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When Blue Chips Give You the Blues

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This article was featured in the Aug 2011 issue of The Business Times. Below is the original article by William Cai, for your reading pleasure.

Why worry?

In the 3rd quarter of 2010, a slew of positive economic data was evident in the media. The idea of investing for the long term, by picking Singapore's 'solid' dividend-paying blue chip stocks, became an attractive proposition in a low interest rate environment. Coincidently, this is also when the Singapore Investor Confidence Index Poll reached a high. From a contrarian perspective, that was when one should worry.

A 'Death Cross' occurred when the Straits Times index fell to 2797. It is a term used when a security's 50-day moving average price line crosses over its 200-day moving average line from the top, generating a long-term bearish signal which suggests that investors should adjust their bullish view to bearish.

While 12 out of 18 'Death Crosses' turned out to be false signals (whipsaws) over the past 30 years for the STI, investors should still take the bearish signal seriously. Firstly, as a lagging indicator, the signal usually occurs after the STI has fallen by 10% or more, only to be compounded by further losses if a severe bear emerges. Secondly, 6 out of the 18 signals resulted in losses ranging from 22% to 54%. Thirdly, it is worrying that more than 60% of the

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Straits Times Index constituents, which are classified as 'blue chip' stocks, have generated the 'Death Cross' signal.

Death Cross

Year	% Drawdown
21 Jun 82 - 16 Aug 82	-22%
05 Jun 84 - 29 Apr 86	-41%
16 Aug 90 - 12 Oct 90	-15%
22 Dec 94 - 24 Jan 95	-14%
17 Mar 97 - 12 Jan 98	-50%
20 May 00 - 21 Sep 01	-38%
25 Jun 02 - 11 Mar 03	-21%
21 Jan 08 - 09 Mar 09	-54%
11 Aug 10 - ???	???

More importantly, the 'Death Cross' has also occurred for various other global markets, increasing the odds of a full-blown bear market.

Unconscious speculation

The definition of an 'Investment', as offered by Benjamin Graham in 1934, "is an operation that promises the safety of principal and satisfaction of return. Operations not meeting these requirements are speculation."

The biggest mistake an investor can make is to focus only on the idea of getting stable dividends, with disregard to price. For example, when investors buy blue chips at an expensive price during the mature stage of an economic cycle, this increases the possibility of seeing their stock value fall by 50% or more in the next economic slowdown.

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Despite the potential poor risk-adjusted ratio, investors stick to the concept of buying blue chip stocks as they harbour the hope of capital appreciation that bonds may not match. This does not make sense, as corporate bonds can do a better job of providing a steady income without similar risk to equity.

Untrained investors often focus on buying blue chips with the highest reputation, quoting their good management and their ability to continue to deliver profits for the long term as reasons for investing in them. Such investors do not wish to engage in market-timing activities as they equate them with speculation. Therefore, they place insufficient attention to prices given their assumption that well-chosen blue chips would recover from an economic downturn. Ironically, that is a speculative assumption, as many of today's blue chips could become tomorrow's losers.

For example, an investor who bought SGX shares at $14.40 on 2nd October 2007 would have seen the price fall 53% as at 22 August 2011. Assuming dividends reinvested, the loss would be large at -46%. Investors who bought stocks like Cosco, NOL and Yangzijiang at their peak in 2007 would still be nursing losses of between -50% to -84%.

Contrary to popular belief, Warren Buffett, the famous value investor, is a great market timer. He plays the game well by raising cash when he cannot find attractively-valued stocks. He waits for opportunities to pick up stocks at fire-sale prices, especially when there's blood in the streets. As the key to long-term investment success is to first avoid losing big, a true long-term investor should do the same and wait for a market crisis to buy stocks at attractive prices. Then, they can ignore the madness of short-term volatility and sell the stocks when they become overvalued. Over time, this strategy can substantially increase the an investor's wealth.

Valuation issues

For most investors, professionals included, qualitative factors like good management are difficult to deal with intelligently, and such an evaluation can be clouded by an investor's own confirmation bias. Quantitative factors, like the continued ability for a business to deliver a steady earnings growth, would need investors to have a considerable amount of investigation and business acumen.

Savvier investors could argue that Singapore stocks are now reasonable based on their current price ratios and forward-looking evaluations. This requires the calculation of the intrinsic value of a business as determined by its future earnings. However, history has repeatedly shown that during the good times, many analysts become over optimistic and assume a sustainable earnings trend. In reality, the concept of intrinsic value is arbitrary at best. It is elusive and hard to determine due to the uncertain future and the irrational market.

In addition, few analysts dare to offer views different from the herd, as it is often safer to err with the masses. For an analyst to be wrong when others are right can lead to the demise of his reputation and career. Even if the trend of earnings and intrinsic value can be reliably determined, it does not sufficiently provide a safe basis for investing, especially during a bear market.

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Lowest Level Reached When STI's P/B Fell Below 1.5x

28/8/1998	0.7
28/9/2001	1.2
28/2/2003	1.08
6/3/2009	0.88

Unfortunately, during a mature economic cycle, undervalued blue chips are uncommon and many investors end up investing without sufficient regard to price. Investors should focus on value investing, as it helps them invest better by selecting stocks based on the margin-of-safety principle. This means that one buys undervalued stocks at a price lower than its intrinsic value.

This helps to prioritize the safety of capital while dividends are viewed with secondary importance. While dividends come in handy as a 'cushion' to effectively lower losses when stock prices fall, dividend yields are lower when blue chips are bought at higher prices. Furthermore, during an economic downturn, companies do slash their dividend payouts to preserve cash holdings. This was true during the last crisis for blue chips like SIA, NOL, SGX, Capitaland, DBS, UOB and ComfortDelgro, as their earnings fell.

While value-investing may seem easy, human frailty often prevents successful implementation. It is hard to prevent human emotions from corrupting an investment framework. Even if the necessary fundamental analysis is used to scan for value stocks, investors may end up with a handful of stocks from boring industries which are not what they initially deemed blue chips. More importantly, it is hard to be fearful when others are greedy, and vice versa. It is hard to think independently and go against the herd.

Nevertheless, I hope that this article has helped instil a new level of consciousness to replace unconscious speculation. When the stock market enters a bear phase, extreme fear rather than fundamentals rules the day. Even the bluest of blue chip value picks can fall by a considerable amount. Dividends are often insufficient to avoid a market bloodbath. How much more refuge can an expensive blue chip provide? Investors who buy stocks at a high premium during a stock market high unwittingly end up as 'long-term investors'.

With the current global economic slowdown, coupled with the lingering U.S. and European sovereign debt crisis, the recent market carnage could be the beginning of something worse. Buying blue chips based on dividends alone while ignoring price, potentially deteriorating fundamentals and the economic cycle can be disastrous. It is never too late to avoid unconscious speculation and invest wisely.

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