MINORITY SHAREHOLDERS WATCH GROUP
BADAN PENGAWAS PEMEGANG SAHAM MINORITI BERHAD
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DEVANESAN EVANSON

QUALITATIVE ASPECTS

'TIPS' FOR STOCK INVESTING

WARREN Buffett said there are two rules to investing; "Rule No. 1: Never Lose Money. Rule No. 2: Never Forget Rule No. 1".

On that note, it is worthwhile to ponder over certain qualitative aspects that pose greater risks of losing money. These features do not relate to the analysis and digesting of financial statements but are more general in nature.

The risk-averse investor may prefer to avoid companies that have the following features.

❑ **Boardroom tussles:** A boardroom tussle, where it involves shareholders, is a sign of shareholder activism. That is well and good as it recognises the power of shareholders as owners of the company. It shows that the owners have a say in how the company should be run.

However, the downside risk is that businesses may suffer from such boardroom tussles. Companies involved in such tussles often state that "it is business as usual".

Such statements must be taken with a pinch of salt — it cannot be business as usual when major shareholders and directors, especially executive directors, tussle for control of the company.

Something has got to give and that, inevitably, is the focus on running a business successfully and profitably.

Moreover, such tussles are often accompanied by legal suits from both sides. Again, the focus of the board and management is distracted as they seek to address legal liabilities that may impact them in a personal manner.

And there may be substantial legal costs on the company's part. This, too, will be a drain on the bottom line of the company.

The risk-averse retail investor may prefer to avoid companies with such boardroom tussles, especially if they are foreseen to be prolonged.

❑ **Frequent changes in board and management:** Change is a certainty. Change at the people level is good for a company as it allows the introduction of new blood. New blood brings along new thoughts, perspectives and innovations. But changes must be guided through a holistic succession plan.

It is a red flag when directors and senior management resign in numbers for no apparent reason. There may be much more to such resignations than what meets the eye. The oft-stated reason for such change is the cliche "to pursue other interests" but retail shareholders must not be naive.

Sometimes the change is due to changes in major shareholders, which is understandable and acceptable. And sometimes, it is due to the board seeking to revitalise itself and the senior management.

Explainable change is good, but change for no apparent reason is alarming. Changes at the board and some senior management positions are considered material information and are mandatory disclosure items under the listing requirements.

❑ **Grandiose plans:** It is good to have grand plans but retail shareholders must think rationally if companies have the capacity or capability to achieve them. Often, such grand plans are accompanied by memoranda of understanding (MoUs) but these merely indicate the intention of the parties involved to collaborate. They have no legal consequences.

Even contracts can be concocted and entered — and announced. Such contracts may be between parties acting in concert. Their subsequent termination will not attract legal consequences and sometimes result in losses to the company.

The naive retail shareholder would have believed the veracity of the MoUs and contracts and invested in the company. That is why it is important to perform due diligence on the board – not all boards are created equal regarding integrity and honesty.

Such due diligence will give an indicator as to whether the MoUs and contracts can be relied upon. Here, retail shareholders must exercise a huge dose of sheer common sense as to whether the MoUs and contacts will come to fruition.

❑ **Qualified audit report:** To simplify matters, there are two types of audit reports — clean and qualified with emphasis, modification or qualification. The risk-averse retail investor may prefer to invest in companies with clean audit reports. The good thing is that most Malaysian public-listed companies (PLCs) have clean audit reports.

❑ **Customer concentration risk:** Avoid PLCs with one or two major customers contributing substantially to the company's revenue. For if the major customer stops being a customer, the revenue will drop so significantly that it may affect the company's profitability. This, in turn, may lead to the company's inability to pay its debts as and when they fall due.

The risk-averse retail investor will prefer those companies with a diversified customer base so that the loss of one or two top contributing customers will not lead to the crippling of the company.

❑ **Over-diversification:** Business diversification is good because it spreads risk; if one business stream does not perform, other businesses are ready to prop up the revenue stream.

For diversification to be truly effective and true to the word "diversify", it should be from unrelated sectors. But the downside is that the more the diversification into different sectors, the more things the board and management must focus on.

There is, therefore, a balance to be achieved between diversification and over-diversification. Over-diversifying risks a loss of focus as there will be many sectors to focus on.

Another risk is that there may not be the requisite expertise at the board and management level to handle the diversified portfolio of business. As a matter of strategy, some companies have chosen not to diversify and be in the business they know best — where their forte lies.

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Conclusion

The considerations above do not involve number crunching but form an essential part of investing. They are an important gloss that can be applied to the analysis of financial statements.

As always, the truism is that the higher the risk, the higher the potential for gains and losses.

The writer is chief executive officer of Minority Shareholders Watch Group.