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Banking on the 3-Rights

Right price, right business and right management are key, writes GENEVIEVE CUA (gen@sph.com.sg)

Mr Yeo: "*If we get the '3-Rights' right, time is our friend. In the short term, price and value may not converge but over the longer term they surely must*." - PHOTO: ARTHUR LEE

FUNDS which profess to be absolutely return-oriented typically wield a number of tools to achieve this - cash, short sales of securities, market timing and derivatives, for instance. Not so for Yeoman Capital Management. The home-grown firm, whose flagship fund has an enviable 16-year track record, eschews cash and market timing in its quest for absolute returns. Instead, the Yeoman 3-Rights Value Asia Fund relies on old fashioned, long-only value stock picking, and stays fully invested at any single point in time. So far, the results have been rewarding. In the current year to end-October, the fund has generated returns of 19.34 per cent, compared with the MSCI Far East ex Japan index return of 3.45 per cent.

Since its inception in October 1997, the fund has achieved cumulative returns of more than 638 per cent, compared with the index return of 110 per cent. This translates to a compounded annual return of 13.3 per cent. An investor who put in $100,000 at inception would have seen his funds grow to more than $738,000 - a tidy nest egg.

Yeo Seng Chong, Yeoman's founder and chief executive, says undervaluation is the "prime and only motivation for investing".”If we can't get undervaluation, we don't participate. The undervaluation is measured in terms of PE (price earnings multiple), dividend yield, free cash flow and discount to balance sheet book value. We also look at return on equity to make sure our stocks have capital efficiency.

"We have a track record and returns consistent with our methodology. Because we have not used cash as a buffer or timing tool, what you see today in performance is entirely due to security selection and portfolio construction."

The basic premise is to view stocks as operating businesses. Risk is then defined not as price volatility but as the probability of a company going bust, and avoiding such instances that may result in "total and permanent impairment" of capital. The firm's discipline revolves around what Mr Yeo calls the three "Rs". These comprise the right price - that is, the share price should be below the assessed fair value. The second "R" is the right business, where companies should show a reasonably strong balance sheet, stable cash flows, a long operating and listing history and a track record of financial solvency. Businesses must be "stable and staple".”Concepts work when there is a frenzy and investor hunger for them, but we're not sure it can be sustained, so we look for a business or product that is stable, that the real world might want."

The third "R" is right management, with competent and honest people at board and management levels. Stocks are sold once valuations hit or exceed fair values. Industries the fund is currently exposed to include pharmaceuticals, textiles and apparel and electronic equipment.

A commentary on Yeoman's website explains its approach: "If we have the comfort of time on our side and the stocks that we own are backed by real businesses generating adequate earnings relative to our price at entry and the cost of the company's capital employed, then we are getting richer by the day, no matter where the market goes.

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Point of connection

Mr Yeo says that well before he founded Yeoman, he understood the connection between operating businesses and listed equities. He spent more than three decades in the public and private sectors before he started Yeoman, including stints in Centrepoint Properties, Metro Holdings and Singapore Technologies.

"I recognised that there is a certain logic that joins people who work in portfolio management dealing with listed equities, and people in the private arena. There is a point of connection that I saw ever so clearly - the economics of businesses, the profits generated and returns are important.

"Second, the price that you pay to acquire a business is important. And the management, whether you employ your own or take managers from a joint-venture partner. In the case of a private business, these factors are negotiated. In the public arena, the market gives you a traded price.

"We apply the private business approach and ported it to the public world. We look for businesses with the right economics, that are undervalued relative to the assessed merits of the business, and they must have management that are able to safeguard the interests of shareholders and ensure that the hoped-for benefits eventually accrue to us."

The fund invests in around 70 stocks. Diversification is a key principle. On an equally weighted basis, the exposure to a single stock comes to about 1.4 per cent. "If something doesn't work out in one stock and we suffer permanent and total impairment, we would have lost 1.4 per cent. But if the remaining stocks work out, and typically we pay 50 cents on the dollar - that is, we assess that the stock is worth $1 and we pay 50 cents - ... the loss would be more than covered.

"A lot of people spend time picking that one winner that makes a killing. We think that's best left to the person with a strong imagination. As stewards of other people's money, we can't take liberties. As we work on probabilities, this method of investing is very good. The reward is maximised through the '50 cents on the dollar' approach. Value will be realised at some point. Should something come up to hurt us, the loss is well contained."

While the strategy has generated consistent outperformance - the fund has outperformed the index in 13 out of 16 calendar years - it does not shield investors from short term losses. The worst year, for instance, was 2008 where the fund suffered a 47 per cent loss, compared to the index's loss of 48 per cent.

Still, over its 16-year history, it has generated positive returns two-thirds of the time, compared with the index, which has chalked up positive returns 50 per cent of the time. Interestingly, the portfolio beta on a one-year basis is 0.55, which suggests it is less volatile than the market. Beta is a measure of risk or volatility relative to the market.

Investors therefore will have to be patient and take a longer horizon of at least three to five years. The fund, which has some $117 million in assets, has mostly individual investors. Institutions at the moment account for roughly 10 per cent. These include a family office and trusts. The fund is open only to accredited investors, and the minimum investment amount is $250,000.

Says Mr Yeo: "Not all investors will find us suitable. We tell people our methodology. We make no promises on short-term price movements; investors will have to be prepared to take short-term fluctuations." It would appear that Yeoman's clients understand this as there were no redemptions during the 2008 crisis. This helped the fund to avoid having to sell shares at low valuations to meet redemptions.

He adds: "This is one benefit of a 16-year track record. We have every confidence in the way we've invested and what we've achieved. We look forward eagerly that clients will benefit, that over the future they'll be better off than today." An annual management fee of 1 per cent applies. There is also a performance fee of 15 per cent, subject to a high water mark. The latter means the fund has to exceed the previous high for the fee to be charged anew.

There are also early exit charges if investors hold for less than three years. The charge starts at 7.5 per cent for the first year, and reduces to 2.5 per cent by the third year. There is also a 1.5 per cent redemption charge that is paid to the fund to cover transaction charges such as brokerage costs.