Understand Market Behaviours for better returns

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Teh Hooi Ling, CFA

Portfolio Manager

inclusif VALUE FUND

www.inclusif.com.sg

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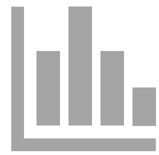
As at 31 Dec 2018

If we include stock markets in Australia, Hong Kong, Japan, Korea, New Zealand, Singapore, Taiwan, China, Indonesia, Malaysia, Thailand and Vietnam



There were <u>22,457</u> individual stocks

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How do we go about selecting stocks for our portfolio?

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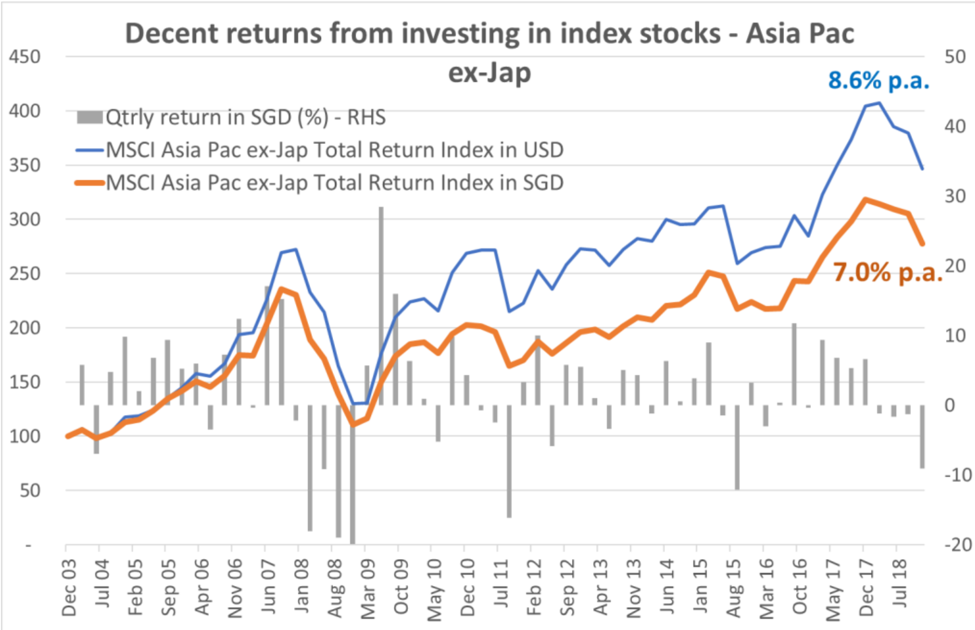

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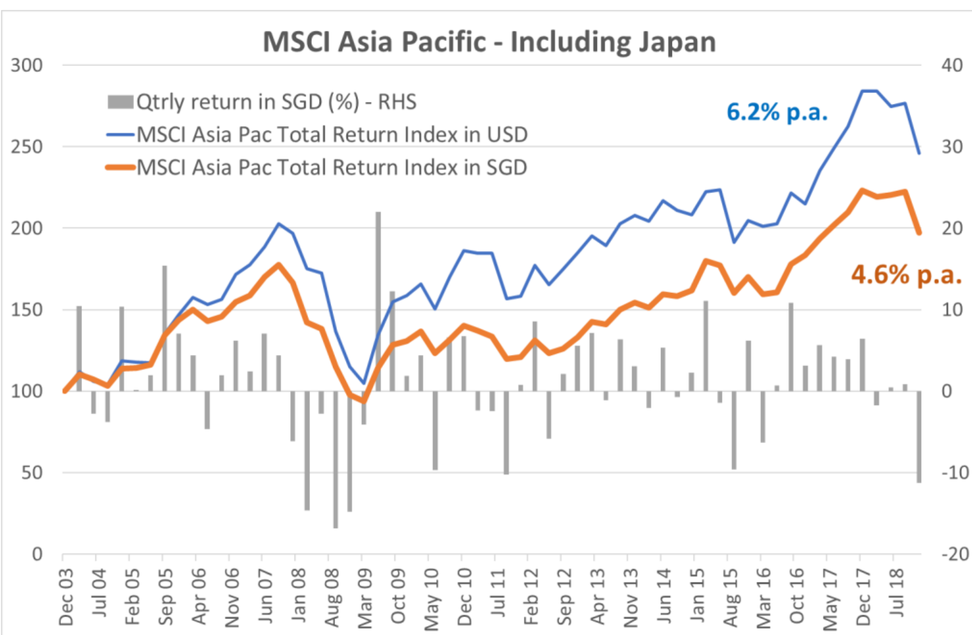

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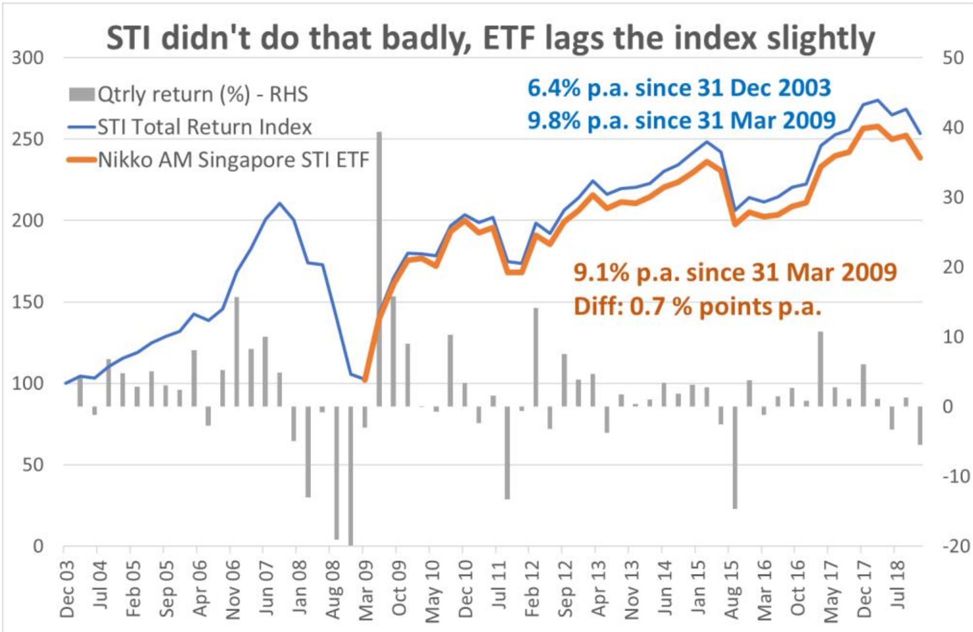

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From Dec 2003 till Dec 2018	% p.a.
MSCI Asia Pac ex-Japan	7.0
MSCI Asia Pac incl-Japan	4.6
STI	6.4
STI ETF	5.7
DBS 18-month Fixed Deposit	0.68

If you keep your funds in Fixed Deposit

A few percentage points, compounded over a long term makes a big difference

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How do you get at least 8% a year from the markets over the long term?

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Things you must do

Things you MUST NOT do

First thing you must do:

Understand the behavior of the markets

Stock market is a place where real assets can be traded

Share prices cannot deviate **too far away** from economic fundamentals for long

Just like when you do valuation for a property

- You value based on **existing attributes**, e.g condition of the property, recently transacted units, rental yield, or for a new project, you may look at the land cost, the construction costs, financing cost plus the margin for the developer to arrive at the fair selling price etc.
- Or **future prospects**, e.g en-bloc potential, an upcoming MRT station or amenities etc.

Similarly for stocks, you can value them based on:

Less uncertainties

- **Existing attributes**
- Metrics used include:
  - Price to book (PB) or Price to net tangible asset ratios
  - Dividend yield
  - Price to earnings (PE) ratio
  - Price to Free Cash Flow (P/FCF)
  - Enterprise value to Earnings before interests, tax, depreciation and amortisation (EV/EBITDA)

More uncertainties

- **Future prospects**
  - You try to predict what this company is able to achieve 3, 5, 10 years from now in terms of earnings, and then you discount that future forecast earnings to today's value and compare to the current share price.
  - If you think today's share price doesn't really reflect the bright prospects of the company, then you buy

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Whichever approach, everything has to relate back to the price you are paying for the stock today

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Illustration of Price/Book value:
Company XYZ’s assets vs its share price

In its books:

In the stock market:

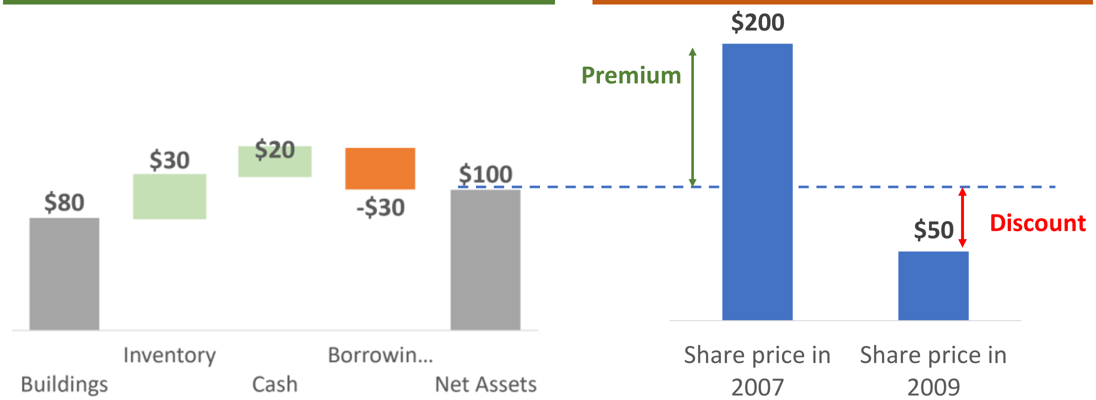

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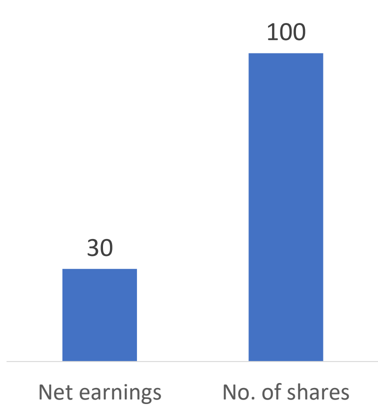
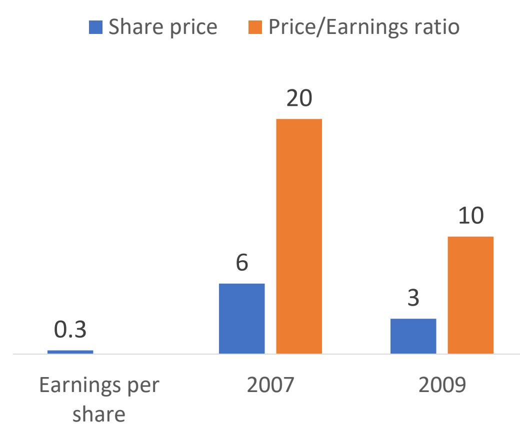
Illustration of Price/Earnings ratio:
Company XYZ: Earnings vs Share Price

In its books:



In the stock market:



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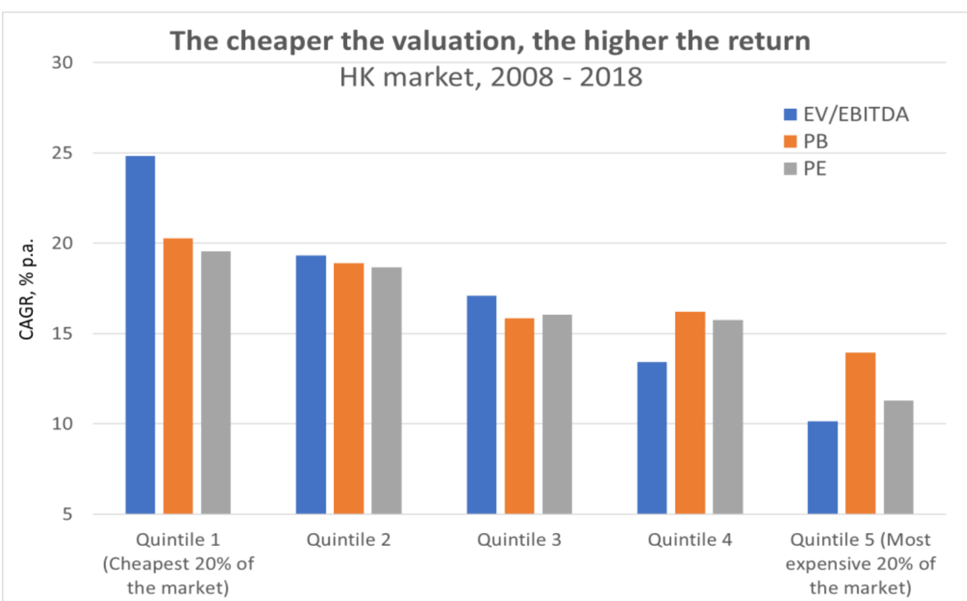
All else being equal

- The lower the PB, P/NTA, PE, EV/EBITDA etc you pay for a stock, the more value you are getting

Evidence:



So first point to understand:

- Value is referred to as the gravitational pull of the financial markets
- When you buy assets which are trading below value, you are exchanging a smaller store of value, i.e. your cash, for a greater one
- **The price may not revert to fair value in the next one day, one week, one month or even one year. But over time, it will definitely come.**

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Second point:

There is randomness and inefficiencies in the market

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- It is precisely because markets are sometimes inefficient that you can get bargains, or stocks trading at significant discount to their fair value
- But because of this randomness and inefficiency, some of these stocks may stay cheap for a long time or may even get cheaper
- Also, some expensive stocks can get even more expensive

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Inefficiencies can occur in individual stocks…

- MegaStudy (Korea)
  - Offers on-line and off-line educational programs to high school students, provides college entrance test preparatory courses, e-learning, and college admission advisory services.
  - Market cap: US$105.8M
  - Cash: US$123.4M
  - No borrowings
  - Revenue: US$121.1M
  - Net income: US$8M
  - Trading at 53% discount to book value, most of which is cash

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Suncall Corp (Japan)

- manufactures automobile parts and electronic equipment like valve cotters, locker arm springs, ABS sensor rings, optical modules, precision shaped wire, and precision cams. Operates in Hong Kong, Indonesia, the US, and China
- Market Cap: US$186M
- Cash: US$108.5M
- Revenue: US$411.7M
- Net income: US$21.9M
- Trading at 47% discount to book value, also most of which is cash

The cheap can get cheaper!

Bekasi Fajar (Indonesia)

Ju Teng (Hong Kong)

Those which reached what we deemed as fair value can rise far above it

Nichidai (Japan)

Epistar (Taiwan)

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How do you counter randomness in the markets?

We just buy a BIG basket of undervalued stocks!

Statistical phenomenon known as "**the law of large numbers**" – the law states that **the more observations we make, the closer our sample will be to the population**, and hence **greater the certainty of our prediction – to construct portfolios of securities that would, in aggregate, outperform the market**

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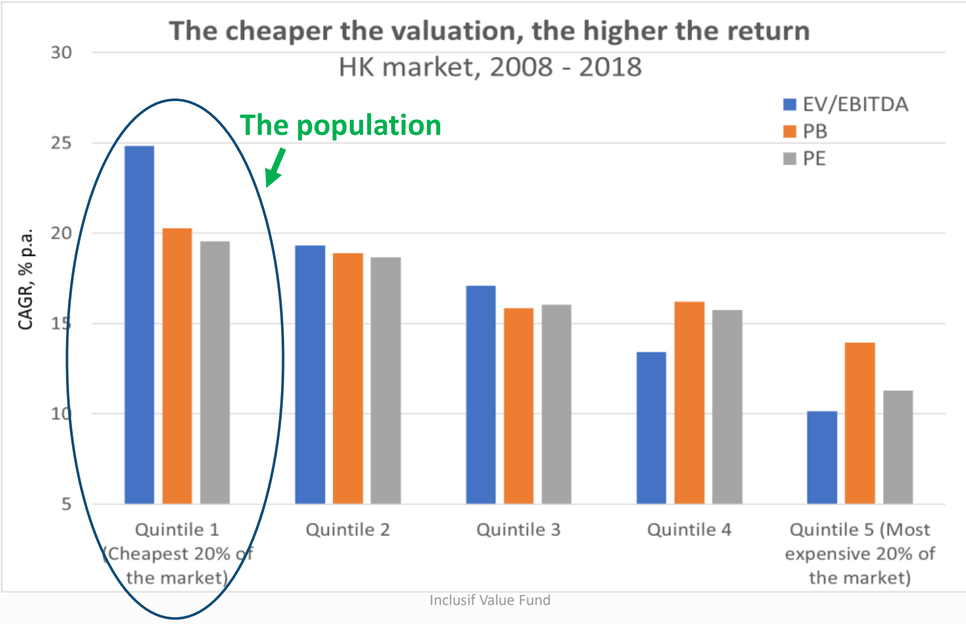
Evidence:



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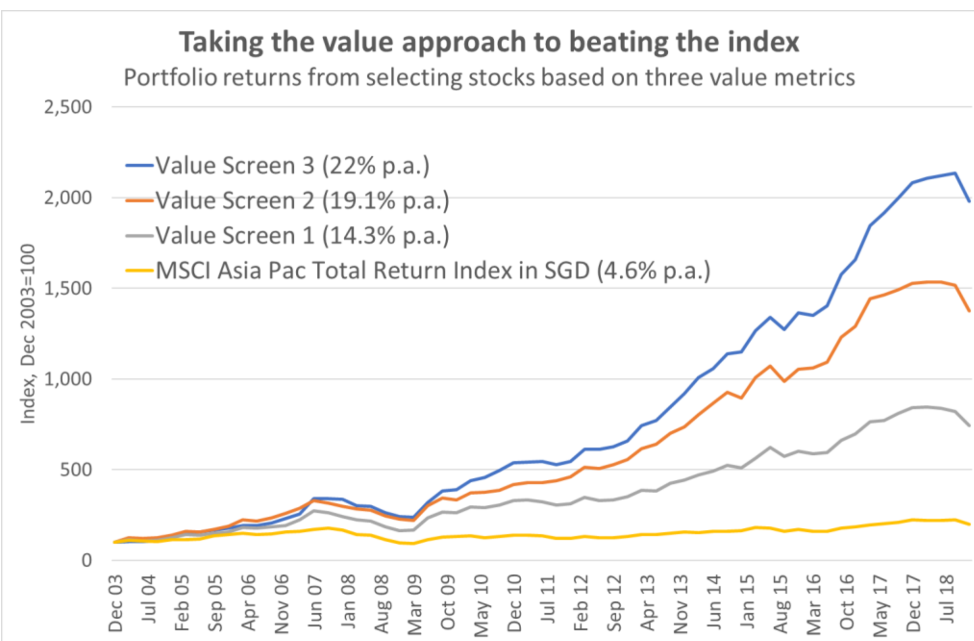

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Inefficiencies can happen on a macro, broad market level…

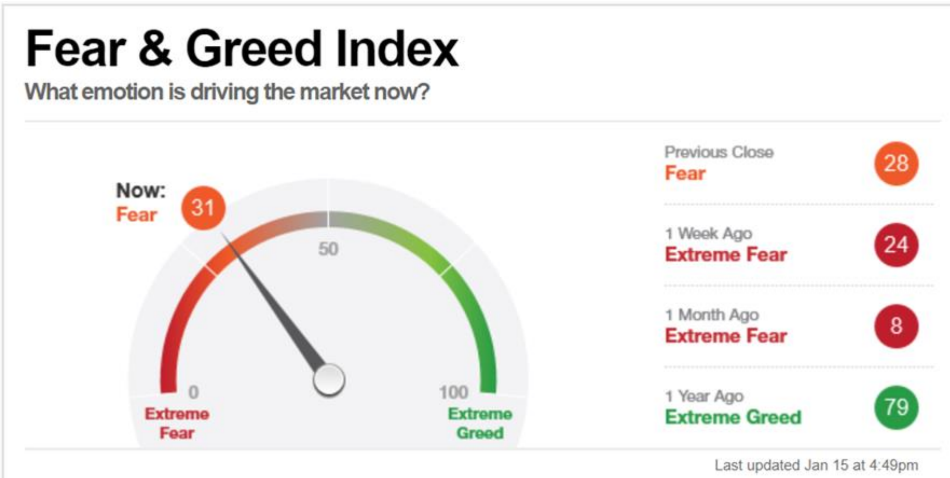
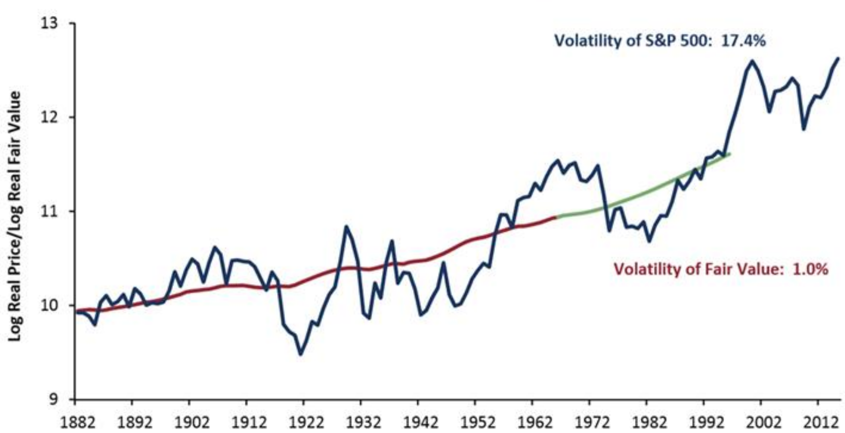
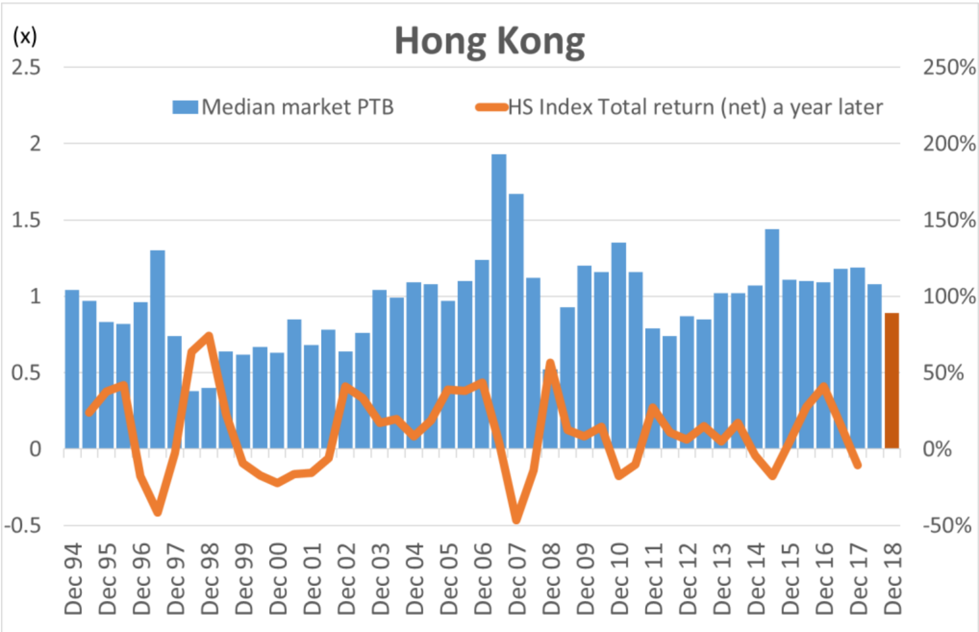


Exhibit 1: S&P Composite Real Price and Clairvoyant Fair Value



Source: Robert Shiller, GMO; Data from 1900-2016



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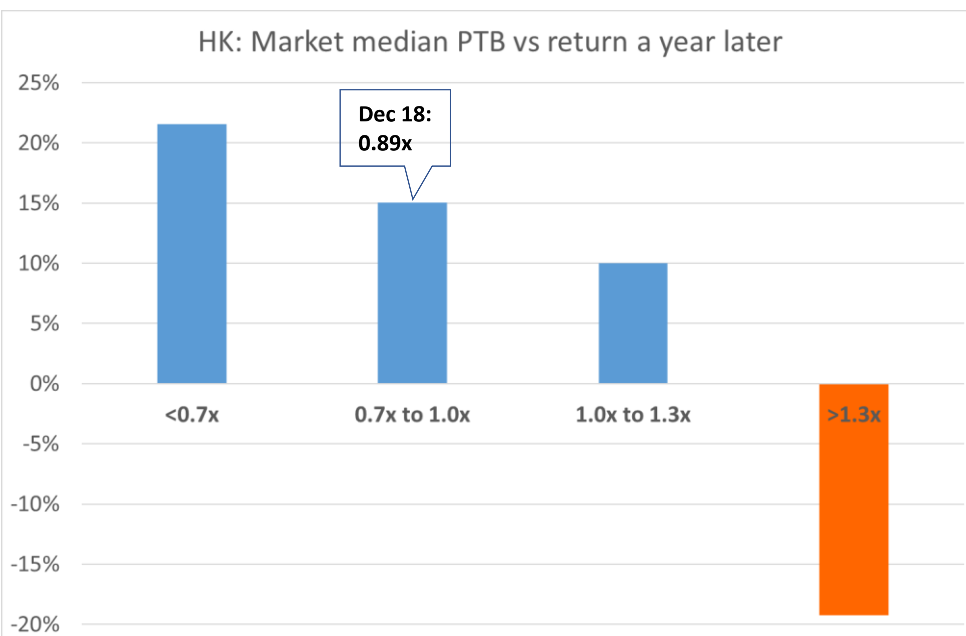

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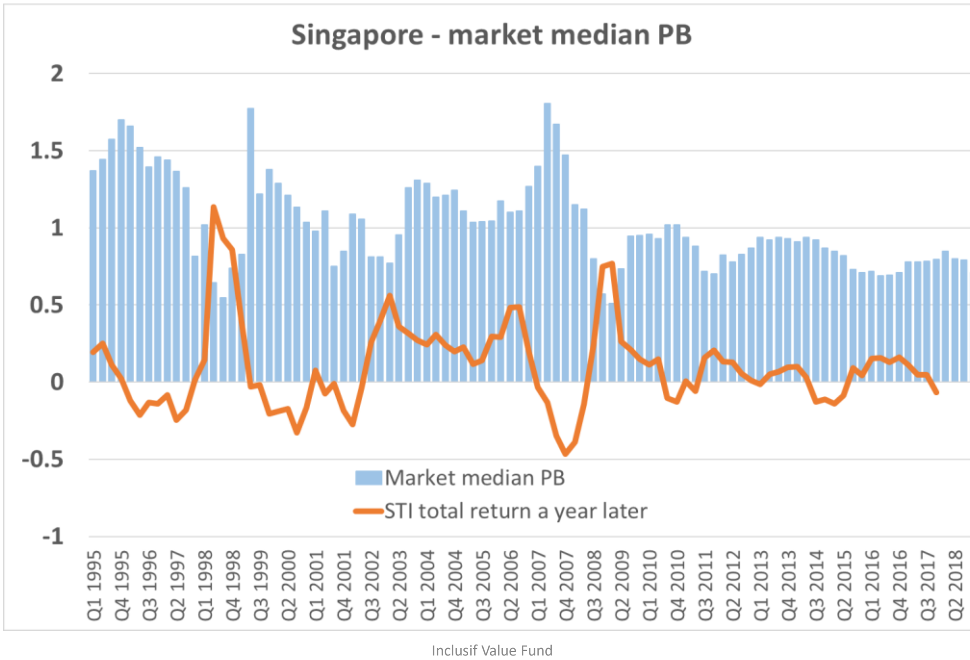

Singapore - market median PB
2
1.5
1
0.5
0
-0.5
-1
Market median PB
STI total return a year later
Q1 1995
Q4 1995
Q3 1996
Q2 1997
Q1 1998
Q4 1998
Q3 1999
Q2 2000
Q1 2001
Q4 2001
Q3 2002
Q2 2003
Q1 2004
Q4 2004
Q3 2005
Q2 2006
Q1 2007
Q4 2007
Q3 2008
Q2 2009
Q1 2010
Q4 2010
Q3 2011
Q2 2012
Q1 2013
Q4 2013
Q3 2014
Q2 2015
Q1 2016
Q4 2016
Q3 2017
Q2 2018
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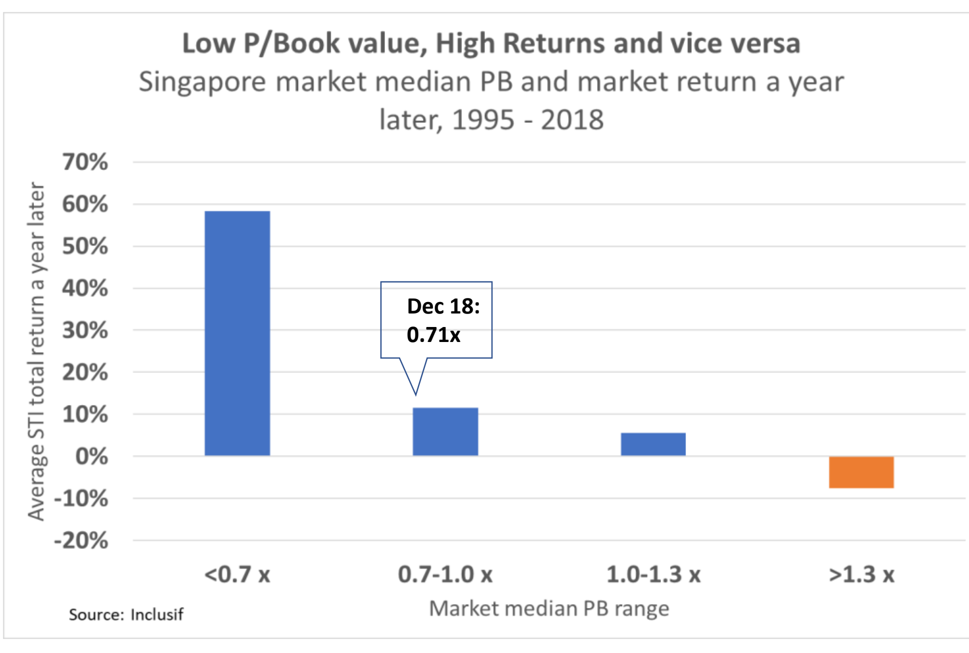

Low P/Book value, High Returns and vice versa
Singapore market median PB and market return a year later, 1995 - 2018
70%
60%
50%
40%
30%
20%
10%
0%
-10%
-20%
Average STI total return a year later
Dec 18: 0.71x
<0.7 x
0.7-1.0 x
1.0-1.3 x
>1.3 x
Market median PB range
Source: Inclusif
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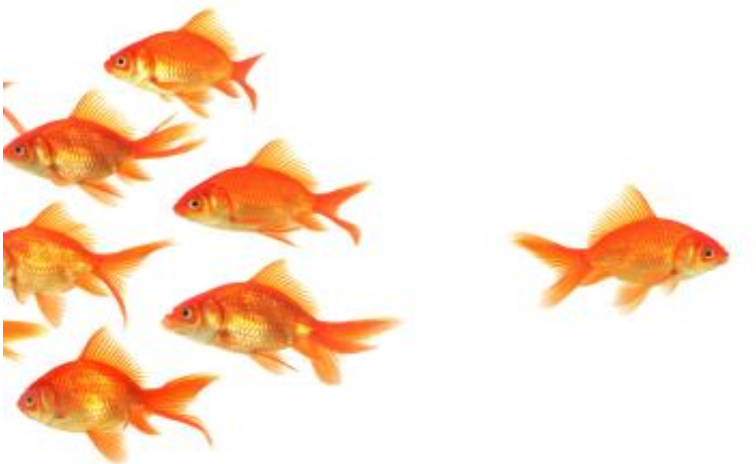

Strategy: Be ready to take money off the table when there is irrational exuberance, and to go in when there is extreme fear – but always be guided by valuation

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Third Point: Markets take the escalator up, but the elevator down

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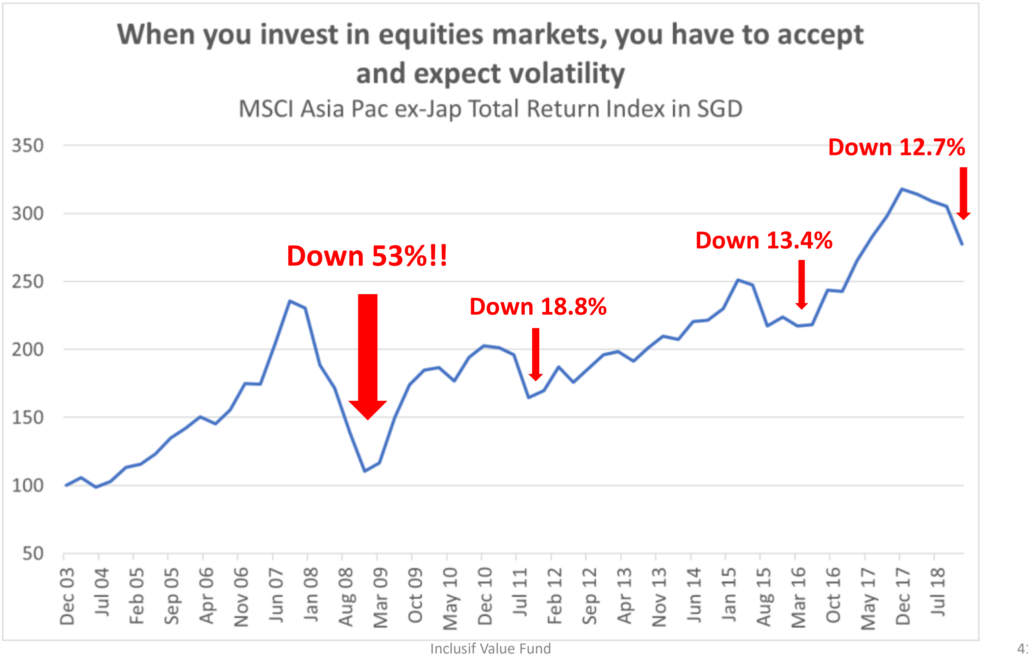
When you invest in equities markets, you have to accept and expect volatility
MSCI Asia Pac ex-Jap Total Return Index in SGD
350
300
250
200
150
100
50
Down 53%!!
Down 18.8%
Down 13.4%
Down 12.7%
Dec 03
Jul 04
Feb 05
Sep 05
Apr 06
Nov 06
Jun 07
Jan 08
Aug 08
Mar 09
Oct 09
May 10
Dec 10
Jul 11
Feb 12
Sep 12
Apr 13
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Jun 14
Jan 15
Aug 15
Mar 16
Oct 16
May 17
Dec 17
Jul 18
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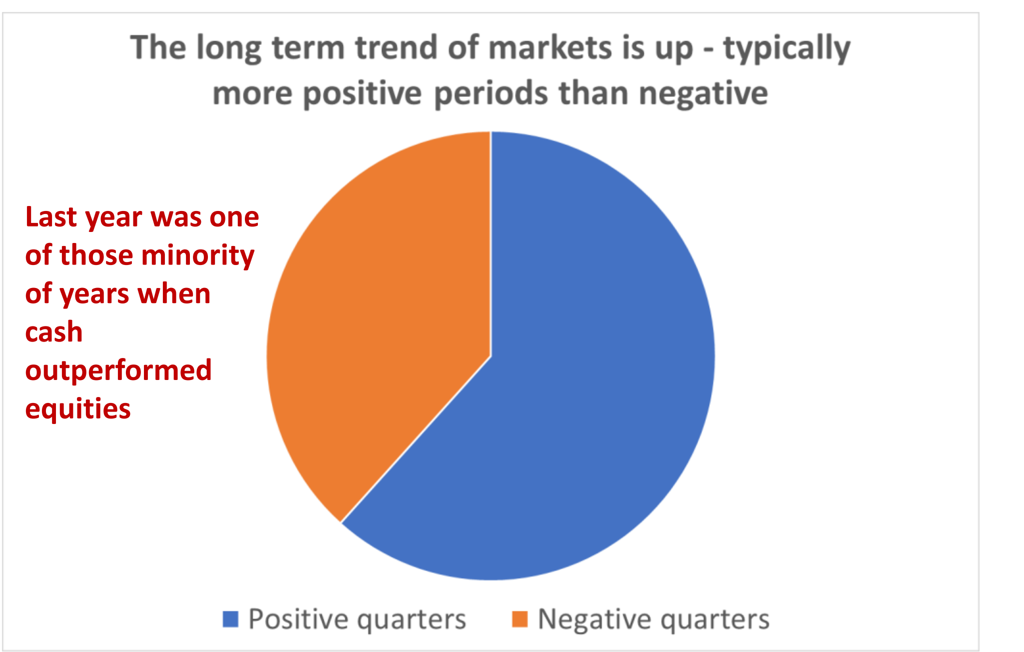
The long term trend of markets is up - typically more positive periods than negative
Last year was one of those minority of years when cash outperformed equities
Positive quarters
Negative quarters
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Volatility is the price for getting higher returns

We need to accept that stocks have negative returns from time to time

What you MUST **NEVER EVER** DO: Throw in the towel after an especially tough stretch!

You should start trimming your positions when the market is getting more and more expensive

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At high market valuations, the plunge can be sharp and swift, like the elevator going down

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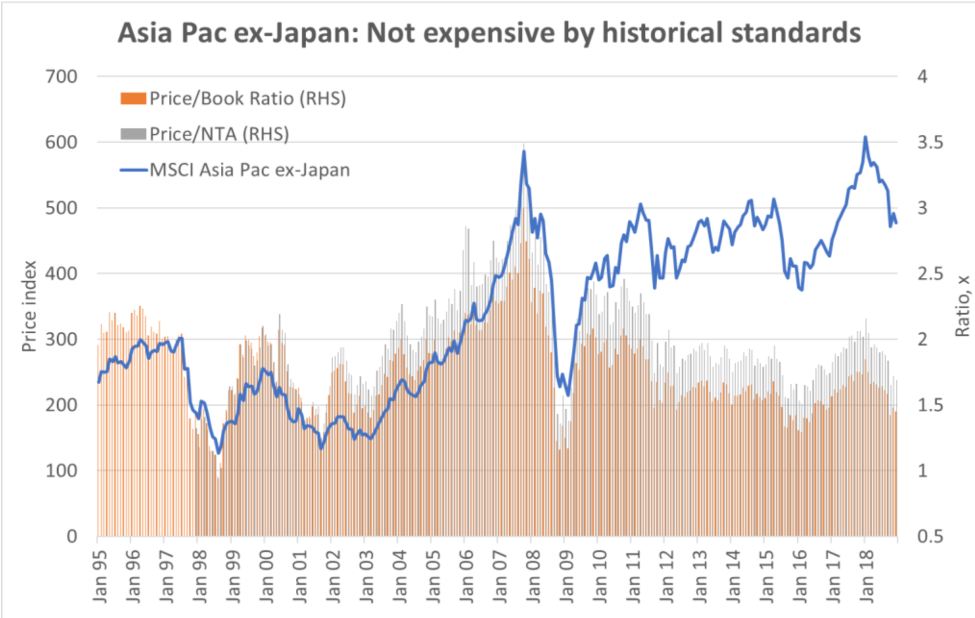

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It is probably too late to sell after the crash has happened

Selling after a big crash is the worst thing you can do to your portfolio

You deny yourself the chance of a recovery

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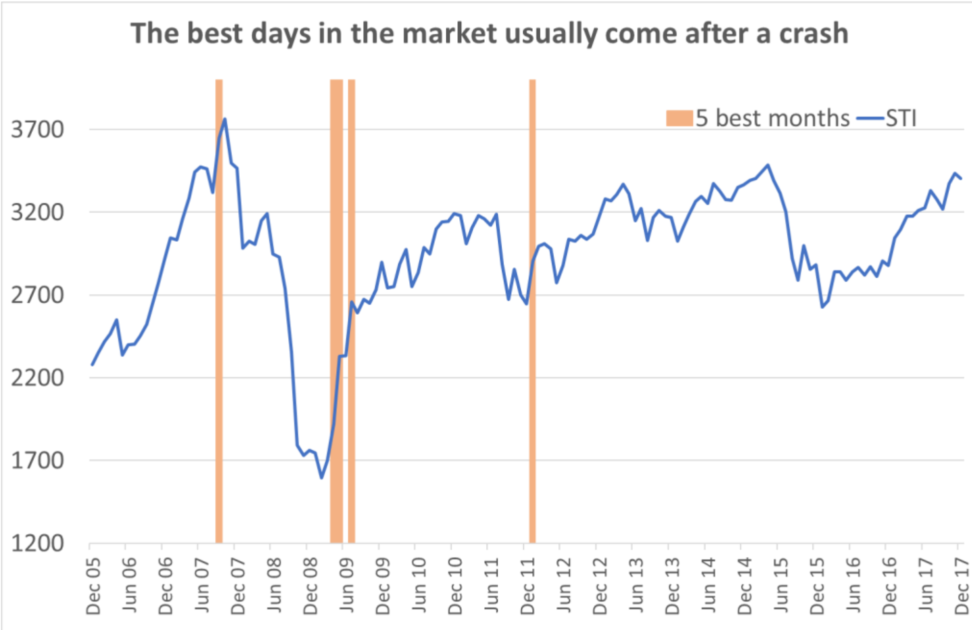

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Ride out the tough periods

Crisis	Period	Loss during period	3 months	6 months	12 months
Iraq invades Kuwait	Aug 1990 to Oct 1990	-28%	4%	32%	25%
Asian Financial Crisis	Jul 1997 to Sep 1998	-32%	40%	46%	117%
Dot-com, Sept 11 Attacks	Jan 2000 to Nov 2001	-47%	27%	25%	1%
Enron, Iraq, SARS	Dec 2001 to Mar 2003	-19%	11%	28%	54%
Global Financial Crisis	Oct 2007 to Mar 2009	-57%	50%	70%	78%
European Debt Crisis	Jul 2011 to Oct 2011	-19%	7%	17%	21%
	Average	**-34%**	**23%**	**36%**	**49%**

Caveat: Provided the stocks you own are at no risk of going to zero
Indexes will not go to zero. If they do, it's the end of the world as we know it!

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Recap

Value is the gravitational pull of the financial markets

But the timing of returns is unpredictable. There are randomness and inefficiencies

Exploit the law of large numbers to counter randomness, i.e diversify. On a macro level, be contrarian

Expect and accept volatility. It's the price to pay for higher returns

Prices are most susceptible to a sharp plunge when valuations are high. The plunge is typically sharp and swift

Don't sell after a big crash. Sell when there is irrational exuberance. Most other times, stay invested

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Putting everything together:

Total return: 10 to 15 % p.a.

Able to time the market using valuation: + 1 to 3 % p.a.

Using value investing process, buy cheap stocks, sell when they are no longer cheap : + 2 to 3 % p.a.

Exposure to more markets : + 2 to 3 % p.a.

Equities exposure 5 to 6% p.a., provided you don't do anything silly like selling after a crash

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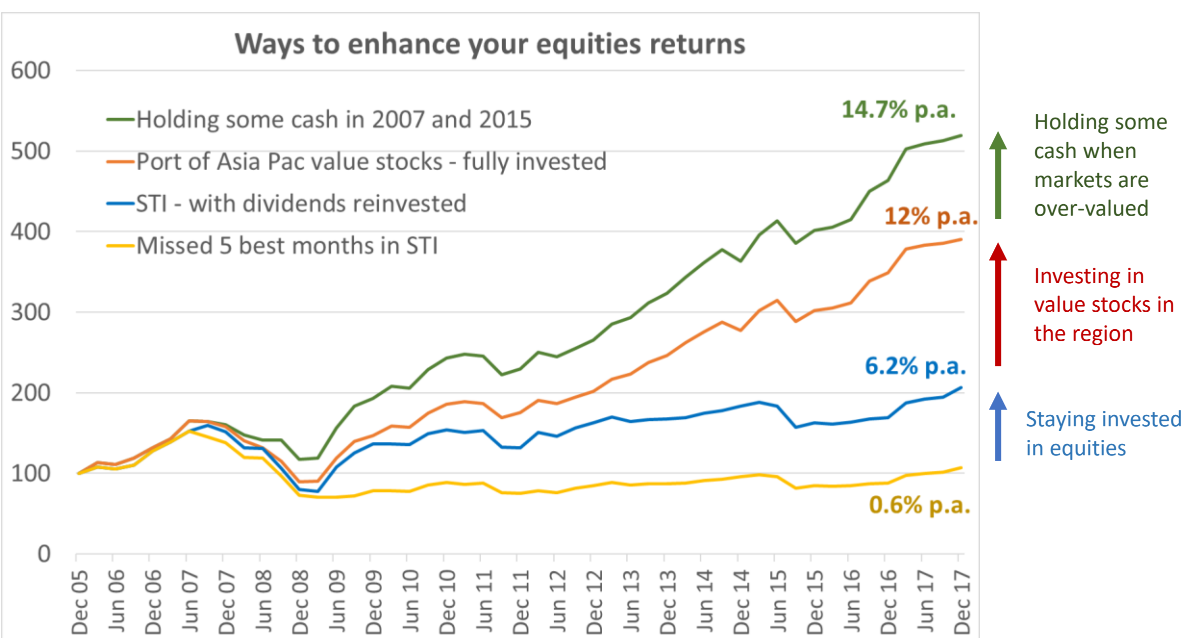

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What it takes

01	02	03
Be invested	Be disciplined	Be rational. Don't be ruled by your emotions

There are no bad days in the market. When the market is down, you've got bargains, and it's lovely to think of what you are buying at low prices. When the market is up, the bargains have gone, but you're rich – Bruce Greenwald

Thank you!

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