AGGREGATE ASSET MANAGEMENT

123RF.COM

The way to wealth — value investing in equities

VALUE investing is a simple concept. It is quite easy to understand but hard to implement because not every investor can stick to their conviction and analysis, but will instead succumb to the emotions of investing. It requires the investor to keep a level head and systematically implement his plan in a disciplined manner.

The value investor buys a dollar's worth of asset for fifty cents or less. The stock market misprices stocks most of the time because of people's fear, greed and apathy. What a stock sells for in the market can be quite different from its "fair value". The value investor's job is to determine a stock's fair value and buy it when it is priced way below its fair value. The larger the difference, the safer the investment.

The value investor is not concerned with what the stock market is going to do next. He does not let the talking heads on TV affect his work.He takes the view that if he buys a stock, he is buying a share of a business. He determines the fair value of a business by understanding its business model and studying its financial statements. He embraces the idea that if one always owns a cross section of undervalued companies in the economy, one will end up quite rich.

The value investor can expect to earn upwards of 10% a year quite easily. If he is talented, at least 12% a year. This return is nothing to be scoffed at — it is quite substantial. At a 15% annual rate of return, it means your investment will grow fourfold in 10 years and 16-fold in 20 years. That can almost make anybody very wealthy.

There are two styles of value investing. One is to focus on the prospects of the business. If the business is forecast to do well, and if it is available at a reasonable price, then it can be considered a sound investment. This is called the "growth-at-a-reasonable price" approach — made popular by Warren Buffett. He quipped that it was better to buy a good business at a reasonable price than to buy a lousy business at a cheap price. However, this approach is difficult and time-consuming for the layman because it requires an in-depth understanding of the business. It is prone to misjudgement and overenthusiasm. Overenthusiasm in forecasting earnings that do not materialise can be disastrous. The stock market is a ruthless teacher, it will severely punish the investor for mistakes made in projecting growth when earnings falter.

The second style is more straightforward. It is pioneered by Benjamin Graham, also known as the father of value investing. Called the "cigar-butt" approach, it is akin to finding one or two puffs left in a free thrown-away cigar found in the street. In financial terms, this means purchasing stocks at a steep discount to book values. It does not require the investor to forecast earnings. The investor ensures that the balance sheet contains the stated assets and he is not paying more than that. The advantage of this method is that it is straightforward, less time-consuming and just requires one to be of average intelligence. The downside is that the investor may have to wait a long time for the market to price the stock to reflect its fair value — and sometimes never. This results in a lower return because of capital left idle in a languishing stock. One can alleviate this by picking dividend-paying stocks — at least you are paid while you wait.

To illustrate, here is an example of two "cigar butts" in 2016.

HSBC, listed in Hong Kong, had a book value of HK$67.35. It sold for as low as HK$44.50. This means that an investor paid just 66 Hong Kong cents for HK$1 of net asset. Not only that, the investor also enjoyed a dividend yield of 8.8%. Nothing beats being paid to wait and then reaping the capital gains later. Closer to home, in 2016, UOB traded at a discount to net asset and it also came with dividends.

So far, we find the cigar-butt approach works quite well in Asia and is capable of delivering satisfactory results. We suggest that a novice investor start with the "cigar-butt" approach and chalk up experience before attempting the "growth-at-a-reasonable-price" minefield. And if he is too busy for all this, there is always Aggregate Asset Management.