First State Stewart Asia - Asia Pacific Equities

Asia Update

May 2016

- The First State Asia Innovation Fund invests in Asian (excluding Australia, New Zealand and Japan) securities.
- The First State Asian Growth Fund invests in Asian (excluding Japan) securities.
- The First State Asia Innovation Fund and First State Asian Growth Fund are invests in emerging markets which may involve a greater risk than developed markets including sharp price movements, liquidity risk and currency risk. It is possible that the entire value of your investment could be lost.
- You should not base your investment decision solely on this document. You should not invest unless the intermediary who sells it to you has advised you that the Fund is suitable for you and explained how it is consistent with your investment objectives.

The last time we wrote to you was slightly over six months ago, in October 2015. In the meantime, investment management has felt even more duck-like than usual. There seems to have been a lot of, at times somewhat lively, underlying activity for very little perceptible progress.

“Never forget that only dead fish swim with the stream.”

Malcolm Muggeridge

And so the world goes. Last October, we thought that it was time to stop worrying about what we had to lose and to start focusing on what we maybe had to gain. Somewhat surprisingly, markets obliged and thereafter bounced pretty sharply.

That sharp rally meant that we underperformed in the shorter-term, as markets levitated on an even higher tide of free money. That is absolutely fine. Though we all know that we absolutely do not do macro, we seem once again to be confronted by ever-higher risks, for ever-diminishing returns.

It is difficult to believe that things are not about to become rather messy. A strongly contrarian stance looks appropriate. We have been positioning the portfolio with such a view in mind.

This commentary provides an update on our current thinking and will cover the following issues:

- Performance and update on regional funds
- Review of the last six months
- Current portfolio positioning
- Mistakes
- What we are worried about
- Outlook and conclusion

Performance and update on funds

The First State Asia Innovation Fund and the First State Asian Growth Fund have continued to perform quite resiliently, though both have suffered capital losses in the last twelve months. Though there is significant overlap across all of our funds in terms of the companies that we own, each strategy is dependent on the specific fund mandate.

For the First State Asia Innovation Fund and the First State Asian Growth Fund, the main difference is that the First State Asian Growth Fund is a Leaders strategy. The fund can only invest in companies with a free-float greater than US$1.5bn. The First State Asia Innovation Fund, by contrast, has a broader mandate and is able to invest into smaller companies. It is an all-cap strategy.

It is very noticeable that the all-cap First State Asia Innovation Fund has outperformed the much bigger, large-cap First State Asian Growth Fund. The major reason has been the strong performance of our Australian holdings. Exporters have been further re-rated in a predictable response to a weaker currency. Meanwhile, the First State Asian Growth Fund only owns Australian gold-miner Newcrest.

The smaller-company effect is latterly something that we have leant against strongly. The two funds now look even more the same than usual. We have sold a number of small companies, some at a loss, but believe fortune is unlikely to favour the brave at this stage of the cycle. We have held on to all of our Newcrest holding, remaining steadfastly positive. We will, as has become de rigueur around here, discuss the company later in this note.

Over the last six months, we hope that we have further improved the quality of the portfolio. In times of prospective turbulence, it does no harm to think purposefully about some of the potential headwinds (and consequent tailwinds) that we may experience in the years ahead. There have been some changes in India, a reduction in the overall number of holdings, a move up the market-capitalisation curve and consequently an increase (particularly in the last month, or so) in the level of our cash holding.

Overview

From a bottom-up company point of view, meeting by meeting, the news continues to deteriorate. The widely reported injection of US$1 trillion[1] into China's economy in Q1, 2016 has clearly, as we might all have expected, had a short-term stimulatory effect. It is hard to keep up with all the zeros. Stock and property markets have been the two most obvious beneficiaries, but such largesse looks thoroughly unsustainable to us. If something cannot go on for ever, then clearly it will stop, as Herbert Stein originally noted.

How, when and why it stops is, of course, the subject of much current debate. Whether it is with a sharp Asian-crisis-style explosion, perhaps triggered by currency weakness, or a rather slower Japan-like implosion hardly matters in our view. It is easy to see the denouement being some combination of both. Whatever the likely path we end up taking, the current risk-reward environment looks decidedly negatively-skewed for equity investors.

We have continued to generate decent absolute returns, other than over the last twelve months, which surprises us probably more than most people. Again though, in the interests of full disclosure, it is worth taking note of our laughable track record for macro-forecasting. But even a stopped clock is right twice a day and in our view we seem to be purposefully sleep-walking into the next economic crisis. It is as if Adam Smith had never existed.

The other more important point, at the risk of seeming rather dull, is that it does not matter if we are wrong, anyway. We are lucky in that respect. Thankfully, we only have to invest in the best Asia-Pacific companies that we can find. Our assumption, which is well supported by history, is that the strongest management teams and good companies will find a way forward, whatever happens. We just have to be sure that this is more likely than not to be true for the companies that we own.

In our view, we have all become so accustomed to monetary expansion that we have become anesthetised to the growing risks. Any UK-born child of the 1970's will fully understand that the trust we are again putting in governments to fix our problems is laughable. Central banks have generally come to be regarded as omnipotent. This is clearly mad and obviously false. The only thing that they appear to have achieved is to generally inflate asset prices.

We all have our own financial versions of 'if only', but here is a good recent one from Hong Kong. A house in Jardine's Lookout, an attractive residential area on Hong Kong Island, has just been sold for HK$650 million (US$83 million)[2]. The seller originally put it on the market for HK$750 million. But, they bought it in 1992

Cumulative performance (%)

	Since Inception	5Y	3Y	1Y	YTD	6M	3M
First State Asia Innovation Fund	280.3	27.3	17.4	-8.1	2.8	1.1	10.6
MSCI AC Asia ex-Japan Index	148.6	-3.3	-1.5	-18.3	0.9	-2.9	9.2
First State Asian Growth Fund	286.3	17.3	5.6	-10.2	1.3	-2.8	9.4
MSCI AC Asia ex-Japan Index	167.9	-3.3	-1.5	-18.3	0.9	-2.9	9.2

Source: Lipper, Nav-Nav (USD total return) as at 30 April 2016.
The First State Asia Innovation Fund Class I (USD - Acc) - inception date: 18 October 2002. Benchmark: MSCI AC Asia ex-Japan Index. Calendar year performance: -2.4% (2015); 14.7% (2014); 4.0% (2013); 20.3% (2012); -7.9% (2011).
The First State Asian Growth Fund Class I (USD - Acc) - inception date: 5 August 1999. Benchmark: MSCI AC Asia ex-Japan Index. Calendar year performance: -2.4% (2015); 13.1% (2014); -3.3% (2013); 24.2% (2012); -9.8% (2011).

1. Source: Xinhua Finance Agency, as at Q1 2016.
2. Source: The Standard as at 5 May 2016.

for US$3.5 million. Let us just reflect on that. It is ridiculous and wrong and we all know that it cannot continue.

Financial Stockholm Syndrome

It is as if the whole world has succumbed to an all-encompassing financial version of Stockholm Syndrome. Just as a hostage should resist their kidnappers, we all know that monetary-debasement and more debt to fix too much debt in the first place are wrong. Similarly, we know too that it is all likely to end pretty badly, but in the meantime, as time has passed, we have grown accustomed to how things are and worse still we have all become complicit.

This is hardly surprising and indeed, from a policy point of view, is just what the world's central banks have wanted and engineered. Savers and capital-allocators, us as in we the people, have all been forced to capitulate. But now that we are here, as Japan's experience might have foretold, we can very obviously conclude that it has not worked. The only thing that has been achieved is to jack-up valuations, irrespective of very obviously declining (zero?) growth. In our mind, the tipping point is fast approaching. Only the timing remains in question.

True for the whole world

Economic activity is moribund, trade has slumped and debt continues to rise. We all know that we are not being compensated for the risks that are being run on our behalf. But people are not so dumb. The populace knows it has been disenfranchised and the growing as well as predictable reaction is rage against the political and economic elite.

The signs are clear in rising social violence, slumping confidence, higher savings ratios in the United States, an appreciating gold price and of course the rise of political radicalism. Donald Trump, Xi Jinping's muscular communist leadership and the resurgence of right-wing politics in Europe are all obvious manifestations of the same thing. The very recent Philippines presidential election is but another example.

If you believe that politics drives policy and ultimately economics, then such a broad shift across the world is as noteworthy as was the rise of the Reagan-Thatcher axis in the early 1980's. The pendulum of that neo-liberalist policy, (free trade, open borders, markets as the arbiter of all things), has been reversing for some time as it has predictably sown the seeds of its own destruction.

We can all but wonder how a doctrine of markets-first, with small government alongside fiscal and debt rectitude, has disintegrated into the mess of intervention and state-sponsored capitalism that we have today. Reagan was absolutely right when he said that the most terrifying words in the English language are: "I'm from the Government and I'm here to help."

We have no idea what happens next, but the pre-conditions for significant change are firmly in place. But, we suppose first something has to break. Devaluation, deflation and the potential for a sharp reversal in valuations seems like one of the more probable and shorter-term outcomes. We know that we should be very careful about what we wish for. But we think it now looks like a pretty sensible strategy to be scared, perhaps even very scared.

Headwinds and tailwinds

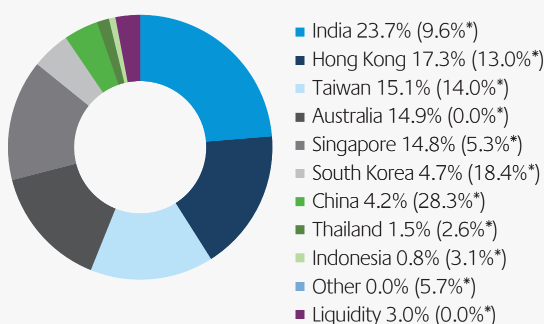
As markets have flip-flopped over the last six months, our underlying views have not shifted very much, if at all. If anything, the policy response in China, while predictable, has strengthened the intensity of our stance. It is a truism of markets that as things persist and risks are perceived to ameliorate, so in fact the opposite is true.

When we are at our most relaxed, the risk (and often valuations) are usually at their highest levels. Today, we have the odd situation of elevated markets despite high levels of fear-mongering. This is not reassuring. With interest rates never before in recorded history at these levels, perhaps things are somewhat different. Investors are seemingly faced with little choice, as intermediators go out of their way to assure us that cash is trash.

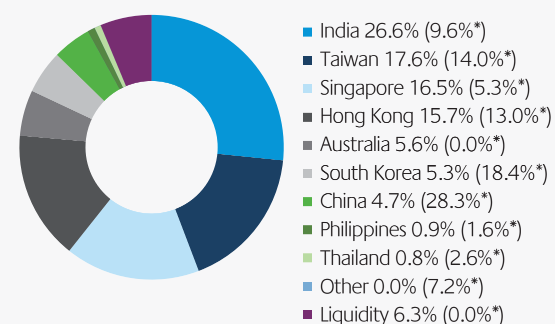
Despite China's GDP figures, we still struggle to observe much (if any) bottom-up growth. We have said it before, but reading all the easy commentary around economic re-balancing is a bit too much to stomach. China remains an export-led and investment-fed economy. Of course, as you would expect, consumption and services intensity is rising and will continue to do so, but of itself, it is unlikely in our view to prove sufficient to drive the overall economy.

Country allocation

First State Asia Innovation Fund (All-cap)



First State Asian Growth Fund (Leaders)



Source: First State Investments as at 30 April 2016. *Index: MSCI AC Asia ex-Japan Index.

Export-competitiveness remains key, but a sharp appreciation of both the currency and general costs in recent years have undermined the People's Republic of China's (PRC's) comparative advantage. We all instinctively know this. Most other countries and many direct competitors, bar the US, have seen their currencies weaken materially. Meanwhile the competitive position of the US, with flexible labour rules, cheap energy and growing concerns around intellectual property has improved. We have seen the practical consequences with on-shoring, despite the stronger US dollar.

A key policy prerogative in China remains the maintenance of low levels of unemployment. Growth and economic progress underlie that assumption. To that end, buttressing industrial China and the export economy remains central, irrespective of all the talk about a new economy and services. More debt and an absence of restructuring can only defer these pressures, in our view. Either way, a weaker currency still seems like the most likely outcome. Our exposure to China remains small.

To that end, a lot of recent commentary has fixated on the likelihood of an Asian Crisis Two. There are plenty of parallels, from debt to stalling property prices, though by contrast less US dollar corporate debt (outside China, particularly) and certainly no talk about miracle economics (or the commensurate elevated ratings). But perhaps a more interesting analogue with China today is Japan in 1989.

Japan and China

Japan then, like China today, dominated the headlines. Just as for Japan, it is a generally held truth that China is destined to have a bigger economy than the US. And then, of course, will naturally take over the world. Today, (who now remembers the book and film, Rising Sun?), we similarly have Chinese companies announcing a new global acquisition every other week. The Radisson hotel chain is but the latest. It is relevant (and slightly uncanny) to note that China's share of the global economy today, as well as of global exports, is very similar to the level of Japan in 1989.

Of course we all know what happened next. Clearly, it has already been more than twenty five long years for Japan. But in the meantime, the rest of the world has restructured; innovation and progress have continued apace and many companies have done very well. Returns have compounded at a high level, even for some Japanese companies. Yes, we know it is different this time, (the fall of the Berlin Wall, for one thing), but perhaps there are more similarities than differences. The key point is that if we end up paralysed into inaction by macro-concerns, we will do everybody a disservice.

Moreover, even with the benefit of hindsight, Japan's implosion was no reason to be scared of everything. It certainly bears thinking about, in the context of current China commentary. With the PRC today, it is either: everything is fine and you should continue to buy; or alternatively, the apocalypse is upon us. Neither outcome is likely to be true. Some reflections on economic history, per the above comparison with Japan, demonstrate that we are likely to be faced with a far more interesting range of outcomes.

Given all of the above, alongside our key focus on avoiding permanent loss of capital, we continue to have a healthy appetite for exporters and US dollar earners in general. That has meant that our exposure to Taiwan and technology companies has increased generally. We remain concerned about the Asean markets. We all learnt as long ago as 1996, ahead of the Asian crisis, that when it comes to China for the rest of the region we are all very much in bed with an elephant whatever the outcome.

We still own a lot of Hong Kong and Singapore listed companies, though an important point is that these businesses often have a much bigger geographical footprint. For instance, the Jardine group companies are often included in Singapore country-splits, but are obviously head-quartered in Hong Kong. They are broadly-based regional businesses. It is the same, for instance, with Singapore Telecom; only 25% of its profits are derived in Singapore.

Overall, our biggest country exposure remains India; indeed our percentage holding has increased further. However, a recent trip confirmed some of our earlier nascent fears. We do not expect the currency to remain an isolated stand-out, irrespective of the outstanding central bank head. He is holding the line on reform, fiscal discipline and building up reserves. Nevertheless, perhaps unsurprisingly, it seems that domestic India is slowing quite markedly.

There are a number of reasons for the slowdown, (falling inflation, poor monsoon, lower agricultural commodity prices and lesser flow of black-money). In that sense there are some similarities with the China of two years ago. Some of these factors are one-off, but high valuations leave little scope for error. We have further trimmed our exposure to domestic companies and added to a number of very high quality and globally competitive exporters.

Current portfolio positioning

The portfolio changes of the last six months mark a continuation, with the intensity of our previous views increased, as time has passed and risk has risen in the face of escalating debt levels. As far as the top ten holdings for both funds go, there has perhaps been slightly more change than usual. **Tata Consultancy Services** (India: Information Technology) and **Dr. Reddy's** (India: Health Care) are the two main additions. Tata Consultancy joins **Infosys**, which we have already held for some time.

Dr. Reddy's is a new holding for the First State Asia Innovation Fund, with a doubling of the position-size for the First State Asian Growth Fund on recent stock-price weakness. We have continued to add to **Tata Consultancy Services (TCS)** too, this being a new position for the First State Asian Growth Fund and a significant addition to the existing holding in the First State Asia Innovation Fund. On divestments, we have entirely disposed of **CK Property** (Hong Kong: Financials).

For the First State Asia Innovation Fund, **Li & Fung** (Hong Kong: Consumer Discretionary) has fallen out of the top ten on further share price weakness, while for the First State Asian Growth Fund modest trims to **LG Chemical** (Korea: Materials) and **HDFC**

Bank (India: Financials) mean that they too have slipped out of the top ten holdings. For the First State Asian Growth Fund, we have continued to add to **Singapore Telecom** (Telecom Services), which is the other new top ten holding for the fund. We added to **Taiwan Semiconductor** (Taiwan: Information Technology) for both funds too.

For Tata Consultancy, our renewed optimism was confirmed by a recent visit to see the company in Mumbai. Every time we meet the company, we are reassured and simply think that it should be a larger holding. We are convinced by the arguments of growing IT complexity and intensity. We further believe that in an environment where all businesses are increasingly totally intertwined with, as well as dependent on technology, that the larger companies will continue to gain market-share.

It is an updated take on the 1970's view that nobody ever got fired for buying IBM. In a further nod to IBM it seems too that despite their scale, TCS is still an elephant that can dance. TCS's market-capitalisation is, even today, still half the level of that of IBM. TCS trades on a high-teens price-to-earnings ratio (PER) for just about double-digit growth, with a net cash (US$4 billion) balance sheet (6% of market cap).

In a similar vein, we bought **Tech Mahindra** (India: Information Technology), meeting with them a couple of times in the last six months. We like the family and the company has lately struggled, (as has the sector), on shorter-term growth concerns. The other general point is that all of these companies are collectively already so much more than just plain-vanilla IT outsourcers. Just as Infosys designs airplane wings for Airbus, so Tech Mahindra designs the fuselage for a US commercial plane manufacturer.

Tech Mahindra already has nine of the world's top ten car manufacturers as customers. The distinction between IT and engineering looks increasingly indistinct. Cars are, so we are reliably assured, likely to be more about software than metal in the future. It is fanciful, but perhaps these IT outsourcers are evolving into automation-plays. Tech Mahindra trades on a forward PER of say 14x, with double-digit earnings growth. That looks rather attractive in our view.

IT outsourcers and generic drugs companies

Dr. Reddy's, like several other pharmaceutical companies in India, has run afoul of the US Food & Drugs Administration (FDA). To some extent this is something of a systemic issue. The FDA are clearly clamping down on companies that generate the bulk of profits from the domestic US market, with a clear message to improve overall quality. We have been somewhat disappointed by Dr. Reddy's seeming lack of purposeful resolution, but we are very much comforted to see the family step up and buy stock (US$13 million since May 2015) for the first time in five years.

Meanwhile, what attracted us to the business in the first place remains unchanged. They spend the highest percentage of sales in India (12% from 9% in FY14) on research and development and the second highest amount after **Sun Pharmaceutical** (US$250 million) in absolute dollars. Furthermore, they appear to be one of the companies that are furthest along in expanding into biosimilar drugs. The shares have fallen by a third in the last six months and now trade on a high-teens forward PER. The growth outlook is less clear, but we suspect the management team will surely find a way forward in the next few years.

As already noted, we sold CK Property (of course, before it bounced with the markets). The property markets look increasingly toppish. Of course, appetite has rebounded of late, but real property volumes are falling and affordability has deteriorated, despite record-low interest rates. Some Hong Kong developers have begun to discount prices to generate sales, but we think the general outlook is poor. Supply is finally increasing and governments have introduced demand-curbing fiscal restraints in a number of jurisdictions.

Most of the Hong Kong investment property companies currently trade at fifty-cents on the dollar, with CK Property trading at 0.7x book. As the company is primarily a developer, profits could fall away very quickly. We believe that our alignment with the major shareholder, Mr Li Ka-Shing, is far greater at the holding company level, **CK Hutchison Holdings** (Hong Kong: Industrials). Indeed, the reason for the original restructuring was, we suspect, so that the family can further reduce exposure to Asia and property in particular.

For Singapore Telecom, we have added broadly, in particular after a recent meeting with the company. Some believe the company is a cash-proxy, which is not an unreasonable view. We believe the company can continue to grow at a low single-digit rate (3-5%), while the forward PER of 16x and a dividend yield of 4.5% make it a more attractive alternative than cash. Furthermore, the company believes that we have finally reached the point where data revenues are now sufficient to offset declining SMS and voice turnover. If so, then perhaps the outlook is improving.

Domestic India is softer

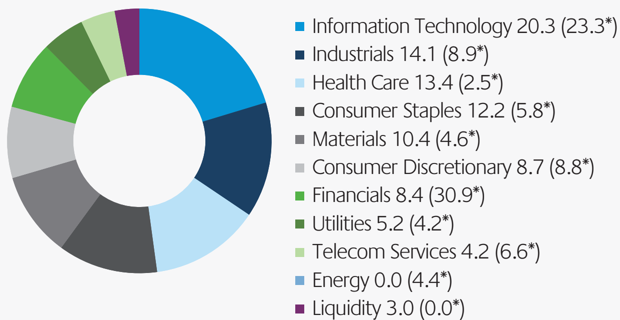
Coming back to India, as already remarked, we reduced our exposure to the domestic consumer sector quite sharply. In particular we trimmed **Godrej Consumer** (India: Consumer Staples), though the company continues to execute extremely well particularly in overseas markets such as Africa. The forward PER is now a rather demanding 40x. Perhaps we will get an opportunity to add again at a lower price in the future. We reduced **Marico** (India: Consumer Staples) in the First State Asia Innovation Fund, for similar reasons.

For the same fund, we finally sold **Tata Global Beverages** (India: Consumer Staples) as well. We like the Indian business very much, with the added kicker of a 50% interest in Starbucks India. The issue is perhaps more that the company still appears rather more focused on international and territorial expansion, particularly of the Tetley tea business, than they are on return-on-equity (ROE). Presumably, they will get there, but it may take longer than we are prepared to wait.

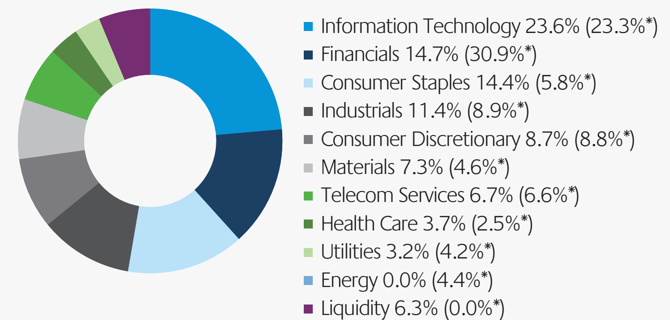
We trimmed HDFC Bank as already noted, again on valuation grounds, while we reduced our holding in **Kotak Mahindra Bank** (India: Financials) much more sharply. We met with these banks quite recently and they are both finding it tough. Conditions are some of the most demanding that they have

Sector allocation

First State Asia Innovation Fund (All-cap)



First State Asian Growth Fund (Leaders)



Source: First State Investments as at 30 April 2016. *Index: MSCI AC Asia ex-Japan Index.

experienced in a couple of decades, which is certainly something that gives pause for thought. On the other hand, reform of the Indian banking sector remains a necessary condition for economic progress and some modest progress appears to have been made. We are following these developments rather closely. Some of the state banks look interesting.

Realised and unrealised mistakes

In China, by contrast, we have further reduced our exposure. We exited both **Tsingtao** (China: Consumer Discretionary) – after expressing our misgivings in our last note – as well as **Want Want** (China: Consumer Staples) in the last six months. We lost money on both, so they can be very readily classified as mistakes.

With mistakes, there are two main types: the realised and the unrealised. With the unrealised, you can always argue that it is too soon to tell, but we all know that far more money has been lost by not selling your losers than by selling your winners too early. We constantly question our holdings, with such interrogations being one of the more obvious benefits of our generalist approach to company coverage.

In the case of these two companies, we have now (and arguably a little late) taken the view that things may well get worse before there is any improvement. The most obvious mistake, in hindsight, is that we paid far too high a multiple at the point of purchase. It was clearly too high in an absolute sense, but became thoroughly unsustainable as growth rates collapsed for both businesses. We have made the point before about how growth will usually get you out of trouble and that is why 'value-investing' is so difficult. As somebody once remarked, if there isn't any growth, there usually isn't any value.

The growth point is worth reiterating, all over again, in a world where it is so elusive. Surprisingly, beer sales are still declining at a 6-7% rate in China, even into the current year, while around a quarter of Tsingtao's earnings are derived from government grants. The longer-term argument is for higher prices and margins, but with falling earnings currently, the 21x PER-multiple still looks rather demanding to us. For Want Want, despite the obvious power of the brand, we struggle increasingly with the distribution-driven nature of the company and the still very high profitability.

Brand management and more Western-style FMCG-type disciplines, as well as an attitude of spending money (research and development; advertising and promotions) to make money, are now arguably required to take the company through to the next phase of growth. Indeed, it is not just about Want Want. As China 'shrinks' with new transport-links, better logistics and the power of social media increases, all companies will need to twist their business models. It was just the same for American companies in the 1970's.

We continue to like **Uni-President** (Taiwan: Consumer Staples) for just these reasons. They may not succeed, but at least they seem to understand the issues and appear to be trying to change the way they do business. By contrast, we continue to hold on to **China Mengniu** (China: Consumer Staples), which has already been sharply de-rated and have added significantly to **Sun Art Retail** (China: Consumer Staples).

China is still struggling

Our enthusiasm for adding more to China Mengniu has been curbed, on the back of seeing that their balance sheet now includes US$1 billion of wealth management products. But for this, we would have added. We know Sun Art faces multiple challenges, not least from e-commerce, but in the longer-term we believe there is probably a place for at least one national supermarket chain. Today Sun Art's forward PER is 17x and the market-capitalisation is US$6.5 billion. Despite all its many travails, the UK's Tesco (one of four/five large grocery retail companies) still has a market capitalisation of US$19 billion.

We have added to Hong Kong-headquartered **Jardine Matheson** (Singapore: Industrials). We wrote at length about the company in our last note. We continue to be enthusiastic, though everybody now seems surprised that the company is struggling to grow. Where is the surprise, we wonder. Our confidence stems from the diversity of their businesses, as well as their track record in allocating capital. We have bought **Jardine Strategic** (Singapore: Industrials) for the First State Asia Innovation Fund, though the shares are relatively illiquid and only suitable for an all-cap fund.

We also discussed **Jardine Cycle & Carriage** (Singapore: Consumer Discretionary) in our last note and bought the

company across a range of our funds. Jardine (via Jardine Strategic) have added marginally to their stake, which now stands at 75%. The bulk of the business consists of Astra in Indonesia, but that company has already been sharply de-rated. We believe that with Astra's range of activities, (from autos and heavy equipment to property and banking), the company will continue to prosper on any sensible longer-term view.

Jardine Cycle & Carriage trades at a relatively attractive 15x PER, a discount to our sum-of-parts valuation and increasingly has a number of attractive businesses in Vietnam and Southeast Asia. It seems clear that the group is positioning the company as the main vehicle for further expansion into Southeast Asia, with the relatively recent purchases of a 25% stake in Siam City Cement, as well as further expansion in Vietnam. This seems very exciting to us.

We have added further to **Dairy Farm** (Singapore: Consumer Staples), with the CEO recently buying shares in a personal capacity (US$1 million-worth), for the first time. Dairy Farm's results continue to be relatively poor, with supermarkets in Singapore and Malaysia in particular both still relatively weak. The shares have bounced somewhat, though remain well below the levels of a couple of years ago. One of the jewels of Dairy Farm is their 50% shareholding in Maxim's catering group (circa 20% of profits), run by the Wu family. Management has already passed to the third generation, Michael Wu, who was appointed to Jardine's main board in 2014.

Adding to quality

We remain enthusiastic shareholders of **Hong Kong China Gas (HKCG)** (China: Utilities), though the profits growth is currently pretty negligible. The problem is industrial growth in China, given the relatively high prices for gas compared to the much lower oil price. The gas purchase price, which is effectively set by the PRC-state, was cut recently and apparently volume has begun to recover. The shares are clearly quite expensive at 22x PER for not much growth.

However, pollution is firmly a political issue in China and the required switch to cleaner energy (including gas) means that the policy-framework should remain favourable. More recently we acquired **Towngas China** (Utilities), (61% owned by HKCG), for the First State Asia Innovation Fund. The parent has increased its stake and the forward PER is now only 8x, while the price-to-book ratio (PBR) has declined to 0.8x. Even removing profits from one-off connection fees, the PER of 15-16x seems attractive in our view.

We have not added further to **Li & Fung**, but the valuation seems rather compelling in our view. The forward PER is supposedly 13x, while cash-flow has been improving and the dividend yield is 6-7%. Things are very tough in US retail, (witness the profit warnings from all and sundry), but we trust the family to do the right things. They appear to have woken up somewhat of late, now seem to be getting real on cost-cutting and recently sold an Asian healthcare products distribution business for US$350 million.

The disposal reduces their debt by a third and was made at an attractive valuation. Li & Fung's share price declined on the news, as analysts took the opportunity to reduce their estimates. This is nonsense, with the disposal unequivocally positive news. You could well argue that our investment in Li & Fung has been a mistake. In hindsight, we certainly made the position too big, too soon. We would still argue that it is too soon to say, but the balance sheet and the family (who have been buying shares too) give us comfort. We do not lose much sleep over the holding.

In fact, given the lack of inflation in the West and rising costs in the East, you could argue that they are doing quite well to stand relatively still. We would not be surprised to see inflation return to the system (and there are clear signs in the US), at the same time as declining cost pressures in the PRC. We are inclined to add, but acknowledge that the business is very clearly not what it was.

The internet, a flatter world, just-in-time sourcing and the long tail of fragmented demand are some clear structural changes for the sourcing sector. All of that means that we could well be wrong about Li & Fung, but we do not think, as somebody told us the other day, that the business is broken. When people say things like that, (it's different this time), it usually isn't.

In Taiwan, we have added to our favourite US dollar exporters, which include **Giant Manufacturing** (Consumer Discretionary), **Delta Electronics** (Information Technology) and **Asustek** (Information Technology). All three are struggling for growth, with estimates probably still yet to reflect the degree of slowdown. Delta and Asustek are both adjusting to a post-PC world, while Giant is being impacted by the lack of growth in China. As we discussed last time, all three are family-backed businesses, in which we retain a very high degree of confidence.

Some new holdings

Somewhat more controversially we bought **Mediatek** (Taiwan: Information Technology), a mobile phone chip manufacturer, (think Qualcomm). This is a new position across a number of our funds. The shares have collapsed, which happens periodically with the company. They are, even if a fast-follower, truly astride the bleeding-edge of technology. When transition-shifts take place, the company often struggles. It was so, when mobile phone technology moved from 2G to 3G (feature to smart-phones) and today they are moving firmly to 4G. We have always liked the company, given their track record and management capability.

But, in up-cycles the company is always very richly priced, the more so given that they are always but one cycle away from the next product shift. Accordingly, we have not owned the company for quite some time. And yet, every time we meet them we conclude that in the next cycle downturn, we will get our chance. Well, here is the next downturn, but of course it is different this time (and it may well really be). At the top-end, Qualcomm have cut prices and new competitors in China (Spreadtrum) at the bottom-end of the market mean that of course it is harder than ever.

Top 10 holdings

First State Asia Innovation Fund (All-Cap)

	Fund Weight (%)	Index Weight* (%)
Newcrest Mining	7.5	0.0
Infosys	6.0	1.1
Haw Par Corp	5.2	0.0
HDFC Bank	4.6	0.0
Taiwan Semiconductor (TSMC)	4.6	3.8
Tata Consultancy	4.3	0.6
CK Hutchison Holdings	4.2	1.1
CSL	4.2	0.0
Dr Reddy's Laboratories	4.0	0.2
Hong Kong & China Gas	3.5	0.4

First State Asian Growth Fund (Leaders)

	Fund Weight (%)	Index Weight* (%)
Newcrest Mining	5.6	0.0
Infosys	5.1	1.1
Taiwan Semiconductor (TSMC)	4.9	3.8
CK Hutchison Holdings	4.2	1.1
Singapore Telecom	4.1	0.7
Tata Consultancy	4.1	0.6
Dr Reddy's Laboratories	3.7	0.2
Hong Kong & China Gas	3.2	0.4
Li & Fung	3.0	0.1
OCBC	3.0	0.7

Source: First State Investments as at 30 April 2016. *Index: MSCI AC Asia ex-Japan Index.

Mediatek's recent results were weak, (decent sales, weak margins), but net cash of US$3.5 billion (35% of the market-capitalisation) and a PBR of 1.3x give some comfort. For what it's worth, (not much), the forward PER is 13x. We are betting, once again, that the very talented and aligned people that lead and work for Mediatek will find a way. Only time will tell. Again, it is not a company that keeps us up at night. Our fund holding is currently around 2% only.

Some disposals

Other portfolio changes included finally exiting from **Axiata Group** (Telecom Services) in Malaysia, on weak growth, a reinvigorated competitor (in Maxis) and worse, some equivocation from the Malaysian government around payments for spectrum. We were already worried about the lack of growth, given a relatively high PER-multiple; continual buying from government funds meant we were able to sell at a good price. In Korea, we trimmed **LG Chemical** (Materials), but continue to like the company. More substantially, we sold **Samsung Fire & Marine** (Financials) and **Shinhan Financial** (Financials). Generally, we have been reducing financials.

Shinhan Financial is, without a doubt, the best bank in Korea. The problem is that, even more so than for most businesses in Korea, the banks, telecom and power companies do not primarily exist to make returns for shareholders. National interest and the industrial competitiveness (of the export-sector) seem more likely to be the main yardsticks for advancement. Shinhan is very attractively valued (8x PER, 0.6x PBR, 7% return-on-equity) and well-managed, but given everything we know we have concluded that it is more likely to remain a value-trap than anything else. We realised a loss on the sale, so clearly this was another mistake.

Samsung Fire & Marine (SF&M) is more difficult, as it used to be a large holding and we owned a significant shareholding in the group. It is comparatively attractively valued too, trading at around embedded value currently. The problem comes with the lack of alignment, as well as recent corporate behaviour, which is clear from a reading of the latest annual report.

It is an old story, but suffice to say that the 4.8% purchase of Samsung C&T (SC&T) from Samsung Life (in return for SF&M treasury shares) was clearly not executed in the interests of minority shareholders. Rather, it appears to have been designed to facilitate the merger of Cheil Industries with C&T. SF&M subsequently booked losses on the SC&T stake. We are always keen for companies to cancel treasury shares and SF&M continue to buy back shares, which are not being cancelled. It seems likely that there will be more transactions, as the founding Lee family rearrange their affairs. We took advantage of share price strength to exit completely.

Newcrest and gold

As we noted earlier, no meeting or communication from us would be complete without some discussion of **Newcrest** (Australia: Materials). The short conclusion is that Newcrest, today, is far more the company that we thought and hoped it was when we first bought it. Of course, the gold price is another matter.

We made many mistakes in our original analysis of the group, with the position simply remaining too large at the same time that gold speculation reached a fever pitch (gold reality-TV shows and people trading in their jewellery for cash). Newcrest has the rare distinction of having gone from being the biggest positive contributor to overall fund performance, only to subsequently then become the biggest detractor. Otherwise known as a round-trip.

Today, things seem rather different to us and the company has again recently been a big positive contributor. Gold is back to being something of a fringe taste (seen as something largely for the crazies), irrespective of recent performance. With zero interest rates (and even negative rates on deposits) the opportunity cost of owning gold has clearly declined.

In a previous note, we made the observation that thinking top-down, but always investing on a bottom-up basis, is often a good way to think about portfolio positioning. Following from our above thoughts, with little growth and a world drowning in debt, it is not surprising that we are, from a risk point of view, thinking about the reciprocal of equities. It used to be bonds, it used to be currencies and it used to be cash.

But, in a world denuded of returns and where we appear to be running increasing risks, gold has obvious attractions. It has been an alternate currency throughout history and has intrinsic value, especially when people lose confidence in the system. Without being a 'flat-earther' or hoarding guns and baked beans, we can see plenty of reasons why general levels of confidence may suffer in the coming period. It is unlikely to be permanent, but a bit of insurance against such a reversal seems pragmatic, given everything that we see and hear when we talk to companies.

As for Newcrest, the company, here is the good news. The CEO is executing as expected and the business is much improved. The Lihir mine is being fixed and they are generating a lot of cash-flow, repaying debt and will surely return to paying a dividend in the not-too-distant future. Today, they have thirty-years of reserves and the lowest all-in-sustaining cost in the sector. In a general sector reversal, not that this would help much, Newcrest should be the last gold miner standing.

With gold, we doubt the answer is ever really in the numbers. But, as a sanity check, it is worth noting that the net present value (NPV) of future cash-flows at today's gold price gives you a current value of maybe A$14/share (at a 5% discount rate). Today the company trades at circa A$20/share, suggesting a premium of 40%. Of course, it all depends where you think the gold price is going.

Given our top-down concerns, the gold price could possibly go up, which means Newcrest should continue to prosper. The trick, this time around, will be to ensure that it is not a 10% position at the peak of the market. In our view that is nothing but art, irrespective of the NPV. Of course, all of us will only know when to sell in hindsight. The hindsight fund remains the biggest missed opportunity for our marketing department; and, it will always be so.

Outlook and conclusion

We have observed before that just as the trick in life is not to die, so the trick in investment is not to lose. To that end, investment experience teaches us over and over again that we should try not to swim with the stream. Things trend, we all know, until they don't.

That is what kills you, especially in relatively illiquid and serially-correlated emerging markets. Given some of the concerns that we have highlighted above, as well as the difficulty of finding growth irrespective almost of valuations, we believe it is again a time to be relatively careful.

Not dying, or protecting capital amidst periodic blow-ups, is how we slowly but surely move ahead. We know how lucky we are to be investing in such a dynamic and interesting part of the world, but cycles make economies stronger. We have not had one for far too long now. It is true enough for the world, too.

Luca Brasi

We remain firmly focussed on not losing, rather than winning. We believe it is time to focus more than ever on the downside risks. Last time, we concluded that worrying works, as 90% of the things that we worry about never happen. We are worried now that those odds are slipping and not in our favour. None of us wants to end our days like The Godfather's Luca Brasi, that is, swimming with the fishes.

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