

Intelligent Investing When Asia's Mr. Market Is Fearful

This article is authored by MOI Global instructor Sid Choraria, Asian Equities Portfolio Manager, based in Singapore.

We look forward to learning from Sid, both at the Best Ideas 2019 online conference and at Ideaweek St. Moritz 2019.

Asian markets offer a rich fishing ground for the diligent value investor. Our philosophy is to invest in great Asian businesses when Asia's Mr. Market is irrationally fearful in the short-term so we can act decisively and concentrate *only* when we truly like a business and it is in the "fat pitch" strike zone, trading against irrationality to reduce the amount of mistakes.

Asia offers an incredible environment to invest in great world-class companies with long-term growth amidst attractive demographics. The key is to be disciplined on the purchase price and not look to Mr. Market as a predictor of value in the business but as a friend to trade on irrationality. In my experience in Asia, investing in sub par businesses at a great price still offers sub par results relative to the Market, and is not a sustainable strategy.

Mr. Market in the book *Intelligent investor* is described as a moody character. I would argue that Benjamin Graham would say Asia's Mr. Market is more inefficient fluctuating between very depressed and very enthusiastic more frequently than the US or European markets. So as a long-term investor, Asia's Mr. Market is a great friend to the diligent investor where patience and emotional character, combined with scuttle butt research is greatly rewarded. What differentiates the long-term track record in Asia is business quality + emotional integrity on the price.

Several reasons exist for frequent mispricing in Asia: short-term mentality in markets like China where the stock market is a casino and price and value are very separate, stark differences in governance, accounting and disclosure standards causing investors to frequently bucket good businesses with the same brush, uncertain macro-economic or political headwinds creating fear and limited analyst coverage as Asia has more than double the companies than the US. India and China, among the largest economies, fastest growing, and vibrant stock markets alone have 10,000 companies!

Within Asia, each market is very different which makes the job of a foreign investor without boots on the ground and experience difficult to avoid landmines but great opportunity for the diligent analyst with local networks. For example, in China 80% of investors are mom and pop investors who focus on anything but fundamentals, and this leads to speculation as mentioned in Seth Klarman's *Margin of Safety* chapter 1. Gambling is in the blood of the Chinese investor and the stock market brings out this emotional trait perfectly. Even institutions in China have very high portfolio turnover which means stocks are NOT seen as a business but as a piece of paper.

Disclosure in Japan is challenging and varies company by company providing significant opportunity for the diligent analyst. Many Japanese high quality consumer companies are successfully selling their branded products to the wealthy Chinese and Asian consumer — who crave quality, yet local Japan analysts who cover these companies tend to be very Japan

focused providing an information arbitrage. India tends to be more of a GARP (growth at a reasonable price) market and investors looking for “deep value” are going to miss out on great businesses. Countries like Hong Kong, Taiwan, South Korea offer value in the traditional sense, but it’s very important to pay attention to minority shareholder friendliness, cross shareholdings, capital allocation, etc as they can differ significantly.

Over many years, I have developed an exhaustive database of Asian companies that assists me mine for key factors I look for in a systematic way, quantitative and qualitative. In the last 12 months, we have met over 200 Asian companies in over 9 countries including high growth countries like China/HK, India, Vietnam, developed markets like Japan, Taiwan, Singapore, South Korea and frontier markets like Bangladesh and Myanmar. While I am primarily searching for high quality businesses, I allocate a small portion of the portfolio to more illiquid securities, as there are plenty of ignored securities in Asia, that offer a Heads You Win, Tails you Can’t Lose Much scenario. The ideal bet is a large liquid security offering such odds!

We constantly take careful notes when meeting Asian companies assigning scores of 1=in, 2=out, 3=too difficult, learning from the Charlie Munger approach. Investing successfully is saying no and managing time well, as time is finite and cannot be bought. As a value investor, I prefer fishing more in the Chinese and Indian markets as they are deep markets offering plenty of great businesses. Once attractive opportunities are narrowed down, the key is to spend a substantial amount of time understanding the business, specifically its competitive position (i.e. pricing power, economies of scale, customer captivity). Then I look for an alignment with and incentives of management with shareholders (i.e. capital allocation, compensation, sticking to core competency, etc.).

Finally, I look for opportunities to purchase companies at a substantial discount to the price a rational private owner would pay for the business. A company’s intrinsic value is derived from the earnings power of its operations and corporate governance plays an significant role as well, because it determines how much of a firm’s value can be claimed by minority shareholders. We try to understand what will increase the intrinsic power of the company – this is usually as a result of strengthening its moat, new business innovation, better use of balance sheet (ROA, ROE), improvements in capital allocation etc.

I keep a watch list of 70-80 high quality Asian companies and add companies and remove companies diligently, if the moat shrinks or corporate governance disappoints. The goal is to construct a long-term portfolio that is concentrated in a dozen or small number of favorite businesses which are great businesses at highly attractive prices acquired when Asia’s Mr. Market is irrational. Accumulated knowledge about the business, industry and management often lead to greater opportunities to compound information.

At Best Ideas 2019, we will present a China A share company that is defensible in the current market context and available at an attractive price as a result of Asia’s Mr. Market irrationality. Interestingly it is a security that legendary Charlie Munger has discussed in an interview on investing in Chinese companies with durable competitive advantages.