# Investing with conviction to outperform in times of volatility and uncertainty

## Our Investment Strategy

*"Charlie and I decided long ago that in an investment lifetime, it's too hard to make hundreds of smart decisions. We adopted a strategy that required our being smart only a very few times. If you are a know-something investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk. I cannot understand why an investor of that sort elects to put money into a business that is his 20th favourite rather than simply adding that money to his top choices – the businesses he understands best and that present the least risk, along with the greatest profit potential. In the words of the prophet Mae West: Too much of a good thing can be wonderful."*

- Warren Buffett in Berkshire Hathaway's Annual Letter to Shareholders in 1993

"Too much of a good thing can be wonderful". This penetrating comment by Warren Buffett captures the essence of our investment strategy going forward to make ongoing market volatility and uncertainty our friend in generating long-term outperformance.

### Investing with Conviction to Overcome "Disposition Effect" and Make Market Volatility Our Friend

The disposition of the typical investor in selling winners too early and keeping losers for too long is a reflexive choice under uncertainty and reflects an aversion to loss realisation. In our view, investors ride losers far too long to postpone regret, hoping for a rebound in prices, and sell winners too quickly because they want to hasten the feeling of pride at having chosen correctly in the past.

Market volatility and chaos, mania and panic - they would be our friend if we have the willpower quotient to overcome this harmful disposition effect. This willpower comes from anchoring ourselves with knowledge in identifying and investing in misunderstood, neglected, overlooked and underappreciated wide-moat companies and sizing up the portfolio bets with conviction when the management continues to deliver in their long-term business plans. Such conviction requires intensive analysis and monitoring of companies and entrepreneurs. This is akin to the investment decision process when Buffett invested 42% of Berkshire Hathaway's funds in American Express in 1974, whose share price has since compounded over 3,000%. In essence, position size can be more important than entry prices.

To align ourselves with this investment approach which allows for 8IH to protect, to preserve, and to guard our shareholders' funds in difficult times, we have made an extensive review and restructuring of our investment portfolio in the month of September, whereby we sold off 11 companies because of (1) the narrowing or deterioration in their economic moats; (2) the inability to reinvest profits back into core business to widen the moat; (3) management integrity and corporate governance issues. The heartening thing is that our investment returns were buttressed in investments in wide-moat innovators as our current portfolio is up 6.7% in the rolling 12-months, outperforming the Straits Times Index which is down by 14.8% over the same period.

### Identifying the Underappreciated Wide-Moat Businesses and Sizing Up Our Portfolio Bets

To illustrate how we can and will improve our investment performance going forward, we will briefly highlight the thought process in some of our winners in our current investment portfolio - Thailand's *Major Cineplex* and Malaysia's largest synthetic nitrile glove-maker *Hartalega*. Our 12-month rolling returns (in SGD terms) from Major and Hartalega are 32.1% and 11.8% respectively, overcoming the performance drag from the sharp depreciation of the Baht and Ringgit currencies and trouncing the negative 14.8% decline in the Straits Times Index. Our average annualised returns since we initiated the purchase of Major Cineplex and Hartalega is 46.3% and 28.3% respectively.

To gain conviction in sizing up the investment bet, we apply the acid test for our stocks with a seemingly simple but profound question: "Does the business get easier as it gets bigger?"

CEO Khun Vicha Poolvaraluck, a proven innovator with an eye for detail in operations and execution, has built Major Cineplex into a lifestyle entertainment business model attracting 30 million Thai consumers to its "destination to be", resulting in a dominant 80% market share with strong operating cash flow generation ability to support dividend yield and expansion plans. An underappreciated wide moat factor is its advertising services business segment, which is the crown jewel of the group despite contributing only 13% to group sales. A full-range of advertising services are provided to advertisers and media agencies, ranging from simple cinema screen advertising to fully-integrated below-the-line media solutions in the Cineplex network. These include VDO walls, tri-vision, LED/marquee boards, plasma screens, poll signs, bowling masking units, outdoor media (billboard). This is additional revenue generated on existing assets with high gross profit margin of 86-88% with minimal CAPEX investments.

Thus, as Major Cineplex expands its screen penetration into upmarket and provincial areas outside the Bangkok metropolitan area, advertisers will pay even more for the consumer reach. The business gets easier as it gets bigger. This is akin to the old newspaper model in which ad revenue climbs exponentially with greater readership reach. That's how Rupert Murdoch scaled up News Corp by buying up newspapers regionally and globally and consolidating them as a bundle with a greater readership reach to pitch to advertisers. Yet, when Murdoch was building this business model before its categorisation into a "wide-moat" business becomes obvious, investors underappreciated the tipping point dynamics of the business model once the network grows to a certain critical mass to generate exponential returns subsequently.

For Hartalega, its rivals Top Glove, Kossan, Supermax can also produce nitrile gloves, but not to its scale and focus; in other words, the businesses of its competitors do not get easier as it gets bigger. The tipping point in the business model was when founder Kuan Kam Hon and his son Kuan Mun Leong launched the world's thinnest 4.7g nitrile glove in 2005 and subsequently an even thinner 3.7g nitrile glove in 2007, creating a pull-based market in which the nitrile gloves can be used by healthcare professionals and patients who are allergic to rubber protein. Before Hartalega, nitrile gloves were chiefly used in industrial applications and not in the medical sector due to their heavy weight and thickness, which was a hindrance for medical practitioners in the examination of patients. The Kuans demonstrated far-sightedness when they invested in automated mechanical stripping system that mimics the human hand motion of stripping gloves off and industrial barcode tech system to scale up to 45,000 gloves an hour at a lower cost, accumulating intangible know-how that gets stronger as they grow bigger.

| Stock | % Weight of Stock in Portfolio | | | |
|---|---|---|---|---|
| | Original | Sizing Scenario 1 | Sizing Scenario 2 | Sizing Scenario 3 |
| Major Cineplex | 4% | 20% | 25% | 30% |
| Hartalega | 2% | 20% | 15% | 10% |
| Other Stocks | 94% | 60% | 60% | 60% |
| 12 month Rolling Returns (in SGD) | 6.7% | 13.7% | 15.6% | 17.4% |
| | vs STI -ve 14.8% | | | |

The above table illustrates the 12-month rolling return of our investment portfolio under 3 different scenarios when the portfolio bet size in Major Cineplex and Hartalega is increased. In the original situation, the return is 6.7% when the actual weight of Major Cineplex and Hartalega is 3.9% and 1.6% respectively based on the investment cost. When the portfolio weight is increased to 20% for each stock, portfolio returns doubled to 13.7%. In the scenario when the weight in Major Cineplex and Hartalega is increased to 30% and 10% respectively, portfolio returns jumped to 17.4%. Noteworthy is that the portfolio returns are in SGD, outperforming the Straits Times Index which is down 14.8%.

Investment Team
From left to right:
Sim Zhipeng, Joshua Zhang, Alex Ng, Kee Koon Boon, Low Chern Hong, Kelvin Seetoh, Jackson Yeow

### Staying Vigilant for Tipping Point in Business Model to Lower Valuation Risk

Thus, to build our investment conviction in order to size our bets with prudence, we are vigilant to tipping points in business models that will result in a valuation re-rating and potential index inclusion if they are not yet in the index. We are watchful for longer-term fundamental changes, as opposed to reacting to short-term news "catalysts" which could be manipulated to create buzz around a stock. Some of these include:

- New products or services, and new markets and customers: We employ textual analysis of the companies with relevant keywords using linguistic databases on a bi-weekly to monthly basis that include "new product(s)", "new development", "patents", "research and development", "innovation", etc. We monitor the ratio of the sales contribution from new products/services and markets/customers.
- Robust improvements in CAPEX execution efficiency and cash conversion cycle (CCC): We monitor the CAPEX efficiency ratio in CAPEX as a percentage of new sales, gross profitability, EBITDA and operating profit; widening of the CCC advantage on an absolute and relative basis to its rivals.
- Significant corporate event in spin-offs, M&As, restructuring.
- Overall health of value chain and ecosystem: We like to invest in quiet resilient consolidators in fragmented industries and we monitor news of strengths in the companies' customers, weaknesses in their rivals, and harmonious relationship with their suppliers and stakeholders.
- Corporate culture, strategy, innovation, partnerships: We are fervent readers of interview transcripts and articles on the management to gain an understanding on (1) the management's desire in cultivating a culture of decentralisation, trust and cooperation to foster innovative experimentations, including investing in a system to cascade decision rights throughout the organisation; (2) the management's discipline in handling power and wealth; (3) the management's focus and sense of urgency to build something with a Purpose and commit to an idea larger than themselves to care for and serve others with love; (4) the management's skin in the game with aligned performance-based incentives. We monitor the sales, EBITDA and EBIT per employee. Our textual analysis of relevant keywords include: "culture", "empowerment", "trust", "support", "decisions".

### Structuring the Investment Process and Team to Scale Up

We have structured our research and decision-making process to foster vigilance, collaboration, and engagement and to leverage off the strengths of one another in our investment team of 7 (5 in Singapore and 2 in Malaysia) to win together. Our target portfolio weighting by business model and by geographical region is as follows: based on our assessment of the prospects of the country; the kind of wide-moat businesses that we like; and the prevalence of these potential compounders listed in the respective countries and regions:

| Business Model | Weight |
|---|---|
| Wide-moat companies – Stalwarts | 30-40% |
| Wide-moat companies – Fast-growers | 30-40% |
| Asset plays & dividend-yield businesses | 10% |
| Cash | 10-30% |

| Country | Weight |
|---|---|
| Australia and New Zealand | 30-40% |
| India | 20-30% |
| Greater China (HK, Taiwan) | 10-20% |
| ASEAN1 – Thailand, Philippines, Vietnam | 15% |
| ASEAN2 – Singapore, Malaysia | 5% |
| Japan and Korea | 10% |

### We Are Cognisant of the Macroeconomic Risks in the Horizon

Besides the uncertainty surrounding the US Fed rate hike decision, we are cognisant of the following macroeconomic developments and risks that signal potential market dislocations ahead:

- Sharp devaluation of EM / Asian currencies x Highly-geared Asian companies loaded on dollar-based loans = Recipe for disaster for wave of corporate default and profit warnings.
- Fragility of China's financial sector. The RMB36 billion default of Fanya Metal Exchange, once the world's biggest rare metals trading platform has been the tip of the iceberg of China's bad debt problems. On 13 Oct 2015, Hebei Financing Investment Guarantee Group, one of China's largest state-backed guarantors, had failed to honour guarantees on loan defaults by five companies worth RMB227 million and affecting 660 investors in high-yielding Global Wealth products. Financial news agency Caixin said the amount owed to Global Wealth by the guarantor is now RMB620 million. A disgruntled Chinese investor has stabbed the chief executive of this Hebei guarantor, the latest sign of escalating

tension in the country's financial system amid rising defaults. CLSA uncovered on 13 Oct 2015 that a quarter of Chinese firms with debt are unable to cover their annual interest expense currently. According to CLSA estimates, Chinese banks' bad debts ratio could be as high as 8.1%, a whopping 6 times higher than the official 1.5% NPL level reported by China's banking regulator. With total Chinese bank assets at roughly US$30 trillion, if one very conservatively assumes that loans are about half of the total asset base (realistically 60-70%), and applies an 8% non-performing loan to this number instead of the official 1.5% non-performing loan estimate, the capital shortfall is a staggering US$1 trillion, amounting to 10% of China's GDP. In early Oct, it is reported that emerging markets are set for the first annual net capital outflow in 27 years since 1988. Investors are estimated to pull US$540 billion from developing markets in 2015, led by China.

- Demise of petrodollar flows into equities and the capital markets. According to Financial Times on 28 Sep 2015, Saudi Arabia has pulled out US$50-70 billion of funds over the past six months. In addition, as Norway announced on 6 Oct 2015 that it experienced the first negative global petrodollar export balance in 18 years, resulting in the world's largest sovereign wealth fund being forced to liquidate assets.

- Commodities bust and its impact on the financial sector, led by Glencore. When Aussie mining giant Pasminco went bankrupt in 2001 with debts of over US$1 billion, it posed systemic risk to both the commodities sector and Aussie banks with huge exposure to Pasminco's debt. According to market estimates, Glencore is at least 50-100 times bigger at US$50-100 billion, with counterparty risks in derivatives liabilities and debt.

- Internet sector correction led by the collapse of Alibaba below its IPO price and the cooling of VC investment environment has taken its toll on startups.

- Harvard University endowment fund warns of market "froth" in Sep 2015 and is looking to allocate funds into investment managers with expertise as short-sellers.

## More Actionable Stock Ideas than Funds - Allocating Capital Thoughtfully In Our "Watchlist"

"Float like a butterfly, sting like a bee" is the catchphrase that epitomises the highly unconventional boxing style of the legendary world-class boxer Muhammad Ali. Never an overpowering puncher, Ali relied early in his career on his superior hand speed, superb reflexes and constant movement, dancing and circling opponents for most of the fight, holding his hands low and lashing out with a quick, cutting left jab that he threw from unpredictable angles. His footwork was so strong that it was extremely difficult for opponents to cut down the ring and corner Ali against the ropes.

We have been following closely a number of entrepreneurs building their enterprises in Asia over the years, observing up close their struggles and their breakthroughs, compiling the progress of their corporate lifecycle dynamics by "Stage 1", "Stage 2" and "Stage 3" in our "Watchlist":

| Corporate Lifecycle Stage | Valuation Dynamics | Business Model % Weight in Portfolio |
|---|---|---|
| Stage 1: Emerging growth industry companies started by wide-moat innovator | At several points in time, the financial market holds back in according a proper price on the company, as the company grew in market cap too fast despite the strong fundamentals and growth; market panics and PEG falls | Wide-moat companies – Fast-growers: 30-40% |
| Stage 2: Rides the rising tide, niche potential transforms to mass market scalability | As company continues to deliver, there is positive re-appraisal of the company and PE re-rating; PEG climbs back up again | |
| Stage 3: Milks the cow and consolidator | PEG remains relatively steady as company "milks the cow" for cash flow – or company gets complacent with size and falters | Wide-moat companies – Stalwarts: 30-40% |
| Stage 4: Dominance/ Legacy/ Built-to-Last | Growth slows down, but PEG climbed due to "dominance" or "winners-take-most" factor, resulting in steady market cap | Asset plays and dividend-yield businesses: 10% |

To lower our risk that comes from investing in new stock ideas, we float around like butterflies in our "Watchlist", obsessively gathering relevant information about the business model dynamics, value creation levers and critical success factors, management and corporate governance quality.

Before we sting like a bee to jab in a stock inclusion, to guard against the risk of confirmation bias, we insist on every investment team member to voice out and write down their "Top 3 Dislikes" about the company – and we make a critical and calculated evaluation on whether the positives still overwhelm these "dislikes".

We are honoured and grateful to be able to have the opportunity to share our thoughts and to have a sincere and productive conversation on 23 September 2015 with the top management team of the Monetary Authority of Singapore (MAS) – Mr. Paul Yuen, Head of Market Conduct; Ms. Gillian Tan, Head of Enforcement Division; Ms. Lee King See, Director (Enforcement & Investigations); Mr. Ang Eng Seng, Deputy Director; Mr. Eric Chia, Deputy Director; and the team at the Secondary Markets & Enforcement Division - about implementing a world's first fact-based forward-looking fraud detection framework to bring about benefits for the capital markets in Singapore and for the public and investment community.

Accounting information can be used to inform – or to deceive. We believe strongly that this potential fintech platform that combines accounting data, especially footnotes, with a wide array of contextual information - including unusual related-party transactions; money-go-round off balance-sheet activities; governance, group structure and ownership analysis; textual and linguistic analysis; analysis of event-based "catalysts" (information-based manipulation) and sensitive market announcements (action-based manipulation in prices and volume) - will provide fresh insights and actionable, dynamic, inter-connected analytical information, as opposed to merely descriptive static data or a loose bag of disparate red flags, on Singapore and Asian companies, for the regulator and the public.

## Sting like a Bee When There is Informational and Temperament Edge and Valuation Odds in Favour

We have deployed some of our funds in several new wide-moat companies in our "Watchlist" after the portfolio restructuring, and we are targeting concentrated portfolio bets in two companies with dominant market leadership in their respective fields and are on the verge of strong quality core earnings trajectory in the next 12-18 months. Another new stock inclusion is a key crown jewel asset of an Asian tycoon after the restructuring of his family business empire and has potential for index inclusion and importantly, is a powerful consolidator in its domain with a proven track record in execution.

Currently, we have the problem of having more actionable stock ideas than funds to fully execute our investment process to deliver potentially greater returns to our shareholders.

We are confident that distinct efforts to master the investment formula in identifying the right stock, and investing with conviction in the right amount when we have a commitment and informational edge in the assessment of how that business would perform in the decades ahead, and when the valuation odds are in our favour, would overcome these macroeconomic headwinds and generate sustained investment performance.

Caring is an exacting, serious and demanding business, especially when it comes to investing in another person's financial assets, which are a tangible product of his or her life's work, a repository of aspirations for the future. We do not believe in painting rosy pictures or beautifying ourselves. We tell cold, hard truths – with a warm and devoted heart. We hope this will capture the 8IH investment philosophy of entrepreneurs investing in entrepreneurs. We are of the conviction that the future is created one wide-moat innovator at a time and each will flourish from their own wisdom. If you also share in our values and investment process, and support our conscious efforts to promote entrepreneurialism in Asia, we invite you to join us in this uplifting journey to participate in the compounding returns in overlooked and underappreciated wide-moat innovators – and to make a positive difference to society.

Disclaimer

The material contained in this article is a presentation of general information about the 8IH's investment activities current as at the date of this presentation (30 October 2015). It is provided in summary and does not purport to be complete. You should not rely upon it as advice for investment purposes as it does not take into account your investment objectives, financial position or needs. These factors should be considered, with or without professional advice, when deciding if an investment is appropriate.

To the extent permitted by law, no responsibility for any loss arising in any way (including by way of negligence) from anyone acting or refraining from acting as a result of this material is accepted by the 8IH including any of its related bodies corporate.