Phillip Capital Management

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Buying blue chips at a discount – are you game?

Buying an iPad; Buying a stock

Suppose you are looking at buying say, an iPad for yourself and you have checked out the price at the Apple store in town. Your mind is set and you are ready to buy it the next time you're in town. But on your way back from your overseas business trip you spot the exact same model selling at the duty-free outlet selling for 7% less because of GST exemption. Would you buy at the duty-free outlet or would you skip? Remember, this is the exact same iPad model.

Translate that to a blue-chip stock you have always been eyeing. Would the answer be the same?

May we venture to suggest that the answer lies in a golden saying from Warren Buffett: "Price is what you pay, value is what you get". If you get the same value (eg. the iPad is the same exact model, or the stock is the same one with no change in business fundamentals), then clearly the lower the price you pay the better (an airport outlet is definitely no fraud).

What is value?

The problem is that for stocks, even though price is clear (the price quoted on the exchange), the definition of "value" varies for different people. For somebody with limited holding power, perhaps the "value" of the stock is the possible price that he can sell, hopefully at a profit, back to the market in the short term (much like the flipper looking to quickly resell the iPad at a profit).

The investor who buys for income is more likely to be focused on the sustainability of the income stream of the stock, otherwise known as the dividends: whether it is sustainable, whether it could have growth potential over the long term. Since the dividends are typically directly linked to the operating cashflow of the business, the quality of the company behind the stock becomes important to him: a good company with strong competitiveness is more likely to generate a dependable and growing stream of dividend income. Short-term market price fluctuations are of relevance to him when he seeks to enter at an attractive (low) price.

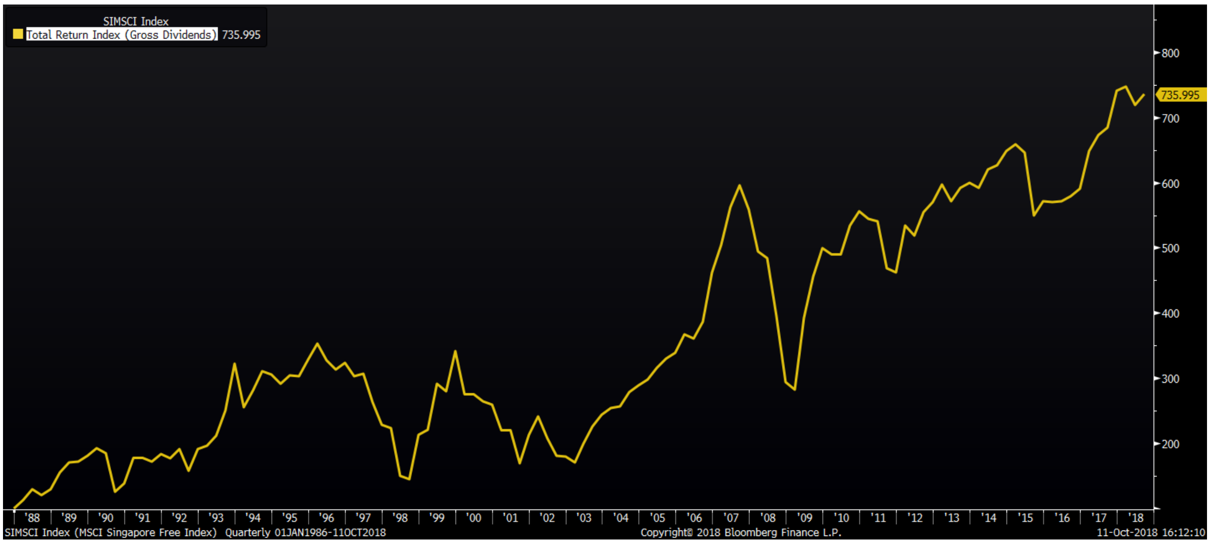
And he would be right to focus on the dividends. Since the year 2000 till now, the total return (price gains plus dividend income) that major Singapore stocks have delivered to investors on average comprise about 2/3 dividends and only a minority 1/3 in price gains.

The quality of the company is important

The caveat is: the company that the investor is buying at a bargain into must be a quality company. Otherwise, even if the investor buys in at a low share price following a market retreat, it may not turn out well for him if the company's business deteriorates due to weak competitiveness or worse, enters into financial distress due to weak financials. A declining stream of dividends would naturally follow.

It therefore helps if the company has a well-established track record of steady growth over the years. These are generally what people call "blue chips"; in the Singapore context they would be stocks like the three banks (DBS, UOB, OCBC), Singtel, ST Engineering etc. Usually, buying them on dips has proven to be a good investment decision provided the investor has holding power, as evidenced by the long-term total return of a well-recognised Singapore index of blue-chips such as MSCI Singapore:

MSCI Singapore Jan 1988-Sep 2018: Delivering +636% total return (inclusive of dividends) over 31 years



Phillip SING Income ETF (the "Fund")

An equity ETF, basically, is a collection of stocks. The Phillip SING Income ETF is designed as an income solution for long-term investors who are more concerned about dividends, and through its screening process it selects stocks with not just attractive dividend yield, but they must have quality along two facets: business quality and financial quality. For business quality, emphasis is placed on the competitive strengths of the company, or in Morningstar's term in the Morningstar Singapore Yield Focus Index that the Fund benchmark against, "economic moat" that protects its profit margins from existing and new "invaders". For financial quality, emphasis is placed on the resilience of the company's balance sheet and its ability to weather economic down-cycles.

We end up with a selection of 30 stocks inside this ETF, most of which are familiar to many: the likes of the three banks, Singtel, SGX, ST Engineering, major REITs like Capitaland Commercial and Capitaland Mall Trust, supermarket operators like Dairy Farm (owner of Cold Storage, 7-11, Giant) and Sheng Siong, are all among this list. More than half by index weightage are government/Temasek linked companies, with the other half controlled by equally credible owners such as the Wee (UOB), the Lee (OCBC) and the Jardine family.

Two things to note that are especially relevant in the current environment. Firstly, some point out that even blue chips can be vulnerable to new entrants in this age of disruption. We agree, hence diversification is important, and an ETF holding a diversified collection of securities provides this. Secondly, in an interest rate hike environment, bonds tend to weaken in value because the fixed coupons collected from a given bond are now discounted at higher interest rates, hence the present value of these coupons is lower than before. However for stocks, dividends are not fixed like bond coupons, and may be able to grow because a rate hike environment is often associated with a period of economic growth (which provided the reason for rate hikes in the first place). Hence over time, dividend yielding stocks with good fundamental value and growth track record tend to perform better than bonds in a rising interest rate environment.

Take advantage of lower prices to subscribe to the Phillip SING Income ETF

The Phillip SING Income ETF (the "ETF") will start investing into its constituent stocks **after** the Initial Offer Period, which started on 1 October and ends on 19 October 2018.

Between end-September 2018 till today (11 October), the broad Singapore market has dropped nearly 7%, providing an opportunity for the ETF to buy the constituent stocks and their underlying business after the offer period at a 7% price discount! Have the fundamental value of the quality stocks changed in a matter of 2 weeks? Such stocks still have the same business fundamentals but now at a cheaper price.

Just like you should be glad to buy something like the iPad you would have bought anyway, but at 7% GST-exempted prices.

By Tan Teck Leng, Senior Fund Manager Phillip Capital Management (S) Ltd

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