ABUNDANT SEASON FOR STOCK HUNTING

At a time when many still hold bleak prognosis of the macro economy, this fund manager sees myriad investment opportunities

TEXT _ TEH HOOI LING **PHOTO** _ ARTHUR LEE

YEO SENG CHONG, 55, is not the typical fund manager who ventured out to set up his own fund after accumulating a few years of experience in the fund management or stockbroking industry. The fact is, he's not worked in any financial institutions prior to setting up Yeoman Capital Management in 1999.

He started his career as an engineer working for oil and gas engineering contractor McDermott Engineering in Singapore and Dubai, and then for civil engineering contractor CDC Construction in 1981-84. After that, he moved to the Trade Development Board and stayed there for five years. Out of that time, four years was spent as an assistant commercial representative, mainly as a diplomat based in Beijing. The next port of call for him was Singapore Technologies Industrial Corp, as deputy director for international marketing. Then it was on to Metro Holdings as general manager for its China projects. His last stop in the corporate world was at Centrepoint Properties, as its general manager (corporate).

He found that his training as an engineer and his life in corporate employ can be usefully deployed to the investment world. So he started to help his father manage the family fund on a discretionary basis during the Asian crisis. A meeting with David Goh, then a senior financial analyst with Great Eastern Holdings, over a dinner hosted by his aunt in early 1999 set the ball rolling for the setting up of Yeoman Capital. "After managing my family fund for over a year, I had the idea of setting up my own fund. David gave me the encouragement. And so we signed up the lease for our office here (at Robertson Walk) in the first quarter of 1999."

Mr Goh is now chairman of Yeoman Capital with a 5 per cent stake in the fund management firm. Mr Yeo and his wife have a 35 per cent stake each in the company. The remaining 25 per cent is held by Eric Kong who joined the firm as vice-president for research in 2002. He has since been promoted to senior vice-president, research. "It's our goal that over the long term, people who contributed to the company see this as a long-term career path and will get shares in the company."

His father's account was subsequently moved to the collective fund, Yeoman 3-Rights Value Asia Fund. And the fund's track record – starting from the initial family fund up till the end of March 2009, as verified by one of the big four auditing firms – has been impressive, the dismal performance last year notwithstanding.

For the 11 years and five months to the end of the first quarter of this year, Yeoman Capital's fund returned a compounded annual rate of 9.26 per cent. It outperformed its benchmark by 7.64 per cent a year, net of all fees. And according to Mr Yeo, the fund didn't have any redemptions at all in the past year. It has to be noted, however, that the fund size is relatively small, at $160 million at the time of interview in early March.

Below are excerpts of *Pulses*' interview with Mr Yeo.

Does your varied experience in the corporate world help you in portfolio management?

In the direct investment world, we would select businesses that we wish to participate in and make valuation appraisals. If the price is right, we would participate in these projects, whether wholly owned or on a joint venture basis. Management would be selected and appointed. So as a direct investor, the requirement of right business, right price and right people matter very much. Effort is direct, we have control in most cases.

In the portfolio world, the three "rights" matter just as much, except that we don't have direct negotiation input when it comes to price. The market gives it to us. In terms of selection of business, it would be what fits our assessment criteria. And in terms of people who manage the business, it comes with the listed entities. So the only items that we would have control over are what business we wish to participate in, what price the market is able to give us, and what management comes with it.

What's your view on market timing?

The three "rights" become the three criteria which we define tightly. If met, we would participate in a portfolio basis. If not, we would avoid. For us, market timing, market sentiment, what politicians and what macro people might say – these inputs are de-emphasised. We work an internal process every day through all market cycles. Our average holding period is from three to five years. At most points in time in our history, cash holding is minimal, near or close to zero. We've been able to find investment securities today as well as in previous times.

Do you find a lot of investment opportunities today?

Yes, very much so. Today, at any point in time, we would have up to 4,000 ideas at the initial idea generation stage. A year ago, we had the tune of 500. So for us, the climate today is very very abundant, very rich, very uplifting. We feel very good about it. (As at mid-April, Mr Yeo still sees the same number of opportunities because "there is still a lot of undervaluation out there today".)

But everybody's giving a very bleak prognosis of the macro economy still.

We de-emphasised the macro view. The macro views, whether from politicians or central bankers, are like the views taken from a helicopter, flying high over the jungle. We, being bottom-up securities analysts, are like the ants and the squirrels on the jungle floor. The view on the jungle floor is vastly different from that of a helicopter.

We find today the listed securities

Savvy Investor_pg36-39.indd 2 24/04/2009 6:52:37 PM

that are presented before us are selling at significant discounts to balance sheets, significant discounts to discounted earnings – no matter how conservatively or prudently we discount them to take into consideration the present environment. Given their existing franchises and the existing track records of these various listed businesses, we find that for us, from a bottom up basis, there are more reasons to be optimistic than pessimistic.

Where do you see opportunities?

We see opportunities all over the world. Our fund mandate prescribes Asia outside Japan as our hunting ground and given our hunting ground, we see abundant opportunities, in order of prolific numeric count, in Hong Kong, Korea, Malaysia, Singapore and Thailand.

Given the abundance of opportunities, how do you select which securities to buy?

Given a situation where we have ammunition constraints but no target constraints, our investment methodology requires us to rank investments in order of attractiveness based again on the three rights, led chiefly by under-valuation. Under-valuation is the chief motivation for making any investment actions, followed by the other two criteria as support.

What do you use to measure under-valuation?

We use all measures. We use discounted free cash flow which measures future income or future cash flow streams. We would use balance sheet items, which would take into consideration items like cash, inventory, current assets, and of course fixed assets, which are plants, property, equipment. We usually ignore or discount entirely intangibles. The balance sheet case would be made up of net current assets, or net tangible assets.

There's the discounted net cash flow method, the balance sheet method, the reported earnings method, which uses the price-earnings (PE) multiple. But unlike other people we tend to look at the longer-term earnings record of the company – between five and 10 years, as opposed to just last quarter which some people like to do. We also require

Mr Yeo's $160 million fund has returned a compounded annual rate of 9.26 per cent in more than 11 years

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dividend yields, we also require an average or above-average return on equity (ROE) to ensure that there is some capital efficiency in the business.

In short, we like low PE, we like low price-to-book, we like high free cash flow, we like high dividend yield, we like high ROE.

Do you prefer small or big-cap stocks?

In all environments, we find that small and mid-cap segments offer more value. And big-cap stocks only come into the investible range for us during market stress.

So in today's environment, we see more big caps than we normally do. But in all market cycles, for us, the smaller capitalisation segment is always more prolific in terms of attractiveness than bigger-capitalisation stocks. And I suppose, logically this is correct. Because the market is more efficient for the big cap segment.

But small caps get hit harder in a downturn, right?

It's a general wisdom by the academics in the financial world to recognise that small-cap stocks are more risky. And the corollary to that is that small caps give higher rewards. On balance, the market is efficient in pricing risks, and hence in times of market stress, small caps perhaps get penalised price-wise because this would reflect the wisdom of millions and millions of people participating in the market.

For us, our role as fund managers is to go beyond the cursory examination that the market might give, the perception the market might accord, but to dig into the underlying fundamentals as reflected in the financial statements and the history of the company. We find that when we are able to satisfy our balance sheet, cash flow and financial statement requirements historically through many recessionary phases of the world and regional economies, we may make a case for investing, whereas the cursory examiner may discard it. This is where knowledge is the key management tool for us.

Can you trust financial statements?

We know about the Fibrechems, the Satyams and Enrons of the world. I don't think they are going to be the last, nor are they going to be the first. Hence having a listing record of a minimum of five years (the longer the better), a tangible track record of rewarding shareholders with a consciousness of the rights of minority shareholders and dividend payments, a track record of the business having gone through cycles is important. Many of the frauds you would agree happened in the corner of the field of recent listings.

But a lot of small and mid-caps are recent listings, right?

Not in every case. I think it comes back to the process. So your mesh has to be very tight. Not if even a humpback whale can swim through it. And you must believe in the steps you've established and be disciplined to implement them.

What do you attribute the performance of your portfolio to?

For us performance attribution is from two areas: securities selection and portfolio construction. Not market timing, emphatically not market timing. We are happy with our stock picks when (the managers of) the underlying business of the stocks we've selected stay focused on what they said they would be doing. We don't like companies that zig and zag and try this and that. We like simple-to-understand and focused businesses and owners who stay focused.

We are encouraged when we see free cash generation over the longer term. Short term, ya, there may be no and negative free cash because of business re-stocking, etc. Over the long term, net net it should be positive cash generating. We are happy when we see balance sheets grow in terms of net tangible assets and in terms of cash. We are happy when we see dividends announced every time as a percentage of net profit. We are happy when management keep their remuneration in a reasonable band. Internally, we've set up what we deem to be acceptable management and board remuneration.

We are happy when we see our investee companies not engaging in any dilutive issues, including new share placements, convertible bonds, participating in flavours of last month – derivatives and toxic instruments.

We are unhappy for the reverse, when companies – in the words of Peter Lynch – start to "diworsify" (or to expand beyond their core competency into businesses that give low returns). It gets from bad to worse. We get very, very alarmed and take action in the event of diworsification. Businesses going into something strange and unknown ... we are unhappy when we see balance sheet erosion, long-term negative free cash flow, dilutive issues. And we are unhappy when we see falling dividends when profits increase.

We are particularly happy when we see under-valuation continue to persist. Unlike momentum people, the longer we hold the stock, the longer the under-valuation persists, the longer the stock price goes down, the more balance sheet value goes up, the more free cash is generated, the more we really relish the opportunity to buy more and more of what people dislike more and more.

For us this is one of the main opportunities for overall portfolio performance. Something that gets better and better goes cheaper and cheaper, rather than to sell the sucker to cut loss, we would be very happy to take it from whoever is selling. Also, we stay with businesses that don't need leverage. That spells safety for us.

That's why we don't have any cross-border financial institutions in our portfolio – never had and probably never will – because these are leveraged business models.

What are your three biggest holdings now?

As at end of January, our largest holding is a spectacles manufacturer in Hong Kong. Second is a Malaysian distributor of consumer and industrial products. And the third is a Korea-listed manufacturer of materials for high heat applications in the cement and steel industry. The blended weighted average market cap of the three as at end-January was $135 million. The range is $48 million to $270 million.

Savvy Investor_pg36-39.indd 4 24/04/2009 6:52:41 PM

Given how value funds have underperformed in the last few years, and were not spared by the downturn last year, do you think value investing still works?

I believe value investing is evergreen. It will outlive all of us, will outlive this or the next market cycle because it is not just smart mathematical formulae that go to support it. In value investing we are anchored in balance sheets, we are anchored in free cash generation, we are anchored in the assessable merits of an underlying business that's generating cash and with real people working at it.

When you have a business with above-average economics as I have described earlier, if it was undervalued at the point of purchase, and you have the management dedicated to working for your interest, you basically have a dice that is loaded in your favour. And every time you throw a dice, figuratively, it should show "six".

In the physical world, the cause and effect is immediately visible, like when you drop an iron ball from the window, it will immediately fall. In the world of finance, the underlying science also works. But because it is not in the physical world, it is in the financial world, the result may take some time to become apparent. But slowly and surely, over-valuation and speculation is punished and under-valuation rewarded. It's a matter of time.

In the case of the recent problems, we find that it's taken five, six years to come to a head. Five to six years is a long time for some people. For value practitioners like ourselves, five, six years is a very short time. Because we don't want ever to be on the side of speculation and over-valuation no matter how long it takes to come home to roost. We always want to be on the side of under-valuation. Prudence above all dictates that we should do it that way. Our role is to – day after day, week after week – generate investment gains for our clients with relatively low risk. We think that you get less return for more risk when you get all excited about the next winner.

The next winner is not known to mortals ... People call that growth investing but in our opinion, it's guesswork. When it's known, it's no longer cheap. When it's no longer cheap, and it doesn't work out, it collapses in your face. Benjamin Graham's book *The Intelligent Investor* is instrumental in defining all of these approaches that we have.

For us, we take to it like duck to water. We find it very mentally coherent.

Why is it that despite having deep value, your portfolio fell by 47 per cent last year?

Well, at any point in time, at any quarter, or sometimes over two, three years, you can conceivably find that value investing will underperform other more speculative or momentum approaches – that's on the way up. On the way down, in a time of blind panic, I now know on hindsight that value investing is not much more ahead of the market.

But I can only say that over longer periods of time, the inefficiencies for speculative froth and/or panic will revert to a more reasonable level. In terms of the 11-year Yeoman record, the cumulative outperformance is a factor of 15, that's quite big. But month by month, you'll get reasons to be disillusioned.

What does it take to be a value investor?

Value investing requires two broad requirements in terms of the manager or the investor himself. One is of course the ability to understand and apply fundamental financial analysis. Financial analysis and accounting and financial processing can be taught in any school. The second one may not be teachable. It's called the emotional temperament to stay detached and to apply the methodology that you know works through gut wrenching up, as well as down, swings.

The third thing is to measure. When you have one fund, one methodology, one theme, and are able to measure the performance, you know what efforts resulted in what outcome. Whereas if you were managing 20 funds, with different strategies – long-short, arbitrage, distress debt, and so on – one would be thoroughly confused. So we stay with one fund.

But there's a lot of randomness in the market, right?

To make sense of the randomness, you must commit to a course of action – not for one day, not for two days, maybe for 10 or 11 or 12 years. You must also test and measure your results under all market conditions. You've got to track, measure, track, measure. Review, review, track, measure. What have you done right in terms of portfolio holding, what could you have done better. So there must be learning.

But the market learns, right? Investment returns probability changes over time.

The father of value investing said this: after 100 years' booms and busts, the market has learnt nothing. I firmly believe that with Wall Street as an amorphous mass of people all jostling for gain, the discipline to distill experience and to highlight key and causal and repeatable drivers for investment returns – that element is missing.

When do you think this crisis will blow over?

Intelligent people, well-informed people worldwide at policy-making and political level have given a range of dates for recovery between 2010 and 2015. Some of them will be right, some of them wrong. But for us, it doesn't really matter. We will stay focused to the process. Just know one thing, that even as they talk, some are talking about the broad economies, local, regional and the world. Others in the same breath are talking about market price action.

The two may or may not correlate. Certainly as we've found in the past, markets will certainly move aggressively ahead of any sign of the real economy improving. If I may also give your readers some room for optimism – there's a report put up by Bloomberg and Leuthold Group at the end of December 2008 using Federal Reserve data. They claimed there was US$8.85 trillion held in cash, bank deposits and money market funds, that's equal to 74 per cent of the market value of US companies – the highest ratio since 1990.

This amount of cash at a time of very low yield, both in terms of treasuries and bank deposits, suggests that the incentive and motivation for taking risk-bearing investments, which equities investment is, should be very high. But the only thing that is holding it in check today is sentiment. But as you know, sentiment is something non-numeric. And sentiment, like fashion, changes at the flick of a switch. So I won't want to be holding large amounts of cash – which we haven't been anyway, by way of habit and process – when these people deploy this vast amount of cash back into equities. **P**

Savvy Investor_pg36-39.indd 5 24/04/2009 6:52:41 PM