



# ASTRAL VALUE FUND

Monthly Commentary

DEC 2016

	YTD 2016	Dec 2016	6 Mth	1 Year	MAY-15 Inception To Date	Outperformance Since Inception
<b>Astral (Class B)</b>	7.0%	-1.6%	8.5%	7.0%	5.1%	
<b>ASIAD*</b>	2.3%	-0.3 %	5.7%	0.1%	-7.4%	12.5%
<b>HSI</b>	0.4%	-3.5%	5.8%	0.4%	-21.8%	26.9%
<b>FSSTI* (USD)</b>	-2.3%	-1.8%	-5.6%	-2.3%	-24.4%	29.5%

\*ASIAD refers to the Bloomberg Asia Developed Markets Large & Mid Cap Index

\*\*FSSTI was rebased to USD using the month end exchange rate

## INVESTMENT OBJECTIVES

Astral Value Fund is a long-biased fund that aims to offer investors exposure to Asian markets equity returns with lesser risks through a disciplined approach to investing in mispriced situations.

## FUND INFORMATION

<b>Fund Manager</b>	Astral Asset Management	
<b>Currency</b>	USD	
<b>Jurisdiction</b>	Cayman Islands	
<b>Share Class</b>	A	B
<b>Management Fee</b>	1.5%p.a.	1.2%p.a.
<b>Performance Fee</b>	15%	12%
<b>Early Redemption Fee</b>	3% Year 1 1% Year 2 1% Year 3	3% Year 1 2% Year 2 1% Year 3
<b>High Watermark</b>	Yes	
<b>Dealing Frequency</b>	Monthly	
<b>Redemption Frequency</b>	Monthly	
<b>Fund Admin</b>	APEX Fund Services	
<b>Custodian</b>	DBS Bank	
<b>Fund Auditor</b>	Deloitte	
<b>Legal Advisors</b>	Rodyk (Singapore) Walkers (Cayman)	
<b>Bloomberg</b>	ASTRALV KY Equity	
<b>Website</b>	www.astralasset.com	

Dear Partners and Friends,

It was a tough December for investors in the Asian markets. The continued strength of the dollar coupled with increased outflows out of Asia into the US rally, resulted in significant headwinds for Asian investors. Only Japan benefited from this bout of reversal during December as the weakness of the Yen favoured the exporters in Japan.

Hong Kong was down as much as 5% during the month before a strong rally during the last 3 days of the year propelled the index to a small positive return for the year. In Singapore, the recent OPEC truce and expectations of higher interest margins saw relief for both the oil and gas as well as the bank counters. Both sectors rallied strongly during December after swooning badly for 2016. The STI ultimately finished negative as the index's strong run was dampened by the continued strength of the dollar. Indeed the USD/SGD had a volatile year, starting at 1.42 in Jan and then sliding 5% to 1.34 at its lowest point before ending the year up 8% to 1.45.

Given the challenges in our primary markets in HK and Singapore, we managed to prevent a large drawdown in December and achieved an overall annual return of 7% for 2016. We seized the opportunity during the month to add to existing positions where we continued to hold strong convictions.

As at the end of the year we were 95% invested in equities and bonds. We remain optimistic of the returns that could be generated by our undervalued portfolio.

Do read on for our annual newsletter.

Yours Sincerely,

Astral Asset Management

## YEARLY COMMENTARY

Dear Partners and Friends,

Astral's goal is to beat the long-term equity market return of the market over time and to try to achieve consistent positive returns.

To achieve this long-term goal, we set the following objectives at the start of each year:

- 1) Make a positive return from the previous year.
- 2) Beat the trailing 3-year return of the market.
- 3) Minimise volatility as far as possible for our investors.

The three objectives often do conflict with each other. For instance, making a positive return very often requires one to buy when times are volatile. Being value investors, we almost always tend to buy too early. As a result, we occasionally suffer unrealised temporal losses and our portfolio suffer from market lagging returns for a while. Another instance of conflicts between the goals is that our strategy of beating the market index is to invest in under-covered stocks that are not in indexes. Some of these stocks being thin in liquidity contribute significantly to higher volatility, but if done correctly will help us beat market returns.

Our method of achieving the third objective of minimizing volatility is mainly through a broad diversification of value investing strategies and based on our reading of the market. The first is within our control but the second is not something we can predict with reasonable certainty except with the benefit of being through market cycles. This could mean that when we feel that markets are expensive, we will raise more cash and stay on the sidelines. In times of market euphoria, it could mean the fund is less volatile but we will lag the market in terms of return.

Regardless of what happens, our purpose is first and foremost, a positive return. It is inevitable that in some years the fund will see negative returns and hence investors or potential investors in our fund must have the stomach to at least not to capitulate and redeem.

Seasoned investors would recognize that achieving all three objectives in a single year is a lofty aspiration but we believe in aiming high. On rare years, we will be able to hit all our goals. 2016 is a rare year. We managed to achieve all the 3 objectives that we set out to do. We finished 2016 up 7%, outperforming both the Hang Seng and STI by 7% and 9% respectively. Our Sharpe ratio was 1.07 vs 0.37 for the ASIAD. Since inception, we have outperformed the ASIAD by 12.5% and more than 25% for both the Hang Seng and STI.

We attribute our strong results to the seeds sown since the start of our fund in May 2015 as much of the positive performance attribution stems from stocks bought in 2015. Throughout 2016, we maintained our portfolio diversification with more than 70 positions, with each position not exceeding 4% of the portfolio. This gives us confidence that even as our AUM increase, we will be able to maintain our diversification and returns.

## Portfolio Movements

We are optimistic in the coming year and this is reflected in our nearly fully invested stance in our portfolio. In July, we emphasized that our portfolio as at June was undervalued with PB of 0.89x and

EV/EBITDA of 7.0x. The good news is even though our NAV has appreciated significantly since then, our portfolio remains undervalued with an ending PB of 1.06x and EV/EBITDA of 6.98x. Price to Book has increased as we strategically reduced certain deep value situations that have rallied significantly and bought into turnarounds, special situations and fast growing situations, as we believe the latter offers us a better risk reward ratio.

## What We Have Learnt

Sometimes we should recognise that certain investment situations just aren't our game.

In late 2015, we invested in a Hong Kong company dealing in licensing and distributing of characters for kids fashion and toys. The company's other business was licensing non-core high fashion products such as hats and umbrellas for large fashion labels such as Kate Spade. We liked the management and the asset light business model. Our investment thesis was that the company was on a verge of the turnaround even as it tried to streamline its portfolio to focus on higher margin recurring products. We bought into a substantial position for our portfolio when the price of the stock fell due to the restructuring.

Unfortunately, by the end of 2015 the company was hit by a warmer than usual winter and its restructuring efforts continued to hit sales badly. At the same time, gearing rose substantially as the company drew down on its credit facilities to acquire new brands. As news on the weak sales filtered through the market, the stock price tanked. Our review and talks with the management revealed that the turnaround plan was still in place and hence we dithered on whether to cut loss for this position. As the weeks went by, the stock price continued to drop precipitously and triggered more reviews and finally the high debt burden due to continued M&As proved to be the straw that broke the camel's back and we sold out. Unfortunately looking back, we sold at the 52-week low and the stock have since rallied almost 50% back from the price we sold. Ouch!

Our investment mistake was that we ignored our dislike for debt to invest in a company, which we fell in love. We were too optimistic on the turnaround prospects that we thought that the short-term debt was manageable. Our takeaway was not to take excessive risks beyond our comfort level. We clearly do not like high debt and we have resolved not to invest in companies that are highly dependent on short-term financing in future.

## Investment Situation Showcase

Below is an investment example to explain our investment process for a franchise situation for our fund. Please note that it is not to be interpreted as investment advice.

A franchise investment is what we term as buying a wonderful business at a fair price. This style of investing was made famous by Warren Buffett and Charlie Munger. Buffett, as a young investor, started out as a Benjamin Graham disciple practising the net-net style investor but Munger managed to convince him that buying wonderful businesses at fair price would be a more rewarding venture. He never looked back and his investing of businesses with strong economic moats made him the world's most famous value investor.

In a gist, an economic moat is the degree of competitive advantage that a company has over his competitors. The stronger or bigger the moat, the more enduring and powerful the competitive advantage and companies with strong economic moats are wonderful businesses.

So what's a wonderful business? Rather than bore you with technical terms like economies of scale, high switching costs or network effect, we think Richard Russell best puts it:

*"All right, let's return to that wonderful world of perfection. I spent a lot of time and thought in working up the criteria for what I've termed the IDEAL BUSINESS. Now obviously, the ideal business doesn't exist and probably never will. But if you're about to start a business or join someone else's business or if you want to buy a business, the following list may help you. The more of these criteria that you can apply to your new business or new job, the better off you'll be.*

*(1) The ideal business sells the world, rather than a single neighborhood or even a single city or state. In other words, it has an unlimited global market (and today this is more important than ever, since world markets have now opened up to an extent unparalleled in my lifetime). By the way, how many times have you seen a retail store that has been doing well for years - then another bigger and better retail store moves nearby, and it's kaput for the first store.*

*(2) The ideal business offers a product which enjoys an "inelastic" demand. Inelastic refers to a product that people need or desire -- almost regardless of price.*

*(3) The ideal business sells a product which cannot be easily substituted or copied. This means that the product is an original or at least it's something that can be copyrighted or patented.*

*(4) The ideal business has minimal labor requirements (the fewer personnel, the better). Today's example of this is the much-talked about "virtual corporation." The virtual corporation may consist of an office with three executives, where literally all manufacturing and services are farmed out to other companies.*

*(5) The ideal business enjoys low overhead. It does not need an expensive location; it does not need large amounts of electricity, advertising, legal advice, high-priced employees, large inventory, etc.*

*(6) The ideal business does not require big cash outlays or major investments in equipment. In other words, it does not tie up your capital (incidentally, one of the major reasons for new-business failure is under-capitalization).*

*(7) The ideal business enjoys cash billings. In other words, it does not tie up your capital with lengthy or complex credit terms.*

*(8) The ideal business is relatively free of all kinds of government and industry regulations and strictures (and if you're now in your own business, you most definitely know what I mean with this one).*

*(9) The ideal business is portable or easily moveable. This means that you can take your business (and yourself) anywhere you want -- Nevada, Florida, Texas, Washington, S. Dakota (none have state income taxes) or hey, maybe even Monte Carlo or Switzerland or the south of France.*

*(10) Here's a crucial one that's often overlooked; the ideal business satisfies your intellectual (and often emotional) needs. There's nothing like being fascinated with what you're doing. When that happens, you're not working, you're having fun.*

*(11) The ideal business leaves you with free time. In other words, it doesn't require your labor and attention 12, 16 or 18 hours a day.*

*(12) Super-important: the ideal business is one in which your income is not limited by your personal output (lawyers and doctors have this problem). No, in the ideal business you can sell 10,000 customers as easily as you sell one (publishing is an example).*

*That's it. None of us own or work at the ideal business. But it's helpful knowing what we're looking for and dealing with. As a buddy of mine once put it, "I can't lay an egg and I can't cook, but I know what a great omelet looks like and tastes like."*

Reading through the list of characteristics, one would think of companies like P&G, Visa, Google, McDonalds who have a combination of some of the characteristics. The fact is no one business in this world has all the characteristics mentioned above or everyone would be queuing up to buy the stock. Businesses that have a combination of the characteristics above stand a chance of being a wonderful businesses.

Identifying a wonderful company is the first step but paying a fair price for it is the tricky part. In today's world of low returns, many of these wonderful businesses trade at high prices with their ability to grow earnings consistently more than priced in. So what advantage does a value investor who wish to do franchise investing have?

*Sunevision (8008 HK)*

The past 3 decades saw a fast growing demand for data or specifically data storage. Together with the advent of cloud computing, the need for specialised providers of space to house all these servers have seen tremendous growth. Outside of China and in the Pacific region, the 2 most logical locations for regional data centre placement immune to natural catastrophes with the necessary infrastructure is Singapore and Hong Kong.

Sunevision is the largest data centre provider in Hong Kong catering to the premium segment of data users such as financial institutions and large IT companies. In Hong Kong, supply for purpose built land for data centres is tightly controlled by the government. This only serves to mean that data centres in Hong Kong do have pricing power. Once tenants are in, it is unlikely they will leave the data centre as certain companies such as stock exchanges cannot contemplate downtime for small amount of cost savings. In some cases, certain functions such as cross connect makes its impossible for companies connected to each other to leave a certain data centre. Strong operating leverage for data centres exists for this business in that once it is set up, very little additional CAPEX is required. All these characteristics add up to imply that Sunevision possess a wonderful business.

Now we believe that a fair price for such a wonderful business with steady growth is mid-teens multiple of cash earnings. We bought in early during our fund's inception as the earnings continued to rise but cash fell as the company invested in another piece of land to double its capacity. Impatient investors had sold down the company to fair valuation based on current operations. We continued to buy in even as the shares got sold down in 2015 in face of the market panic over China's meltdown. We felt that the meltdown has no implication over the company's prospects as data growth in Hong Kong will continue to grow at double digits regardless of what happens to China's economy.

Fast forward to late 2016, as the company neared the end of its expansion, a broker started covering the stock and the price soared 50%. From our further channel checks, we understand that the new facility will be fully tenanted within a year and no new data centre with significant capacity will be up in the next few years. We believe that there will be more good news and will continue to hold on to the stock.

Returning to the question on what advantage does a value investor have in franchise investing? A true value investor possesses patience and a much longer time horizon than typical investors. In Sunevision's case we identified it as a wonderful business but most investors were not patient enough to see out the fruits of the company's new business extension. Hence value investors could have used the chance to buy in when the valuation of the company only took into account its existing business and not the potential of the new business.

## **Our View of the World Now**

We think that China is in the stage of recovering from its recent slowdown. Besides drawing comfort from the improvement in PMI and consumption numbers, our optimism stems from our observation during meetings with management where they have expressed a consensus that China's demand for goods and services is stabilising from the sharp fall last year. This means that comparable sales are likely to grow from the previous low of 2016 which will improve sentiment. Another bottom up angle which we use frequently is that the valuation of the Hong Kong names we hold are still at a historical low.

Our optimism is not without risks. Whenever we discuss about China, two everpresent risks keep us awake at night. One is that given the knock on effects, the potential collapse of China's property will have a devastating effect on the economy. The other related risk is a possible bond market collapse. For the uninitiated, China's bond market is now more than US\$3.2trillion and is the 3<sup>rd</sup> largest in the world behind US and Japan. Official figures show more than 370 foreign institutions own a total of USD 150 billion in Chinese bonds, a relatively tiny amount compared to the local investors, who have a preference to leverage. As Chinese bonds are sold off in December, Beijing quietly announced its intention to allow foreign credit-rating agencies to rate local Chinese bonds for the first time. While bond defaults are rare in China before this year, this has not been the case in 2016 with many bonds in old economy stocks such as steel and shipping being allowed to fail. It is always a tricky balance between discouraging moral hazard and spooking investors – Think Bear Sterns and Lehman Brothers. Should a bond run occur, the reverberations is likely to be global as we foresee capital flight to meet margin calls.

We have assessed the odds of the 2 risks that we mentioned above happening to be still low to moderate as the Chinese government has actively intervened whenever things have gone out of hand. We are constantly monitoring indicators of stress to see if there is widespread panic due to possible bond defaults or property failures. Our way of hedging against the two key risks mentioned above is mainly not to participate in the businesses of banks and property companies with significant exposure to China. We are choosing instead to invest in companies that participate in Asian consumption story knowing that rising incomes will increase demands for better standard of living via higher quality or aspirational goods and services.

## **Thanks**

Our utmost appreciation is reserved lastly for our partners for the trust they have placed in us. This month we welcomed our 18<sup>th</sup> partner. While we have returned better returns than the market for the past one and half years, we believe that equity returns should be higher given the current valuations and will strive for better performance.

We welcome potential partners to contact us at [enquiries@astralasset.com](mailto:enquiries@astralasset.com) for more information.

Sincerely,

Astral Asset Management