"Sell in May and go away" doesn't work

COLing the Shots is a monthly publication by COL which provides insights on investment opportunities based on global and local developments that could affect the market. COLing the Shots aims to provide timely and relevant information and analysis as well as a model portfolio for successful investing.

Key Highlights

- Many investors are wondering if they should "Sell in May and go away" especially given the PSEi's elevated valuation and similarities of market conditions today and May of last year. However, a study of the monthly performances of the PSEi during the past 10 years shows that returns for the month of May is no worse than those of other months of the year.

- Although the market is currently undergoing a correction, we don't expect the magnitude of the drop to be the same as that of 2013. Unlike last year, US interest rates are now going down, leading to a wider spread between US and Philippine bonds. As such, there is less incentive for foreign investors to sell their peso assets.

- DD is a good company that could become a bad stock. Although it has an attractive story to tell with the right owners and partners and the right product in the right location, we are concerned that it could disappoint investors given its over ambitious earnings target and the significant jump in its share price recently which makes its valuations unjustifiable.

- Our COLing the Shots stock picks continued to perform well the last month. Unfortunately, out of all the stocks that we like, only three remain investible – MBT, MEG and SMPH. The rest have become unattractive due to valuations. This is the reason why we welcome the ongoing correction as this would allow us to buy more fundamentally attractive stocks at reasonable valuations.

- As far as changes in the COLing the Shots stock picks list are concerned, we are removing EEI due to its disappointing 1Q14 earnings performance. We also want to highlight that we increased our fair value estimate for AC to Php715.00/sh resulting to an increase in our "buy below price" to Php621.00/sh.

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Compared to the last time we issued our "COLing the Shots" report which was April 11, the PSEi has gone up by another 3.2% to close at 6,811.33. The market continued to rise as foreign fund flows remained strong, with net foreign buying totaling Php19.9 Bil during the past six weeks. S&P's surprise upgrade of the Philippines' credit rating to BBB also helped boost investor sentiment as the PSEi jumped 1.2% the day after the upgrade was announced.

Not surprisingly, many investors are wondering if they should "Sell in May and go away." After all, the PSEi is starting to look expensive as it is already trading at 18.5X 14E P/E, significantly above its historical average of 13X. Moreover, it is already trading at a level that is very close to our end 2014 target of 6,900.

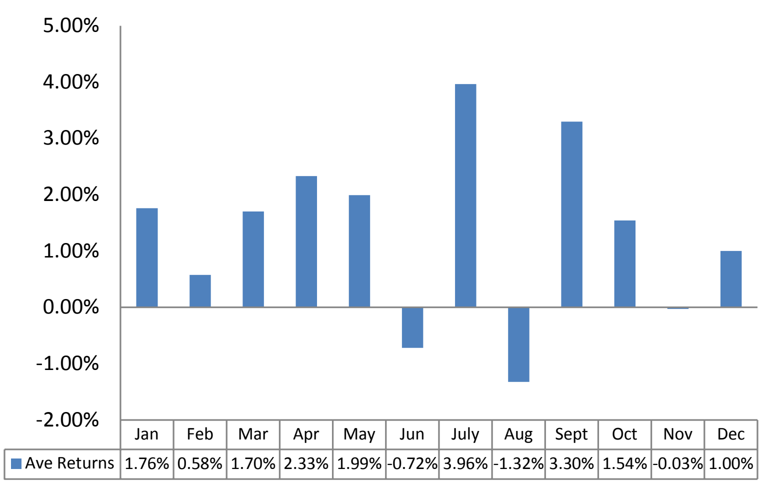
As a background, the famous quote "sell in May and go away" came about as a result of a study on the performance of the US market during different times of the year. According to the "Stock Trader's Almanac," since 1950, the Dow Jones Industrial Average has had an average return of only 0.3% during the May-October period, compared with an average gain of 7.5% during the November-April period.

Last year, "Sell in May and go away" would have been a very profitable strategy. Recall that the PSEi began to correct in May last year due to concerns that the Fed would start tapering its bond buyback program soon. This caused foreign investors to sell emerging market stocks as they moved their funds back to developed markets such as the US. Selling in May last year would have allowed investors to lock in to a very attractive 22% return in the stock market.

To determine whether a "Sell in May" strategy would have delivered above average performance on a consistent basis, we gathered the monthly performances of the PSEi during the past 10 years.

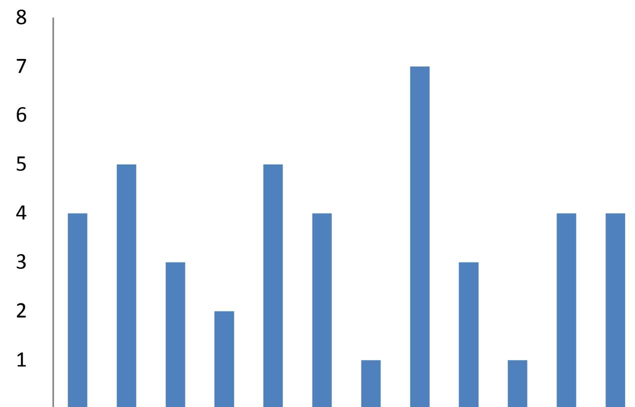
Looking at the data, it can be observed that the PSEi's performance in May is not really weaker compared to other months of the year. Average return was 1.99%, which is higher than the average monthly returns of 1.34% throughout the year. Moreover, although the PSEi fell five times during the last 10 years during the month of May, this is not significantly more often than the average of three to four times for the other months of the year.

Exhibit 1: Average M/M Returns of the PSEi (10-years)



Source: Bloomberg

Exhibit 2: Frequency of down M/M Returns of the PSEi (10-years)

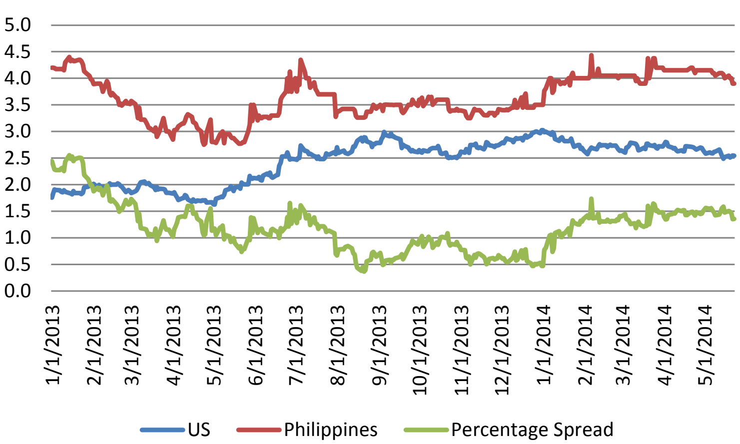


	Jan	Feb	Mar	Apr	May	Jun	July	Aug	Sept	Oct	Nov	Dec
No. of times down	4	5	3	2	5	4	1	7	3	1	4	4

Source: Bloomberg

Understandably, the market's condition today is reminiscent of last year's - Valuations are elevated and foreign funds are net buyers. However, unlike last year, US interest rates are now going down, leading to a wider spread between US and Philippine bonds. Note that the US 10-year T-bond recently fell to 2.5% after trading between 2.6% to 3.0% during the first four and a half months of the year. In contrast, during May of last year, the US 10-year bond rate jumped from 1.6% to 3.0% after the Fed hinted that it would soon taper its bond buyback program. Due to the increase in US interest rates, the spread between the US and Philippines 10-year bond narrowed to 40 basis points which was too small. The narrowing of the spread made it unattractive for foreign investors to hold on to peso assets, triggering the sell-off. In contrast, the spread between the US and Philippine 10 year bond rates today is much higher at 140 basis points as a result of the drop in the US interest rate.

Exhibit 3: US and Philippine 10-year Bond Rates and Spreads



Source: Bloomberg

In conclusion, selling in May is not be a good idea as a study of the PSEi's performance does not show any compelling evidence that May is the weakest month of the year. Moreover, although a correction is currently taking place, we don't expect the magnitude of the drop to be the same as that of 2013 as conditions today are different.

Investors who are more active and would like to try their hand at timing the market using calendar anomalies may want to sell in August instead. During the month of August, the PSEi fell seven out of the past 10 years. It also fell by an average of 1.3% during the said month. This might be due to August being the ghost month.

DD - A good company that could become a bad stock

Since its IPO last April 7, Double Dragon's (DD) share price has more than quadrupled from Php2.00/sh to Php9.85/sh as of this writing. As a result, DD's market capitalization has reached Php21.9 Bil, making it at par with other more established names such as RFM and Pepsi (PIP).

The company admittedly has a very attractive fundamental story to tell and this is something that we have been very vocal about. DD's principals are successful entrepreneurs, namely Jollibee's Tony Tan Caktiong and Mang Inasal's Injap Sia. The company plans to have a total rental portfolio of 1,000,0000 sqm by 2020, 70% of which will come from the 100 community malls that it plans to build in the Visayas and Mindanao areas - areas that are underpenetrated compared to Luzon and where growth prospects are more attractive. In early 2014, the SM group bought a 34% stake in CityMalls, DD's subsidiary that will be responsible for the community mall roll out. The buy in by the SM group is critical for DD as it ensures that CityMalls will have enough tenants to enjoy high levels of occupancy (JFC will most likely be its restaurant tenant).

Given the said plans, DD said it is targeting to earn Php1.0 Bil by 2016, when it benefits from the full year contribution of 25 CityMalls and Php5.0 Bil by 2020, when it has 100 CityMalls.

Although DD's story is very attractive, there are a few reasons why we think it could be a bad stock.

1. **Minimal income from existing businesses.** In 2012, DD only earned Php92.2 Mil. Although DD earned Php122.1 Mil in 2013, around 19.2% of revenues came from unrealized gains from changes in fair values of investment properties, which is not part of its core operations.

2. **Not enough money to execute its ambitious plan.** According to its prospectus, DD only has Php1.0 Bil in credit lines and Php1.0 Bil in cash raised from its IPO. Potential capital infusion by SM into City Mall is also minimal at less than Php200 Mil. Given CityMall's estimated capex of Php200 Mil to Php270 Mil per mall, DD can only put up eight to ten CityMalls with its existing resources, way below its target of more than 25 malls by 2016.

3. **Income target is too ambitious.** Based on an aggressive assumption that DD can put up 10 CityMalls using its existing resources and that each mall would have a leasable area of 10,000 sqm and enjoy 100% occupancy at a rental rate of Php450/sqm/mo, annual revenues would only reach Php540 Mil. DD's net income would be much lower as the company would still have to pay interest on debts, income taxes, and take out SM's 34% share in CityMall's profit. This is a far cry from its target of earning Php1.0Bil by 2016.

4. **Valuations are unjustifiable.** Based on a very aggressive assumption that CityMall's profits will be equivalent to its revenues of Php540 Mil, DD's implied 16E P/E at its current price of Php9.85/sh is 40.7X which is very high as the said level is even higher than that of industry giants ALI (32.7X 14E) and SMPH (22.3X).

Although DD could reach its goal of earning Php1.0 Bil by 2016 and Php5 Bil by 2020, the company would have to issue new shares to raise fresh capital. However, current shareholders will be diluted which would also reduce the value of existing shares.

DD's share price would be vulnerable to a correction assuming that the company fails to meet its ambitious net income targets or if the company announces a share offering. The likelihood of these two occurrences materializing is very high based on our analysis. For the said reason, we think DD might be a "good company, bad stock" and as such, we advise investors to exercise caution in trading the stock.

Removing EEI, raising FV estimate for AC

I'm happy to say that our COLing the Shots stock picks continued to perform well the last month. Compared to April 11, a portfolio with an equally weighted allocation of stocks in our list would have returned 3.6%, which is higher compared to the PSEi's return of 3.2%.

Exhibit 4: COLing the Shots Stock Picks M/M Return

	Price		
Stock	**11-Apr-14**	**23-May-14**	**M/M Change**
EEI	11.88	10.7	-9.90%
MEG	4.49	4.52	0.70%
TEL	2,744.00	2,902.00	5.80%
DNL	8.7	9.1	4.60%
AC	619	651	5.20%
BDO	87	89.5	2.90%
MBT	79.8	86.9	8.90%
ALI	29.55	32.15	8.80%
SMPH	15.56	16.38	5.30%

Source: Bloomberg

Unfortunately, out of all the stocks that we like, only three remain investible – MBT, MEG and SMPH. The rest have become unattractive due to valuations. This is the reason why we actually welcome the ongoing correction as this would allow us to buy more fundamentally attractive stocks at reasonable valuations.

As far as changes in the COLing the Shots stock picks list are concerned, we are removing EEI. Recently, EEI reported that first quarter 2014 earnings fell by 52%. This is despite the fact that the company had a huge backlog of construction contracts worth Php28 Bil as of end 2013, which makes us wonder why profits fell so significantly. We are not discounting the possibility that profits could rebound in the future. Nevertheless, at EEI's current price of Php10.70/sh, investors who had bought the stock when it was first recommended in March 2012 would have already made a return of 76.3%. As such, we think now would be a good time to lock in gains.

We also want to highlight that we increased our fair value estimate for AC from Php689/sh to Php715.00/sh after we factored in the impact of its move to increase its shares in BPI from 44% to 48.3% and the higher market value of subsidiary IMI. As a result, our new "buy below price" is Php621.00/sh.

Exhibit 5: COLing the Shots Stock Picks

	Price	FV	Buy Date	Buy Price	Current Return	Buy Below Price
MEG	4.52	5.48	11-Jan-13	3.11	45.30%	4.77
TEL	2,902.00	3,260.00	11-Jan-13	2,636.00	10.10%	2,834.78
DNL	9.1	10	14-Feb-13	6	51.70%	8.7
AC	651	715	5-Aug-13	600	8.50%	621.74
BDO	89.5	94	23-Jan-14	80	11.90%	81.74
MBT	86.9	100	23-Jan-14	79.8	8.90%	86.96
ALI	32.15	36.08	23-Jan-14	27.55	16.70%	31.37
SMPH	16.38	19.41	23-Jan-14	14.48	13.10%	16.88

Source: Bloomberg

Follow us!

The idea for the first two topics that we discussed this month – "Sell in May and go away doesn't work," and "DD – A good company that could be a bad stock" – came about as a result of the feedback from investors who follow both COL and myself in twitter. As such, we would like to take this opportunity to thank you for following us. Please encourage more of your friends to follow us in twitter (@COLFinancial, @AprilLeeTan) as we continue to find ways to share stock market insights, new product features, and continuing education seminars that will help you succeed in your investments.

Investment Rating Definitions

BUY	HOLD	SELL
Stocks that have a **BUY** rating have attractive fundamentals and valuations, based on our analysis. We expect the share price to outperform the market in the next six to twelve months.	Stocks that have a **HOLD** rating have either 1.) attractive fundamentals but expensive valuations; 2.) attractive valuations but near term earnings outlook might be poor or vulnerable to numerous risks. Given the said factors, the share price of the stock may perform merely inline or underperform the market in the next six to twelve months.	We dislike both the valuations and fundamentals of stocks with a **SELL** rating. We expect the share price to underperform in the next six to twelve months.

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