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An Introduction for Prospective Clients

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1. Regulatory Requirements

Lighthouse Advisors is regulated by the Monetary Authority of Singapore under section 321 of the Securities and Futures Act. It is a registered fund management company (RFMC) subject to Paragraph 5(1)(i) of the Second Schedule to the Securities and Futures (Licensing and Conduct of Business) Regulations.

RFMCs are limited to no more than 30 qualified investors. Qualified investors include accredited investors and institutional investors. Both groups are defined in Section 4(A) of the Securities and Futures Act. The definition of accredited investors is summarized below (equivalent amounts in foreign currency accepted):

A. Individual with net personal assets over S$2 million, or financial assets over S$1m;

B. Individual with income in the preceding 12 months of at least S$300,000;

C. Corporation with net assets exceeding S$10 million in value; or

D. Collective investment scheme offered only to qualified investors.

Prospective clients must meet at least one of the above definitions of an accredited investor. This is a legal requirement and is <u>not</u> negotiable.

2. Investment Team

The current team consists of Benjamin KOH and OH Chiah Ching.

Benjamin has been investing in the stock markets since 2002. During 2005-2007 he also helped to manage a venture capital fund. Prior to setting up Lighthouse Advisors in 2008, Benjamin worked at APS Asset Management Pte Ltd.

Benjamin holds a Bachelor of Science in Chemical Engineering, and a Bachelor of Arts in German Studies. Both degrees were obtained at Stanford University, California.

Chiah Ching has been investing in the stock markets since 2005. Prior to joining Lighthouse Advisors in 2011, she worked at First State Investments.

Chiah Ching holds a Bachelor of Accountancy from Nanyang Technological University, Singapore.

3. Investment Philosophy

Lighthouse Advisors practices a three-pronged investment strategy: “bargains”, “quality” and “special situations”.

“Bargains” are securities deemed to be undervalued by measures such as price-to-earnings, price-to-book value, price-to-cash flow, and dividend yield.

A bargain-based approach is not new. It was first described by Benjamin Graham and extensively documented in his 1934 book *Security Analysis*, co-authored with David Dodd. This “Graham-and-Dodd” strategy was used with great success over long periods of time by many investors, and continues to produce excellent long-term results today. The most famous practitioner today is perhaps Warren Buffett, whose investing foundation began with Benjamin Graham’s approach.

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"Quality" refers to buying companies with superior long-term prospects due to various criteria such as a very strong consumer brand, an innovative business model, exceptionally skilled management, or a sustainable technological edge.

The quality-driven approach is also not new. Philip Fisher advocated buying exceptional companies for the long term in his 1958 book *Common Stocks and Uncommon Profits*, which outlined the basic framework for finding companies with such characteristics. Warren Buffett has openly acknowledged that it was the ownership of such outstanding businesses, starting with See's Candies in 1972, which ultimately led to the great success of Berkshire Hathaway.

"Special Situations" are unique opportunities where an investor may extract a satisfactory return within a reasonably well-defined period of time. Examples include spin-offs, rights issues, privatizations and so on. Joel Greenblatt's 1997 book *You Can Be A Stock Market Genius* outlines many examples of special situation investing.

In execution, your manager uses a "conservative aggressive" approach. This sounds self-contradictory, but the meaning will become clear shortly.

(a) Conservative Investment

i. Very limited use of margin

Leverage is not an investment strategy; it merely amplifies the swings in both directions. If the decision is right, leverage is not needed to show a good profit. But if the decision is wrong, the outcome can be disastrous.

Additionally, a chosen security that eventually proves profitable may decline significantly in market value in the short term. In such a situation, a margin call may force the investor to sell at the worst possible time, when prices are at their lowest, and the risk/reward ratio is ironically at its most attractive.

In the rare event of a market-wide collapse, there may be a significant "positive carry" available, where the dividend or coupon yield substantially exceeds the cost of borrowing. In such a situation, a moderate level of margin borrowing may be justified. However, at present this condition is not present in the capital markets.

ii. Very limited short-selling

In a "long" position, the downside is a 100% loss, while the upside is unlimited profits. This is reversed in a "short" position. In other words, the risk of capital loss is considerably higher, and a strict cut-loss approach is necessary to avoid being wiped out.

Furthermore, as with borrowing on margin, short-selling requires collateral. As share prices appreciate, margin calls have to be met, and the investor may find himself forcibly bought in at high prices, even if the stock price eventually crashes and proves the original thesis correct.

Short-selling works best when market levels are very high and public sentiment is strongly optimistic. This is not the case as of August 2020. This issue may be revisited in future, when security prices are unreasonably high, and the short-selling risk commensurately low, but for now there will be no short-selling.

iii. No limit on cash

Inflation makes cash an unattractive asset to own over the long term, but in the short term it is better to sit on cash than poor quality assets, or good assets bought at inflated prices.

Your manager is like a hunter on a safari expedition: ammunition is limited and expensive. It makes sense to target elephants rather than rabbits. Bagging 2 elephants yields far more meat than 10 rabbits.

In fact, assuming he misses half the time when aiming at elephants, the hunter could use 4 rounds to bag 2 elephants, and still come out ahead of the hunter who uses 10 rounds to bag

10 rabbits. The elephant hunter has obtained more meat, and yet has ammunition left over for further hunting.

iv. Maximum exposure 15%

It is accepted common sense not to put all of your eggs into one basket. Yet, at the same time, a concentrated portfolio is more likely to yield above-market returns. 15% is a rule of thumb your manager uses to balance the competing needs of risk management and concentrated investing.

v. Dividend-Paying Stocks

Past studies have shown that dividends are an important component of the total return from stocks[1]. Furthermore, high-yielding stocks have actually delivered *higher* total returns than market indexes[2].

Common sense also suggests that all things being equal, a company that can afford to pay out some of its earnings to shareholders is in better financial shape than one that has to retain all its earnings.

Your manager has a rather old-fashioned view about investments: if it doesn't generate cash, it's not an investment.

"Growth" investors may point to the potential capital gains promised by non-dividend-paying companies that are growing rapidly. It has also been argued, notably by Warren Buffett, that earnings should be retained if company managers can deploy the cash at attractive rates of return[3].

To this, your manager humbly offers 2 points of rebuttal:

One, the "gold standard" for good management is a company that can maintain its current capacity, fund future growth **and** pay dividends. It is true that such companies are not common. But then, successful investing is not about investing into "common" companies.

In fact, it could also be argued that a company that has to retain all its earnings to fund growth is not very well managed at all! It seems obvious that nobody would buy into a private business that never returned any cash to the investor. Why then should a public company be exempted from this requirement to return cash to the ultimate owner?

Two, investors who look to Warren Buffett for investment inspiration should keep in mind what Buffett does, not just what he says. Buffett did not achieve investment success by buying companies that do not pay dividends.

Indeed, Buffett requires, by default, *a 100% dividend payout ratio*: while he leaves the company managers to run their respective businesses, "excess capital" is sent back to Berkshire Hathaway[4]. Clearly, whatever it is called, returning "excess capital" is the payment of a dividend.

As such, your manager makes no apologies for generally requiring potential investments to pay an acceptable dividend. Further musings on dividends can be found in Annex I.

vi. Little or No Debt

As with borrowing on margin, a company that requires significant levels of debt in order to operate normally is skating on thin ice. By itself, debt cannot turn a poor business into a good one. Too often, it is used to dress up a poorly-managed business; it raises the return on equity, and operating results look attractive in benign economic times.

For long-term success, however, a company must be structured to not only prosper in good times, but to also survive in bad times. Bad

[1] *The Future for Investors*, **Jeremy Siegel**

[2] *Dividends Can Play Key Role In Retirement Income Plans*, **T. Rowe Price Report Issue No 100**

[3] *Chairman's Letter – 1984*, **Berkshire Hathaway**

[4] *Chairman's Letter – 2002*, **Berkshire Hathaway**.

times come when least expected. Credit facilities vanish when most needed.

The company that has little or no debt sees bad times as an opportunity to expand and acquire choice assets, whether people, buildings or entire businesses, at a bargain price.

Conversely, the company dependent on debt to survive will one day find itself in dire straits. At the very least, the business will shrink, and investors may find themselves owning a much smaller company, with a considerably diminished investment value.

Your manager has attended annual general meetings where investors asked management to "optimize the capital structure" and return excess funds to shareholders. While your manager normally applauds the return of excess cash to the rightful owners, in reality there is no such thing as an optimal capital structure, because business conditions are constantly changing.

Even when a company complies with all its bankers' requirements, lines of credit can still shrink and the cost of credit can still rise, simply because of the external environment. Therefore, a business structured for long-term success must be, by necessity, conservatively financed.

(b) Aggressive Investment

i. Investment Hurdle Rate 50%

Your manager is mindful of the cost of investment ammunition; capital must be put to the best use. Therefore, unless the potential returns are very attractive (defined as 50% or more), your manager prefers to wait.

Your manager has no timeframe to achieve the 50% return – it may happen in just a few months, or over a few years. Such is the nature of the stock market: it is possible to predict the eventual outcome with some accuracy, but very difficult to predict *when* it will happen.

ii. Ignore stock market (pricing) risk

Short-term price fluctuations are beyond your manager's control. Consequently, investors should be prepared for the likelihood that prices may decline further after purchase. Indeed, as your manager professes no skill at identifying the "bottom" it is likely that prices will go down further after purchase. Similarly, a lack of skill at picking the "top" means that prices will probably go up further after selling.

Essentially, the only "guarantee" your manager can make is that prices will decline after a purchase, and increase after a sale!

Your manager is not aiming to buy at the bottom and sell at the top. Your manager buys when prices are low enough, not lowest, and sells when prices are too high, not highest. Please bear this in mind when looking at investment results. Your manager is focused on absolute long-term results, so short-term results may seem unsatisfactory at any given point in time.

iii. Limited Diversification

With too many securities in the portfolio, it is difficult for an investor to fully understand exactly what he has invested into. Far better, instead, to invest into a few companies he understands well, than into many companies about which he knows little or nothing.

At the same time, with too *few* securities in the portfolio, the cost of a mistake becomes very high. Your manager is human, too, and mistakes are inevitable.

As a ballpark figure, 15-30 selections provide a compromise between over-concentration and inadequate diversification.

(c) Negative Examples (Companies to Avoid)

i. Highly-Indebted Companies

This has already been elaborated on. Bankruptcy risk needs no explaining.

ii. Working Capital-Intensive Companies

Businesses that depend on working capital financing to operate are at great risk during periods of credit contraction. Should the bankers reduce credit availability or increase its cost, the effect can be devastating.

Consider a trading company that operates on a "back-to-back" model where inventory is held only briefly before it is sold to the customer. A bank might normally finance 90% of the inventory's value, at perhaps 5% per year.

But in a downturn, the bank could reduce the financing to 80%. This would instantly double the working capital requirements. In other words, if the company can't raise the cash, it has to do half the business. Obviously, this severely damages the value of the business.

The bank could do equivalent damage by raising the financing cost to 6% or 7% per year. The thin margin enjoyed by the trader goes to zero, or turns negative. Business is no longer worth doing, and the company shrinks.

iii. Market Darlings

Market darlings are companies who have compiled a good recent track record. Their share prices have often enjoyed significant appreciation, and trade at above-market valuations.

While such companies are often well-managed, the risk comes from the fact that companies are ultimately run by people, and <u>people make mistakes</u>.

The longer someone goes without a mistake, the bigger and more expensive the eventual mistake becomes. Yet, the longer a company goes without a mistake, the more inflated the stock price often becomes. Management <u>execution risk</u> is then very high.

When, not *if*, management makes a mistake, the resultant bad news can severely impact the stock price, and investors who buy at high prices may suffer a permanent loss of capital.

Your manager *does* like to buy into well-managed companies, but preferably after prices have dropped due to temporary mistakes i.e. "fallen angels" whose stock prices ignore the strength of the underlying businesses and discount their ability to regain their former glory.

4. The Lighthouse Fund

The Lighthouse Fund is domiciled in the Cayman Islands as a Registered Mutual Fund. It serves as the pooled investment vehicle for clients.

Your manager will always invest a significant proportion of his personal net worth into the Fund. This is not only a demonstration of "eat your own cooking" conviction but also sound financial sense: it is the best way for your manager to employ any funds not needed for day-to-day expenses.

5. Fees

(a) <u>Management Fees</u>

The annual management fee is 1% of the fund's net assets, calculated monthly and paid in arrears.

(b) <u>Performance Fees</u>

A performance fee of 15% of profits is accrued and paid annually in arrears. A "highwater mark" applies, so any subsequent investment losses must be earned back before new performance fees are paid.

(c) <u>Early Redemption Fees</u>

In order to ensure that investors are aligned with the Fund's 3-5 year investment horizon, there is a lockup period of 3 years, during which clients who redeem will be subject to early redemption fees.

The fees are 5% for redemptions within the first year, 3% for redemptions in the second year, and 1% for redemptions in the third year. Such fees are paid to the Fund in order to

offset the disruption suffered by other fund investors when the Fund's investments have to be sold at inopportune times to meet client requests for redemptions.

6. Service Providers

The Fund Administrator is **Swiss Financial Services**. Swiss Financial Services has been providing fund administration services to funds worldwide since 1996. It has offices in Switzerland, Ireland, the US, the Cayman Islands, and Singapore.

The Fund Auditor is **Baker Tilly**. Baker Tilly International is the world's 8th largest accountancy and business advisory network. It has 149 member firms in 125 countries.

The Fund Stockbroker-Custodians are **UOB Kay Hian** and **RHB Securities**. UOB Kay Hian is a subsidiary of **United Overseas Bank**, one of Singapore's three local banks. RHB Securities is an indirect 100% subsidiary of **RHB Bank** in Malaysia.

The Fund Bank is **OCBC Bank**. OCBC is the oldest Singapore bank. It was formed in 1932 from the merger of 3 banks, one of which dated back to 1912. Today, it is the second largest financial services group in Southeast Asia by assets, and consistently ranked among the "World's Top 50 Safest Banks" by **Global Finance**. It operates in over 18 countries and territories with over 29,000 staff worldwide.

The Fund's Legal Advisors are **Conyers Dill & Pearman** (for Cayman law), **Chan & Goh** (for Singapore law), and **Crow & Cushing** (for US law).

7. How To Invest

The Lighthouse Fund will only accept subscriptions and redemptions via the Fund Administrator. Such monies are paid directly to and from the Fund's bank accounts with the Fund Bank, while units in the Fund are issued or cancelled by the Fund Administrator.

The Fund Manager does not handle any client money at any time for any reason.

Please contact Lighthouse Advisors directly if you are interested to find out more.

End

Annex I

More about Dividends: Show Me The Money!

History:

Here are some historical studies which illustrate the importance of dividends.

Dow Jones Industrial Average: A study by Stanford University in 2000, *The Dow Jones Industrial Average: The Impact of Fixing Its Flaws* looked at the Dow Jones Industrial Average (DJIA) from Oct 1928 to Dec 1998. It calculated that if dividends had been taken into account, the DJIA would not have been 9,181 on 31 Dec 1998, but 233,060, *25 times* higher.

Dividends vs. Capital Gains: In *The Future For Investors*, Jeremy Siegel found that from 1871 to 2003, *97%* of real stock market returns came from dividend reinvestment. In other words, over the very long term, dividends were far more important than capital gains.

Retirement Spending: An article in the T. Rowe Price Report Issue No 100, *Dividends Can Play Key Role In Retirement Income Plans*, observed that from 1972 to 2007, a retirement portfolio of high-yield stocks outperformed both the S&P 500 index and US government bonds. Under the same conditions, a retiree who invested in the S&P 500 index exhausted the principal in 2005, while the bond portfolio's principal was 6 times *smaller* than the high-yield stock portfolio at end-2007. Additionally, total income from the bonds over the 35 years was less than half that of the high-yield stock portfolio. In other words, high-yield stocks delivered both higher capital gains and higher income.

Theory:

For the investor, dividends provide an important margin of safety against management malfeasance. While accounting tricks can be used to improve reported profits, the same tricks cannot create cash dividends from thin air. Thus, cash dividends are an important affirmation of the quality of earnings.

Cash dividends also impose discipline on company management. At the minimum, it is a reminder that they are answerable to shareholders, not merely the board of directors. A company should only fund growth if it will increase the future cash generated. Unfortunately, few projects eventually pay off in such a manner. Most companies are better off paying out their earnings to shareholders to re-allocate as opportunities allow.

Practice:

Declining Markets: High dividend yields tend to provide a floor for stock prices. This buys an investor time to exit with most of the capital intact, or to sell and redeploy the funds into other opportunities. When existing holdings are retained, the cash being generated allows reinvestment at attractive prices without having to sell. The cash also provides a buffer to the portfolio, as cash holds its nominal value. Conversely, non-dividend-paying stocks often show the greatest decline in market value. This can severely impair the ability of an investor to sell out and redeploy the funds.

Rising Markets: With the cash being generated, the investor can continue to invest without having to sell existing holdings; one can "ride the winners" for longer. Yields also serve as a signal; when dividend yields are too low, stock prices are probably too high, which should then trigger divestment as a matter of prudence.