

CHAPTER 1

Value Investing in Asia

You're looking for a mispriced gamble. That's what investing is. And you have to know enough to know whether the gamble is mispriced. That's value investing.

— Charlie Munger

We wrote this book to share with you about the practical applications of a value investing approach here in Asia. With many books written on investing 101, introductory concepts of value investing are not the focus of our book. However, we still like to do a quick refresher before heading on to the fun stuff.

Value investing was first made famous by Benjamin Graham, with many considering him as the father of value investing. We believe that walking along this path of value investing will provide you with a disciplined approach in your financial adventures.

To start, we first must draw a clear line between what is an investment and what is a speculation. Even after 80 odd years, the explanation by Benjamin Graham and David Dodd in *Security Analysis* made the most sense to us. They stated: “An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative”. Nicely put.

From where we stand, speculation is more like guesswork without evidence. With its negative long-term expected return, a good example of speculation is a lottery. Buying a lottery ticket and hoping to

win is speculation. If you really want to try your luck, no one is stopping you. However, we should not confuse the two.

On the other hand, an investment is something you buy now based on reasons that make sense, and with reasonable confidence that you will receive more money down the road. For us, value investing is simply a strategy of stacking the odds in your favour. Imagine being able to consistently buy a dollar's-worth of asset for 50 cents over and over again. Over the long term, this should work out much better than just buying the lottery ticket and hoping for the best.

With that said, here is what we think value investing is all about.

Finding Value

Great investors come from across a spectrum of investing styles – from legends like Warren Buffett, Walter Schloss and Irving Kahn to fund managers like David Einhorn, Guy Spier and Joel Greenblatt. Even in Asia we have famous investors like Target Asset Management's Teng Ngiek Lian, APS Asset Management's Wong Kok Hoi, Pheim Asset Management's Dr Tan Chong Koay and Value Partners Group's Cheah Cheng Hye and Yeh V-Nee. Value Partners Group Limited is the first independent asset management firm to be listed on the Hong Kong Stock Exchange – and one of Asia's largest.¹

The differences in strategy and style among value investors are countless. Some go for large-cap stocks while others spend their whole careers in small-cap stocks. There are successful investors who invest domestically in just their home market, while many venture overseas as well.

Although the practical application of value investing differs among individuals, the common underlying theme is similar. At the end of the day, everyone tries to find discrepancies between the market price of the stock and their estimated value of the company, commonly known as intrinsic value.

Even with the diversity, there are some fundamental characteristics common among most value investors. They

- accept that mistakes do happen and learn from them
- do not feel the need to fit in with the market
- follow the margin-of-safety principle
- have conviction in their analysis and decisions that are based on logic and reasoning
- think and invest like a business owner.

In a nutshell, value exists when you think that the asset is worth more than its market price with the probability of this asset appreciating in value being more likely than not.

The Investor and the Market

Two of the most important concepts regarding value investing are best described in the book *The Intelligent Investor* by Benjamin Graham, specifically in Chapters 8 (how the investor should view market fluctuations) and 20 (margin of safety). These were the two chapters recommended by Warren Buffett so that “you will not get a poor result from your investments”.

The Investor and Market Fluctuations (Chapter 8 of The Intelligent Investor)

Most of us hold the misconception that the market price of a stock is the intrinsic value of the company. However, these two terms are as different as day and night. Market price is easy to understand; it refers to the current market price of the asset. On the other hand, value is what that investment is worth to you. And this is when things start to get confusing, because value is a matter of opinion and can differ greatly between investors.

John Burr Williams, one of the pioneers on investment valuation and the author of *The Theory of Investment Value*, stated: “The market can only be an expression of opinion, not a statement of fact. Today’s opinion will make today’s price; tomorrow’s opinion, tomorrow’s price.”

At any time, market price simply reflects the opinions of the most optimistic non-owner (bid) and the most pessimistic owner (ask). To put it simply, price fluctuations are nothing more than the consequence of supply and demand between the buyer and the seller, and market price is nothing more than the result of the marginal opinion. When asked about what the stock market would do next, John Pierpont Morgan (better known as J.P. Morgan) simply replied, “It will fluctuate.”²

Yet why do so many investment professionals still relate price volatility to investment risk? If you think about it, all volatility symbolises is the changing opinions of the market. It is worth thinking about this logic while reading this book. To us, this logic is pretty illogical. Interestingly, this irrational volatility is also how most value investors can hunt for bargains within the stock market.

Mr Market (Chapter 8 of *The Intelligent Investor*)

To better appreciate how the market works, we like to introduce you to Mr Market, a metaphor coined by Benjamin Graham in *The Intelligent Investor*. Mr Market is a representation of how the market works. But who exactly is this Mr Market?

Mr Market is an imaginary, highly emotional investor driven by panic, euphoria, greed and apathy. Basically, Mr Market is an emotionally unstable person who approaches investing based on emotion rather than through analysis. Think of him as your business partner in the company you invested in. Every day he tells you what he thinks your interest in the business is worth and offers to buy your share or sell you more shares. Sometimes his offer appears reasonable while at other times he lets his enthusiasm or fears dictate his offer and to the point of being ridiculous. Does this remind you of anyone? Not so imaginary now, is he? This, guys, is how the market works.

Benjamin Graham famously said, “In the short run, the market is a voting machine, but in the long run, it is a weighing machine.” In the long term, prices should reflect business value. However, short-term price movements tend to have little to do with the fundamentals of a business. Sometimes prices move on fundamental reasons and sometimes just for the fun of it. Why? Just because they can. Therefore, as investors, we should stick to the business over the long term instead of worrying about the emotions of the market in the short term.

However, due to our strong need to make sense of the world, we cannot help but try to make sense of every single price movement in the market. Notice the number of pundits that will take a shot at finding a reason for every single price movement. Seeing three pigeons on your roof just before the Hang Seng Index tanks by 10% does not mean that those three crafty-looking pigeons perching on your roof evaporated those billions!

This might have been why theories like the efficient market hypothesis grew to become the main school of thought in the finance world. Most of these theories within efficient market hypothesis work well in a perfect and hypothetical world. Working most of the time and working all the time are two different things. Unfortunately, our world is much more unpredictable than finding out what is inside a Kinder Surprise. In theory there is no difference between theory and practice; in practice, there clearly is.

On a personal note, our experiences during the Global Financial Crisis in 2008 taught us how hard it is not to join in the irrationality of the market during times of panic. Saying that market prices did not seem to reflect reality during that period was an understatement. Even a “Blue Chip” like one of Singapore’s largest listed company, Singapore Telecommunications Limited (“SingTel”), saw over 40% of its share value wiped out in just two months. But did SingTel lose 40% of their customers in those two months? We do not think so. That said, although it is easy to spot the irrationality of the market, it is extremely difficult not to get sucked into the vortex of negativity.

Essentially, most of these modern market theories assume that we are all rational and can make the most efficient choice in every situation. This implies that we are both emotionless and have perfect information to make logical decisions. Doesn’t this sound like something out of a fairy tale? That’s what Snow White and her seven dwarfs thought as well.

In reality, our decision-making process typically involves making sense of the situation based on what we know, how we feel and our past experiences. That is why the price of the stock can differ from *our* estimated value of the company.

We should always remember that Mr Market is just here to provide us with options. It is 100% up to you to decide if it is to your advantage to act on them. As investors, the advantage we have is patience. No one can force us to act. All we should do is sit patiently and wait for the right hand before striking. We can take advantage of Mr Market’s over-optimism and his panic desperations.

To round up our discussion on Mr Market, we will leave you with the wisdom of Howard Marks – “If you think markets are logical and investors are objective and unemotional, you’re in for a lot of surprises. In tough times, investors often fail to apply discipline and discernment; psychology takes over from fundamentals; and ‘all correlations go to one’ as things that should be distinguished from each other aren’t.”³

Margin of Safety (Chapter 20 of The Intelligent Investor)

We like to start with a quote by a former United States Secretary of the Treasury, Timothy Geithner, in his book *Stress Tests: Reflections on Financial Crises*: “Even the best forecasts, I learned, were just educated guesses. They could tell a story about how the economy might evolve, but they couldn’t predict the future.”⁴

Even though Timothy Geithner referred to economic forecasts, we felt that this also applied to our expectations of a company, especially when it comes to valuation. When reading through equity reports, we are frequently amused that an exact value (sometimes even down to two decimal places!) can be pegged on a business, especially when the valuations are based on so many assumptions! Remember, forecasts tell us more about the forecaster than the company, thus it is important for us always to read the assumptions made for a valuation exercise.

Given the large number of assumptions we need to make during a valuation exercise, we believe that at best valuation can be narrowed down to a range. Herein lies the essence of value investing: the importance of having a margin of safety. A discussion of value investing is not complete without a margin of safety. With a margin of safety, you need not know the exact value of a company to conclude that it's undervalued. You do not need to understand every single detail to survive in the world of investment.

A margin of safety is a way for investors to control the risk of investing by having a safety gap between the market price of a company and our estimated intrinsic value. A good analogy is an engineer's safety factor calculation. When constructing a bridge to handle a load of 1,000 tonnes, an engineer doesn't build it just for 1,000 tonnes; this bridge might be built to hold 2,000 tonnes, 3,000 tonnes or more. Why? Because in the real world, unexpected things happen, so it's always better to be conservative.

Thus, having a margin of safety makes it unnecessary for us to need a crystal ball when analysing a company. Here is an example that shows why.

Let us assume that Singapore-listed CapitaLand Limited, the largest property developer in Southeast Asia, was priced at S\$8 billion in the stock market, and you have estimated the company's value at somewhere between S\$10 and 14 billion. At S\$8 billion, you would have at least a 20% *margin of safety* even in your "worst case" scenario.

In the context of investing, this is like having a buffer between what you think the asset is worth and what the asset is priced at. Based on your data and analysis, if you think that this company is worth \$2 and you get it at \$1, you have a margin of safety of 50%. This means that if your estimates are off by 50% you might still be able to protect yourself from making a loss in your investment.

Unlike the “perfect economic man”, who makes perfect and logical decisions every time, we are more than capable of making mistakes. Some might even say that we are well versed at it. Therefore, only by insisting on a margin of safety before we make an investment are we able to minimise the risk of making an expensive mistake by not overpaying. Remember, the best investment is one bought at a good price.

We hope that appreciating Mr Market and the concept of having a margin of safety will help you as much as they have helped us. A good start to having a successful value investing journey is to have the right mindset in place. However, this is just the beginning. Like everything else, we need to train ourselves before we can be good at something. Investing is no different. We definitely do not want to shoot ourselves in the foot by assuming that as long as we have the right idea, we can throw everything else aside. We cannot just will ourselves to get up and run a marathon without training for it. That will not end well.

Why Value Investing Works

Every boom and bust in the financial markets might be different, but what many don't notice is that history tends to repeat itself and investors never seem to learn. The more things change, the more they tend to stay the same. Ironically, this irrationally provides us with windows of opportunity. For most publicly traded companies, there will be times of under- and overvaluation, simply because shareholders do panic and act irrationally from time to time. When the right opportunity arises, we just have to exercise conviction in our judgements.

Thus, Rudyard Kipling's famous words, “If you can keep your head when all about you are losing theirs. . .”, ring true for a level-minded value investor if they are to take advantage of what Mr Market has to offer. And this unchanging aspect of human emotions is what makes value investing work. The key attraction of value investing is its logical and commonsense approach. In the stock market, you will soon realise, common sense is not really that common.

Instead of trying to predict the future, we should spend our time trying to find value from the realm that is relatively more knowable – companies, industries and securities – rather than basing our investment decisions solely on, as Howard Marks puts it, “the less-knowable macro world of economies and broad market performance”.

If you still have doubts on the utility of value investing, we recommend that you look at the short story “The Superinvestors of Graham-and-Doddsville” in *The Intelligent Investor*. This was from an edited transcript of a Columbia University talk in 1984 by Warren Buffett commemorating the 50th anniversary of *Security Analysis*. Buffett presents a group of investors who have, year in and year out, beaten the Standard & Poor’s 500 stock index. Perhaps his story may lay your doubts to rest.

For the rest of us, let’s get to work. Here are the three types of value you can find in the stock market.

Three Types of Value to Be Found

Before exploiting any opportunity, we must first know what we are looking for. We can start by understanding the different types of value to be found in the market. Otherwise, we may be as confused as Alice when she just arrived in Wonderland.

Before diving in to estimate the intrinsic values of companies, we need to be able to differentiate between the types of opportunities before us. As investors, we want to know where we are going, and we believe that there are three major areas where value can be found in the market.

Asset Value

First, value may be realised from companies trading at levels significantly below their asset value. Asset value can be the liquidation value of the company, the replacement value of the business or just the sum of its net assets. This generally applies to companies in capital-intensive industries with assets underappreciated by the market.

Typical companies with value under this segment could include utilities-related companies, property-related companies, Real Estate Investment Trusts or even conglomerates.

Current Earning Value

Value can be found in companies with strong and stable earnings. Some of these companies might be trading at a deep discount compared to the estimated intrinsic value. Bear in mind that we focus mainly on the current earnings when estimating intrinsic value for these companies. This means that we might assume zero to moderate

growth in these companies. These possible undervalued gems turn up when our estimates of their value are much higher than their market price.

Typical companies with value under this segment could include companies in industries with a decently long history of profitability that are operated in conditions that are unlikely to be massively disrupted. Examples include consumer staples and healthcare.

Expected Growth

This type of value is based primarily on projecting the future. Generally, these investments are considered relatively riskier, given the uncertainty in the future. However, this segment can also present to you the highest potential in returns compared to the other two segments. This is because companies with undervalued assets or current earnings potential tend to have a limit on how much the value can be. However, a company with future growth potential can theoretically have unlimited growth potential in the future. After all, who would have thought that Apple Inc., with an initial public offering value of close to US\$1 billion back in 1980,⁵ would grow to a size of about US\$600 billion by the end of 2016?⁶

To illustrate the diversity of values, consider these two companies. The first is Hong Kong-listed Orient Overseas (International) Limited (“OOIL”), an asset-heavy container shipping company in a cyclical industry currently in a down-cycle. The second is NASDAQ-listed Baidu Inc., a Chinese web service company with a huge growth potential. Both these companies can turn out to be great investments in their own rights. However, it is obvious that the method we use to estimate the intrinsic value for OOIL should be vastly different from the way we value Baidu Inc.

Under the appropriate circumstances, OOIL might appear undervalued relative to its asset value. On the other hand, the bulk of value from Baidu Inc. might potentially be derived from the future growth of the business.

Notes

1. Value Partners Group Limited. “Annual Report 2015”.
2. Benjamin Graham. *First Collins Business Essentials*. “The Intelligent Investor”. Edition 2006.

3. Howard Marks. Oaktree Capital Management, L.P. Memo to Oaktree Clients. "The Lessons of Oil". 18 December 2014.
4. Timothy Geithner. Random House Business Books. *Stress Test: Reflections on Financial Crises*. Published: 2014.
5. Apple Computer, Inc. Common Stock Prospectus. 12 December 1980.
6. Google Finance. Apple Inc. <https://www.google.com/finance?cid=22144>. Accessed: 27 April 2017.