Explanatory notes to the AW Portfolio:

I believe that buying companies with high returns on capital, good long-term growth prospects and low valuations reaps fabulous rewards over time. This is because these buying criteria all lead to the most important principle in investing – building in an adequate margin of safety/error. To win is not to lose (one’s capital) in the first place!

Working out the first part of the “formula” – high returns on capital – is easy, especially when I have access to Quam’s data (including the earnings forecasts in the QuamResearch Weekly). The second item – good long-term growth prospects – requires more subjective thinking but one can do it by a bit of extrapolation using again Quam’s historic data. The last limp – low valuations – is, I find, the hardest bit to get right and, of course, everyone knows that, the lower the entry price, the higher the return.

I found different yardsticks on this last hurdle. Jim Slater suggests buying shares with PEG less than 1. John Neff says he prefers stocks whose total return (being earnings growth plus dividend yield), divided by the p/e, exceeds the market average by 2 to 1 (which is actually the flip side of PEG!) David Dreman preaches employing a combination of low price/earnings, low price/book, low price/sales and high dividend yield. I also like Warren Buffett’s advice that investors should treat a stock like a bond that pays a variable interest and compare a stock with 30-year US Treasury bond. I believe the logic is that, if one were able to find and buy a stock at a rate of return that is initially higher than that of the nearly risk free US Treasury bond and that keeps growing in subsequent years, one should be onto a sure thing! I think however that this approach applies well for large capitalisation stocks like HSBC only. Tony (Measor) has his own hard and fast rule of simply multiplying Quam’s forecasted earnings for a particular stock by a p/e he deems by experience to be appropriate and compare the result with the price offered by Mr. Market. This last yardstick I like very much but I don’t of course have Tony’s experience!

Given that I must buy stocks within a very short specified period, I have decided as a starting point to look only at those with a BUY recommendation in the QuamResearch Weekly. This should help me sort out the first and second buying criteria. I am then left to contemplate the last part.

I know I should not time the market but I have a bad habit of not buying when the index is up. I know also that for diversification purposes there should be about 20 stocks in the portfolio. I had intended, within the specified investment period and given the size of the portfolio, to use up 2/3 of the fictitious money to buy about 5 stocks. The balance would be held for other buying opportunities, should they arise later. In the end though, I managed only to buy 2,400
HSBC shares at HK$134 each and 800 Manulife shares at HK$358 each on the last day! The rationale is as follows:

HSBC

HSBC is one of the largest banking groups in the world. Historically it has very high return on capital. Over the past 10 years, it has an impressive record of increasing NAV and earnings. It is still very much expanding – the acquisition of Household last year and moving into China, Korea and South America (which accounts for a very small portion of HSBC’s present earnings). Quam has forecasted HSBC’s 2005 earnings per share to be around HK$8.424. If one were to accord HSBC with a prospective p/e of 18 times – which is a fair valuation for an international banking group, one would get a price of HK$151.63 (HK$8.424 x 18). This is above HK$134. There is a more than 10% upside to HK$151. Looking at HSBC’s past records, its p/e had reached 29x in some years. So if one were to accord HSBC with a 20x prospective p/e, the price would be as high as HK$168.48 – about 25% upside from HK$134. Now, the chance of HSBC going under looks slim. It is probably comparable to buying US government bonds. If one were to buy HSBC shares at HK$134 per share, the initial rate of return would be around 6.3% (HK$8.424 divided by HK$134). This is much better than what one gets from buying 30-year US Treasury bonds (fixed now at around 4.9%) and the rate of return on capital for HSBC is likely to keep rising. Also HSBC pays a relatively high dividend yield, about 4% per annum. When this is factored into the equation too, the actual return is even greater. Assuming a share in HSBC is comparable to the 30-year US Treasury bond, that would translate to a price of HK$171.91 (being HK$8.424 divided by 4.9%) – a 28% upside from HK$134. Whichever angle one looks at it, HSBC at HK$134 (or lower) fits squarely in the categories of companies with high returns on capital, good long term growth prospects and low valuations. Tony also talks about writing back the amortised goodwill. I am afraid, whilst I like the argument, I am not brave enough to accept it!

Guoco

I don’t know enough about the group and I don’t have time to read up. So, pass.

ICBC (Asia)

I like this company but if I have HSBC, I feel I only want to buy ICBC when it’s cheap. By multiplying the forecasted 2005 eps (HK$0.85) by a 15x p/e, the price is HK$12.75. If one knocks off 20%, one gets HK10.20. I think I will buy at or around HK$10.20.

Manulife

Like a bank, a life insurer will not get out of fashion. Once a person subscribes for a life insurance policy, he is unlikely to stop the yearly premium payments for fear of losing the cover. The premium payments received, the float, can be invested and the return on the investment forms a secondary source of income for the insurance company. Historically Manulife has high return on capital. It bought John Hancock, another life insurer last year. It is expanding its operations in Japan and China. Quam has projected Manulife’s 2005 earnings per share to be around HK$24.88. At around HK$355 per share (the current price), that gives a prospective p/e of 14.27 times only (being HK$355 divided by HK$24.88). That
is a low valuation for a large and well-run insurance group like Manulife. If one were to accord Manulife with a prospective p/e of, say, 18 times instead, the price would rise to HK$447.84 - a 25% upside from HK$358. Also, buying Manulife now at HK$358 per share would give an initial rate of return of 7% - much higher than 4.9% - the fixed rate offered by a 30-year US Treasury bond. And the rate of return on capital for Manulife has been growing each year. After all, the trend is that more governments are cutting back and more people are relying on private insurance coverage. Finally, if one were to equate Manulife’s 2005 earnings (HK$24.88 per share) to that from a 30-year US Treasury bond, one would get a price of about HK$507.77 per share for Manulife (HK$24.88 divided by 4.9%). This is a more than 40% upside from HK$358.

Kowloon Development & LCH Investment

I don’t know enough about these companies and I don’t have time to read up. So, pass. Generally I don’t like property companies. Don’t know why. So I will ignore Chevalier International and Swire B too.

CLP and CKI

I don’t worry too much about the end of the concession scheme for CLP in 2008. In theory, if one multiplies Quam’s forecasted 2005 eps for CLP (which is HK$3.45) by a more respectable p/e for a respectable company like CLP, one gets HK$55.20. This is way above the current price but, having seen CLP gone from under HK$30 to where it is now, I am hesitant. I like CKI also but do not want to buy above HK$18.50 (HK$1.54 x 15 p/e and then discounted by 20%). I like China Mobile but feel the current price too rich given her low dividend yield. Whilst I am on infrastructure-types of stock, I note Quam has a BUY on Road King Infrastructure but I just can’t get excited on highways! So, sorry, pass, again!

Yip’s Chemical

Opportunities are not restricted to large capitalisation stocks. Currently Yip’s Chemical is another stock that can be a growth stock as well as a value stock. It has had fairly impressive growth in NAV and earnings over the last few years. This is probably because the paint/products it makes are needed in China’s current economic growth. Quam has estimated that the earnings of Yip’s Chemical will grow by 14.6% next year. Yet the market accords Yip’s with a p/e of around 8 times. Yip’s offers a high dividend at the same time. I think this stock will fit in with Neff and Slater. I am however a bit concerned over her liquidity. So, pass please.

Retail

I note Quam has Oriental Watch, Luk Fook and Veeko down as BUY too. They all have low p/es but high dividend yields. Oriental Watch doesn’t have to worry too much about rent increase but I wear a HK$200 watch and I don’t think I know much about the business. So, pass again. I read sometime back on Quam that Luk Fok’s fortune might have more to do with the gold reserve it has than its sale of jewelry. I don’t know enough about the company. So, pass this as well. I like (or more precisely I have noticed the girls in the office like)
Veeko. However, I think her stock price now is high. To let you in, I did take your advice and bought at 18 cents early in the year. So I will give this a miss for the present portfolio.

Electronics/ Toys/ Printing

I don’t know enough about ASM, TPV, Nam Tai and Herald and I don’t have time to read up. I am not comfortable with Samson Paper’s debt position. So, pass, pass, pass, pass and pass.

In the end, I feel that, whilst the market may offer (and it is easy to spot) great companies with high returns on capital and good long term growth prospects, the stock prices may be too high. Of course, the market changes all the time. A market event (like 911 or SARS) or a company specific event may help bring the stock price of a company down to worth buying again. In the first category, one needs only look at certain retail stocks, Cathay Pacific and SHK Properties and their stock prices after SARS and now. In the second “company specific” category, whilst I cannot think of recent Hong Kong examples, several US ones come to mind. There is Citigroup, the currently largest banking group on earth, whose stock price has been brought down by the Enron and Worldcom scandals. There have been write-offs but they should be of an one-off nature and the group should be strong enough to go forward. So it is in my mind both a growth stock and a value stock. The same can be said for AIG after the fiasco with March & McClaren. Altria, the holding company of Philip Morris, is affected by tobacco litigation but my guess is that it will pull through. Besides, Altria owns Kraft Foods and has interests in the beer company - SAB Miller. Altria has a dividend yield as high as 7% per annum. I am actually a bit disappointed with myself that I have only bought 2 stocks. However, I try to convince myself that I am not competing with others and I will and should buy only when Mr. Market is obliging and I feel like it!

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