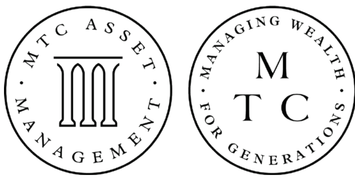

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Commentary (Founders Fund)

September 2023

Written by Devan Linus, Chief Investment Officer

Objective

MTC Founders Fund ("Founders", "MTC" or the "Fund") aims to achieve a net return of 8-12% p.a. over a 3-5-year period by investing in a portfolio of global listed equities. MTC invests predominantly in large cap companies listed in the US and other developed countries and employs a value driven, bottom-up investment approach. MTC's benchmark is the Straits Times Index ("STI") and the MSCI All Country World Index ("MSCI ACWI"). The STI was chosen as a benchmark as MTC's investors are predominantly from Southeast Asia and benchmark themselves to Singapore. MSCI ACWI is the second benchmark as it was designed to best represent broad global equity-market performance. Performance is reported in USD.

Performance

MTC delivered a since inception net return of 90.5% (5.9% p.a.), outperforming the STI but underperforming the MSCI ACWI, which returned -0.8% (-0.1% p.a.) and 116.3% (7.1% p.a.) respectively.

Benchmark Comparison

Founders, STI & MSCI ACWI

Founders continued to appreciate for the quarter, although with volatility (Jul: 14.6%, Aug: -3.7%, Sep: -6.0%). While our stocks outperformed the benchmark for the quarter, they were also negatively impacted by the recent change in the macroeconomic outlook in the markets, shifting from positivity to negativity. This negativity has sparked a current debate among macroeconomists, suggesting that the current outlook for the US might change from a soft landing to a recession in 2024. However, like a typical manic-depressive, the market might change its mood to positivity next month. Our investors should not worry about the macro when it comes to our portfolio. Instead, they should focus on whether we've selected the correct individual companies at the right price, as their share prices are expected to grow regardless of the macroeconomic factors.

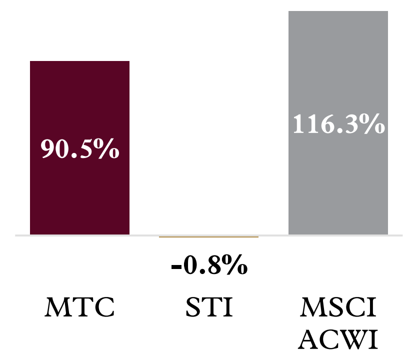
However, a solid understanding of macroeconomics is still necessary, but it's crucial to keep in mind that with high-interest rates, adjustments need to be made in terms of the stocks we select and the associated risks. For instance, in the current environment of high interest rates, we should avoid excessive leverage.

NAV

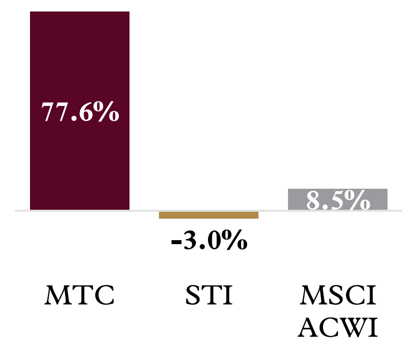
Class S:	190.45

Performance

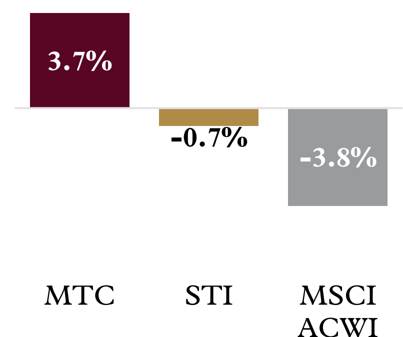
Since Inception (24 Jul 2012)



Year to Date (Sep 2023)



Quarter (Sep 2023)



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Benchmark Comparison (contineud)

Founders, STI & MSCI ACWI (continued)

As a result, you'll notice that our leverage is currently at 33%, and we anticipate further reductions as we trim our holdings from deep value to fair value. And here's the thing in an environment of high-interest rates, investing in companies with dividend yields of 5% is no longer appealing when you can obtain a risk-free return at the same rate.

Portfolio

YTD Updates

If you analyse our charts in the appendix, 32% of the portfolio is now categorised as 'Fair Value', primarily consisting of Meta and our other internet stock categorised under 'Communication Services'. These two stocks have been the key drivers of returns this year, alongside our Semiconductor stocks in the 'Information Technology' sector. As for our other stocks in the 'Communication Services' sector, specifically the Film & Entertainment companies, they experienced double-digit appreciation earlier in the year, but have since declined to single-digit or negative returns YTD. This decline can be attributed to the actors' and writers' strike, decreasing profitability in broadcast and traditional cable, and the ongoing unprofitability of their streaming business. Regarding the profitability of streaming services, we firmly believe that all streamers will eventually become profitable, with Netflix serving as a testament to this business model. The increased costs of actors and writers should be offset by the continued global expansion of Film & Entertainment companies through their streaming services, often at the expense of country-specific local cable providers like Astro in Malaysia, Foxtel in Australia, or even DirecTV in the US. As for the declining profitability of broadcast and traditional cable, we expect those profits to shift towards streamers, especially as they begin to feature forms of entertainment such as sports and news. However, it's important to note that not all Film & Entertainment companies will experience significant appreciation, so the key lies in selecting the right companies with the most attractive share prices within a given content portfolio. We have strong confidence that we have made the best selection in this sector.

Regarding our remaining sectors, 'Consumer Discretionary' and 'Others', which include China Tech, US retail, and our recent re-entry into the auto industry (NOT Tesla), they have not yet shown recovery or appreciation for the year. These companies including Film & Entertainment still fall under the 'Deep Value' category, accounting for 52% of the portfolio. We firmly believe it's only a matter of time before they experience the same kind of share price doubling that we've seen with Meta.

New Entries for the Year

<u>US Retail</u> – In Q1 2023, we utilised a portion of our liquidity buffer to reinvest in an Australian retail-listed company. However, as we closely monitored the retail industry in the subsequent months, we noticed a significant crash in the share prices of US retail stocks. Consequently, in Q2/Q3 2023, we decided to shift our investment from Australia to US Retail. Our thesis for the chosen US retail companies revolves around their well-established brand value, suggesting their potential to rebound to pre-COVID-19 levels of profitability. Currently, they are trading at approximately five times those profit levels. Additionally, these specific companies are undergoing turnaround plans aimed at further increasing their profits, potentially surpassing their pre-COVID profitability. The reason behind their substantial decline can be attributed to an overestimation of demand due to stimulus checks and record sales during the COVID-19 period, resulting in excess inventory. Moreover, they face competition from online companies like Temu and Shien, which focus on unbranded, affordable, and fast fashion. At the current valuation we invested, we believe it offers a compelling risk/reward ratio. It's important to note that not every company is like Meta, outstanding and inexpensive. From a risk management perspective, our investors do not expect us to allocate 100% or even 50% of our investments in Meta. Therefore, we sometimes identify these good or average companies that are trading at a significantly discounted price, and we invest in them, with the understanding that these are not long-term, buy-and-hold stocks.

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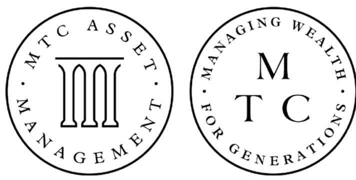

Portfolio (continued)

New Entries for the Year (continued)

Autos – In Q3 2023, we re-entered the Autos sector, a domain we have been intimately familiar with since our investments in this field dating back to 2017. We have consistently received dividends exceeding 5% annually from these investments while also enjoying some capital appreciation. In 2021, we decided to divest our holdings in this sector as we identified other opportunities with more favourable risk/return trade-offs. However, with our recent trimming of Meta, it has opened up the opportunity for us to revisit the Autos sector. The market, in our assessment, has yet to provide a fair valuation to traditional automakers, and we believe that most of the established players in this sector are still somewhat undervalued. Our focus here leans towards companies like Ford, Volkswagen, and Toyota, rather than companies such as Tesla, Nio, or Vinfast. It's important to reiterate our investment philosophy: we are not investing in Autos because we are macro investors who believe it's the best sector at the moment. Instead, our approach is based on our ongoing affinity for companies that happen to operate in the automotive industry, and these companies remain attractively priced. As you can see in our charts below, we currently have a 3% allocation to Germany, indicating that we have invested in German automakers. The companies boasts a strong brand, lacks the union issues currently experienced in the US, has a proven ability to manufacture premium electric vehicles, and, most importantly, demonstrates robust and growing positive cash flows.

Market Insights & Outlook

Our approach to the market isn't about attempting to predict its future direction, as such a task is virtually impossible due to the market's unpredictable and often erratic behaviour. Instead, our primary focus is on identifying stocks, sectors, or securities that are undervalued, taking into account the prevailing economic and geopolitical conditions at any given moment.

At present, the most significant economic concern centres around high-interest rates. As a general principle, with interest rates at historic highs, most equities, especially those that used to offer dividend yields of around 5% when interest rates were at 1%, are viewed as overvalued. Today, interest rates in the US stand at 5%, and there is even discussion of the possibility of them rising to 7%. In this environment, companies with no substantial growth prospects should theoretically be valued less. However, in practice, we have yet to see a significant shift in this direction. Nevertheless, it's crucial to note that this doesn't imply that everyone should simply park their investments in fixed deposits, especially since interest rates over the long term are expected to at least keep pace with inflation. If you're exclusively invested in fixed deposits, even at a 5% return, you're essentially treading water in terms of beating inflation.

Therefore, it's wise to consider investing in growth companies or stable companies (non-growth companies) that are significantly undervalued, offering earnings yields of 10% or more. Such stable companies do exist, as exemplified by our investments in Film & Entertainment, Autos, and US Retail. Moreover, there are growth companies that present significant undervaluation, like certain players in the Semiconductor industry within our portfolio. Finally, there are growth companies trading at fair value, such as Meta, which we also hold.

Another important lesson concerning high-interest rates pertains to the concept of the risk premium. In times when interest rates were at 1% per annum, investing in stable company shares or bonds that offered a 4% p.a. expected return meant you were essentially paying a 3% p.a. risk premium for that investment. On the other hand, a medium risk investment, providing an expected return of 8% p.a., came with a risk premium of 7% p.a.

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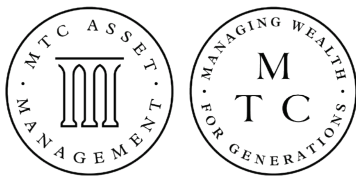

Market Insights & Outlook (continued)

Now that interest rates have risen to 5% p.a., it's appropriate to consider a benchmark for a safe investment at around an 8% p.a. yield (comprising the 5% risk-free rate and an additional 3% risk premium). For medium-risk investments, one might expect a yield closer to 13% p.a. (comprising the 5% risk-free rate and a 7% risk premium). This approach reflects the principle of adjusting expected returns to account for the level of risk associated with an investment, and it can serve as a useful guideline in a changing interest rate environment.

This concept carries significant implications, particularly for fixed income securities. In the current environment, investors should be seeking yields in the range of 8-13% p.a. for securities falling within the spectrum of safety to medium risk. Yields below this range may not provide adequate compensation for the inherent risks.

The risks, as always, can take various forms, from the potential of a bond default to the complexities of structured products linked to shares in depreciating companies or dual currency investments that can result in immediate losses when converting back. However, one of the most prevalent risks lies in investors inadvertently acquiring securities with the belief of safety, only to discover, after neglecting due diligence, that they are dealing with higher-risk entities like Country Garden, WeWork, MyAirline, rather than well-established names such as Maybank, Capitaland, or Apple.

In conclusion, our insights emphasize the growing need for investors to exercise thorough diligence, especially when it comes to fixed income investments. For equities, whether in venture, private, or public markets, this scrutiny should centre around three key factors: (1) the acquisition of portfolio companies at attractive valuations, (2) the capacity of the underlying business model to adjust prices in line with inflation, and (3) maintaining a low or manageable debt load, or if debt is present, ensuring strong cash flows and a clear plan for prompt debt repayment. Furthermore, it's worth noting that securing yields in the 8-13% p.a. range with low to medium risk is feasible, particularly within the realm of private credit only by established global investment houses such as Oaktree, TPG, etc. However, such opportunities are often accessible mainly to Tier 1 Institutions and Ultra High Net Worth Individuals. For the broader investing population, it's crucial to be cautious, as appearances of safety can be deceiving, and careful scrutiny remains essential.

Lastly, when it comes to the state of the economy, it's worth reiterating a point we've emphasized many times before. If we've successfully weathered past crises like the Global Financial Crisis (GFC), the bursting of the Tech Bubble, and the Asian Financial Crisis, we shouldn't be unduly alarmed by market predictions of a potential recession in 2024. It's possible that we may face a period of flat or negative returns, as we did in 2022, but history has shown that subsequent years often bring about robust recoveries, ultimately surpassing any temporary bearish periods.

What remains crucial is not trying to time the market too precisely, but instead adopting a strategy of consistent and prudent investment. This approach has proven effective in navigating through various economic challenges and uncertainties.

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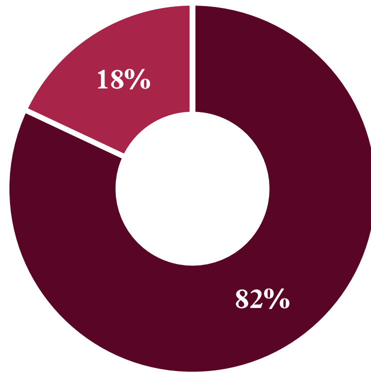
Charts 1: Company Listing and Sector Breakdown

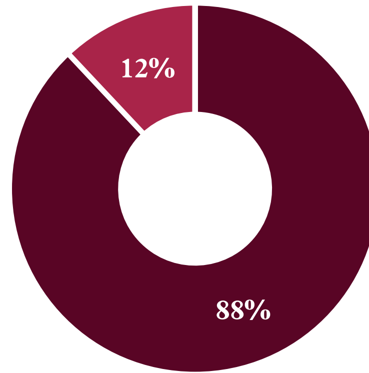
Company Listing Breakdown

Prior Year (Sep 2022)



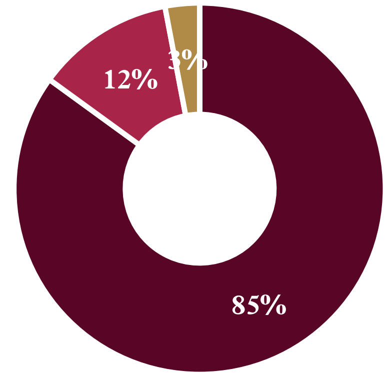
▪ US ▪ HK ▪ DE ▪ Others ▪ Cash

Prior Quarter (Jun 2023)



▪ US ▪ HK ▪ DE ▪ Others ▪ Cash

Current Quarter (Sep 2023)

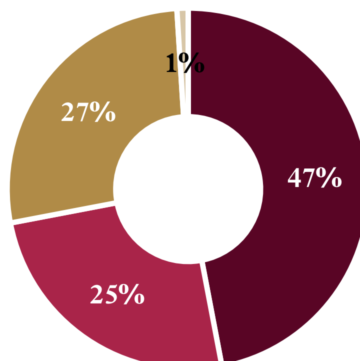


▪ US ▪ HK ▪ DE ▪ Others ▪ Cash

For Q3 2023, US allocation reduced to 85%, as a by-product of us trimming our US shares namely Meta and another internet company, and our new investment in Germany.

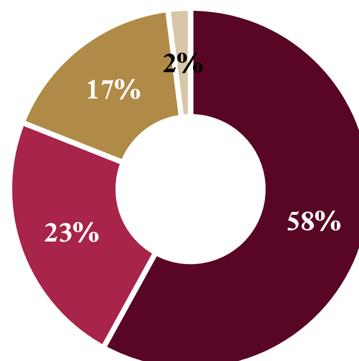
Sector Breakdown (GICS)

Prior Year (Sep 2022)



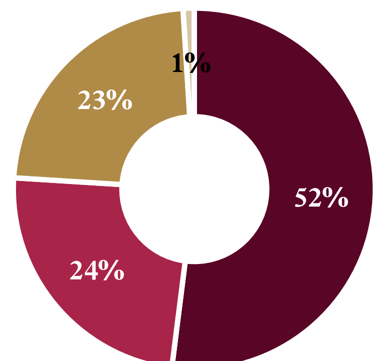
▪ Communication Services
▪ Information Technology
▪ Consumer Discretionary
▪ Others
▪ Cash

Prior Quarter (Jun 2023)



▪ Communication Services
▪ Information Technology
▪ Consumer Discretionary
▪ Others
▪ Cash

Current Quarter (Sep 2023)



▪ Communication Services
▪ Information Technology
▪ Consumer Discretionary
▪ Others
▪ Cash

For Q3 2023, Communication Services reduced to 52%, as we trimmed Meta and another internet company classified in this category. The share prices of our stocks in Film & Entertainment also declined in the quarter.

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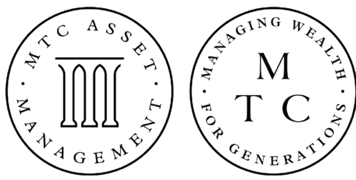
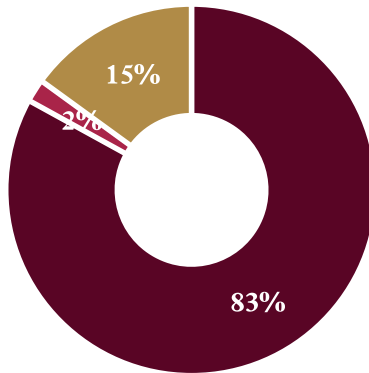


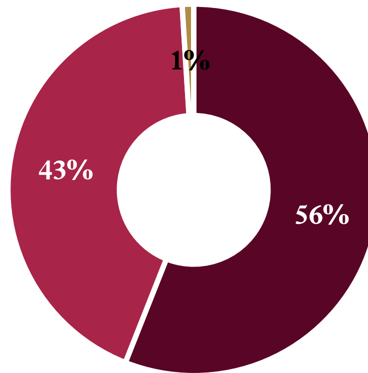
Charts 2: Value and Leverage Breakdown

Value Breakdown

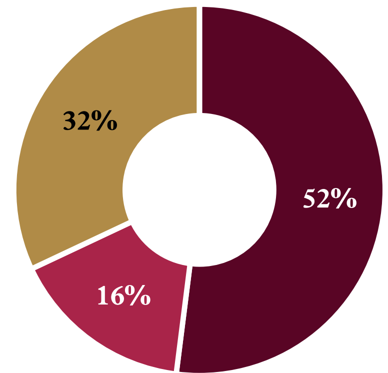
Prior Year (Sep 2022)



Prior Quarter (Jun 2023)



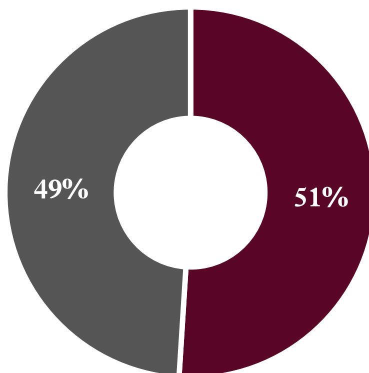
Current Quarter (Sep 2023)



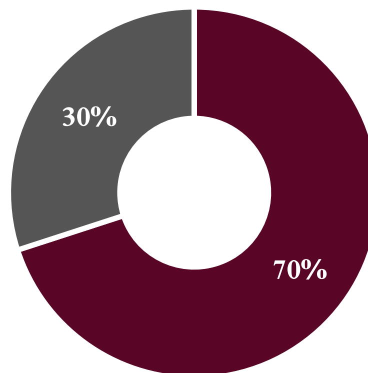
For Q3 2023, we re-rated Meta and another internet stock to fair value, which now constitutes 32% of the portfolio. We also re-rated some semiconductor stocks that appreciated ~40% for the year to value from deep value.

Portfolio Leverage Breakdown

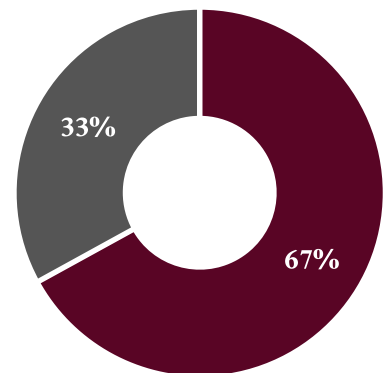
Prior Year (Sep 2022)



Prior Quarter (Jun 2023)



Current Quarter (Sep 2023)



For Q3 2023, leverage increased to 33% as we used some of the proceeds of the trimming of Meta last quarter to take up new undervalued positions, namely our new entry into Autos.

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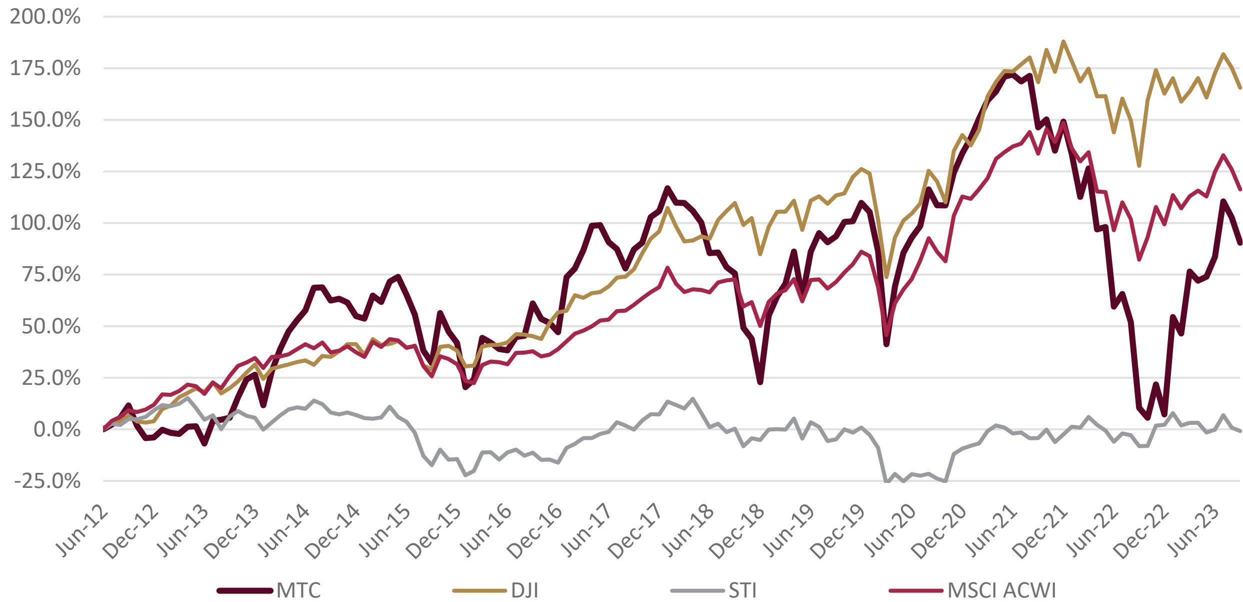
Devan Linus, Chief Investment Officer

Charts 3: Performance

Since Inception (Jul 2012 – Sep 2023), net of fees, USD



Disclaimer

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