ASTRAL VALUE FUND

Newsletter

JUN 2018

	Jun 2018	YTD 2018	1 Year	Annualised since Inception	Inception to Date***	Outperformance since inception
Astral (Class B)*	-2.9%	2.8%	6.2%	7.5%	25.8%	
MSCI Asia Pac	-3.6%	-4.5%	8.8%	2.5%	8.3%	17.5%
Hang Seng	-5.0%	-3.2%	12.8%	0.9%	2.9%	22.9%
FSSTI (USD)**	-6.4%	-5.8%	3.4%	-2.9%	-8.9%	34.8%

*Net of all fees
**FSSTI was rebased to USD using the month-end exchange rate
*** Inception date was 1 May 2015

HALF-YEARLY COMMENTARY

Dear Partners and Friends,

Our year to date returns for the first six months of the year was 2.8%. All the major markets around the world ended the first half of the year in red.

The year started brightly with the majority of the market, including us, expecting a bullish year ahead. Optimism abounded that after the much-heralded US corporate tax cuts were pushed through and major economies were seemingly undergoing a synchronised recovery. On hindsight, perhaps we should have been more cautious when everyone was so bullish, as geopolitical risks followed by the spectre of a trade war and rising rates made investors turn cautious.

Markets were up in January as inflows poured into the Asian region. It did not take long before the first announcement of a well-flagged rate hike in February started making everyone think twice about inflation and reconsider their positions in a rising interest rate environment. March saw Trump starting his protectionist talk as he tried to get China to abolish their unfair trade practices. This gesture was met with a forceful response by the Chinese and resulted in the market falling further. At the same time technology stocks started to undergo a correction as concerns over their stretched valuations sparked a run to the exits.

In April, oil and banking stocks staged a mini-rebound as rising rates were judged to be beneficial to banks and crude oil stayed above the psychological US$70 level. The trade war spat seemed to have been resolved with Trump and Xi making conciliatory remarks. However, in May and June, Trump suddenly raised the stakes by insisting on raising certain tariffs on Chinese goods unless his terms were accepted. This was met by an equally forceful response by China. The whole trade war saga evolved to a game of chicken which saw each side upping the ante with each response.

In the meantime, the Chinese economy seemed to have lost steam from last year's steady growth as PMIs started falling in April and May. The crackdown on Chinese property speculation and shadow financing continued early this year but this has had the impact of slowing down the economy. Orders slowed as continued worries of the trade war led to more cautious demand from corporates.

A fallout of the rising rates in US and slowing demand in China was the depreciation of the Renminbi. Memories of the consequences of the recent devaluation of RMB in 2015 were probably still fresh in people's minds.

Coupled with the spectre of a full-blown trade war with a slowing Chinese economy, the worries were enough to unnerve investors, and markets around the world fell.

Under the backdrop of a rapidly changing financial environment, our portfolio performed credibly to return 2.5% for the year. We managed to avoid the volatility of the banking, property and technology sector due to our avoidance of them since late last year. While most of the portfolio were still negatively affected by the negative macro environment, several stocks which we invested in late last year did well. Of note was our investment in Nissin Food Hong Kong where we have already returned close to 50% year to date. We see a nascent return to the luxury and retailing space in Hong Kong after many years of decline and we have positioned ourselves accordingly to benefit from this.

Our View of the World Now

The era of cheap capital is over

We have warned in our previous newsletters that rising interest rates will have profound impact. This is none more so than in the private equity space when valuations of some Unicorns are much higher than the valuation of their listed parent. Either the private equity players are wrong or investors in the secondary market are undervaluing the parent. One argument for the continued undervaluation of Alibaba and Tencent goes like this: If you include the private valuations of all the stakes which the parent owns, it is likely that the valuations of Alibaba and Tencent have room to run. However, many have failed to consider if the Unicorn was over-valued. This has resulted in a recent phenomenon whereby newly listed Unicorn firms see their share prices plummet over the first few weeks of trading. One likely reason is because when the companies were privately held, certain key information were not required to be published; but once the not so attractive metrics got published at the point of going public, the potential for further valuation gains disappeared. We will see less funding for high risk ventures and more rational risk taking. Ventures which have no near-term chance of making money or face deep pocket competitors are now being allowed to fail, as seen by the recent winding-up of bike-sharing companies in Singapore.

Another potential area to watch is that of virtual currencies. The volatility of bitcoins has again inflicted great losses on investors. Since the high of last year, bitcoin's price has plummeted 70%. In addition, 800 other cryptocurrencies are now officially worthless. Underpinning the rationality of investing in bitcoins is the idea that fiat currencies are manipulated and blockchain, which records every transaction, makes cryptocurrencies more secure. Unfortunately for a currency to really take hold, it must be used as a medium of exchange in everyday life which requires the backing of government. While some people have bought into this story and have started transacting using crypto, it will take far more than that to displace fiat currencies. Not least the fact that more and more governments are clamping down on the usage due to the potential of it being used for illicit purposes such as money laundering.

Deleveraging of the Chinese economy and Trade War

The mainland indices fell significantly during the first half of the year with the main Shanghai and Shenzhen indices down close to 20% since the start of the year till mid of July. This was mainly due to a slowing economy because of a crackdown in shadow financing in the system. The strict pollution enforcement also seems to have taken a toll with many industries struggling to comply with the increasingly stringent regulations. The cost of financing small businesses has risen to new highs with Chinese banks still reluctant to give out loans to non-SOE companies, despite being told explicitly to do so. The potential of US tariffs only served to spook markets further as markets became afraid that the tit-for-tat action will result in China using tools such as a sudden devaluation of the RMB to combat the rise in US tariffs. However, with the RMB depreciation wreaking havoc on the markets two years back fresh on the government minds, we believe that it is unlikely that the PRC government will depreciate the RMB unnecessarily this time round.

We continue to believe both countries will not risk a full-blown trade war and the nascent recovery of both economies. One party just wants to show his constituents that he is doing something whereas the other needs to continue to benefit from the existing trade flows in order to stabilise the rapidly slowing economy. Hence, we believe at some point in time, concessions will be made by both parties at the negotiating table. That is not to say that if tomorrow China and US come to an agreement, markets will rally. Instead, market concerns that by the time both countries come to a consensus, the world economy will be irreparably damaged, could be too dire a prediction.

How are we managing our portfolio?

We do have to be rational about taking risks. At the start of the letter we mentioned that we were probably too bullish at the start of this year. The inverse is true too. Given the prevailing excessive pessimism, we do not wish to hold too much cash.

While we are fully invested, we are adopting a defensive posture in the stocks that we own though. The advent of indexing and dearth of coverage in the mid-cap equity space continues to produce huge discrepancies in valuation. Together with the widespread pessimism, we are starting to find great moat companies at Ben Graham's type of valuations. Domestic based stocks producing solid recurring cash flows fully backed by balance sheet assets now take up the large part of our portfolio.

The table below tracks the changes in our equity portfolio EV/EBITDA and Price to Book over time. Despite appreciating a further 2.8% year to date, our portfolio's EV/EBITDA has fallen further to 5.1x in June 2018, an all-time low. Our portfolio weighted gearing is about 20% debt to equity and yields an estimated dividend yield of 5%.

Date	P/B	EV/EBITDA
30 Jun 18	0.72x	5.1x
31 Dec 17	1.12x	6.6x
30 Jun 17	1.34x	7.4x
31 Dec 16	1.08x	6.6x
30 Jun 16	0.89x	7.0x
31 Dec 15	0.88x	7.3x
30 Jun 15	1.26x	9.0x

What We Have Learnt

Seasoned investors would tell you the real art in investing is not in the buying but the selling. This is because it is the selling price that determines whether you make a realised gain or not. Paper profits can be easily lit into fire when things go wrong.

When do we at Astral sell? We usually sell in a few scenarios:

1. When the stock has appreciated to or above its fair value
2. When our original thesis turns out wrong
3. Business has deteriorated, or the external environment has invalidated our thesis
4. If we can buy better value elsewhere

It may seem easy on paper to just follow the rules written above. However, psychological forces, such as herding occasionally allows Mr. Market to offer prices far above intrinsic values. The problem with value investing is that there is no precise single value for a company. Remember Keynes' axiom that "it's better to be roughly right than precisely wrong". Since there is no precise value for intrinsic value, we need to approximate a range of intrinsic values for the fair value of a company.

When a stock price usually runs far beyond its intrinsic value, the logical thing would be to sell. Unfortunately, in certain situations. as the initial assumptions were rather conservative, value investors tend to often make the mistake of selling too early. Keenly aware of this weakness of value investors, we try to sell only when the price hits the upper range of our fair value estimate. In addition, we may adjust some assumptions to reflect the current reality. However, we run the risk of holding on to overvalued positions sometimes.

This was what happened to one of our stocks Sunevision, which we talked about in one of our previous newsletters. The stock rose exuberantly in January in anticipation of the company shifting to mainboard and we kept revising our assumptions until they were a tad too optimistic. Sadly, we lost all the gains as we did not sell a single share. A case could be made that over the long run, this franchise situation could still work out for us. It was just that we could have enhanced our returns by top-slicing at high valuations to lighten a certain position, especially as we could find better value elsewhere then. We learnt our lesson well and during May 2018, when some of our positions suddenly rallied en masse, we sold down some stocks and reinvested into other more undervalued situations.

Selling for us no doubt continues to be a work in progress.

Investment Situation Showcase

High Income Portfolio

Over the last five newsletters, we have elaborated on how the various investing situations can lead to value investing. They are purely examples to showcase our investment strategies and are not to meant to be investment calls. The last situation we will explore is the high income situation. This situation will face significant headwinds in a rising rate environment, which we will explain later. First, let us look at how we consider high income as an investment situation.

The easiest way to think about a high-income situation is to imagine a stock trading at 10% dividend yield per annum. If we believe that the fair dividend yield should be 9% and the price will revert within a year to reflect this yield, a stock will return 11% in capital appreciation and 10% in dividends in the meantime. This brings a total return of 21% in a year. Not a shabby return in a world of low returns.

Viva Industrial Trust

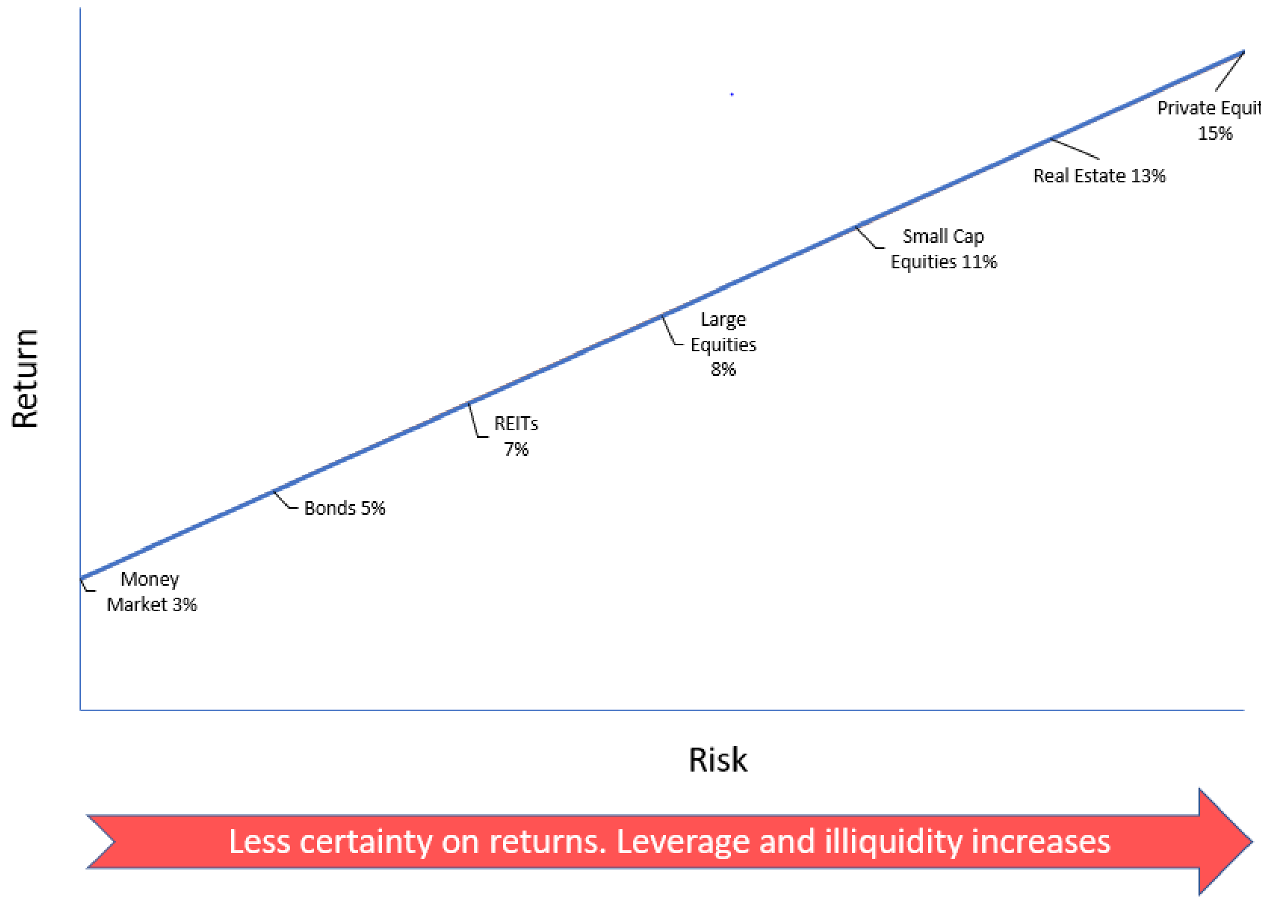
Viva industrial trust is an Industrial Reit traded on the SGX. It came to market with a rather unconventional set of assets comprising of a stapled hotel and several industrial assets. Free float was rather thin as much of the shares at IPO were allocated to a prominent Chinese investor. Due to poor marketing, the Reit traded at a yield of 9% since the start of its trading. Our opportunity was when we were offered a placement to subscribe to the Reit at a discount to the current price at S$0.78. In our opinion then, the major problem with the Reit was liquidity. With that placement, we believed that the liquidity problem could be solved. The assets were in accessible locations and moreover the proceeds of the placement would be used to do asset enhancement on its industrial park in Chai Chee. Being familiar with the area, we thought that the asset enhancement would have appeal as the asset has a long visible frontage along the main road in Bedok.

We estimated that even during the enhancement, the company can still afford to pay out its existing yield of 8%. This was in theory and Yogi Berra's famous words remind us that "In theory there is no difference between practice and theory but in practice there is." After we invested, there were a few hiccups as the first fund raising did not raise enough money and a second placement was done at an even lower price. Another problem that cropped up was that one of its recently acquired properties saw some tenants breaking the lease. The rash of bad news prevented the share price from rising to reflect the fair dividend yield of the company.

With the management working hard to promote the Reit, gradually after two years, the stock finally garnered interest from the investment community. The AEI at Viva Business Park in Chai Chee was completed and managed to secure full tenancy. The additional income from the AEI contributed substantially to an increased DPU as well. The stock price rose to S$0.95, at which point we exited. In two years, we made 21% in capital gains and 8% dividends in between. This translated to a compounded return of 20% which was as good as it gets for a high income investing position.

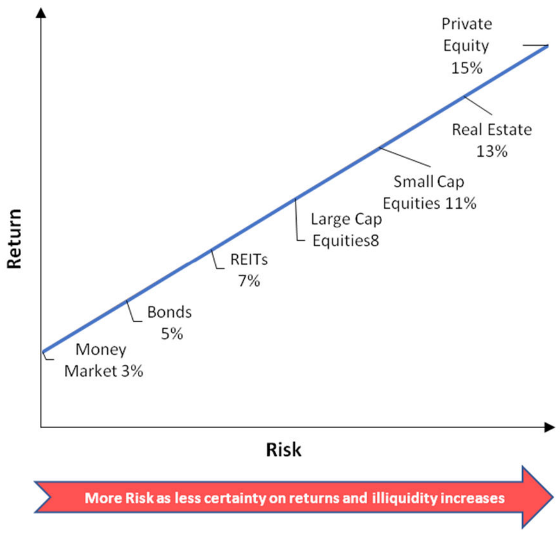
Warning

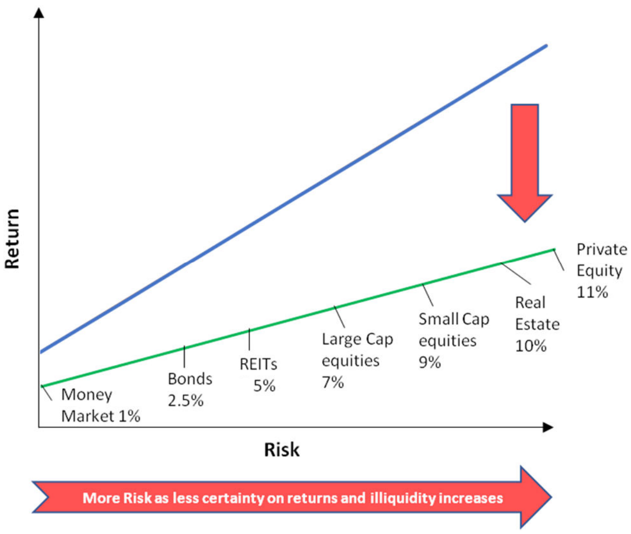
As mentioned earlier, we are bearish on high income situations. It is first useful to understand Howard Marks' Risk Return Curve, a graph so intuitive for capital markets but, for some reason, was never taught in high schools.



What Marks essentially was saying is that there is a certain set of "rules of the jungle" such that the returns from the higher risk asset class must compensate you sufficiently or you will rather settle for safer asset class. For instance, a money market fund as seen from the chart above is risk-free and allows you the flexibility of withdrawal without any limitations. As we go up the curve the returns should compensate us adequately if we are taking more risks. A bond ought to give us a higher yield than the money market as we bear credit risks. In addition, bonds give us certainty of return if we hold them to maturity. Moving up further, we go to Reits and large equities. They can potentially give us higher returns but in exchange, we give up the certainty of returns. Yields must be increased further as we go into small cap equities, real estate and private equity, as now liquidity and leverage are factors we need to consider. As Mark explains in his book, all returns of the various asset classes simply take bearing from the risk-free rate.

What has happened in recent years or should we say the last decade, is that the risk-free rate has been artificially reduced such that the whole capital asset risk return line has been shifted downwards. This has seen investors accepting higher risk for lower returns.





Alert readers would have spotted that the returns of the various asset classes in the first chart are much higher than the second. If we look at the second graph, the returns do correspond more to the current returns of the various asset classes, whereas the first chart happens to be the Reward-Risk chart a decade ago. Many of us have gotten used to low interest rates and have somehow decided that they are here to stay forever. Unfortunately, things are about to change as the risk-free rate has started to rise significantly. There are always 2 sides to a coin. Just as how the fair value dividend yield of an equity that falls from 10% to 9% produces an 11% capital gain, the rise in required yield from 5% to 7% produces a capital loss of 28%.

Acknowledgement

We wish to place on record our sincere appreciation to our partners who continue to put their faith in us. Not many funds get to celebrate their third birthdays. We hope to be still around even when we are thirty.

As mentioned earlier, our metrics continue to show that our portfolio is at one of the lowest points of valuation. We welcome feedback and potential partners to contact us at enquiries@astralasset.com for more information.

Sincerely,

Astral Asset Management

Fund Information		
Fund Name	Astral Value Fund	
Bloomberg Ticker	ASTRALV KY Equity	
Base Currency	USD	
Portfolio Manager	Astral Asset Management	
Jurisdiction	Cayman Islands	
Share Class	A	B*
Subscription Charge	1.0%	Waived
Management Fee	1.5% p.a.	1.2% p.a.
Performance Fee	15%	12%
Early Redemption Charge	3% in Year 1,	3% in Year 1, 2% in Year 2, 1% in Year 3
Redemption Charge	1%	
High Watermark	Yes	
Fund Administrator	Apex Fund Services Singapore Pte Ltd	
Fund Custodian	DBS Bank Ltd.	
Fund Auditor	Deloitte	

*Limited Capacity

Note: Our fund is only open to “accredited investors” as defined by the Monetary Authority of Singapore