finexis
ASSET MANAGEMENT
汇信资产管理有限公司

FAM ASIA FUND

INVESTOR LETTER

October 2018

Dear Investors,

"If they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful."

- 2004 Berkshire Hathaway Chairman's letter

I am not sure how many of you have been asking yourself: Is the longest equity market bull run since 2008 coming to an end? Let us look at the figures: The Asia ex Japan equity market has dropped 22% since its peak, led by China. Market darling Tencent has seen its stock price drop 44%. Sounds familiar for those who went through the Great Financial Crisis of 2008? If you remember, Apple's stock price declined 59% in 2008 while Nokia stock dropped 72%. Fast forward to 2018, Apple stock hits its record high at $232 with 2100% gain over 10 years, and Nokia never recovered.

How would anyone know in 2008 whether to invest in Apple or Nokia? Both companies were doing well in the mobile phone market. After large price drops, both were very cheap. In fact, Nokia's price dropped more, and it was the market leader. If we applied our investment strategy back in 2008, we would choose Apple. Why? Amid the market uncertainty, we find certainty in companies that are cheap and good. One of the attributes of good companies that gives us confidence is cash flow, a factor not many investors pay attention to. Apple in 2008 was number three in the mobile phone market but it generated much better cash flow than Nokia. In this letter, we are going to share with you how cash flow plays out in our investment strategy.

We believe so long as business fundamentals are intact, it is better to buy a stock at a meaningful discount rather than at peak prices. The market's fear now gives us a great opportunity to invest in good companies which are under-priced, and time will reward investors if they have the patience. Investing is like making good wine, time is one of the essential ingredients.

THOUGHTS ON INVESTMENT

Cash is king

Everyone has heard of the term "cash is king". This is commonly misunderstood as holding on to cash. In our definition, "cash is king" refers to the importance of cash flow for individuals, businesses, and investors to generate wealth. For the individual, cash availability is crucial when one needs to pay for a purchase or when a loan interest payment is due. Cashflow is often referred to as being the lifeblood for companies, for reinvesting into their business, and staying out of trouble when times are hard. For investors, "cash is king" when we have capital to invest when opportunities arise, such as investing in businesses that generate cash.

Cash is king when invested

Ask anyone what value investing is, and you would get different responses. Some prefer to buy based on how discounted the asset is relative to its value (e.g. price to book), while others might focus on companies paying dividends. Generally, these different approaches to finding value in investments tend to work.

Price to book and dividend yield are considerations for our stock selection to find cheap and good companies. Furthermore, we have found that cash flow is an important consideration, especially under uncertain market conditions. Cash flow is more tangible; owning a discounted asset that is yet to be monetized is different from receiving cold hard cash. The value of a discounted asset can be disputed while there is little dispute over the value of cash. As the English say "a bird in hand is worth more than two in the bush", a similar adage in Chinese that relates well to cash flow is 钱生钱 (cash generates cash).

We focus our portfolio on having favourable Free Cash Flow (FCF). To illustrate FCF, we use an analogy by comparing a business to an individual. (Do note that the illustration is a simplified model and should not be used for determining financial metrics of all businesses.)

Individual	**Business**
Gross income Less taxes = *Disposable income* Less necessities e.g. housing, food, transport, insurance = *Discretionary income* Less discretionary spending = *Savings*	*Revenue* Less costs and operating expenses = *Operating profit* Less taxes Plus depreciation, Less changes in working capital = *Cash flow from operations* Less capital expenditure e.g. on land, building, equipment = *Free cash flow*

It is evident that savings benefit the financial well-being of an individual. Savings can be used for a rainy day, and invested to compound wealth for achieving financial independence. If you were the individual above, I would imagine you want to have plenty of savings left after taxes, necessities, and indulging yourself.

Similarly, free cash flow is beneficial to a business, and its shareholders. A company with free cash flow is more sustainable as it has "savings" left after paying for "taxes, necessities" and future needs (in the form of capital expenditure). Companies with free cash flow are also robust to financial stress. A company with profits but poor cash flow is more likely to face bankruptcy compared to one with favourable cash flow.

PORTFOLIO DISCUSSION

Year to date, the Fund is down 6.25%, much of that driven by the 5.23% decline in Q3. Our portfolio continues to exhibit its market-beating qualities of cheap and good. The prospects for investing in Asia are clear, and we believe a portfolio of companies with superior qualities (as shown in the table below) will reward investors in the long run.

	FAF	**Asia Pacific ex Japan market**
Free cash flow yield	7.6%	4.2%
Dividend yield	4.6%	2.9%
Return on equity	29%	17%

Source: Bloomberg as at 30th sept 2018

Markets tend to misprice the value of companies (even cash flow generating businesses), which is why we are not ruffled, but are excited about opportunities being presented amid the current volatility. Though the journey to investment gains is expected to be a bumpy one, but we believe "the market will transfer the wealth from the impatient to patient".

Best regards,

AlvinGoh

Alvin Goh
Chief Investment Officer