Developing**: systems, tactics and processes
6. **Reflecting**: on choices to be made
7. **Digesting**: new concepts and ways of thinking
8. **Writing**: to crystallise thoughts
9. **Exercising**: to build endurance, stamina, etc.
10. **Relaxing**: letting go to "smell the roses"

## Durban-By-Da-Sea

It is holiday time and you want to get to Durban to relax on the beach as soon as possible. You have three choices: you can take the slow, but reliable, train which will get you there in three days or the fast and furious train which could get you there in one day but could derail before it arrives causing you serious injury. Do you play it safe or take the reckless choice or do you choose the latter but make plans to minimise the damage if the train does crash, assuming that these are the only alternatives? One of my holdings is a "Durban-by-Da-Sea" investment. I am presently on the fast and furious train and need to consider changing trains. What would you do, be a sissy or be macho and risk being disabled?

## New Year Resolutions for my Portfolio

1. I must take more care in selecting shares for my portfolio as I intend to hold them for a long time.
2. I must stop trying to time the market – I have never been successful in this endeavour in the past and never will be in the future.
3. I must avoid overweighting individual shares (big hits) as I tend to award halos to some companies and when the share prices revert to fair value, I take big knocks.
4. I must stop listening to stories and do my own research and analysis before investing my hard-earned money in the a share.
5. My long term focus should be on generating Alsi alpha but in the short term I should focus on beating a benchmark attuned to my strategy, i.e. the Findi 30.
6. I must ensure that I am sufficiently diversified to minimise my risk.
7. I must stop chasing the next big thing. I should confine my selection to a soundly researched watch-list.
8. I must stop fiddling – good shares usually recover so I must not buy when they are high and sell when they are low.
9. I must learn to exit a share when it's share price materially exceeds its fair value.
10. I must stay away from companies that merely hold shares in other listed companies as these holding companies tend to destroy value.
11. I must stick to my long term strategy even in years when it does not work.
12. I must avoid high concentration in clusters such as banks and retail shares as these shares tend to move in tandem with each other thereby increasing my risk.
13. I must base all my decisions on sufficient and reliable evidence obtained from the source and not obtained second hand.
14. I must learn to trust my own ability and instincts.
15. I must be proactive, i.e. not procrastinate.