TONG'S PORTFOLIO

Valuation of companies is ultimately about cash generation, not accounting profits

BY TONG KOOI ONG + ASIA ANALYTICA

Global Portfolio

	QUANTITY	AVERAGE COST (US$)	COST OF INVESTMENT (US$)	CURRENT PRICE (US$)	CURRENT VALUE (US$)	GAIN/(LOSS) (US$)	GAIN/(LOSS) (%)
SHARES HELD							
ABF Singapore Bond Index Fund	66,000	0.75	49,588.8	0.75	49,790.4	201.6	0.4
Alibaba Group Holding	4,200	14.6	61,487.7	10.9	45,879.6	(15,608.1)	(25.4)
DBS Group Holdings	2,300	21.1	48,492.8	24.9	57,287.6	8,794.7	18.1
Global X China Electric Vehicle and Battery ETF	3,100	15.8	48,869.1	13.9	43,203.1	(5,666.0)	(11.6)
Grab Holdings-Cl A	15,000	3.2	47,942.2	3.2	47,400.0	(542.2)	(1.1)
iShares 20+ Year Treasury Bond ETF	1,150	95.9	110,338.3	101.8	117,093.0	6,754.7	6.1
Oversea-Chinese Banking Corp	7,500	9.3	69,882.5	9.3	69,547.1	(335.4)	(0.5)
Tencent Holdings	1,300	48.3	62,837.1	44.5	57,896.3	(4,940.8)	(7.9)
Velesto Energy	1,415,000	0.041	58,602.1	0.053	75,094.1	16,492.0	28.1
Total shares held			558,040.5		563,191.0	5,150.5	0.9
SHARES SOLD							
NEXT FUNDS Japan Bond ETF	7,200	7.0	50,132.7	6.8	49,144.0	(988.7)	(2.0)
Cash balance (as a % of portfolio)					58,908.2		9.5
Realised profits/(losses)					116,535.1		
Week's change							
Portfolio							0.7
MSCI World Net Return USD							0.7
Portfolio returns since inception			**500,000.0**		**622,099.3**	**122,099.3**	**24.4**
Portfolio returns (annualised)							**4.7**
Portfolio beta							**0.35**
Risk-adjusted returns since inception							**68.9**

PERFORMANCE COMPARISON	AT PORTFOLIO START	CURRENT	CHANGE (%)	RELATIVE PORTFOLIO OUTPERFORMANCE (%)
MSCI World Net Return Index	5,927.2	8,379.8	41.4	(17.0)

Footnote:
Current price is as at March 8, 2023 or last close
Portfolio started on Dec 18, 2017 with US$500,000
All returns and stock prices are reflected in equivalent US dollar terms
MSCI World Net Return Index is as at March 8, 2023 (GMT+ 8) or last close
Data sourced from Bloomberg

This week, we are revisiting some basics in fundamental investing. We think it is timely, given the sea change in the macroeconomic environment. The world had, particularly in the past two decades, benefited greatly from cheap labour and cheap goods driven by globalisation, as well as cheap energy, thanks to the shale revolution — the combined result of which was years of low inflation that, in turn, drove the secular downtrend in interest rates. But this broad decline in interest rates — especially since the global financial crisis up till the Covid-19 pandemic — has ended, at least for the foreseeable future.

Globally, inflation is at a multi-decades high and looking to be stickier than most have expected. That would, in turn, keep interest rates higher for longer (though still relatively low by historical standards). Many still expect central banks to cut interest rates, once inflation is brought back under control. It may be so, but odds are that they may not return to pre-pandemic lows for some years. This would mean the period of ultra-cheap money is over, and that has broad implications for businesses and investors alike.

Ultra-cheap money had fuelled excessive speculations in risky assets — for instance, stocks without viable business models — and rewarded companies that expanded aggressively, including those with a "growth at all costs" strategy. Cheap money also distorted the efficiency of capital allocations — lowering the hurdle rates for investments (leading to unproductive and less productive investments) and sustained many zombie companies. Zombie companies are uncompetitive but kept afloat with the infusion of borrowings and low debt servicing costs.

When money is no longer readily available at historically low costs, risks must be repriced. In other words, investors can no longer take for granted that "stocks only go up", a trading strategy that has worked surprisingly well for much of the past decade. We expect to see more highly indebted businesses face financial distress as the costs to service their borrowings rise. Against this backdrop, investors need to do more vigorous analyses of companies' underlying fundamentals — especially the robustness and sustainability of cash flows — and valuations.

What is the valuation of a company?

The intrinsic value (V) of assets is, and always will be, the sum of its discounted future cash flows (CFs). It works the same for both bonds and stocks.

$$V = \frac{CF_{t+1}}{(1+r)^1} + \frac{CF_{t+2}}{(1+r)^2} + \ldots + \frac{CF_{t+n}}{(1+r)^n}$$

where: $CFt+n$ = annual cash flow
n = number of years and
r = the discount rate, which takes into account risks

For example, the annual cash flow for Treasury bills and longer-dated notes would be the coupon rate (interest rate) multiplied by the face value of the bond. Since the cash flows are pretty much guaranteed, r is equivalent to the interest rate, which is also the risk-free rate, while n is the maturity period (fixed tenure). Pretty straightforward.

The valuation for companies, on the other hand, is more complicated. For one, the future cash flows are far from certain, subject to changing market demand, competition, selling prices, costs of raw materials and other operating costs, including labour, interest rates and taxes. Because of the inherent uncertainties, we must incorporate a risk premium into the discount rate — that is, r = risk-free rate + risk premium. The higher the uncertainties, the higher should be the risk premium.

Also, unlike Treasury bills and bonds with fixed tenures, the lifespan of a business can be short (if it closes down or goes bust), indefinite or anywhere in between. Assuming a company can generate cash flows in perpetuity, the value of company can be simplified to:

$$V = \frac{CF}{r - g}$$

Where g = constant long-term growth rate of the company

You may notice, however, that most analysts talk about profits, not cash flows, and the most popular valuation metrics are P/E (price-earnings), Price/Ebitda (earnings before interest, taxes, depreciation and amortisation), Price/Sales, Price/Book value and EV/Ebitda (EV, or enterprise value = Market cap + Debt).

So, when you hear people discuss different methods to arrive at the valuation for stocks, remember that there is ever only one definition for valuation— and, that is, the discounted cash flow. All other metrics are merely "short forms" or "shortcuts" for discounted cash flow. These metrics are widely used because they are easier to compute and understand, and can be compared across companies, sectors and markets. Critically, while these shortcut metrics are useful, they are insufficient and, sometimes, can be misused to present a false picture.

Table 1

Company B appears to be more attractively valued

	NORMAL	
	CO A	**CO B**
Market cap (share price) ($)	150	50
Debts ($)	–	100
Enterprise value ($)	**150**	**150**
Sales ($)	100	100
Margin (%)	40	40
Ebitda ($)	40	40
Other cash expenses ($)	10	10
Profit/cash flow before interest ($)	30	30
Interest expense at 10% cost ($)	0	10
Tax (assume exempt) ($)	0	0
Profit after tax/Cash flow ($)	**30**	**20**
Enterprise value/Ebitda (times)	3.8	3.8
Price/Sales (times)	1.5	0.5
Price/Earnings (times)	5.0	2.5
Return on equity (%)	20	40

Table 2

... but has higher risks

	RECESSION	
	CO A	**CO B**
Market cap (share price) ($)	150	50
Debts ($)	–	100
Enterprise value ($)	**150**	**150**
Sales ($)	50	50
Margin (%)	20	20
Ebitda ($)	10	10
Other cash expenses ($)	10	10
Profit/cash flow before interest ($)	0	0
Interest expense at 10% cost ($)	0	10
Tax (assume exempt) ($)	0	0
Profit after tax/Cash flow ($)	**0**	**–10**
Enterprise value/Ebitda (times)	15.0	15.0
Price/Sales (times)	3.0	1.0
Price/Earnings (times)	NA	NA
Return on equity (%)	0	–20

Earnings are not equivalent to cash flows

First, these metrics rely on reported profits/earnings rather than cash flows. And profits, as we well know, are presented based on accounting standards, which may not reflect the actual underlying cash flows. We have written fairly extensively on this issue in the past. For instance, interest paid on perpetual securities (perps) are not considered interest expense — thereby inflating profits. At the same time, accounting for the perps as equity also understates the company's actual gearing. Similarly, companies can capitalise interest expense as assets in certain circumstances: for example, interests during construction of assets or when property developers borrow to purchase land for future development. Again, this would, in effect, understate expenses and inflate profits and book values.

Indeed, companies can be in total compliance with financial reporting standards but still be misleading. Case in point: A company is allowed to recognise construction revenue from in-house concessionaires based on estimated fair values of future income streams under the long-term agreements. This revenue is recorded as financial receivables/intangible assets on the balance sheet. When

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Deep Deep scores a hat trick

BY HARRY HUO

Deep Deep continues to win, gaining 0.34% while beating human-managed portfolios represented by Tong's Portfolio, Warren Buffett's **Berkshire Hathaway**, Aggregate Value Fund and all the benchmark indexes despite a lacklustre month in February. Similarly, it won all competing portfolios and indexes by gaining 22.36% since inception. It is tempting to break into the song by Bee Gees *You win again* but Deep Deep does not sing. Yet.

This month we bought **JB HiFi**, **Algoma Central Corporation**, **CK Hutchison Holdings**, **Hamakyorex Co**, **IJM Corporation**, **SNT Motiv Co**, **Home Bancorp Inc** and sold **Helia Group**, **Canadian Tire Corporation**, **China Merchants Port**, **NTT Corporation**, **Pantech Group Holdings**, **GABIA Inc** and **Auto Nation Inc**.

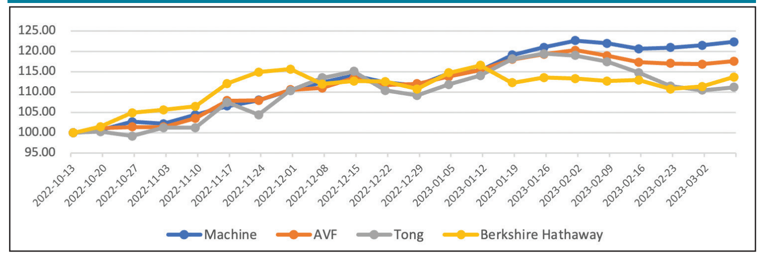
15 stock picks for March

Stock	Country	Price (US$)	% of portfolio
JB Hi-Fi	Australia	28.80	7.0
Algoma Central Corporation	Canada	11.58	6.9
Jointown Pharmaceutical Group Co	China	2.08	7.2
Mercedes-Benz Group AG	Germany	79.75	7.8
CK Hutchison Holdings	Hong Kong	6.26	7.1
PT Bukit Asam	Indonesia	0.25	5.7
Hamakyorex Co	Japan	23.98	7.1
IJM Corporation	Malaysia	0.37	7.0
DMCI Holdings Inc	Philippines	0.20	6.5
Hutchison Port Holdings Trust	Singapore	0.20	5.7
SNT Motiv Co	South Korea	37.75	6.9
Asia Cement Corporation	Taiwan	1.46	6.6
TTW Public Company	Thailand	0.27	5.9
Central Asia Metals	United Kingdom	3.15	6.0
Home Bancorp	United States	37.70	6.7

*Cash level at less than 1%
*Price (US$) as at March 8

CHART AND TABLES: AGGREGATE ASSET MANAGEMENT

Performance comparison since inception on Oct 17, 2022



How the portfolios stack up (%)

Portfolio	1-week change	1-month change	Since inception
Machine	**0.75%**	**0.34%**	**22.36%**
AVF	0.59%	-1.15%	17.54%
Tong's Portfolio	0.67%	-5.32%	11.17%
Berkshire Hathaway	2.07%	0.86%	13.67%
Dow Jones	0.45%	-3.15%	9.90%
MSCI ACWI	0.57%	-2.75%	13.75%
MSCI AC AP	0.09%	-3.89%	18.55%

Top five countries (since Inception)

Country	Performance	Contribution
South Korea	54.7%	3.44%
United States	51.9%	3.37%
Germany	50.8%	3.40%
Thailand	50.4%	2.97%
Japan	29.9%	2.08%

Top 5 performers of last month's picks (1-month performance)

Stock Name	Country	Performance
Helia Group	Australia	19.0%
Jointown Pharmaceutical Group Co	China	9.7%
PT Bukit Asam	Indonesia	8.0%
AutoNation Inc	United States	5.6%
GABIA Inc	South Korea	4.3%

Notable stock picks

This is the sixth article in the series, and we have almost reached the midpoint of the contest between man and machine. For those who have been following this series, I have explained how and why Deep Deep works and the investment process in Aggregate Asset Management since incorporating AI. For this article, let's highlight a few stocks we have picked over the last six months and see if we can learn some lessons on AI's strengths and limitations.

Best performer

Deep Deep's best pick is **Supalai Public Company**. It is one of the largest real estate development companies in Thailand that builds commercial and residential buildings. Deep Deep triggered a buy before its meteoric rise and we bought it on Oct 17, 2022 at US$0.58 ($0.79) and sold it at US$0.69 on Dec 2, 2022, gaining about 39%. What is remarkable about the stock is that the company's financial performance has been largely consistent for the last three years and there was no earth-shattering good news but Deep Deep detected momentum buying by the investors. Deep Deep sees patterns which we humans have missed or failed to see.

Our US picks

Our US stock picks throughout the competition have been spectacular. Since inception, Deep Deep's previous US picks (**Genworth Financial Inc**, **Conn's Inc**, **Citi Trends** and **Autonation**, excluding latest pick) have achieved a cumulative return of 55% versus Berkshire Hathaway's 14%.

Analysts and trendspotters have been declaring the death of bricks-and-mortar stores, the future is online retailing and **Amazon** is king! Hang on. Amazon has fallen 49% from its peak, sorry Bezos. Deep Deep has picked two contrarian companies that have stores. It is like the protagonist Ellie in HBO's *The last of us* who saw a mall for the first time in a post-apocalyptic world — what a strange concept. Conn's Inc sells mattresses, home appliances and furniture in 160 stores across 15 states in the US. Citi Trends is a US retail clothing company that sells discounted products to less affluent, urban customers in 615 US stores. Both stocks gained about 25% and 10% respectively when they were in Deep Deep's portfolio.

Worst performer

Our worst performer was **Guangdong Taipai Group Co.** It manufactures cement and ready-made concrete products for civil projects in southern and eastern China. With the restart of China's industrial engine in the wake of the pandemic, companies that support construction should do well but the stock price languished and it lost 11% before selling it. This is the biggest loss we have sustained so far. It is important to remember Deep Deep is not like the time-travelling DeLorean car in *Back to the future*. It did not see the future and travel back in time computationally to tell us which stocks to buy. It is a probabilistic AI engine that hunts for stocks with the highest probability of outperforming the market's mean returns. How did Deep Deep's portfolio do well despite this loss? The answer is diversification — the other 14 stocks cushioned the loss easily and delivered a win overall.

Importance of being earnest

Readers will be surprised why we highlight our biggest loser in this article. This is Aggregate's ethos — we report our sterling performance with the same level of detailed analysis and transparency as much as we report the bad news. We do not hide or obfuscate. We feel very uncomfortable when we see the websites of funds showing truncated performance data. These websites avoid showing 2022 results for obvious reasons. Our fund management team studies failures and bad stock picks with the same obsession as we study our winners and successful investment strategies. We do not sit on our laurels too. While we are refining Deep Deep, we already have another team headed by Dr Chai Woon Huei, our data scientist, to develop an even more advanced AI. ■

Harry Huo is head, special projects, at Aggregate Asset Management. This article does not constitute a recommendation. Neither is it a solicitation to invest. This is a "live" portfolio that was incepted on Oct 17, 2022 and takes into account transaction costs.

Battle of the Portfolios challenge

The table above shows the 15 stocks picked on March 8 by Aggregate Asset Management to form a concentrated, proprietary AI-picked portfolio. This machine-picked portfolio will challenge human stock pickers via the following competing portfolios and benchmarks:
a. Aggregate Asset Management's diversified fund, Aggregate Value Fund, with nearly 1,000 stocks picked by human inputs but enhanced by AI stock screening.
b. Tong's Portfolio which has been published in The Edge Singapore since December 2017.
c. Warren Buffett's investment vehicle Berkshire Hathaway's stock performance.
d. Dow Jones Industrial Index, MSCI All Country World Index (MSCI ACWI) and MSCI AC Asia Pacific (MSCI AC APAC) will be included as reference benchmarks.
Every month, we will publish an updated table showing the relative performance of these portfolios and benchmarks, and we will continue to do so monthly for a year. In October 2023, we will declare the winning portfolio based on the highest portfolio return. For simplicity, all our portfolios' returns and benchmarks will be in US dollars for easy comparison.

Rolex, Patek investments beat S&P gains over five years

Prices for Rolex, Patek Philippe and Audemars Piguet watches appreciated by an average of 20% a year since mid-2018, outpacing the S&P 500 Index, as values for pre-owned luxury timepieces surged, a new report shows.

The S&P 500 stock index averaged annual returns of 8% from August 2018 to January 2023 while a basket of pre-owned watch models from top Swiss brands grew at more than twice the pace, the report from Boston Consulting Group and secondary market dealer WatchBox said. That's despite prices of some pre-owned models, including Rolex Daytonas, Patek Nautilus and AP Royal Oaks, declining by as much as a third since the market peaked in the first quarter of 2022.

Prices for a basket of so-called independent brand watches including FP Journe, H. Moser & Cie and De Bethune — a small Swiss producer which is majority owned by WatchBox — returned 15% over the same period. The report touts luxury watches as an alternative asset class to stocks, bonds, art and wine.

Over a longer period, stocks outperformed watches as an investment asset. The S&P 500 had a compound annual growth rate of 12% between 2012 and 2022, while Rolex, Patek and AP watches averaged 7%.

Secondary-market watch price increases accelerated sharply during the pandemic as Millennial and Generation Z consumers, cash-flush and stuck at home, discovered a pricey new hobby collecting Swiss watches. The rise and fall of cryptocurrency values has also correlated with used watch prices.

"Value and transparency are the drivers of the secondary market and that has been a driver of liquidity," Sarah Willersdorf, a managing director and partner at BCG in New York, said in an interview. — *Bloomberg*