HERITAGE
VALUE FUND

Heritage Global Capital Fund
Investment Memo
October 2017

History Matters & The Way Forward

It's been slightly under one and a half years since the Straits Times Index (STI) hit 3,500, a level last seen only in the heady days of 2007.

Since then, the economic climate has deteriorated, with the STI falling close to a 1000 points (between April 2015 and February 2016, a loss of 28.6%). Since then, many economists and financial pundits have called for renewed caution amid the current slowdown. No doubt – such advice is warranted. However, at the Heritage Global Capital Fund, we have a slightly different view. Prudence and diligence should be exercised at all times when one is invested in the markets, and not just the bad times.

After all, it is when others throw caution to the wind, and act in a reckless manner that we must redouble our efforts in acting in a prudent and cautious manner. This has been our mantra for the last five years, and forms the bedrock of what we do.

Since 2011, we have had the personal experience of witnessing several events which we think warrant mentioning:

- *The first ever downgrade in the history of the United States of America of its credit rating from AAA to AA+ by Standard & Poors in August of 2011*
- *Meltdown of Singapore listed Asiasons Capital, Blumont Group and LionGold Corp which lost S$8 Billion in just three days of trading in October 2013*
- *The inflation of the Chinese stock market bubble, and its subsequent crash. More than 30% of the value of the A-Shares listed on the Shanghai Stock Exchange was lost in less than one month in July 2015*
- *The stock market rout during the month of January 2016. The Hang Seng Index fell over 35% to 18,319 in February 2016 from the high of 28,442 set in April 2015*
- *The Shanghai Stock Exchange also fell close to 25%, from 3,539.18 to 2,655.66 in the month of January 2016*

These events have coloured our investment philosophy. While we are not immune to market fluctuations, we have come back each time by the judicious avoidance of leverage, and the careful selection of investments in our portfolio.

Risk Control Is at The Heart of What We Do

At the heart of what we do is risk control. Our aim is to earn the best return possible, ***while taking the least amount of risk possible***.

With that set, our first concern is always risk control, not investment return. Volatility in a given for those who invest in the stock markets, and it affords us opportunity. After-all volatility works both ways, allowing us to take positions when markets are pessimistic, and to exit pre-existing positions when the markets get overly excited.

While there are many different types of risk – the most pertinent one that is always on the forefront of our minds is the permanent loss of capital. It is our firm belief that if we can take care of our downside, the upside will naturally take care of itself

While this way of thinking may seem overly conservative in a bull-market, or when markets conditions are benign, it is during trying times like this that such prudence is rewarded.

Investors seeking yield in fixed-income learned that to their detriment when they lent to the likes of Swiber, Rickmers Maritime, Perisai Petroleum and Swissco, only to find their principal at risk when the credit markets tightened.

Valuation Matters

Price is always the starting point when we look at any investment opportunity. History and experience has shown that even good assets can become bad investments – if too high a price is paid. Conversely, very few assets are so bad that they cannot be good investments when a low enough price is paid.

Still, given the choice, our preference has always been to gravitate towards investments that have quality attributes to them.

A stock represents a part ownership of a company, whether good or bad, that entitles the investors to certain rights as dictated by the law. However, one must also recognise the prevailing reality of whether these rights can be enforced.

Fixed-income investors benefit from a contractual arrangement in which the rights of both parties are clear. Investors must place their emphasis on assessing the credit quality of the company and question, and the likelihood of it repaying its interest and principal.

Investors in stocks have no such “payback guarantee”. Careful emphasis has to be placed on assessing the management of the company, and more importantly – the alignment of interests of the controlling shareholders and management. We have through experience, found these to be the most reliable ways to ensure the safety of our principal.

In this case, investing in “blue-chip” stocks, which frequently make up a large section of the leading indexes of their respective countries can be a sensible and logical way of proceeding. Investors who have undertaken such a long term approach with low-cost index funds have often found themselves with satisfactory returns in the region of 6 – 8% per annum over the long run.

However, our goal at the fund is to materially outperform the indexes over the long run, with targeted average annual return of 10 – 12% net of fees. Thus, simply taking the approach above mentioned cannot help us reach our goals.

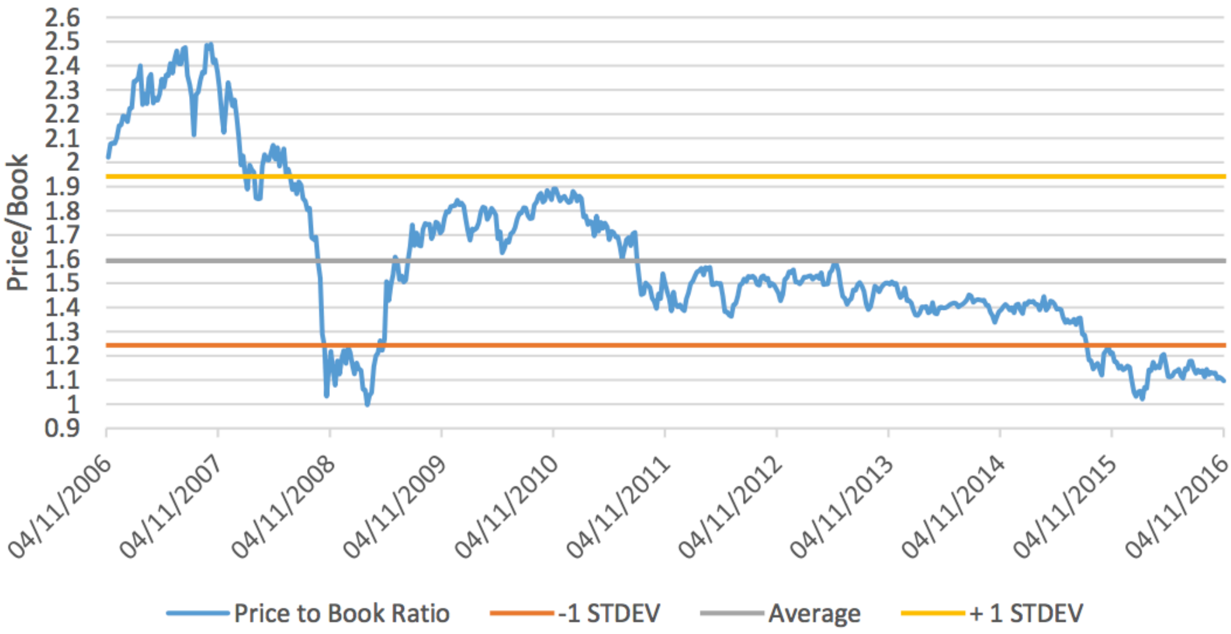
It is widely accepted for the most part that “blue chip” companies tend to be fairly valued. Opportunities to invest in these stocks are rare if one seeks a valuation that will afford both an attractive return, and safety of principal.

In our experience, investors can however do so when:

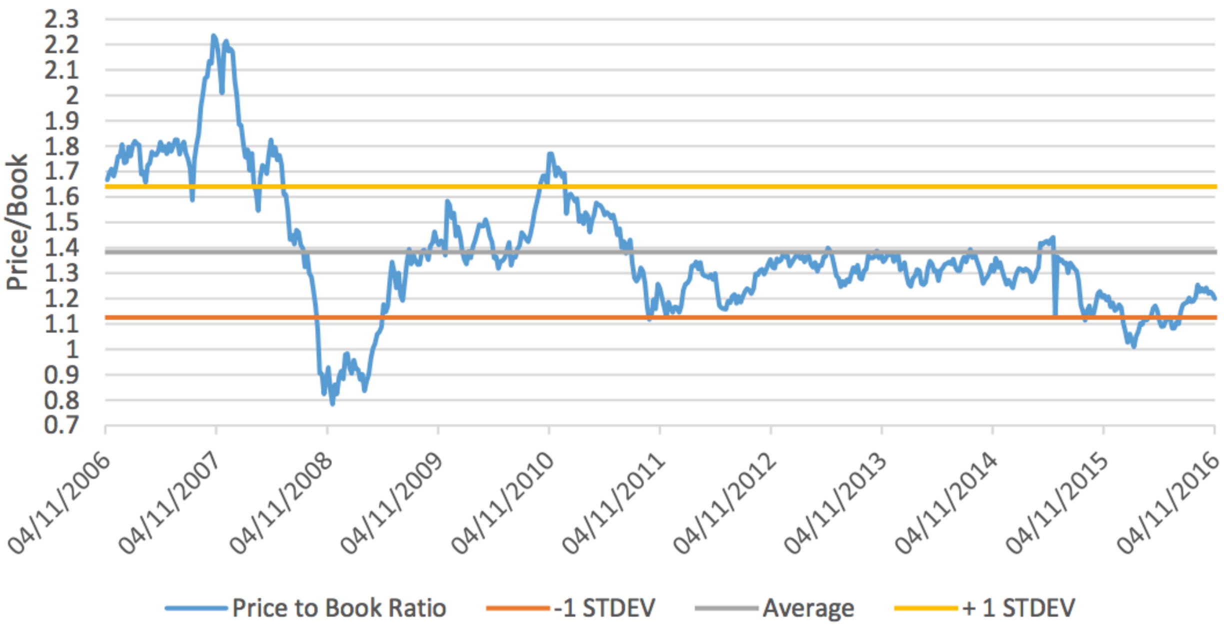
- The company itself faces temporary difficulty or bad publicity outside its control
- The general market as a whole is bearish because economic conditions are poor
- In some cases, both two conditions maybe present

We believe now to be such a time, with valuations of our core markets, Singapore and Hong Kong trading at valuations close to their ten year lows.

MSCI Singapore 10 Year Historical Price/Book Chart



MSCI Hong Kong 10 Year Historical Price/Book



The Outlook is Bleak – So Why Invest?

In the course of our discussions with our clients, it is understandable that investors are generally cautious and worried. The election of Donald Trump has not helped to soothe fears.

Unfortunately, it is the nature of investing that one cannot get both a good outlook and a good price at the same time. Only one can be present at any time.

It is the iron-clad law of valuation that an investor cannot get a higher return on the same asset by paying a higher price as opposed to a lower price. While investing in such times may not be easy, it is precisely because of this negative sentiment that we are able to get attractive prices on our investments.

Some analysts advocate waiting for the outlook to become clearer. However, our own experience is that by the time the dust settles, the clouds clear, and the sun emerges, prices have often revalued dramatically upwards.

The Outlook Today

As with most things in life, it is only with the benefit of hindsight that events are clear. Foresight is rare and hard to find, but a necessary component for us to achieve superior performance.

Our job is to see through the noise that permeates the market and to act accordingly. While the environment is challenging, we believe that the current climate affords us compelling opportunities to earn superior returns over the long run.

We believe now is good a time as any to begin our corporate journey, and thank you for your support and trust.