



ONEY



LONDON

'I'M LIKE A CHINESE BUSINESSMAN WHO TREASURES HARD CASH'

Capital Dynamics MD and index-beater Tan Teng Boo on why a company's borrowings and cash flow are key investment yardsticks



INTERVIEW _ TEH HOON LING PHOTO _ YEN MENG JIN

HIS LIFE HAS PANNED OUT such that Tan Teng Boo, founder and managing director of Capital Dynamics Group, believes that he was destined for the work that he does. In fact, it seems to gel with what he was told when, as a 17-year-old struck with a mysterious illness in his hometown in Alor Star, he was brought to a temple medium by his worried mother. Your son, declared the medium, would not succeed at anything until he was 35 or 36 years old.

As things turned out, that was the age when Mr Tan managed to get his investment advisory licence from the Malaysian government. That marked the beginning of his career in professional investing. And he's been at it ever since, and doing a darned good job at it to boot.

In addition to picking winning stocks, he's made a number of timely market calls. In March 2003, during the Sars epidemic, he gathered his staff together for a special meeting to urge them to invest in the mar-

ket. None did. He had a second meeting in May, repeating the message. Only a few took his advice. So in December 2003, he held a third meeting telling them that if they didn't invest then, he'd deduct their bonuses and invest the amounts for them!

And in late 2008, while the whole world was gripped in fear, he went around telling anyone who was willing to listen that a strong rebound was coming. When stock markets began to rally in March 2009, many doubted its sustainability. Mr

Tan again stuck his neck out to declare that the market was in a new bull phase and there would be no double-dip recession.

Then, there is his track record. His Capital Dynamics Section C Portfolio – which invests in Malaysian stocks and targets longer-term investors – was started on Sept 5, 1991. As at end-November 2009, the portfolio has chalked up an annual compounded return of 18.7 per cent. This was far ahead of the Kuala Lumpur Composite Index's 4.5 per cent a year.

Such talent of course could have been put to better use managing across the globe rather than confined to a small market like Malaysia. And indeed, Mr Tan had meant to play on the world stage from day one. But that dream was thwarted when Malaysia imposed capital controls during the Asian financial crisis. When the controls were eventually lifted at end-2005, Mr Tan wasted no time setting up Capital Dynamics (Singapore) Pte Ltd in early 2006, fearing that the government might reverse its policy again.

In July the following year, he launched his first global fund – the i Capital Global Fund (ICGF). His Malaysian track record proved to be no fluke. ICGF's performance is among the world's best today, in the category of long-only global equity funds with no leverage or derivatives. Between end-July 2007 and November 2009, ICGF's net asset value rose 27.3 per cent, for a compounded return of 10.9 per cent a year. That two-and-a-half year period, as we all know, was the most atrocious time for equities since the Great Depression in the 1930s. As an indication of how tough markets were, the MSCI World Index fell by 26.6 per cent during that period.

Mr Tan followed up his Singapore company with another one in Sydney. Capital Dynamics (Australia) Ltd was set up in 2008, making his company the first Asian fund manager to get a licence in Australia. In July 2009, i Capital International Value Fund, which is targeted at retail investors and denominated in Australian dollars, was launched.

The goal is to build Capital Dynamics into a global fund management firm, with Singapore as its global headquarters. The still energetic and "55-year young" Mr Tan is now in the process of setting up a Hong Kong office.

Overall, the Capital Dynamics group now has just under US\$300 million worth of assets under management. About a

third of that is in global equities with the rest in Malaysian equities. A big chunk of the Malaysian holdings is in his closed-end fund iCapital.biz, listed on Bursa.

Mr Tan says that based on his track record, he should have US\$50 billion to US\$100 billion under management by now. It is just that hitherto, he had neglected the marketing part of his business. Of course, he also needed to build up his global fund's track record. "I'm very under-utilised as a fund manager," he says.

Beyond personal ambition, Mr Tan also hopes that Capital Dynamics' global expansion will be an inspiration to young Malaysians. In an interview with Malaysian newspaper *Eastern Times* in June last year, he said: "The younger Malaysians need a role model that aims to succeed globally, based on hard work, long-term focus, discipline, determination and believing in oneself."

Born in Alor Star in Malaysia's Kedah state in 1954, Mr Tan joined Reuters as an economics journalist in 1973 when he was 19. However, he was put off by the fierce office politics and left his job after just six months. He then headed to Sussex University and got himself a degree in economics. On his return, he was roped in to work at his father's rubber trading and processing business. He stayed for five to six years, modernising it so that he could hand it over to professional managers.

He then moved to Kuala Lumpur in 1983 to work in broking firm GP Securities, the country's largest at the time. That was when entrepreneurship beckoned. He left the company in 1984, aiming to set up his own brokerage. But by the time he qualified for a broking licence, the rules had changed such that a broking business needed to be 70 per cent-owned by bumiputras. So he gave up that idea and instead considered setting up a leasing company or a funeral business. He decided against the first option because it would be too dependent on the government tax policies. He also abandoned the second idea, even though it would prove to be a gold mine, because it required dealing with the state government on land matters.

He eventually settled on investment advisory. "I've always enjoyed research – whatever kind of research. And there was a vacuum there. You couldn't get what I perceived to be objective and independent advice. So I applied for the licence, and I got it." It must have been destined, he mused.

Capital Dynamics' investment philosophy is built on the three "i"s – independence, intelligence and integrity. In its marketing material, it says the framework is driven by an "intelligent eclectic" value investing philosophy. "It emphasises the margin of safety created by divergences between market prices and the underlying intrinsic values of the companies. The investment objective is long-term capital appreciation while reducing the margin of error. Thus, we seek the low-risk, high-return types of investments."

We caught up with Mr Tan when he was in town in November last year. Below are excerpts of our chat with him.

How do you identify stocks to buy?

We don't do stock screening to identify, say, stocks with a price-earnings ratio of five or below.

The thing is I've been tracking the global markets since the late 70s. And I read annual reports, I read financial stuff, generally anything. I read very, very widely. I'd read three books at one time. I'm very familiar with the history of China. I'm very familiar with the history of the US. I plough through 200-300 annual reports over the weekend. It's enjoyable, particularly the foreign annual reports. You really discover, you really learn a lot of things. I think the bottom line is that I enjoy learning things. I enjoy discovering things.

I watch a lot of financial programmes, and I'm very open-minded. I often listen to others. There's this fresh grad who came to interview for a position as an analyst. She recommended that I read a book called *The Luck Factor* by Richard Wiseman. And I did.

I recognise that there's something I can learn from everyone. So that helps me a lot.

I don't do stock screening because I already have the database up here (in my head). The database developed purely from interest, and it's been built up over the years. It has been sustained and expanded because my reading material has expanded even more than before.

I've been following American Express since the 1970s. I've been following Potash Corporation of Saskatchewan for a long time – a company even some North American fund managers don't know about.

I met one of UBS's managing directors last week, and she asked me: "How do you challenge the Western guys? You should

be Asian-focused, not global-focused." So I said: "You are from UBS, right? You are based in Switzerland, right? Have you heard of St Galler Kantonalbank?" She said: "No."

I said St Galler is a town that is one hour's drive from Zurich, and there's this provincial bank that is solid. It has zero sub-prime exposure, its non-performing loans during the worst of times – which was the last 18 months – have never gone above one or two per cent. Capital adequacy ratio, whether Tier 1 or Tier 2, is solid. They are still giving a dividend yield of 4-5 per cent. Not only that, they are at this point expanding into Germany. They have been benefiting from the crisis because a lot of deposits have floated to them, away from people like UBS.

So I get ideas from reading, be it annual reports, magazines, or from what some-

down to cash flow. We also focus a lot on ROE (return on equity) and ROCE (return on capital employed).

We first bought REXLot at around HK\$1.20 to HK\$1.30. Then it crashed to HK\$0.15. At about 20-odd HK cents, we bought so much that our cost came down to 20-over HK cents per share. (The price of REXLot as at Jan 4, 2010 is 91 HK cents.)

We look at valuation over the long term. I try to see what a company's sustainable earning power is like, and then derive a valuation based on good times and bad times. I don't look at just one or two years. In fact, we don't look at price-earnings ratios.

When we first bought Porsche in early 2007 at about 90-plus euros a share, it nearly doubled to 180 euros by end-2007. We didn't sell a share. Then it crashed to

sustained. And at that price, there was no way oil prices could be sustained. If the oil price can't be sustained, companies like that can't sustain their valuation.

So that pushed up our cash level to 40-plus per cent by July 2008. By October 2008, we ran it down to 25-30 per cent cash. We bought Keppel Corp and we bought back Oil Search in October 2008. By February/March 2009, we were down to about 3 to 4 per cent cash.

We sold all of Oil Search recently within five minutes because an Abu Dhabi fund pulled out of a planned capital injection to fund the company's LNG project in Papua New Guinea. It's a huge project, a joint venture with Exxon Mobil, something like US\$30 billion to US\$40 billion. This is at the final investment decision-making stage. Why would a knowledgeable Middle Eastern fund pull out of such a lucrative project

"George Soros described the crisis as the worst in 80 years, I say okay, great. But we have China's transformation which is the biggest in a millennium."

– Mr Tan

body tells me. Then I look at certain variables or metrics, and if those look good, I'd go deeper. Then I go see them. Not only do I see them, I also talk to regulators and so on. So my style is, I kick the tyres.

What are the metrics you look at?

We are very concerned with borrowings. I know a lot of modern corporations like to find an optimum capital structure, and that you can't have too much cash, etc. But at the end of the day, I'm still like a Chinese businessman who treasures hard cash, especially in difficult times.

So I look at gearing and borrowing as one of my most important criteria. If that is okay, then I look at cash flow. But you can't look at these ratios in a vacuum. You must know the long-term economics of the business.

For example, there's this company REXLot Holdings which we invested in. It's in the lottery business in China. This is safer than other types of gaming because they are in welfare and sports lottery, which is a revenue-raising channel for any government in the world, including China. So the fundamentals are there. The government is not going to introduce any legislation to restrict or ban welfare or sports lottery. The economics are sustainable, therefore the long-term earning power is sustainable. Then you move

about 30 euros. We bought some more a few months back.

Here is a company which has – before they got into the mess of Volkswagen and all – the highest profit margin of any car company in the world. ROE, ROCE, no matter how you look at it. It is really extremely good, and very well-managed. In terms of sales and earnings prospects, they have hardly begun. Their major markets at that time when we first started seeing them were Germany, UK and US. Now, China is their third largest market. (Porsche was trading at around 43 euros on Jan 4.)

So you had cash to average down your holdings in these stocks in late 2008 and early 2009?

In July 2008, we were about 40-45 per cent in cash. That's because we sold Diamond Offshore and Oil Search. In May 2008, Diamond Offshore and Oil Search made up 20-odd per cent each of our asset value. (Capital Dynamics doesn't have caps on any single stock exposure.)

Diamond Offshore is listed on the New York Stock Exchange. It's a deepwater oil drilling company. Oil Search is an Australian oil and gas company. We sold our entire holdings in both companies by May 2008 because of valuation. Our reasoning is: With oil at US\$145 per barrel, there was no way the world economy could be

at this last stage? Something doesn't gel.

I don't have time to dig out what really are the reasons behind it. So we sold everything at AS\$6.20-plus. It is probably still attractively valued – but there's this element of uncertainty kicking in.

Why did you wait until oil hit US\$145 before selling Diamond Offshore and Oil Search? Why not when oil was US\$100 or US\$120?

We do primary and original analysis. We don't rely on secondary research. A lot of people focused on the absolute price. When the oil price was US\$40-\$50 per barrel, a lot of people were worried that it would hit the world economy. It went up to US\$80 – nothing happened. Went up to US\$100 – nothing happened. What you have to do is look at the rate of change, not the absolute price.

We looked at the rate of change in the oil price and compared it to previous crises in 1973, 1980, 1990. When the oil price hit US\$145, the rate of change was at danger levels of the past recessions. So we said, the oil price may still go up, we don't know. But the more it goes up, the greater the chance that we are going to have a hard landing for the world economy. So we sold.

At any one point, how many stocks do you invest in?

Our style is very focused. So typically 13 to 15 stocks in each fund. Overall, we have about 30 stocks in our various portfolios. But to arrive at those 30 stocks, I look at something like 3,000 stocks.

So you're the primary decision-maker for your fund. What if you decide to retire one day?

There is a very interesting article in the *Financial Times*. It looks at value investors, and apparently value investors have a tendency to live up to 100 years old. Like (Roy) Neuberger, Irvin Kahn. They live to 95, 96, 106.

It makes sense, because people like us who invest based on value for the long term sleep soundly even when the market plunges and the economy goes into recession. I get very excited because there are so many things to buy and we look forward to the returns that are going to come after that. Partly because of that, we don't have the stress that most people get.

But to answer your question seriously, our biggest insurance is the investment philosophy that we have. If you've invested based on the right philosophy, based on the right investment framework, that means you've got a lot of margin of safety built in.

So companies like Tesco and Porsche are going to be in our portfolio for who knows how many more years to come, unless the companies go and do something stupid. Because we are longer-term investors, what's more important than me would be the CEOs of the companies that we've invested in.

If you increased your fund size, could you still get this kind of performance?

Yes. If you are talking about global investing, no problem. Because the number of choices available in the 40-plus markets in the world is tremendous. We are not restricted to either big or small caps, as long as there is value in it. So like Tesco, it's huge. Or Keppel Corp, in the local context, is pretty big. So in terms of US\$10 billion assets under management, I think I will still be fine.

After reading "The Luck Factor", how big a part do you think luck plays in your work?

Louis Pasteur said: "Luck favours the prepared mind." I believe the harder you work, the luckier you become. Because

you are prepared, when the opportunity comes, you can take advantage of it.

My analysts would say: "Mr Tan, why do you want to look at this sector – it's so depressed." And I say: "That's precisely where the opportunities are. Why would you look at a sector that's booming?"

So the thing is to be open-minded, and then know what important variables to look at. And I guess to do all this, you have to work hard. You can't just put in nine to five. You've really got to work hard and work smart.

What's your work schedule like?

I see my staff more often than I see my family. I have two kids, both are in the US. My wife is in KL (Kuala Lumpur). Out of a month, I spend one week in KL, one week in Sydney, one week in Singapore and one week in maybe Europe, or regional countries like Indonesia or Vietnam. I have a frequent stayer card with Hilton, with Westin, with so many hotel chains.

What's your market view now?

We've been bullish since January or February 2009. We haven't changed that view at all. This is not a bear market rally, this is a genuine new bull market. We don't see a double dip. We see a V-shaped recovery. We are still maintaining these views today.

Of course all rallies will have corrections. But if you look at it from a longer-term perspective, let's say you take March 2009 as the bottom, then this is a multiple-year bull market. But it depends on the rate of increase as well. If it goes up too fast, it becomes unsustainable. This year (2009), it goes up so strongly. Next year (2010), if it pauses for a couple of months and builds another base, then why not?

What about China?

We've been bullish on China for a long time. We have this theory called the i-Capital Long Boom, which I formulated as far back as 2002/3. The theory is essentially centred on China's transformation.

So when people say George Soros described the crisis as the worst in 80 years, I say okay, great. But we have China's transformation which is the biggest in a millennium. China's transformation is something that will have a lot of hiccups, major or minor. But if you look at it as a broad trend, it's going to last for another 30, 40, 50 years. And even then, after 50 years, the per capita GDP of China will still be substantially below that of the US.

But people said Japan was going to be the richest nation in the world 20 years ago.

You must look at the various causes and effects. The cause and effect for Japan and China are totally different. We had a one-day seminar to explain all these phenomena in April 2007.

The Chinese have been humiliated, they've been hungry for a decent standard of living for such a long time. When you visit China, whether you talk to the senior people or the man in the street, the one thing that unifies them is that they want to be as good as America or to overtake America. That hunger, that desire not to be such a weak country ever again, is an extremely powerful motivation.

Japan doesn't have that. Japan had theirs in the Meiji Restoration. That's why the Meiji Restoration was so powerful – because they were so humiliated.

China went through that for two, three hundred years. And it's not just the humiliation. It's the physical poverty, the material deprivation. That's going to drive China for a long time to come.

And if you look at the way the Chinese government has managed the country in the last 30 years, obviously they know what it is they are dealing with. They know the scale, the immensity of the problem. They know that they cannot afford to take one wrong step. And because they are so far behind, they need a very peaceful world environment for the next 100 years so that China can emerge peacefully.

So the factors driving the growth of China in the last 30 years were totally different from Japan's. And the fact is, when the crisis hit Japan, it was already a very complacent country. They were already filthy rich. In China, a huge 70 to 80 per cent of the people are still poor.

Yes, they've made so many policy mistakes that they have learnt. That's why you look at the way China manages its economic development, they always take a little step first. Remember when they first opened up Shenzhen as a free economic zone? At that time, they opened up only four (cities). They experimented first, and they watched and monitored and realised, yes, it works. They fine-tuned it, and within a few years, you have over 1,000 free economic zones. So the same style is being repeated again and again. And what Deng Xiaoping said is very true – you cross the river by feeling each stone. **P**