# ASTRAL VALUE FUND

Monthly Commentary

## DEC 2017

| | Dec 2017 | YTD 2017 | 1 Year | Annualised from Inception | Inception to Date** | Outperformance since Inception |
|---|---|---|---|---|---|---|
| **Astral (Class B)** | 1.4% | 16.5% | 16.5% | 7.9% | 22.4% | |
| **MSCI Asia Pac** | 2.0% | 28.7% | 28.7% | 4.8% | 13.3% | 9.1% |
| **Hang Seng** | 2.5% | 36.0% | 36.0% | 2.3% | 6.3% | 16.1% |
| **FSSTI* (USD)** | 0.0% | 27.9% | 27.9% | -1.3% | -3.3% | 25.7% |

*FSSTI was rebased to USD using the month end exchange rate
** Inception date was 1 May 2015

### INVESTMENT OBJECTIVES

Astral Value Fund is a long-biased fund that aims to offer investors exposure to Asian markets equity returns with lesser risks through a disciplined approach to investing in mispriced situations.

### FUND INFORMATION

| | | |
|---|---|---|
| **Fund Manager** | Astral Asset Management | |
| **Currency** | USD | |
| **AUM** | 13 Mil | |
| **Jurisdiction** | Cayman Islands | |
| **Share Class** | A | B |
| **Management Fee** | 1.5%p.a. | 1.2%p.a. |
| **Performance Fee** | 15% | 12% |
| **Early Redemption Fee** | 3% Year 1<br>1% Year 2<br>1% Year 3 | 3% Year 1<br>2% Year 2<br>1% Year 3 |
| **High Watermark** | Yes | |
| **Dealing Frequency** | Monthly | |
| **Redemption Frequency** | Monthly | |
| **Fund Admin** | APEX Fund Services | |
| **Custodian** | DBS Bank | |
| **Fund Auditor** | Deloitte | |
| **Legal Advisors** | Rodyk (Singapore)<br>Walkers (Cayman) | |
| **Bloomberg** | ASTRALV KY Equity | |
| **Website** | www.astralasset.com | |

Dear Partners and Friends,

We ended December up 1.4% for the month. Overall, markets were on a tear throughout the whole year. We rode the market recovery and, with only 2 down months during the year, returned 16.5% for the full year. Since inception in May 2015, we have returned 22.4% net of all fees.

The start of the month was decidedly bearish as many stocks were sold down by fund managers closing their books for the year. This changed just before Christmas as window dressing took over. Throughout the month we continued to add on to companies which in our view will do well in the coming year. We managed to snag some good bargains especially when buyers dried up and sellers had to sell at a huge discount to unload their positions.

We view 2018 as a year full of opportunities and hidden dangers. At long last, economies are starting to get into a virtuous cycle of higher investment and spending. Yet, underlying pressures such as inflation and rising financial risks continue to simmer in the background. We will do our best to navigate through the uncertain situation and continue to compound our investors' wealth in 2018.

Our annual newsletter below details our year in review and our outlook for the year. Feedback or questions are most welcome and feel free to contact us at enquiries@astralasset.com.

Yours Sincerely,
Astral Asset Management

## FULL YEAR COMMENTARY

Dear Partners and Friends,

2017 was a good year for our fund and the markets. Astral Value Fund investors achieved more than 16% in annualised returns. The markets did even better with the HSI, STI and MSCI all rising more than 27% for the year.

Compounding via consistent positive returns is our tailwind to growing wealth. What is most pleasing for us is that the compounding effect is starting to kick in for our fund investors. For every $1 our initial investors invested in us in May 2015, we have grown it to $1.22. If we are up 10% next year, that value will grow to $1.34. Conversely, a negative return of 10% next year will set us back by 12% and original investors will only be up by 10% since inception in this scenario. Whilst compounding is a simple concept to grasp, executing it year after year is harder in practice. Mechanics aside, we simply distil our plans into one main singular focus at the start of every year – To generate positive returns by the end of the year.

### Year in Review

The year started on an uncertain note with Trump's inauguration sparking fears of the US turning protectionist. True to form, Trump initiated a series of provocative measures, intended to endear him to his supporters, such as the ban on travellers from Muslim-majority countries and, later in the year, recognising Jerusalem as the capital of Israel. The Fed raised rates in March, for the first time since 2009, and went on to increase rates two more times later in the year. Another sign of the end of the flood of easy money was the start of the end of the QE experiment in October. Throughout all these happenings, the US market retained a sanguine outlook and focused on improving employment, implementing potential tax cuts, and improving earnings. Aided by renewed flows into equity and renewed interest in passive investing, the S&P500 kept hitting new highs throughout the year.

In Asia, sentiment improved with China coming out of its mini-recession in 2015 and 2016. PMIs remained in expansionary mode throughout the year. The first year of the stock connect in Hong Kong recorded record volumes and we expect this to continue as China's financial system continues to come mainstream. There was even talk of a London-Shanghai stock connect in late December. Geopolitical risks featured prominently in North Asia in the 2nd half of 2017 with Kim's repeatedly confrontational actions being met with similar rhetoric by Trump. Tensions were ratcheted up further as both sides engaged in name-calling. Whilst the initial impact on market was risk-off, markets eventually shrugged off the risk as the consensus decision was that a war was unlikely to happen. Under the backdrop of improving economic situation, the Hang Seng Index rose 36% for the year, led by the tech sector and its poster boy, Tencent. Properties and Banks were also beneficiaries of the risk-on environment.

We did not outperform the market during the year as our portfolio is primarily set up to protect wealth first and growth comes when we are successful in investing in deeply mispriced opportunities. In 2017, we avoided investing in technology, property and banking stocks as we were not able to find sufficient margin of safety to get comfortable investing in them. These were however the sectors that found favour with Mr. Market and propelled the indexes return. Nevertheless, as we did not suffer the same huge drawdowns by the indexes in 2015 and early 2016, investors in our fund are still outperforming the indexes significantly since our fund inception.

A notable trend for the year was the rise of index investing, especially in US, where it now accounts for 35% of the equity buying today. Even Warren Buffett, who made his fortune as an active manager, seemingly jumped ship by advocating that index funds make the best retirement sense. We will explain why we think Buffett favours index investing at the end of this letter. Our opinion though is that passive investing has gone too far such that investors are now buying the index regardless of the price. This means the quality of the business or valuation is not a concern but the fact that it is in the index means the stock is worth buying. Currently the S&P500 trades at a valuation of 22x which is the highest since the dotcom days in 2000.

We believe the current euphoria mirrors closely to the nifty fifties in the late 1960s when the top 50 blue chip companies were bought simply because they were judged to be solid companies. The market wisdom then was such that these companies were so good that you can buy them and hold them for life. Those who bought in to this theory would go on to see their stock values halved by the time the bear market came in the mid-1970s. It has been said that "history does not repeat itself, but it does rhyme."

## Portfolio Movements

Our turnover ratio for the fund over the last one year was slightly higher at around 55% as we exited stocks which have rallied to fair value or face significant near-term headwinds. With interest rates around the world poised to rise, we have exited most of our High-Income positions. Growth, franchise and turnaround situations continue to be the major part of our portfolio, and they constitute two-thirds of our portfolio.

The table below tracks the changes in our equity portfolio EV/EBITDA and PB. The noteworthy thing is that despite rising almost 2% during the second half of the year our portfolio has become cheaper at the end of the year. Our portfolio's EV/EBITDA fell to 6.6x from 7.4x in June. This valuation is comparable to the levels at Dec 2016 and our PB has fallen lower to 1.1x from June's level of 1.3x.

| Date | P/B | EV/EBITDA |
|---|---|---|
| 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

Except for special situations, our investment horizon usually takes about 1 to 3 years. Time is required for our investing situations to work out and we do not believe in trading in and out of a position given that trading is not our forte. Unfortunately, sometimes things do not pan out according to our initial thesis. That is when we ought to resist the desire to be right and choose good judgement. During the year we exited a few positions that we have held on since the fund started. We found one common trait in the loss-making positions that we sold.

At the point of our investment, the company in question usually dangled strong growth plans which should propel the company's stock price if well executed. However, we have since learnt that most management usually cannot juggle between huge investments in growing the business and making sure that the existing operating business continues delivering strong earnings. Huge growth plans usually entail huge capital expenditure which can easily put a strain on companies' balance sheet if the execution is not planned well. Once the growth plan hits a snag due to poor execution, investors are bound to question if earnings will start to come through.

Once we came to this realisation for some of our initial investments, we immediately exited companies which have floundered. We have since found new opportunities and made use of the funds to invest in better opportunities.

## Investment Situation Showcase

Over the past few newsletters, we have showcased several strategies that our fund has been employing. Below is an investment example to explain our investment process for a special situation for our fund. Please note that this is not to be considered as any form of investment advice.

***Special situations***

Special situations, as the term suggests, are not available all the time. They are commonly found in spin-offs or M&As or major asset sales. In most circumstances, the presence of a catalyst will be required for a special situation to occur. For those who are interested in this topic, Joel Greenblatt's seminal book *You can be a Stock Market Genius* would offer more examples.

At Astral, we define special situations as one where the presence of an event triggers a much higher near-term realizable value of an asset to the existing traded price. So far, we have invested in corporate bonds, convertible bonds and equities for special situations in our fund. In the example below, we will look at major asset sales.

*Orange Sky Golden Harvest (1132HK)*

Astral founders love watching movies and are avid cinema goers. As frequent patrons of cinemas, it has not escaped our attention that cinema operators in certain regions like Singapore and Hong Kong run extremely profitable businesses.

The business model of a cinema operator is that most of the capex would be typically sunk in at the start and it would take 3-4 years to recover the capex if the cinema operation is moderately successful. The advantages of being a cinema operator in a mall is that they are usually the only operator and enjoy the status of an anchor tenant of a mall. A cinema operator typically gets a long-term lease of up to 10-15 years with locked-in step-up in rents. This means if one can identify a site with high traffic to attract cinema goers, an operator can be wildly profitable from the 5$^{th}$ year onwards and the business exhibits high operating leverage. Margins are higher if operators can select good sites and good operators can increase profits further selling add-ons like cheap food at extremely high margins.

Orange Sky Golden Harvest was a company we watched for a very long time. The original founders sold off their business to Wu Kebo in 2007. The new owner cleverly decided to stop uncertain businesses such as film-making and focus solely on being a cinema operator. Taking a closer look at their financials, it would be immediately obvious that the HK and SG business were lucrative for the company. Since 2007 when the company changed hands, it has invested significantly in China, trying to gain first mover advantage by selecting choice sites. This move had the effect of making their overall financials look bad. The company even reported losses in 2015 and 2016. Yet if we exclude the China losses, the company was profitable based on its operations in Singapore, HK and Taiwan.

*Opportunity*

What piqued our interest was the announcement in early 2017 that the company had sold off its entire China business for more than the prevailing market capitalisation and that it would also pay out 1/3 of the net proceeds as dividends. Although the price of the shares rose after this announcement, the market capitalisation was still below the cash proceeds of the deal. Hence, we had a situation akin to where the company sold off its loss-making business for $100 and retained its profitable business which generated $10 every year and yet still trades at $80. We have always been taught that we can't have our cake and eat it. Occasionally, by value investing in special situations, we can get the whole cake plus a free drink.

There is no risk-free trade in investing as there is a chance of the offer not going through. Two main factors gave us more confidence that the deal would go through. Firstly, the offeror was a fellow Hong Kong listed investment company, Nan Hai, the owner of Dadi cinema, the 2nd largest cinema chain in China. This gives comfort that the capital can be raised; the offer coming from someone in the same industry makes it likelier that the deal can go through. In addition, the owner showed his confidence that the deal would go through by subscribing to all his rights that he had received over the years. Whilst it can be argued that his issue price from the rights price is lower than the current traded price, it still meant that he had to put in real cash to subscribe to his rights. Without being sure that there were tangible rewards, it is usually unlikely for majority owners to exercise all their existing rights.

*What happened*

The deal was announced in late January 2017 and the stock was immediately suspended till late February. We bought in once the stock relisted in late February at an average price of 0.76. The deal was approved in late July and the company announced a special dividend of 0.351. We sold off half the position at 1.07 before the company went ex-dividend, making a 40% return in 6 months. The stock currently trades at 0.86 at the time of writing, which, including the special dividend, means that we are still up 59% for the rest of our position.

*Caveat*

A word of caution: The stock market is full of uncertainties. Special situations are essentially logical, high probability bets that the substantial shareholders will do the right thing and share their rewards with minority shareholders. This may not happen all the time as some majority shareholders are reluctant to share their gains with minority sharefolders. Furthermore, there are many deals that fall through even though the analysis were well thought out, due to extenuating circumstances such as changes in the macro environment. While the returns from special situations can be atractive if one is right, we do not think it is prudent to commit too much of the portfolio to a specific situation. Mark Twain's quote aptly sums up the caution that we should have in investing in special situations: "It is not what you know that kills you, it's what you know for sure!"

## Our View of the World Now

After a long period of recovery from the pain of the global financial crisis, the world economy is finally starting to stand on even footing. Since 2009, central banks initially flooded the financial system with record amounts of money from QE. However, that torrent of liquidity laid idle mostly in banks. 2017 was the year when the velocity of money finally picked up. This has resulted in what is now known as the Goldilocks economy. The Goldilocks economy, defined as one that is neither too hot that it causes inflation nor too cold that it causes a recession, should continue for a while. For the first half of 2018, we believe that markets should still be enjoying the effects of improved economic growth, especially with strong growth numbers in major economies. In addition, optimism over the recent tax cuts in the US on the economy should add a tailwind to the existing positive sentiment. Having said that, we continue to be prudent, especially after the strong market rally in 2017.

We still see value in small mid-caps in Hong Kong and Singapore. However, we do think that, trading at above 24x PE and only growing at 2-3% annually, at some point, the US markets will correct. This is simply the law of nature especially since the long term historical PE of the US markets is in mid-teens.

For our portfolio we remain confident of a good performance for the year ahead, despite the key macro risks that we will explain further below. This optimism is not unfounded. It stems from our portfolio remaining cheap relative to historical norms and we believe many will do well in the coming year as they will report better earnings. We do have to caution that if markets continue to rise, at some point of time, we are going to have to go into cash if we can't find investable ideas. We are usually too early to go into cash and you might see us underperforming the indices for a while. To borrow a phrase from Jean Marie:

> *I would rather lose half my shareholders than lose half my shareholders' money.*
>
> *Jean Marie Eveillard*

*Macro Risks*

As 2018 unfolds, we believe what is likely to unnerve investors are possible inflationary pressures, interest rate rises and growth slowdown in China.

Inflation continues to be weak over the last few years, which continues to help companies report higher earnings with small increases in revenue. Weak inflation occurs despite higher employment numbers, which has been puzzling many economists. We attribute this phenomenon to an increase in overall economic productive capacity brought about by two main factors.

The first is the advent of the shared economy which has significantly increased the capacity of existing productive capacity. The shared economy allows idle capacity to be utilised more productively thereby increasing the productive capacity of entire economies. The shared economy has created the so-called gig economy and created much employment. Unfortunately, it has placed riches into the hands of a few while the majority of the lower end workers have not benefited much. The other inflation dampener is the new industrial revolution whereby all types of labour face the threat of being replaced by robots. From robotic arms replacing mundane jobs to AIs which will replace high level decision making, companies have been replacing labour with machines that do not fall sick and work 24 hours a day. The replacement of labour with machines has brought down the costs of production significantly, contributing to low inflation.

While the above two factors are secular trends, inflation could rear its ugly head in 2018. Oil, the forgotten key raw material, which was as low as US$30 per barrel in late 2016 ended 2017 at double the price. Continued rising demand from recovering economies and geopolitical instability could even cause a hike in oil prices. The other less talked about issue is China's fight against pollution. China's environmental controls have also been increasingly squeezing the many old economy industries. This has been sporadically reported in mainstream news, but we have already seen the effect in many companies in our portfolio. Anecdotally many manufacturing companies in China are being affected by the rising costs of complying with environmental law. We believe that with China focusing on a higher quality of life, the enforcement on compliance with environment laws will not let up. Intermediate producers have already adjusted their prices over the past year and we expect finished goods to reflect this increase in 2018.

On interest rates, it is worthwhile stating this. The Fed raised rates 3 times last year and the lending rate rose from 0.5% to at the current 1.25%. The ample liquidity in the system meant that most banks were able to keep their lending rates relatively unchanged to what they have been charging their customers, which were already around 1-1.5%. Most banks likely did not raise their lending rate during 2017 to maintain or gain market share. Yet, if rates were to rise another three more times as forecasted by the market by the end of 2018, the cost of borrowing will increase to 2%. Smaller size banks should start to feel the pinch of borrowing from inter-bank deposits and start offering higher savings rates to target consumers' low-cost deposits. It is then likely that many banks' lending rates will rise to reflect the higher cost of funding. The implication for our portfolio is that we will steadfastly refuse to have leverage in our portfolio and start reducing exposure to companies which have substantial gearing.

Although the Chinese economy grew in 2017, we continue to see stress in the system. Debts continue to rise in the system. The Chinese government has announced a policy of chasing quality growth and reducing the GDP growth targets to 6.5% and below. They have also announced plans to reduce their reliance on infrastructure and property growth to increase GDP and will clamp down hard on shadow financing. This is not something new. The last few times the government mentioned about pursuing higher quality growth and clamping down on property, the country went into a slowdown. It was only after the easing of certain cooling measures that the economy recovered. It is tough to ski down a steep slope at constant speed and change direction at the same time. We cannot predict if this time the government will succeed but our eyes are watching the cost of financing in China closely to manage our risks.

## Acknowledgement

At the start of the letter, we mentioned that Buffett threw his hat into the passive ring. We believe there are two main reasons. One is that his 20% compounding magic, which has turned $100 invested in Berkshire in 1964 to close to $2 million by the end of 2016, has grown too big to continue making such outrageous returns. The current market capitalisation of his company is close to 500bn and the company will have to grow 100bn next year to continue his 20% compounding record. Put it simply, compounding is biting back, and Berkshire may have grown too large for active management to outperform.

The other main reason is possibly trust. Having spent a lifetime pursuing value investing, he would have known that it is almost mission impossible to find someone with a right temperament to avoid behavioural biases to run a large and closely scrutinized company like Berkshire. Hence the reason why he is settling with market returns less some fees.

Trust is a valuable commodity in investing. At this point, we once again place on record our sincere appreciation to our partners for placing their trust in us. Many have trusted us even though we have no public track record at our fund's launch. We believe that we have achieved moderate success to date and will strive to do even better in the years ahead.

We welcome feedback and potential partners to contact us at enquiries@astralasset.com for more information.

Sincerely,

Astral Asset Management