Thoughts on February Market Sell Off

This is the first major market sell-off since the fund's inception. It is however not the first major market decline.

In our first memo in 2016 entitled History Matters and the Way Forward, we wrote:

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.

The Cash Position of The Fund

These words were written when the world economy was much darker and things less certain – but still remain true even till today.

Over the last year, we have been extolling caution as the markets have continued their relentless rise up. We have been building and maintaining a significant cash position of 8% - 10% with the view of deploying it when the time is right (our latest fund fact sheet will show a lower cash balance but that is a timing issue because of a significant amount of cash incoming from an investor in the month of January).

Focusing on Fundamentals Relentlessly

Markets have not declined significantly as of yet (prices are simply at where they were a few months ago) – and it remains to be seen if the sell-off gathers strength. If it does, we will be net-buyers of select positions at the current prices.

As Warren Buffett put it best – You need to be greedy when people are fearful, and fearful when people are greedy.

We are not anywhere that stage, but may encounter that moment in the coming months.
As markets decline, it is easy to panic. We are human too and do not enjoy watching our positions decline in value. And yet, it is moments like this that maintaining a cool head is required.

Our North Star is simple – focus on the business fundamentals relentlessly.

The businesses we own are in strong financial positions and proven generators of both significant profits and free cash flow even during periods of distress.

Take of example one of our core holdings – Hang Lung Properties. Ronnie Chan has been developing the equivalent of one Empire State Building every year for the last decade – all while maintaining a net-cash position and high dividend pay-out.

It generated almost HK$5.7 billion in rental income in FY2017 – most of it which was paid out to shareholders.

The reality is that business rarely changes on a day-to-day basis – unlike the stock market. Prices fluctuate greatly in any given period of time, but in the long run, they always converge on the underlying fundamentals of the business.

With history as a guide, significant decline in stock markets have always allowed us the opportunity to reposition our portfolio and to reap significant rewards in the following 12-18 months.

Although there may be short term volatility in the coming months – maintain a laser focus on the long-run is paramount.

We and our families make up more than 50% of our assets under management and we have significant “skin in the game”. We intend to maintain our usual position of moving forward, but with caution in the coming months.

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