First State
Stewart
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First State Stewart Asia
Asia Pacific Equities
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FIRST STATE STEWART ASIA – ASIA PACIFIC EQUITIES

"To infinity...and beyond!"
Buzz Lightyear,
Toy Story

Although financial types everywhere seem to believe that things are absolutely dire, world-ending and the sky is about to fall on our heads, most of humanity have better lives now than in all of history. That is certainly so in the developed world. Prosperity, in our time, has yet again been underwritten by those clever technocrats at the world's central banks.

Markets and assets everywhere are broadly elevated. All is well. So, why the angst? Why all the talk about Japanification, zombies and unicorns?[1] Just as heresy turns into orthodoxy, is Modern Monetary Theory (MMT) the new QE?[2] To us, it looks like an even madder twist on what has generally passed for economic policy over the last decade. Academic respectability cannot be far behind.

"There are some ideas so wrong, that only a very intelligent person could believe in them."
George Orwell

George Orwell was writing about politics. But these days he would no doubt be appalled at what passes for economics. MMT looks radical, but it is just the latest iteration in a long line of dangerous ideas. Wrapped in the pseudo-science of a theory, MMT offers a pervasive subversion of much of the economics that most of us learnt at school, with regards to sound money management, inflation, independent central banks, deficits, capital flows and even markets.

At present, the Fed's liabilities can only be used to inflate financial assets via the banking system, but the proponents of MMT argue that the law should be changed so that they can be used to pay US government expenditure directly. Onwards and ever upwards, it seems; to QE4[3]... and beyond.

How should you expect your money manager to operate in such economic conditions? After all, we are infamously allergic to macro analysis and top-down views of the world. We call investment themes 'tailwinds and headwinds'. What does MMT and its variants mean from a portfolio point of view? Does any of this make any difference to how we should and do invest?

Well, yes and no. At the very least a PER[4] of 25x has become the new 15x, as interest rates have plunged around the world. Simplistically, everybody knows that free capital broadly erodes returns; and we would argue that overall quality, as well as balance sheets, have become ever more important in our bottom-up assessment of companies.

That has been the case over the past year, when higher quality companies have generally held up well, underpinning our returns. Overall, our positioning has not changed very much, with some modest additions to technology and China companies on earlier weakness.

As recent volatility has clearly demonstrated, the contradictions and instability of a system piled high with debt means that yet another crushing loss of market confidence would not be so surprising. On balance, we remain more focused on capital preservation than reaching for growth.

Portfolio implications

"In preparing for battle, I have always found that plans are useless, but planning is indispensable."
US President and Army General Dwight D. Eisenhower

Like President Eisenhower's reflections on war but rather more trivially, our discussions about macro often seem wholly irrelevant. But, then again, such views can sometimes provide a helpful framework for understanding individual company valuations. Comprehension of the big picture can greatly aid implementation and execution. Investing often involves a synthesis of thinking top-down, but at the same time investing bottom-up on a company-by-company basis.

Today, it seems easy to argue that the world has changed irrevocably and that we are heading for cataclysmic times. Economically, if we do not eventually end up with inflation, it seems that the negative consequences of deflation (no growth and falling returns) might be just as deleterious to returns. On the other hand, often the real and more pressing danger is being paralysed into inaction and thereby missing out on opportunities.

Most of the time, the markets roll on unperturbed. If you read any of the economic histories, say of Britain or much of the world in the 1970s, the environment was much

1 See appendix

2 Quantitative easing

3 Yet another round of quantitative easing

4 Price-to-Earnings Ratio

worse; and yet investing fortunes were made. There is no morality in money. Markets are just efficient discounting mechanisms of future returns. We can deplore all we like, but market conditions are something to be taken advantage of, rather than obsessed about.

> "If something cannot go on forever,
> it will stop."
> Herbert Stein

With much of the developed world now seemingly in a thorough mess – with lack of growth, lack of self-belief and rolling political and economic crises – global capital has, unsurprisingly, projected its dreams onto Emerging Markets (EM). Increasingly, everybody seems all-in on China in particular, with special thanks to MSCI. China's growth will continue and the country will rightfully become the world's second superpower, so the story goes.

That may be true, but even if it marks just another surge in foreigners' enthusiasm for somewhere far away and ill-understood, it suggests an ongoing flow of funds to this part of the world. Moreover, the case for EM is persuasive and easy to understand, given the prospects for longer-term growth and plenty of tailwinds. It does not seem overly fanciful to expect the region to move closer toward global norms, in terms of consumption and wealth, over the next decade. Indeed, we believe that to be so, which is why we expect our absolute returns to remain attractive.

De-coupling?

And yet, we have never believed in the idea of economic or market de-coupling. As goes America, so goes the world. In particular, the impact of US dollar-rates and liquidity has always been amplified in EM. Hence, the conflicted position of a bottom-up Asia fund manager. Today, the very idea that the world will mean-revert and that rates and profit margins will ever normalise seems rather fanciful.

Most analysis, as we all know, consists of trend extrapolation. Our mental framework is usually bound by what has happened recently and many will admit that inflection points are only obvious in hindsight. Yet, just a short six months ago, everything was collapsing. Markets have swiftly recovered, but economic indicators and corporate earnings have continued to be quite weak. Market valuations are predicated on a sharp bounce in both. We now have to wait for the follow-through, with conditions otherwise likely to deteriorate again.

In the meantime, investors feel broadly assured that any market sell-off will be quickly recouped through intervention, given the recent market-driven Fed-panic and policy-reversal. As usual, the stakes get ever higher. Growing political influence argues for further policy-easing, too. Echoing Maya Angelou, we are "*hoping for the best, prepared for the worst, and* (should be) *unsurprised by anything in between*."

Portfolio activity

Our last note, published in late 2018, highlighted that there had been more activity than usual in our Asian portfolios, in a greater effort to focus on absolute quality, above all else. We exited a number of weaker franchises and in hindsight this appears to have been sensible, generally helping to underpin absolute and relative returns.

Over the last six months, as you would expect, these efforts have continued; more so in our All-cap than Leaders portfolios. The swings in markets have, however, been extreme as well as rapid. We have moved from bear to bull market conditions in China in just a quarter, which is quite something, even by EM standards.

Having earlier trimmed a number of our holdings in China, such as Midea, China Mengniu Dairy and Shanghai International Airport (SIA), at elevated levels, we subsequently saw them plunge and then just as quickly rebound to almost regain their previous highs. The MSCI China-rebalancing noise has helped. That is fine, as more broadly (though mostly at the margin), we used this same volatility to add a number of new positions.

Attractive valuations?

The sell-off meant that a number of companies became more attractively valued (though they have since rebounded). These are companies that we have followed for a long time, but in many cases they were previously richly-priced, on what we felt were elevated profit margins. We initiated new, but relatively small, positions in Largan Precision, ASM Pacific Technology, AAC Technologies Holdings, Uni-President China and CK Asset Holdings.

In India, we added a small position in Godrej Consumer Products, as it has struggled with growth and a very high earnings multiple, while in Japan we bought back into Ryohin Keikaku (Muji) and initiated a new positon in Daikin Industries. For both Muji and Daikin, China is the biggest driver of overall growth. On the other hand, we sharply reduced our holding in Nippon Paint which, with 50% of profits from outside Japan, is the PRC's[5] largest paint company.

At the same time, we trimmed a number of our more defensive holdings, such as Hong Kong & China Gas, Jardine Matheson, HDFC Corporation, HDFC Bank and Newcrest. We completely disposed of China's Sun Art Retail and subsequently, Shanghai International Airport. In Korea, we exited from Hanon Systems and LG Household & Health Care, while in Australia we sold Ramsay Healthcare.

In India, after further consideration and post the long discussion in our last note on mistakes, we finally sold Vodafone Idea. Though the position was not substantial, the loss is permanent, which is

5 People's Republic of China

unfortunate. It has subsequently plunged, with the company announcing a highly-dilutive rights issue.

As for our All-cap portfolios, we sold out of John Keells and Hatton Bank in Sri Lanka, Cemex in the Philippines and Greatview Aseptic Packaging, as well as Wuxi Little Swan in China. Only Wuxi Little Swan has done well subsequently, with a takeover offer from their parent, Midea. In India we sold Mphasis, a mid-tier IT services company, as well as HDFC Life Insurance on valuation grounds.

What we bought

A common theme behind three of the new names (Largan Precision, ASM Pacific and AAC Technologies), is technology and in particular smartphones. We have always struggled with such companies and in view of the share price volatility of the last six months that is perhaps understandable. They are manufacturers, but with the general enthusiasm for smartphones, growth and Apple-plays in particular, all three were rated like genuine technology companies.

Today, everybody knows everything that is wrong with the smartphone sector, from saturation to lack of innovation. But, the companies now trade on much more appropriate valuations for cutting-edge manufacturing businesses. We assume that the smartphone cycle will again turn upwards, one day. After all, it will probably not be too long before everybody gets excited about 5G. Such enthusiasm will surely drive a big product upgrade cycle. We like another of our larger holdings, Mediatek, for similar reasons.

All three companies have good balance sheets, pay decent dividends and have strong track records. AAC Technologies is perhaps the most concentrated, or risky, with the business almost entirely focused on acoustics and haptics for smartphones (although, at least it is for both Apple and Android). The share price declined by 75% to its trough, but we expect it to remain profitable and the PER is now probably circa 16x FY19 earnings, on a much reduced profit forecast.

Largan Precision, listed in Taiwan, is more opaque than AAC and quite secretive about its prospects. They operate at the top end of lens manufacturing. We all know that Apple (50% of Largan's sales, previously) makes a fetish out of secrecy, but as ASM commented to us in the past, they can only see a quarter out and that is based on forward orders from clients. It is hard to regard companies, with such characteristics, as ever being large or top holdings.

5G & smartphones to the rescue?

For Largan, the outlook seems as hazy as for AAC, but the longer-term tailwinds are perhaps more powerful and easier to understand. There is the 5G upgrade-cycle to come, but camera quality (dual, triple lenses and so on) is already a smartphone-model differentiator. In addition, vision (and the need for lenses), seems likely to be at the centre of all sorts of future long-term trends. Machine vision is increasingly the primary interface between us and the world of data, from robotics, to surveillance and autonomous driving. Largan is one of the industry leaders; however, its share price has already rebounded very strongly (+50% year-to-date), with the forward PER (21x FY19) admittedly now a lot less enticing.

ASM Pacific is the only company of the three businesses run by professional managers, as opposed to entrepreneurs and owners, which is both good and bad. It is the most institutionalised too, as well as more broadly diversified by customer (though it is probably the same cycle). It would be too much to call ASM the TSMC of semiconductor packaging machine manufacturing, as there are a number of competitors, but the company offers diversified exposure to a large number of industries. They are a leading surface-mount technology (SMT) machine maker too (the machines which attach components to circuit boards at high speed).

Like the other two companies, ASM's economics have more recently been dominated by the smartphone, which probably accounted for up to 40% of sales. Their stock price has similarly fallen sharply and the forward PER is now supposedly 17x. As we all turn increasingly to data and chip-content intensifies, these companies should perform well, while areas like industrial applications and the automotive industry provide new avenues for growth.

In a completely different sector, but using the same playbook, we initiated a position in Universal Robina Corporation (URC) in the Philippines. We have known the company for many years; it is the biggest food and beverages business in the country. Looking back, we had struggled with their governance around the 1997 Asian Crisis, but then failed to appreciate the changes underway. Over the last decade, the company's revenues and profits have tripled and the share price has surged. We watched, but did not bite.

With success came increased challenges and greater competition. Troubles in some of their markets (Vietnam), a botched acquisition (New Zealand) and generational transition all came together. Consequently, their profits and the rating both fell sharply last year. This would ordinarily be enough to pique our interest, but the decision by the controlling family to turn the CEO position over to an outside professional motivated us to act more purposefully.

The appointment of an ex-Proctor & Gamble professional manager, with the family's backing and a high degree of autonomy to reshape the business, is very encouraging. As we've highlighted before, it is one of our favourite combinations. When professional leadership is applied to under-managed or somewhat tired, but fundamentally sound family-owned franchises, the subsequent outcome is often very positive in terms of returns.

Professionals solving old problems

Many of the issues have been experienced before, as well as previously solved, in the West by multinationals. We have a similar view about one of our largest holdings, Dairy Farm, as discussed in detail in our last note. Overhauling the product range, SKU's[6], supply chain, distribution, logistics, capacity and branding are all familiar issues. As the new CEO observed, the overall situation was "not unlike P&G in 1998". Though the shares have rebounded, margins have fallen by a third and you can see (though clearly it will not be easy) a route to recovery.

CK Asset Holdings is another business we know well. We have even owned it directly in the past, before Cheung Kong was split into two listed parts. We continue to hold CK Hutchison, which has become the utility-like component of the group, while our CK Asset shares were previously sold in 2015. The shares have gone nowhere in that time, but it seems that the group is being positioned as the true successor to the original Cheung Kong. The family have increased their shareholding on weakness and the business has become more diversified.

Recurrent earnings account for around half of profits, with the group optically-trading on a PER of sub-10x and a 0.6x price-to-book ratio (PBR). The dividend yield is over 3%, gearing is low and there is plenty of capacity for the group to expand with a USD45bn balance sheet. Though the property earnings will be volatile and the group recently increased exposure to HK, their long-term track record gives great comfort. It should be easier to add on any general reversal. In the meantime, we have added to CK Hutchison as well.

In China (though it is listed in Hong Kong), we bought Uni-President China (UPC). We have owned the Taiwan-listed parent, Uni-President Enterprises, for over a decade. UPC was listed in 2007; its performance has been mediocre, with the underlying PRC noodles and beverages business proving to be extremely challenging. The business accounts for less than 20% of parent profits.

Competition has been intense, with the company engaged in a battle for market share with Taiwanese-owned competitor Tingyi. This has meant years of capital-spend and promotional activity; and, consequently, thin margins, lack of cash-flow and low returns. Whisper it softly, but capital-spending has peaked, cash-flow is rising and it may just be that even competitive intensity has retreated slightly.

Both companies recently declared 100% dividend pay-outs and, while the beverages market remains brutal (subject to competition and fashion trends), we believe matters may be improving on a three-to-five year view. The industry could finally be moving from an obsession with market share to thinking about quality of profits. The group now trades on a forward PER of around 21x. We believe that medium-term growth should be mid-to-high single-digit, with a potential dividend yield of 4%. That looks fine.

India & Japan

Indian-listed Godrej Consumer is already owned broadly across some portfolios, but has lately pulled back some 30% on earnings disappointment. That said, the forward PER multiple is still circa 40x. Hence our newer position is small. They have stumbled in a number of overseas areas, such as Indonesia and Africa, but these operations now appear to be turning around. Issues with the household insecticide business in India seem to be only short-term and the management are focused, as well as motivated, on returning to growth. Like URC today, Godrej Consumer is a good example of a family-controlled company that moved to professional management a number of years ago.

As we mentioned earlier, Daikin's economics are dominated by China (about 40% of profits), as well as the property and investment cycles. Given our general concerns over debt and very high investment spending, it is perhaps not an obvious holding. The attraction lies in their very strong and long track record, their global positioning and their efforts to localise in countries such as China and India.

The heads of both the China and India businesses are on the main board (novel for Japan), while the group trades on a prospective PER of 20x. Our holding remains relatively small because the business is clearly cyclical, as their past profits track record makes amply clear. We are not very good at owning cyclicals. It is always difficult to know when to add on economically-driven weakness (or indeed when to sell). Daikin's quality should make it relatively easier than for most.

For our All-cap portfolios, the sum of all our activity in the last twelve months has been to sharply-reduce the number of holdings, particularly at the smaller-cap end of the spectrum. These actions have been positive, with such companies suffering in general, but in particular those in the Philippines, Sri Lanka, Pakistan and Vietnam doing worse. Liquidity has been an important factor, as all the interest has pivoted to North Asia.

We bought two All-cap companies, both of them in Indonesia. Astra Otoparts is controlled by Astra International, which we already own indirectly through Singapore-listed Jardine Cycle & Carriage, while the other is air-filter manufacturer Selamat Sempurna. Astra Otoparts, though illiquid, looks inappropriately priced. It is the leading auto parts and service company in Indonesia (Astra has 50%+ market share), but the market capitalisation is just USD550m, while the group trades at 11x PER and on a PBR of 0.7x.

Selamat Sempurna is more expensive, but trades at a similarly-

6 Stock Keeping Unit – or an individual item for sale

attractive FY19 PER of 13x profits. Its market capitalisation is not much bigger at USD600m, but they have a strong balance sheet and a good long-term track record. They have strong links with Donaldson of the US and expect to be a beneficiary of any trade wars, though they are always long US dollars, being primarily an export business.

What we sold

In our last note, we highlighted our concerns around Shanghai International Airport's substantial capital expenditure program, and that we had already begun to trim our weighting on the sharp rebound in the share price. The share-price chart has since resembled something of a roller-coaster, thereafter selling off, before rebounding again.

It has now almost recovered back to when we initially made those remarks. Midea Group, the white goods and air-conditioning manufacturer, has followed the same pattern – as has China in general. SIA looks quite fully priced at 23x FY19 PER, given our concerns around earnings, while Midea trades on a forward PER of just 15x profits. We sold out of SIA entirely and we trimmed our Midea holding.

We noted then that we would be more inclined to add on further weakness. However, the company has since rebounded on general A-share enthusiasm, despite concerns around the sustainability of capital-spending and inventory oversupply across the home appliances industry.

We finally exited Sun Art Retail, with the major Taiwanese shareholder selling their stake to Alibaba. As Amazon has acquired Wholefood Markets, so Alibaba is experimenting with next-generation retail. The French shareholder, privately-owned Auchan, are still owners; but we would not be at all surprised if profit is no longer the main focus for the group. The shares have fallen sharply since, with the group now trading on a prospective PER multiple of 22x.

Korea is always difficult

We have struggled to generate strong, sustainable returns in Korea. Governance and indeed even regulation remain rather mixed, to put it politely, while the country as a whole is already rich. Growth is quite limited. Institutional reform, which looks rather necessary, has historically always been choked off by the cosy nexus between the Chaebols and the ruling party. This doesn't look like it is going to change anytime soon.

Over the last six months, we sold out of Hanon after a surprisingly-positive experience, the more so given the company's 50% exposure to Hyundai in particular and the auto sector in general. The group is the biggest manufacturer of HVAC (Heating, Ventilation & Air-Conditioning) systems for cars, with the move to electric vehicles providing a strong tailwind. The group provides a good example of the power of alignment, with the company controlled by Korea's largest private equity company, Hahn & Co.

They are highly motivated to increase returns, as we are all co-invested in the same equity vehicle, with leakages often a structural problem in Korea. Besides the challenges facing the automotive sector, the group subsequently acquired a related American controls business (from US-listed Magna International) for USD1.2bn. With the purchase funded by debt, balance sheet gearing has increased to 95%. While Magna trades on a forward PER of 8x, Hanon trades on an FY19 PER of 19x. It has held up surprisingly well.

We detailed our issues with Korea's Hanssem in our last note, with the weak housing market and expansion into Shanghai de-railing profits. We added to our shareholding, with our confidence somewhat bolstered by their net cash balance sheet and the 25% shareholding of the family. Additionally, 25% of the company's shares are held as bought-back (but not cancelled) treasury shares. However, the opacity of Korea is such that it is hard to add meaningfully when things go against you. That was the case with Hanssem and calls into question our original quality assessment.

Opacity and weak regulation

Since we last wrote about the company, the share price has more than doubled, which of course fills us with relief, but is more of a matter of luck than judgement. The underlying business appears to have stopped deteriorating and Shanghai's losses have slowed, but the rebound seems to hinge on Korean corporate machinations. There are all sorts of speculation that the family are now sellers.

When we initially bought the company, there were suggestions that they would cancel their treasury shares. Now it turns out that they might, with observers pointing out that a buyer would be able to take control of Korea's largest interior design, decoration and furnishing company for less than USD400m. It is very much an insiders' market. We have been reducing our stake on strength.

Lastly, in Australia we reduced and then completely exited our holding in Ramsay Healthcare. Ramsay is the biggest private hospital chain in Australia, but they have been very acquisitive in the last few years, expanding into the UK, France and latterly Scandinavia. Leverage of 130% always concerns us, while the surprise exit (at least, to us) of its well-regarded CEO Chris Rex in mid-2017 was disconcerting too.

Since then, the industry headwinds appear to have grown stronger, with a softening of demand as privately-insured customers trade down (premiums-wise). Insurance companies and governments everywhere have become much tougher as well. The business now trades on a forward PER of 22x profits and we sold our holding completely on the back of a recent share-price bounce. Subsequently, reductions in the personal holdings of both the CEO and CFO caught our attention.

Portfolio positioning

Our overall portfolio positioning has remained fairly constant, despite the stock additions (eight) and deletions (six). India remains the biggest weighting, despite the macro noise around the current general election. The bulk of our holdings still consist of the IT services businesses (TCS, Tech Mahindra and US-listed Cognizant), alongside the private banks (HDFC, Kotak Mahindra and Axis).

It is interesting to reflect for a moment on the differences between India and China. Where China attracts plaudits for its top-down economic management, it is not unfair to say that the opposite is true of India. Typically, you don't buy India for its government; you buy it for its corporate governance.

The opposite, ironically, seems true in China. For bottom-up investors like ourselves, it is perhaps therefore not entirely surprising that we own more companies and typically have bigger weightings in India compared to China. We recently tried to put some number around these assertions.

If you screen both countries' main stock universes for companies of over USD100m market capitalisation, with 10% return on capital employed (ROCE) and average earnings per share (EPS) growth greater than 10% (both over five years), there are twice as many qualifiers in India as China (723 in India compared with 285 in China). As a percentage of the listed universe, though, the countries are much closer at 12% in India versus 9% in China, with 5,820 listed India corporates compared with 3,052 in China[7].

You could easily argue that this comparison is unfair to China, as it excludes the offshore markets where returns are generally higher and there is at least another 1,000+ companies (including all of Hong Kong's H-shares). But are Hong Kong & China Gas, or say Vitasoy, Chinese companies? Increasingly, we would argue that they are and is another reason why we have never felt compelled to follow indexes.

Indian versus Chinese capitalism

The Bombay Stock Exchange, founded in 1875, is the oldest in Asia. China's stock markets (Shanghai and Shenzhen), only reopened thirty years ago in 1990. Capitalism – the idea of a separation of powers between ownership and management, as well as the rights of outside minority shareholders – has been established and subsequently developed for over 150 years in India.

By contrast, in China such ideas are understandably more nascent. It is not at all surprising that as bottom-up investors, we find it is still easier to find opportunities in India. That said, as China continues to develop, the potential for growth and positive change is clear. The challenge, in our view, remains on governance. In particular, as was made clear towards the end of last year, the level of debt and especially the pledging of shares by many A-share companies' owners, is a material hurdle.

In terms of existing holdings, there has been more trimming and adding than usual, as general market volatility has provided opportunity. In particular, we have continued to add to US-listed IT services company Cognizant, which has a new CEO and now trades on a forward PER of 17x. The stock has rebounded since the beginning of the year, but still looks attractively-valued.

The relatively new CEO of AIA gives us great comfort too, with his focus on operations and people. AIA is another case in point, with China now driving 50% of group economics. And yet, the company (being the only 100% foreign-owned insurer in China) is only addressing a quarter of the PRC's GDP, via licenses to operate in three provinces. Another two areas have been added recently and further liberalisation to 2021 is expected. AIA trades at embedded value, plus a multiple of 12x one-year new business. This still seems quite reasonable, given the quality.

Additions to existing holdings

We have added to Techtronic Industries, OCBC, Dairy Farm, TSMC and, latterly, President Chain Stores; and discussed these companies in our last note. As for trims, most were made on valuation grounds, with Comfort-Delgro, Newcrest and Nippon Paint perhaps the most significant, as well as worthy of further discussion. Comfort-Delgro has rebounded strongly, but the core taxi business has been permanently impacted by ride-hailing apps.

The company's response has been to expand more aggressively outside Singapore (already half of earnings), with a significant step-up in mergers and acquisitions (M&A) in the UK and Australia. This seems sensible, but increases the risk profile and erodes free cash-flow (FCF), with the original FCF yield of 8% being what caught our attention in the first place. Perhaps less easy to understand is the company's decision to establish a fund of USD150m for investment into technology ventures. The shares have re-rated from 13x to 18x forward PER. We have trimmed our holding.

Nippon Paint has, unsurprisingly, experienced very tough trading in China and yet the share price has rebounded. It now trades on an FY19 PER of 34x. This seems rather excessive, with our previous valuation being based on a PER of 25x. We have sharply reduced our holding. The CEO described recent trading conditions as the worst in his memory. Japanese M&A, as well as the injection of the other half of the Asian business (and all of Indonesia), may give us another chance.

Gold?

Finally, to Newcrest, which has been one of our top long-term holdings. The company has continued to execute extremely well, with record production, cash-flow and profits. From risk of a

7 Source: Kotak Mahindra, as at end 2017. We believe these figures would not have changed materially.

rights issue four years ago, the current CEO Sandeep Biswas has transformed the balance sheet, with a cash inflow of USD2.5bn and gearing reduced to 13%. The company has delivered against promise and after its recovery is now articulating a growth plan.

With the recent acquisition of a Canadian copper/gold mine for USD807m, as well as plans for existing assets, the group have articulated a transformation path: from owning two tier-one assets to being in a position to control and operate five on a three-to-five year view. They are already there. This will require significant capital expenditure and inevitably much higher operational risk.

We were recently taken to task by a client for indirectly expressing a macro-view through our Newcrest investment. The criticism is broadly fair. Our push-back would be that we have invested in the CEO, but naturally the fortunes of the company depend on the gold price.

With gold attracting much opprobrium until fairly recently, we considered the pricing risks to be more on the upside. That is arguably less true today, though without much prospect of interest rate increases, a dividend-paying gold mine run by sensible people still looks like a pretty decent investment. Nevertheless, we have reduced the position, with the future size of the holding being dependent on the ready availability of better bottom-up alternatives.

Mistakes

As highlighted earlier, we capitulated on Vodafone Idea and a good thing too. Thankfully, there have been no similar examples of such rapid capital loss in the last six months, but in hindsight we sold Korea's LG Household & Health Care (LGH&H) too soon. Our preference for Amore Pacific has yet to be proven, to say the least. Otherwise, having sold Ryohin Keikaku at highs, buying it back (though at much lower levels) looks increasingly questionable.

Our sale of Giant Manufacturing, the maker of racing-bikes, also looks like a possible mistake with the share price rebounding substantially over the last few months. We had concluded that free capital and shared bikes would permanently overturn the industry's economics. That may be true, but the credit contraction in China very quickly saw a number of these start-up companies go under, with Giant's sales now starting to recover. Electric bikes in Europe were more apparent on my last trip there too, which offers another growth avenue for the company.

In the past we have owned a lot of LGH&H and Amore, with both companies at one stage together constituting more than 5% of the portfolio. We trimmed them aggressively on escalating valuations. The entire sector was subsequently sharply de-rated on the geopolitical fall-out between China and Korea, with the PRC preventing packaged tours from visiting its neighbour.

Korean cosmetics

Duty-free sales collapsed and the two stocks declined. LGH&H is something of a conglomerate, consisting of beverages and household products businesses too. We had always thought that Amore was a higher-quality-focused business, with an emphasis on longer-term brand value seeing the group periodically limiting sales. Amore's Sulwhasoo is one of the strongest cosmetics brands in Asia.

On the other hand LGH&H owns the History of Whoo cosmetics brand, which is said to be a favourite of the wife of China's President Xi. Surely that has helped and LGH&H has continued to do well (FY19 PER of 29x), while Amore has lagged. We have added to Amore in the meantime, with margins now at half their historic level and the valuation rather depressed, recently trading down to 2x sales. Even using conservative assumptions, reasonable upside seems more probable than not. The position remains relatively small.

Ryohin Keikaku has been successful in China, with the country now accounting for around 40% of profits. At 30x earnings, we exited our position, but on what we perceived to be shorter-term issues, and we added it back on a supposed-PER of 20x. In the meantime, we read the latest annual report, which undermined our view in respect of the absolute quality of the group. We have since reduced our holding.

Their financial planning and controls are not where they should be, while rapid physical expansion in China has diluted same-store-sales growth (SSSG). Retail is always difficult and there is an element of fashion, which means it can be difficult to add when things go wrong. And then there is the internet. More recently, its results have been disappointing and the shares have fallen. Our position is small, but for now our level of confidence does not give us comfort to add. That probably means it may well be regarded as a mistake in the future.

Outlook and conclusion

Ray Bradbury, the science fiction writer and author of *Fahrenheit 451*, said about his writing: "*I was not predicting the future, I was trying to prevent it.*" One hopes that in much the same way, today's harbingers of doom will succeed in highlighting just how high the stakes are if we continue to subvert old-fashioned economics. Perhaps we may even avert financial disaster.

Thankfully, we are not in the business of prophesy. We have always respected Yogi Berra's aphorism that "*It's tough to make predictions, especially about the future.*" Investing in this part of the world is still all about China, our elephantine bedfellow, in terms of its relative economic dominance. You can find data, or a pithy anecdote, to support any view about the country that you care to advance. America is much the same.

China has lately surged from zero to hero in a furious rebound, but PRC scares come along regularly. Our issue remains finding a sufficient number of companies where our confidence levels are

high enough to add, should the world turn upside-down. This downturn gave scant opportunity to add to existing holdings, being over in the blink of an eye as a substantial jolt of credit was injected just as the second derivative of the downturn was beginning to be felt.

Valuation of top 10 holdings

Just as we concluded in our last note, we remain comfortable with our portfolio positioning, almost irrespective of the market and economic cycle. Somewhat surprisingly, for our top-ten holdings (circa 40% of the portfolio), the current average PER valuation (20x FY19) is at much the same level as the ten-year average. The PBR (4.2x) is at the ten-year average. By contrast, the MSCI Asia Pacific ex-Japan index PER valuation is 13x, but that is just a 10% premium to its 10-year average PER of 12x. The current PBR for the index is 1.5x, which is at the average level.

Given that we have doubled down on quality and balance sheet, in light of our longer-term track-record, we find this valuation data highly reassuring. It is also a little positively-surprising. We are confident that our returns will be absolutely respectable, if money printing continues; but if things normalise, we expect to protect capital and our relative numbers to improve further.

> "Quality means doing it right when no one is looking."
> Henry Ford

Growth, unsurprisingly, remains at a premium. But, any shocks should provide us with good opportunities to recycle capital from our more defensive franchises to bolster overall absolute returns. The key, per Henry Ford, is to make sure that our companies can stand up to closer investigation and endure more stressful conditions. There will always be surprises, but we are very confident of the absolute quality of our portfolios.

Sizzle and story are always seductive. It can be tempting to take the advice of Buzz Lightyear's pal, Woody, and "*reach for the sky*", rolling along with the markets. That is arguably even more the case these days, given generally-stretched valuations and an apparent lack of growth. The sirens are beckoning us all. But, thirty years of history and a long track record of investing in Asia means that we are not about to surrender, or capitulate and stick our hands in the air.

In the meantime, just as Orwell was a firm believer in the wisdom of the ordinary citizen, we do not believe that many of these new-fangled macro ideas will prove to be sustainable. It may indeed be different this time, but just as Buzz Lightyear later discovered, we are probably not in another universe. It is the same old world and perhaps the same old, if rather extended, cycle.

We will instead continue to invest in growth, on a company-by-company basis, all the time worrying most about capital preservation and focusing on absolute returns. If we can still do that in a disciplined fashion, our longer-term returns – whether absolute or relative – should compound respectably. That should be true no matter what returns-universe, or indeed even which galaxy, you happen to prefer.

We are always very happy to hear investor feedback or reply to your questions. Many thanks.

Appendix

Economics & MMT

At its heart, MMT expresses contempt for the idea that money matters, arguing that it is just another thing that the modern state arbitrarily decides. In some ways, it is an inevitable consequence and the logical culmination of the very idea of fiat currencies. It is already long ago and far away that money was a claim on something tangible, first via barter for goods and services and then as an easy means of exchange via gold.

> "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist."
> John Maynard Keynes

As for fiat currencies, if a little bit of something is good, then surely more must be a whole lot better. And so, we find modern economics in love with the idea that governments can print money with no inflationary consequences, interest rates will remain low forever and debt does not matter. So far, so good. Japan is doing fine, the argument goes.

It is really an economic vision of magic realism. Governments can supposedly print as much of this stuff as they want, summoning cash from computer code at will. Central bank balance sheets swell, with government paper (bonds) on the asset side, matched by growing cash and bank reserves on the liability side, as funds are injected into the banking system. The price of money goes down and assets generally escalate in a virtuous and seemingly never-ending spiral.

It is easy to see why this may well have been warranted as an emergency response to an international liquidity and capital crisis, such as the world experienced a decade ago. But, it has become habitual and now looks like the standard global response to any economic bump in the road. Long gone are the days when actions, such as the Hong Kong Monetary Authority's direct intervention in the Hong Kong stock market in 1997, drew a deafening chorus of disapproval around the world. These days, it has almost become standard operating procedure.

Wealth transfer

But, why so serious? We seem, in all our over-clever modernity, to have finally discovered the alchemy of finance. Almost certainly though, such intervention will prove to be unsustainable, if for no other reason than the machinations of the political process. Over the last ten years, there has been a massive transfer of wealth from labour to capital and from the poor to the rich. This has fed political extremism, populism, intolerance and a growing sclerosis in public affairs; in history this has produced revolutionary conditions.

> "What has been will be again, and what has been done will be done again; there is nothing new under the sun."
> Ecclesiastes 1:9

In democracies, we know politicians will eventually respond to such high and rising levels of dissatisfaction. The rest of the world's citizens are unlikely to behave as quiescently as the Japanese. Nor is that desirable. We know too, that when such excesses reverse, the unwinding is never gradual or indeed even particularly manageable. That is what, we believe, makes today's market conditions so unpredictable, volatile and really quite dangerous for investors.

More fundamentally (and this is old-fashioned, real economics), money-printing and excessive debt build-up have always proven to be toxic for real returns. Such conditions systematically undermine the constructive beauty and utility of capitalism. The longer-term damage to the basis and credibility of capitalism – the force that has broadly driven wealth generation and human progress over the last few hundred years – is even more invidious.

Zombies

Interest rates are used to price risk; whilst creative destruction, as cycles rise and fall, is the process that keeps an economic system honest and vigorous. If you break the key pricing signal, then arguably everything ends up being mispriced. The subversion of market forces, as well as inappropriate allocation of capital, leads in time to a decline in growth and returns for everybody. Demonstratively, we find ourselves economically becalmed. Inefficient and zombie companies stay in business and returns generally fall towards the very low and falling cost of capital.

In the meantime, the predictable corporate response is not to invest, but to add even more debt through M&As and buy-backs in an effort to bolster lower returns. These M&As increase corporate concentration, decrease competition and underpin corporate profit margins at the expense of the broad populace. Buy-backs underpin and trigger stock incentive schemes. The division between capital and labour is exacerbated and political division exaggerated.

Long-established and proven business moats erode, too. A new competitor can, increasingly, borrow billions and take on any business stalwart. Hence, the mighty are fallen and we live in an age of accelerating disruption. Mal-investment thrives and today's business plan, backed by billions, is soon off to the races. Unicorns have become commonplace, soaring (or not?) on a tide of free money and hope. Whether it is sustainable or not hardly matters when debt (and refinancing) is abundant.

Some have argued, (like Y2K's over-investment in fiber-optics), that society still broadly gains. But the trouble, as any cursory reading of economic history teaches, is that when governments bypass markets or dictate the price of money and allocation of resources, we all end up impoverished. Socialism has not worked in the past, but there is a generation coming of age that feel like giving it a try. You can understand why.

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