First State Stewart Asia – Asia Pacific Equities

Client Update

November 2017

It was John Templeton who famously skewered that old bull market hubris: "It's different this time," as the four most expensive words in the history of investment.

But, it is different this time, isn't it? Well, yes and no. The combination of all-time low interest rates, massive money printing and quiescent inflation is unique. It is different and has rolled on for much longer than we expected.

On the other hand, with markets now discounting high levels of enthusiasm, there is nothing different in these valuations – they are fully comparable with previous bull-runs. The degree of stock-concentration, bifurcation in performance and the capitulation of well-proven bears is reminiscent of 2000's dotcom-bubble.

The current bull market is not that surprising, given that the world is closing in on the second-longest economic expansion in history. Then there is the China factor, with its debt-fuelled-boom contributing 55% of cumulative global GDP growth since 2008's Global Financial Crisis (GFC)-bust. China's banking system, relative to GDP, is four-times the size America's was on the eve of the GFC.

> "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria."
> – John Templeton

As John Templeton further noted, markets invariably climb a wall of worry. Every day seems to bring new risks. For now, we look through all of them. Though these beneficent conditions roll on, there will come a time when something happens and market psychology turns on its head – just like that. What, when and where? Who knows? With valuations at extremes, the risks are clear.

When *The Economist* cover recently proclaimed "The bull market in everything", they performed an important service to bears everywhere. Hubris and then nemesis, as night follows day. We remain optimistic, but ever mindful of these signs of euphoria and the growing risks to capital preservation.

In the following commentary, we aim to provide an update on some of our current stock views and will cover the following:

- Performance and an update on our regional portfolios
- Review of the last nine months – buys and sells
- Portfolio positioning
- Mistakes
- Outlook and conclusions

Performance and update on Asia Pacific portfolios

The last time we sent a note to our investors, we concluded that the market's animal-spirits had finally arrived and that we should hold on for the ride. So far, so good; but while our absolute returns remain respectable, our relative performance has deteriorated further. The reversal has been swift. Indeed, our performance has been quite lamentable of late, which is unfortunate though not altogether surprising. But, it is always a reason for regret.

Given our view that risk is more properly expressed as the permanent loss of capital rather than deviation from the benchmark, we are reassured by our absolute returns. However, we appreciate the patience of our clients in such times. It has been said that performance over time is the product of actively not seeking to perform all of the time. We would agree with that. In some ways, we regard such periods as unavoidable given the consistency of our approach. This has always been our philosophy and the essential core of our corporate DNA. What is less forgivable is a number of unforced errors, which we will discuss later.

Clients who have been with us for a long time will recognise that we have been here before, survived and – ultimately – even prospered, with performance snapping back quite quickly. Much as you would expect, the harder the decline, the bigger the recovery. Our relative performance was similarly poor in 1997, 2000 and 2008, with markets racing away from us. But, something always subsequently snapped and everybody began to again focus on the dangers rather than the opportunities.

Cumulative Performance in SGD (%)

	3 months	1 year	3 years	5 years	Since inception
First State Dividend Advantage					
Fund (Ex initial charges)^	6.8	21.3	36.4	76.0	253.8
Fund (Inc initial charges)^	1.4	15.2	29.6	67.2	236.1
MSCI AC Asia Pacific ex Japan Index	5.3	25.3	31.9	62.1	168.6
First State Asian Growth Fund					
Fund (Ex initial charges)^	7.4	13.8	22.5	46.5	1,016.7
Fund (Inc initial charges)^	2.0	8.1	16.3	39.2	960.9
MSCI AC Asia ex Japan Index*	6.4	28.0	37.8	70.2	N/A

Source: First State Investments, as at 31 October 2017.

The First State Dividend Advantage Class A (Dist) - inception date: 20 December 2004.
The First State Asian Growth Fund Class A (Acc) - inception date: 10 October 1984.

^ The performance prior to 18 October 2002 is in relation to the Fund before its conversion to a feeder fund.

* Inception - 1 November 2005: MSCI All Country Far East ex Japan Index.
From 2 November 2005: MSCI AC Asia ex Japan Index.

Most businesses have some version of a founding myth which grow in the re-telling and are often apocryphal. It has been said (and of course we believe it) that this particular Asian business, for instance, was very nearly strangled at birth. Performance was so far behind the index in the 2000 tech-boom that our then brand new owners were said to be considering their options.

Such numbers could surely only be due to incompetence? But, thankfully the tech-boom quickly turned into a tech-wreck and performance rebounded. The then Portfolio Manager not only obviously survived (and similarly, retired recently at just the perfect time), but vitally, secured our governance agreement. And, here we are today.

Of course, many believe that this time really is different, with today's technology companies making huge amounts of money and high concentration (winner takes all) in the real economy as well as in markets. Whatever turns out to be the case, we have always materially lagged in heady bull markets; our index-indifference being especially impactful lately, given the degree of absolute performance from those technology leviathans.

The Asia Pacific ex-Japan index has risen by 32% year-to-date (to end-October), but almost a third of that uplift has been delivered by just four stocks: Tencent, Samsung Electronics, Alibaba and Baidu. (Although, without them the index rose by a still very respectable 22%.) For the first time ever, the technology sector has surpassed financials in scale, quite a thing for Asia. These four stocks alone now account for 17% of the index.

Looking back at our history, our crude rule of thumb in surging markets is that we typically manage to secure between a half and two-thirds of the absolute gains. We have struggled against that rough benchmark in this cycle, due to the market's extreme concentration and a few mistakes, but we hope to do much better when the tide reverses. We have no idea when that will be and given the potential profitability of some of these companies, as well as their alignment with government, their elevated status does for now appear rather unassailable in our view.

Against that, our modest relative performance improvement in recent months signifies little; though there is the sense that the current trend-extrapolation has perhaps moved too far in one direction. On the other hand, this level of market concentration and machine-driven herding has produced some potential opportunities in smaller companies (although these companies are only eligible to be included in our all-cap portfolios).

Just as John Templeton questioned past bull market certainties, current conditions seem similar to the periods of unbridled optimism and euphoria that we have experienced in the past. The world is very different today, just as it always is in every bull market and just as it was when Templeton wrote those words in 1993. But, it is human behaviour (greed and fear) which ultimately drives markets and that has probably not changed very much at all. That at least, is what we are counting on.

In the meantime, we have our core philosophy, our process and our investment history to build on. These are the very same things that we look for when we invest in any company and has tended to work for the past thirty-or-so years. We trust that the cycle will turn and greed will morph as it always has to fear. Given current extremes, we believe it might well happen very quickly too.

Nevertheless, we continue to examine our prejudices, reflect on our mistakes and have as usual cut our losses in a few cases. We have undertaken a robust review of our portfolios and, furthermore, have re-visited and re-examined the big e-commerce companies. We have focused even more intently on bottom-up stock opportunities, irrespective of the macroenvironment.

Just as the market diverged in 2000, so today there appears to be opportunities in sectors that are the opposite of 'hot-tech'. As the market concentrates and passive-flows accelerate, we expect that we should be able to take advantage of our longer three-to-five year time-horizon.

In general, sectors like manufacturing and the conglomerates seem especially vulnerable to investment opprobrium (don't these companies get it?), but at the same time we see some interesting longer-term valuation anomalies. The likes of Astra International, Telkom Indonesia, CK Hutchison, Dairy Farm, Swire Pacific, Midea Group, Hanon Systems, Techtronics, Comfort-Delgro and Ramsay Healthcare have all de-rated quite sharply. Some of them have recovered in short-order; however, for some like CK Hutchison, we remain divided about the outlook, even internally.

The Tech sector

As the Technology sector has pulled away, many investors have increasingly asked us why we don't own the BAT-complex (Baidu, Alibaba and Tencent). Firstly, we do; and at least for Tencent we have done for many years. However, in general we have not bought these companies for our regional portfolios. Having re-examined our prejudices with fresh eyes and with more research, we regret not owning Tencent. Similarly though, we conclude that we would be doing our clients a disservice if we bought it today, at current valuations.

In hindsight, we have been surprised by Tencent's ability to continue to scale at such high rates of growth on top of an already substantial base. Our research consistently underestimated that growth and as a consequence we always balked at the valuations. Some of the younger members of our team believe that we should just pay up. Perhaps they are right. The broader issues around the sector, in respect of governance and alignment, have not been the impediment, at least in the case of Tencent.

One overarching hurdle has been the VIE (Variable Interest Entity) ownership structures. These arrangements were originally designed to facilitate foreign investment into supposedly sensitive or strategic areas of the Chinese economy, including the media, telecoms, ecommerce and gaming areas. VIE structures were specifically designed to get around People's Republic of China (PRC) rules that prohibit foreign ownership, which doesn't seem like a great starting point from a governance point of view.

They are an effective legal work-around that gives foreigners the practical control in relation to their ownership interest as well as a share of the profits, but is not derived directly from voting/ownership rights in the operating company. PRC contract law does not specifically address VIE structures, but does hold that a court may declare a contract void if a lawful form is used to conceal an unlawful purpose. That does not sound very good.

What that means, in extremis, is that if there is ever a confrontation, foreign investors have no title or effective equity interest in the operating company that holds the assets. This, arguably doesn't matter until it is the only thing that matters. But, such structures have been well-tested since SINA listed on NASDAQ in 2000 and defenders will always ask: why would China ever wish to upset such an arrangement, given how significant these companies have become?

Furthermore, companies like Alibaba and Tencent have transferred their service platforms, their most valuable asset, to the VIE companies in an effort to mitigate these risks. Even so, it is clearly a compromise, something akin to a PRC financial version of Clinton's "don't ask, don't tell" rules for the US military. It seems highly unlikely that anything untoward will happen, but the risk is certainly not zero.

What could possibly go wrong was perhaps highlighted by Alibaba's 2012 row with Softbank and Yahoo, when Jack Ma transferred Alipay out of the operating company, supposedly without consulting with what were at the time Alibaba's nominally controlling shareholders; highlighting that in the event of a dispute, foreign shareholders are more than usually reliant on the PRC shareholders. That is another reason why we have always preferred Tencent. All of its assets are in one structure and the management track record is unblemished from a governance point of view. Its management alignment is alongside shareholders, via share ownership in the listed company.

Alibaba is an absolute juggernaut and to some extent is Amazon, eBay, Microsoft and PayPal all rolled into one. We had another good look at the group recently and, similarly, some members of the team believe we should own it, while on the other hand, one member of the team compared the company unfavourably with Enron. It is clearly a complex company, with over 600 subsidiaries and some accounting methods that appear to be quite aggressive (the booking of capital gains and losses, in particular). The interests of the management team are highly dispersed too, with a number of major subsidiaries held both privately and via a number of listed entities. Overall, it is difficult to understand.

That said, Jack Ma is clearly a visionary and we pay close attention to what he says and what the company is doing. For instance, Alibaba's moves into omni-channel and ownership of physical assets were made quite some time before Amazon's recent purchase of Wholefood Markets. Indeed, in many ways the PRC companies have overtaken the American model and improved as well as innovated on that base.

We believe Tencent's WeChat and particularly the linkage with WePay is more innovative than Facebook; and China, as a whole, seems increasingly further ahead of the West in the e-payments business. Experiments with e-commerce by Alibaba and even the likes of Yonghui do not seem to have comparables in the West (maybe Amazon?). Alipay has been at the forefront of this development, but it is no longer owned by Alibaba.

In conclusion, we struggle with the complexity of Alibaba, as well as some of the decisions they have taken in terms of ownership and alignment with minority shareholders. Although the company has increasingly campaigned against "brushing" (fake orders) to inflate sales figures, as well as counterfeiting on their sites, we find the opacity of the group rather off-putting. Given our governance hurdles as well as our preference for straightforward alignment, notwithstanding the valuation we concluded that it is probably not for us.

Another company that has always been the subject of much keen discussion internally is Samsung Electronics, which we own in some portfolios, but only a small weighting. Again, it may be different now, but given our Environmental, Social and Governance (ESG) and sustainability culture, it should be considered a clear outlier, especially after the recent and latest lurid disclosures on bribery charges and the general conduct of the management team.

We met with Samsung Electronics recently in Seoul and the group was very robust in arguing that there has lately been a wholesale change. Most Koreans are sceptical, but the very recent management rotation does perhaps signify a turning point. We have previously noted real change in their cultural attitude to sustainability and the responsibilities that come with being a global company. It is a relief to no longer be met with the response that: "We're a Korean company," to any criticism over deviation from corporate norms, when the group quite clearly makes the bulk of profits overseas and is more than 50%-owned by foreign investors.

The issue with Samsung today is more prosaic. Despite the governance hurdles in the past, Samsung has always been autocratically and in our opinion brilliantly run by KH Lee and his culture of perpetual crisis. Incapacitated, he is no longer directing capital allocation. Meanwhile, two-thirds of today's group profits are derived from the traditionally commoditised memory and components businesses (DRAM and NAND-Flash). It is fabulous how the group's profits have pivoted from two-thirds mobile-phones to components in just three short years, but we wonder if it is sustainable?

The bulls argue that we are in a structural mega-cycle, with data consumption and the technology-intensification of society meaning that this cycle should roll on. Furthermore, the supply-side is highly concentrated with Samsung, Hynix and Micron effectively controlling the market. Margins for DRAM/NAND are 65/50% and now everybody is trend-extrapolating.

Such businesses have always been cyclical in the past and while it may be different this time (really!), we doubt it. In the meantime, owning as much Samsung as possible seems to be the consensus view, but we question whether these returns will prove sustainable. Furthermore, we have no firm view on the new management team. If they really wanted to change the culture, we would have hoped for some outside appointees and a much more effective board. It will be difficult to emulate KH Lee, surely one of Asia's (and the world's) very greatest businessmen?

Portfolio positioning

Our generally cautious stance, as well as overall portfolio positioning, has not changed very much in the last nine months. One real surprise, looking back, is how significant Korea has been as a positive contributor to performance. You would never have bet on it and once again it proves how unhelpful macro and top-down overviews can be to bottom-up stock-picking. It is another timely reminder that the less we do of it, the seemingly better are our investment decisions.

We have continued to add to a number of existing key holdings. Partly, this has been the result of our efforts to ignore macro and the crescendo of noise around geo-politics and North America in particular. We are increasingly determined to avoid the T-word in investment discussions, with the real world impact (despite all the sound and fury) seemingly about as impactful as his 140-character-storms on that other T-word.

Some of this stock-activity has been successful, in particular where we added to the likes of Mediatek, Tech Mahindra, Overseas Chinese Banking (OCBC), AmorePacific Group and LG Healthcare & Household. For other companies, such as Dairy Farm, Cathay Pacific and Brambles, we have yet to see much sustained material benefit.

We have added a number of new names too, some of which were previously owned in a more limited fashion via country funds or in a few rather than across all regional portfolios. These include Ramsay Healthcare, Swire Pacific, Midea Group, Hanon Systems, Comfort Delgro, Bank of Central Asia (BCA) and Indocement. Others were companies that we know well and have returned to at lower prices, such as KasikornBank and China Mengniu.

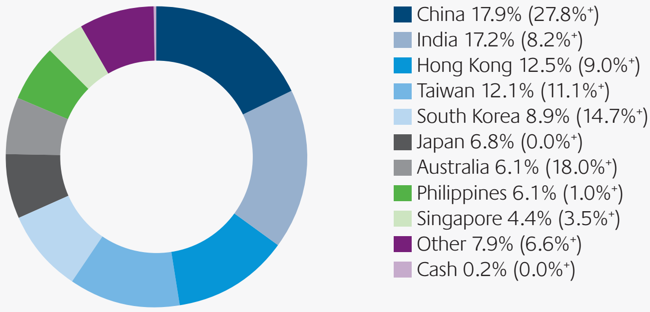
As noted, we do not believe stocks are priced very attractively at present. For valuations to appear superficially attractive and prompt further research, there is often something wrong in the shorter-term with our potential new holdings. Unsurprisingly, we are not very good at market timing and we seldom manage to buy at the bottom (if we do, it's only by luck). However, our advantage, with our longer-term time-frame, is that we can look through such noise. We believe this should be one of the more obvious ways in which we can potentially add value.

In our last note, we reiterated our continued enthusiasm for exporters and US dollar earners in general (despite the new US president) as being amongst Asia's more competitive companies. We still have such a view and in particular continue to have a relatively high exposure to Taiwan and technology (excluding e-commerce). This has now become the mainstream consensus; and many of these companies have already done very well.

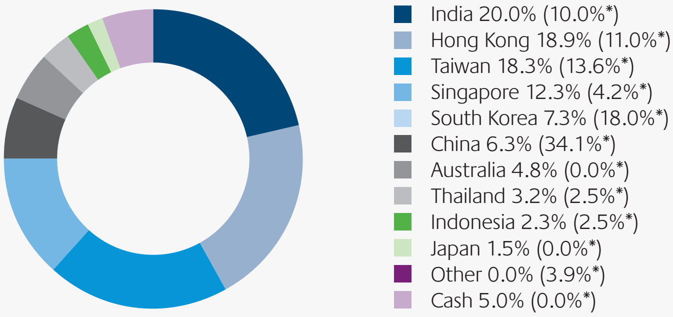
Given how bifurcated and concentrated markets have become, alongside smaller companies we have begun to look for and have found more attractive opportunities in the Asean region. In particular, many companies in Indonesia seem comparatively attractively valued both in an absolute and relative sense. Despite that, we continue to prefer the globally competitive and north Asia. India remains our biggest single-country exposure.

Country allocation

First State Dividend Advantage



First State Asian Growth Fund



Source: First State Investments as at 31 October 2017.
+Index: MSCI AC Asia Pacific ex Japan Index
*Index: MSCI AC Asia ex Japan Index

India

India is always incredible. Having looked through and found the structural positives in both demonetisation and the more recent Goods and Services Tax introduction, after seemingly running increasingly on fumes, we finally have something to celebrate with the planned recapitalisation of the public sector banks. The lack of an Indian capital-spending cycle, with low investment, job creation and the implications for sustained GDP growth have been a growing hurdle to the investment story. Meanwhile, valuations have surged irrespectively.

Although the details have yet to be finalised, with the planned US$32bn bad-debt swap we now have a PRC-style big bang solution, which should provide some legs for sustained economic development, growth and consumption. This is important, because India's consumer companies now trade on valuations that would make even China analysts blush. In hindsight, we probably reduced our India domestic consumer exposure too soon.

Although this recapitalisation is good for India, could it be bad for India's privately-owned banks and valuations in general? Just as capital is overly abundant in China, in India it is not and barriers to entry are generally high – which explains much of the Return on Equity (ROE) differential. Furthermore, our argument has always been that with two-thirds of the total banking system assets held by the effectively broken public sector banks, the private banks have had a huge and long-term structural advantage.

While the playing field will, in our view, be somewhat levelled, the private banks' advantage (and companies everywhere) comes back to management quality. Therefore, we do not think this upends the investment story. With public sector bank employees likely to continue to be paid like civil servants, the private banks could gain as much from India's improving economy as they might lose in terms of more competition.

The private banks sell-off lasted just a day and amounted to less than a 5% mark-down. The longer-term opportunity remains significant, with over half of India's population unbanked. We have added modestly to HDFC Bank and Kotak Mahindra.

Generic drugs companies

Rather less positively, the performance of the Indian generic drugs manufacturers has deteriorated, going from bad to worse. We met with the management of both Dr Reddy's and Lupin recently, partly to revaluate our holdings with fresh eyes and to question whether the investment case remains sufficient.

Our conclusion is that there has been a permanent and structural change in the market place. As a consequence, we have now sold out entirely of Dr Reddy's. We retain our smaller holdings in Lupin. In the past, we argued that supply-side inspection issues, with a much keener interest from the US Food & Drug Administration (FDA), was a product of their growing success and rising market share. We still believe that to be mostly true, but it has been nearly two years and the response to compliance issues still seems more piecemeal than broadly cultural.

It is clear that Dr Reddy's is still struggling with these new required standards. We were disappointed to hear that after finally passing US standards in a couple of factories, the German government then failed them for similar issues. There seems to be much to do in respect of changing the way things are generally done. Lupin appears to have been more proactive, but is having ongoing issues as well.

Though we still believe that generic drugs are the answer to the US healthcare industry's problems as people get older and richer, there has been a material change in America's wholesale marketplace. In the last two years, after a number of mergers and take-overs, the number of large US drug distributors has fallen from seven to three. It is this that has contributed most to the change in our views.

With said consolidation, the rate of price-erosion has accelerated to high-teens for 2017, with low-to-mid-teens expected in 2018 (from a high single-digit rate, originally). Generic drug prices always fall, with a typical 80% decline in the first couple of years when a compound goes ex-patent. But now the pressure is even more unrelenting; the innovators patent-cliff of a few years ago has meant that there are less easy opportunities for me-too generics.

If that that were not enough, US drug prices have become increasingly politicised on the back of very public price-gouging by some US-based companies and now we have an opioids crisis on top of everything else. Dr Reddy's and Sun Pharmaceuticals have both been cited in the recent class-action suit in America. Lupin does not appear to have been included. Putting all of this together, it looks like this is an industry that is moving from tailwinds to headwinds.

Last time we wrote about these companies, we believed that the headwinds would abate, but we are far less certain today. As a consequence and as noted, we sold Dr Reddy's. Though analysts expect earnings to bounce strongly in FY18, we are not so sure. Our Lupin position is relatively new and was a return to a company we have owned before.

IT services companies

The share price performance of the IT services companies has continued to be quite challenging, though the businesses have performed resiliently over the period. Generally, revenue growth has been modest, while margins have broadly risen. The finance industry, which remains the biggest customer for IT services at 40-50% of revenues, still has its issues; the telecom sector is under pressure; and retail companies still seem to be navel-gazing, rather than proactively dealing with the threat from ecommerce.

Growing protectionism in the US and the H1B[1] visa issue in particular seems to have eased, with the realisation that it would impact everybody equally and lead to higher pricing across the industry. Against all of this, the world is increasingly digital and businesses have little choice but to invest in ecommerce and mobility. Digital revenue is already 20% of Tata Consultancy's (TCS) sales and grew 26% year-on-year in the first half. We believe that IT intensity will continue to increase and that these companies should benefit, particularly as they become more sophisticated.

We also had a good meeting with the then CEO at Infosys, Vishal Sikka, given our growing concerns around the governance of the group. The resignations of a large number of ex-SAP executives that he had brought into the company, as well as negative media coverage (seemingly sourced from the ex-founders), prompted us to take another look. Our conclusion was that the situation was probably unsustainable and we sold. Subsequently, Sikka resigned (a new CEO is yet to be appointed) and we exited Infosys across our funds. TCS is probably a beneficiary of this.

Tech Mahindra has been another source of stress, with the share price falling away on the back of weak revenues and poor margins. The results have been further eroded by write-downs for acquisitions. In the final quarter of FY17 (to March), the EBIT (earnings before interest and tax) margin declined to just 8%, with an annual level of 11%. The rest of the sector has margins of roughly twice this level.

We met with Tech Mahindra's CEO, CP Gurnani, and while the consensus is for margins to rise by just 1 percentage-point, we believe they can do much better than that. The CEO's job is on the line, as he put it. We added to Tech Mahindra and the shares have subsequently bounced. We hope it is sustainable and indeed the recent results suggest that things have begun to turn.

[1] A visa program which allows foreigners in specialty occupations with advanced degrees to be employed in the US.

China is finely balanced, all over again

All hail China, again proving why we think that you really should not pay any attention to the macro. It could have been scripted, but with the 19th National Party Congress (and Xi Jinping's coronation) recently completed, it was a fair bet that things would continue to spin along in a favourable manner. And they have, despite rising levels of debt and slowing GDP growth.

A clamp-down on some very high profile local investors (Dalian Wanda, HNA Group and Fosun), in respect of overseas ambitions and investment, as well as a purge of some of the more aggressive Ponzi-esque insurance companies, has prompted a strong yuan recovery and a stock-market bounce. Now that the Party Congress is over, perhaps things will become less one-directional with rumours of stock-market support and the like.

We have become more sanguine about the outlook for China. While debt levels are high and at, if not beyond, the type of level (250-300% of GDP) that has seen other countries throughout history get into trouble, perhaps China is indeed different, at least in an economic sense. Like Japan, most of the debt is local and unlike everywhere else, the State is effectively on both sides of the balance sheet. That is certainly the case for the banks.

There are clearly risks and while such an approach may ultimately prove unsustainable, in the meantime debt levels can easily continue to climb. We think a pragmatic approach is likely to prove most rewarding. We approach China with a similar governance framework as we do everywhere else – only investing in companies where the track record, the management and alignment are as good as elsewhere in Asia.

On a big picture basis, the economy is clearly subordinate to politics, but we should still be able to find some qualifying investments. In particular, given our debt-concerns, we are mindful of looking for companies that have an international perspective and export-earnings.

As we pointed out in our last note, no country can overturn the monetary trinity (a managed currency, independent monetary policy and an open capital account) on a sustainable basis. The PRC's answer was to clamp down on capital flows to get a grip on the currency. The last thing the authorities want to do is tighten policy and raise interest rates but Zhou Xiaochuan's (China's central bank governor) recent warning of a potential Minsky moment makes you wonder.

After meeting with China Mengniu, we increased our shareholding, with the company introducing a new incentive scheme alongside its replacement of the CEO. We were initially unimpressed, but aligned management along with a woefully-performing and under-managed franchise is often a good starting point for something good to happen. After a kitchen-sinking exercise, the new management team has targeted a doubling of revenues in the next five years.

Mengniu's margins, (at circa 6% for FY17), remain pitiful in the context of global dairy businesses. However, the growing middle-class appetite for ice-cream and yoghurt should give them a structural tailwind; margins could certainly reach double-digits. Yili, Mengniu's main competitor, already has an EBIT margin of 8%. Even so, we have been quite surprised with the sudden re-rating and now find the shares rather expensive (FY17 price-to-earnings ratio, PER, of 29x).

Sun-Art Retail has continued to execute well, with same-store sales recovering, although we are surprised that there has been no tie-up as yet with any of the ecommerce companies. The stock still seems reasonably-rated on a forward PER of 21x. Indirectly, we have exposure to the listed Yongui Superstores too, via Dairy Farm's 20% shareholding in the company.

Yonghui has performed strongly, but now trades on a forward PER of 40x. If you back Yonghui out of Dairy Farm, the rest of Dairy Farm is currently being valued on a PER of 18x. We think this is attractive, though it may just mean that Yonghui is overvalued. We used to own Yonghui in our China A-share portfolio, but we think that it is overly characterised by a more entrepreneurial than governance-driven approach to life.

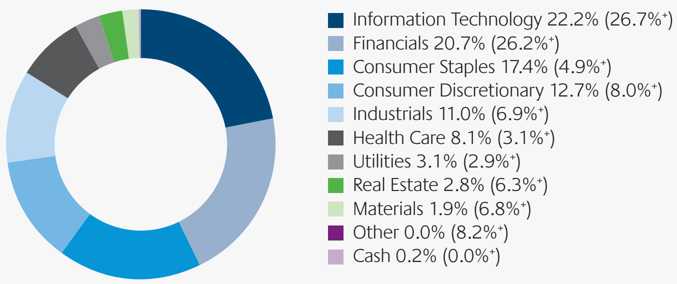
With the wider opening-up of the A-share market via Stock Connect, we have increasingly been able to invest directly into A-share companies across our regional portfolios. Collectively, we now have around US$2bn invested in this market. Out of some 3,200 companies, our A-share portfolio holds only twenty-three names, so we are being quite selective despite several members of the team being in China every month.

Midea Group is the mostly widely held A-share that we own. It is an air-conditioning and white-goods (fridge/washing machines) manufacturer. The group has been in the news of late, having acquired 95% of Kuka (a listed German robotics company), as well as the kitchen appliances business of Toshiba. Around 40% of revenues are derived from exports.

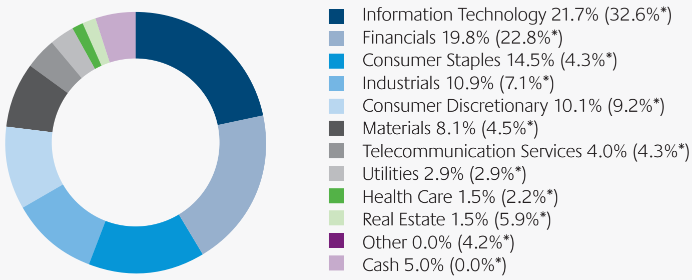
It is not that fanciful to envisage Midea becoming a global brand name. The market capitalisation is already US$50bn. When we acquired the company the forward PER was only 13x for double-digit earnings growth. Midea's recent profit growth has been strong and the shares have re-rated. The forward PER is now around 16x, but with higher growth.

Sector allocation

First State Dividend Advantage



First State Asian Growth Fund



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To get a real idea of our broader China exposure, we believe that Hong Kong (HK) and Taiwan should be included to reflect the true economic picture. For instance, 50% of Hong Kong & China Gas's (HKCG) earnings are derived in the PRC; similarly for Uni-President too. China/HK has also been the biggest driver of new business growth for AIA.

Taiwanese Mediatek is a company where we added into adversity, with the view – on the strength of the management team and track record – that their 4G-chip mobile phone issues would probably prove to be temporary. The group has endured four profit-recessions in the last twenty years and, until 2015, profits always rebounded in a year. This time it has been four years; the company should return to growth in 2018.

Smartphones still account for around half their business and they are gaining ground on Qualcomm after a relative loss of market share when three of their PRC customers (Meitu, LePhone and Xiaomi) failed to succeed at the top-end of the market. In the mid-market, their customers (Vivo/Oppo) are gaining share and profits appear to have bottomed. The group still seems reasonably valued despite rebounding and is now a top-ten holding.

All-cap ideas

With market bifurcation there have been more changes in our all-cap portfolios, given the greater opportunities. We have added a number of companies, including Towngas, which is majority-owned (66%) by HKCG and where the business is entirely derived from China even though the group is listed in HK. China recently confirmed a new returns framework for the city-gas sector, with 8% return on assets implying a decent return on equity. Moreover, the regime-emphasis on pollution-abatement means that gas market share should continue to rise.

We also bought Greatview Aseptic, which is a Tetra Pak-like company in China. Around 70% of sales are domestic, with the dairy businesses being their main customers. We have known Greatview since it first listed in 2010, but with Jardine Matheson's recently acquired 28% stake, we believe this could bring more opportunities, as well as financial discipline to the group. We expect earnings to grow quite strongly, while the valuation (forward PER of 15x, 5% yield and net cash) seems reasonable.

In the Philippines, we bought Integrated Micro-Electronics, with the group being majority-owned by Ayala Corporation. The company is an electronics/electricals manufacturing services business, effectively producing components on behalf of Western principals. It is difficult to find these types of businesses in such a consumer-driven country and the sub-10x PER was attractive. We have met with the CEO a number of times and the market has subsequently grown very (over?) excited about the group's exposure to autonomous driving.

Around half of its revenues are from the auto-sector and we believe growth is likely to be strong after a number of acquisitions. Despite being a small company, the group already operates globally in 15 countries. After a sharp re-rating the current-year multiple is now 20x and we have taken some profits.

We invested in Cemex Holdings Philippines as well. Cemex is a relatively recent Initial Public Offering and has declined 60% from the listing price. Now trading at an enterprise value of just US$100/tonne, we believe it to be attractively valued, while shorter-term concerns over Vietnamese imports remind us of the situation in Indonesia earlier this year (which proved to be temporary). The group is trading below book value and on a forward PER of circa 12x. It is the Philippines' third-largest cement producer with seven million tonnes of capacity – we believe the longer-term infrastructure story for the country should bode well. Lately, there has been management buying as well.

We added a number of new companies in Sri-Lanka, this being a good example of a small market with a number of companies that are too small for most people (and certainly the machines) to bother with. And yet, rather like India, there are some very high quality family-owned businesses. Barriers to entry are high, after years of war, but it is clearly a frontier market. Our collective holdings remain modest.

We added to John Keells, the country's leading conglomerate, with businesses that include a leading hotel, branded foods and a supermarket operator – and yet the market capitalisation is just US$1.5bn. The valuation seems reasonable at just 13x PER. We also initiated a small position in Hatton National Bank. The management team is young and impressive, the bank trades at just over book value and is on a forward PER of under 10x, while the group has 10% market share. Here, the market capitalisation is less than US$1bn.

Otherwise, we have added small positions in Sinbon Electronics in Taiwan and Mahindra CIE Automotive in India. Sinbon is an industrial cable manufacturer with a good long-term track-record. 50% of revenue is from the industrial and green-energy sectors, while automotive (cables for charging electric vehicles) is 10%. We believe the business is attractively-valued on a mid-teens PER, while the dividend yield is 5% and the group has net cash. We regard it as a good example of a conservatively-managed and family-run business.

For Mahindra CIE, despite the name, the company is controlled and managed by CIE-Group of Spain. We believe it is attractively valued, especially for India, but is relatively small at around US$1.5bn in market capitalisation. We like the management's global view and expect the business to grow substantially in the next three-to-five years, both organically and by acquisition.

Korea and some opportunities

Enigmatic Korea has been much in the news over the past year and always for the wrong reasons. Despite all the grand-standing, we have increased our exposure, only more recently taking profits on the cosmetics companies and some LG Group companies.

As we observed in our last review, although we do not hold out much hope for broad reform, Korea has often moved forwards in a disjointed manner and usually against a background of adversity. Change seems to be thrust upon the country rather than actively embraced. In that sense, the latest changes at Samsung in reaction to fearsomely poor governance should probably be regarded positively rather than taken as further evidence for despair.

LG Group companies, despite their reputation for being second-best to Samsung, have done very well over the past year and have contributed positively to overall performance. This makes a change, though of course Samsung Electronics remains in a different league. Last time, we noted that we had been adding to LG Chemical when it was trading at 1.2x book. Today, the shares are trading at 2x book (with an ROE of 12-13%) and we have reduced the position.

The chemicals business has done extremely well, with margins almost back to historic highs on lower oil prices. Meanwhile, volume has been strong as China sales (40% of turnover) recovered. What has really propelled the share price however, is investor belief in the growing potential of the Electric Vehicle (EV) battery business. The group now has some US$40bn of forward orders and will have invested an aggregate US$5bn in this area in three years' time.

By 2020, we believe that the EV business (if everything goes to plan) could account for 20% of group profits. Today, the chemical business accounts for 95% of earnings and is clearly cyclical as witnessed over the last five years. We believe LG Chemical to be one of Korea's best businesses, but the valuation now seems quite full.

Last time we wrote, we were adding to LG Household and Health Care (LGH&H) too, after earlier selling on previous enthusiasm around sales of duty-free cosmetics to visiting PRC tourists. The arrival of Terminal High Altitude Area Defense (THAAD) missiles in South Korea as well as North Korean missile testing gave us an opportunity to buy, as China effectively cut off the flow of visitors.

China, both onshore and offshore via duty-free, accounts for as much as 40% of LGH&H's profits. For AmorePacific it is even higher, at around 70% of the total. We expected that any subsequent recovery would take some time and have been surprised by how quickly and by quite how much the share prices of both LGH&H and Amore have rebounded.

Investors seem to have looked through the earnings dip entirely, effectively placing their trust in the long-term structural PRC opportunity. Both companies have re-rated sharply and it seems that, post-Party Conference, relations between the two countries are beginning to thaw again.

Nine months ago, Amore and LGH&H were trading at respective forward PER multiples of 23x and 20x. Today, they trade on forward multiples of 38x and 25x. Partly, it is because earnings estimates have been reduced, but the share prices of both have risen in absolute terms as well. We think these valuations are now rather excessive and have trimmed back our holdings to circa 1% each.

LGH&H's profits have held up better as a third of profits is derived from household products, but they have been less mindful of the longer-term impact on their brand value from discounted sales of parallel imports into China. Amore has purposefully limited sales to individual customers, which hurt their short-term profitability but says much about the longer-term brand-value and ambitions of the company.

We reduced our holdings in LG Corporation too. It is a holding company, with the bulk of the value contributed by LG Chemical and LGH&H. Together with LG Electronics the three companies account for 70% of the value of LG Corp, while accounting for 150% of LG Corp's market capitalisation (and there is barely any debt, with just 3% gearing[2]).

[2] Gearing ratio is a general classification describing a financial ratio that compares some form of owner's equity (or capital) to funds borrowed by the company.

New Korean names

We have added a couple of new companies in Korea: Naver and Hanon Systems. We have owned Naver before. It originated as Korea's answer to Google, but is now more broadly involved in ecommerce with NaverPay and various different portals. It is also the majority shareholder in Line (a Japanese version of WhatsApp). The group is determined to push into other areas such as artificial intelligence and autonomous driving which means that margins have been compromised in the shorter-term.

In March, there was a top-level management reshuffle and the chairman and founder Mr Lee stepped down from that role to become Global Investment Officer (GIO). Mr Lee's new job is to make sure, just as services moved from PC's to mobiles, that the group is ready for the shift to the internet of cars, homes and things (otherwise known as IoT). Accordingly, they have announced a step-up in capital expenditure from US$200m (in the last five years) to US$500m next year.

We saw the recent share price underperformance as an opportunity, again with a management transition, to build a position in a strong existing franchise. Google does not work in Korea; and recent results confirmed that the core business can still grow at a double-digit rate. Backing out the group's 79% stake in Line means that the core Korean business is currently being valued at circa 18x PER. We believe this is quite reasonable.

We bought Hanon Systems earlier in the year when the share-price, like many auto-parts-related companies, was depressed at the prospect of rising protectionism. We were surprised by how quickly the company re-rated, with investors (per LG Chemical) becoming highly enthused over the prospects for EV. Hanon manufactures climate-control systems (air-con and heating). With Korean private equity ownership, (Hahn & Co.), we believe the alignment is good and anticipate margin improvement.

Singapore and Indonesia

In Singapore, we have continued to add to our Jardine Group holdings, in particular Dairy Farm and Jardine Cycle & Carriage (JC&C). JC&C appears attractively valued, but the share price is currently becalmed on account of Astra (75% of the Net Asset Value) experiencing more difficult shorter-term trading conditions. Mitsubishi and a PRC car brand (Wuling) have entered the Indonesian car market meaning Astra's 54% auto-share will surely come under some pressure.

We do not see that as surprising and believe Astra's high market share is unsustainable in the longer-term. It has been de-rated and now trades on a forward PER of just 15x, which seems attractive. Meanwhile, JC&C's Vietnam auto business (Thaco) profitability has been eroded by price-cuts ahead of the removal of auto-tariffs, as the market is readied for Asean open-trade.

As the biggest auto-manufacturer in Vietnam, we expect volumes at Thaco to pick up to compensate. In addition, over the next couple of years, the group should see a material increase in property contributions with the development of a large centrally-located site in Ho Chi Minh City. The site is compared favourably with Pudong in Shanghai, in terms of scale and proximity. The Group believe the property profits contribution should ensure Vietnam profits begin to rise again next year.

In Singapore, we bought Comfort-Delgro, which is a new position for a number of regional portfolios, only to see the shares fall sharply after purchase. This is clearly vexing, as the explanation is supposedly the challenge from new entrants (UBER and GRAB) on the core taxi business. The taxi business accounts for around a third of Comfort's profits and it is not as if we did not anticipate more difficult times. We believe that investors are unduly worried, given the strength of their other businesses.

We expect the rail and bus businesses to do much better, with buses in particular moving from an at-risk asset-heavy model to a fee-driven business. Local politics means that the government is more interested in service, rather than the cheapest option available. Quite a departure for the People's Action Party (PAP). This has positive implications for profits, cash-flow and even capital deployment, in our view. With the full commissioning of the MRT line (Downtown Line) that they own, we would expect a material uplift in rail profits as well, as they add in the stops that run through the population-dense suburbs.

The group has a net cash balance sheet, produces a free cash-flow yield of 10% and a dividend yield of 5% (two-thirds pay-out) and trades on a forward PER of 14x. We expect some form of a link-up with UBER, (there has already been an announcement of talks) and believe that the overall business is relatively defensive. In the meantime, competition is intense, but we expect this too shall pass. We are not too worried and have always been very impressed with the management team – it may take some time, but they are likely to find a way.

In Indonesia, we added to Bank of Central Asia (BCA) and Indocement, as already noted. We have known BCA for a long time, but tended to balk at the valuation and wonder about the ultimate ownership of the bank. The valuation point seems less relevant when everything is generally more expensive, while the very high quality of the bank means it should in any case be more relevantly compared with the likes of HDFC in India and Public Bank in Malaysia. We have learnt over the years that you should buy expensive, rather than cheap, banks.

In many ways, BCA is the Public Bank of Indonesia, with the same deposit franchise and focus on a particular segment of the population. However, the longer-term opportunity is so much greater and, after a period of slow growth we believe that the Indonesian economy is beginning to improve. Like HDFC, BCA generates an ROE of circa 20% and despite the price-to-book ratio (PBR) of almost 4x, we would expect the book value to roughly double every four years. Like India, the mortgage market in Indonesia is tiny too.

Their stringent credit-approval process and solid long-term track-record mean that it would not be a difficult decision to add, should conditions deteriorate more generally. As for the major shareholder, the Hartono family who control 57%, we hear increasingly positive things; and, as time goes by, we believe the influence of the founding Salim family (2% shareholder) to be a non-issue. We do not, for instance, believe that the Salim family are the real owners, as some have suggested.

Indocement is a comparatively new holding for us; the Heidelberg-controlled company had fallen quite sharply when we bought the shares in 1H17. The concerns were around market-oversupply with the addition of 10 million tonnes into the Java market in the face of relatively weak demand and which was exacerbated by the entry of China's Anhui Conch. However, since then, prices haves stabilised and Indonesia's economy has improved.

At the time, our arguments in favour of taking a longer-term view were supported by the group's net cash position, dividend yield of 4% (35% pay-out) and a valuation of EV/tonne of US$150, which we believe is just at or below the replacement cost. While we are pleased that the shares have rebounded, the position is relatively small at just over 1% across most of our regional portfolios.

Other acquisitions

Global Brands has continued to be a laggard, with virtually no analyst coverage and perhaps now most of the loose (ex-Li & Fung) shareholders gone. The shares have fallen significantly since the business was spun-out of Li & Fung. The group's numbers are messy (earn-up and earn-out provisions on previous acquisitions) and they have changed the year-end too. The absolute level of progress seems decent, however, with top-line growth to March 2017 (the new year-end) of 12% and EBIT margin lifting from 3% to 4.4%. It should be more like 5-6% in the medium-term.

We met with the company and they were as reassuring as ever, but the operating (and financial) leverage is high. We need to see some progress in cost-discipline, a further improvement in margins and some positive free cash-flow. The shares have bounced lately on high volume, with no explanation or sign of stake-building. They are almost back to what we paid for them and we are watching the company rather closely.

As noted before, we reduced our exposure to the Singapore banks prematurely. We met with OCBC and added to our exposure; we also own their listed insurance subsidiary Great Eastern Holdings (GEH). OCBC have been executing well and have demonstrated the quality of their decision-making, being relatively unaffected by the recent pick-up in regional oil & gas non-performing loans (NPL's).

GEH now plan to list their Malaysian business, which accounts for around 30% of profits. Given a choice they would not, but the plan is designed to satisfy the Malaysian authorities. We believe the listing should highlight the value of the group and means that any potential privatisation remains some way off. GEH trades at only a modest premium to embedded value and on a PER of circa 14x. We think this is attractive for Singapore/Malaysia's largest (and well-managed) life insurance company. It is much cheaper than AIA, which we own broadly.

In Thailand, we bought back into KasikornBank. The Thai banks have been de-rated and Kasikorn now seems comparatively attractive. The bank trades on a forward PER of 12x, with a PBR of 1.4x for 12% ROE. We consider the bank fairly-valued, while Thailand's economy has been through a relatively torpid patch lately. Many believe things may start to improve.

Before moving on, we should mention Swire Pacific, where we recently added a small position, and Cathay Pacific, which we have owned for a while and have added to. Cathay is a relatively small part of Swire's value (15%); and, despite the business being loss-making on earlier fuel-hedging decisions as well as operating in the current tough environment, we are quite enthusiastic about its prospects.

When not a single analyst (out of twenty) has a buy recommendation on a stock and everybody is forecasting losses, you can assume that an awful lot of bad news is already well-discounted. Such was the situation with Cathay six months ago. It is another company where we believe the franchise is strong, but had faced extremely negative shorter-term trading conditions.

However, with the chief executive now changed (to Rupert Hogg, who has a very good hands-on reputation), the negative fuel hedging rolling off in 2H18 and the cargo business picking up, the shares look cheap should things ever normalise. We are assuming that they will and indeed there does appear to have been some improvement of late. The business has a top-line of HK$100bn, but is still currently unprofitable. It does not take much for that to change materially (mostly on the oil price).

Swire Pacific now trades at just 0.5x book value, not unlike many of HK's other property investors. However, the holding company has lagged the listed property business (Swire Properties) materially. We can understand why. There is the double-discount; their foray into the marine business (oil & gas support services) was spectacularly poorly timed; Cathay has had its issues; and the group seems to have lacked purposeful direction.

That said, Swire Properties (which accounts for around 70% of group value) has a wonderful collection of assets. Pacific Place, one of its flagship properties, is irreplaceable. It is where all rail-lines converge on HK Island and they are now midway through aggressively re-positioning the retail component. Meanwhile, Swire have been successful with their office-portfolio as well as their moves eastwards with the redevelopment of Quarry Bay. That should provide the group with revenue-legs for the next decade.

The group has moved to strengthen their governance at the board level. The leaders of the main businesses previously accounted for the bulk of the board, which, in hindsight, did not make for a robust discussion of failings, or for the constructive critique of investment decisions. A new development director has been appointed from outside (ex-McKinsey) and his job is to lead a review of the group's structure, businesses and approach.

We expect change and believe it should be positive, with the largest upside likely to emerge at the holding company where family ownership is greatest. Swire are keenly aware of their performance versus Jardine Matheson and the need for reform. As for marine (and oil & gas), there is surely time for at least one more cycle before the whole world finally abandons the internal combustion engine.

Mistakes

We have a number of holdings that may be considered problematic. We have discussed some of them in the above commentary. Companies that concern us include Global Brands, Giant, Comfort-Delgro and Idea Cellular, as well as perhaps Brambles and Lupin. As commented, we are more confident about some than others.

Some of the companies that we worried about in the past, such as Mediatek, Tech Mahindra, China Mengniu and maybe even Cathay Pacific, have turned around in the last six months and have become decent positive contributors to performance.

However, sometimes the world changes in permanent ways and that is much more difficult. It is probably fair to say that the current age of significant innovation and high levels of broad disruption means that we should be more mindful of such shifts than we have been in the past.

Li & Fung

Clearly, it is hard to distinguish between a company that is experiencing shorter-term difficulties and one that is likely to end up being permanently impaired. You can gather as much data as you like, but it is often more about judgement than science. We hope to be right more often than wrong. We believe that to be the case.

Sometimes however, we are just plain wrong and then we need to cut our losses. After more than a decade of ownership, we mostly do not hold Li & Fung anymore. Sadly then, this negative performance contribution is permanent and must count as one of our more significant mistakes in recent times. To compound the error, the shares are now somewhat (although not much) higher than where we sold them. On the other hand, and far more importantly, the capital was deployed into companies that have done materially better. And that is the point. It is all about opportunity cost.

We believe that the transformation in US retail, with more than 300 retailers filing for bankruptcy to date in 2017 (more than during the GFC) as well as the travails of once-stalwart businesses like Under Armour (an L&F customer), may well overwhelm Li & Fung's bottom-up transformation efforts. It seems that they are at last (and very belatedly, in our view) executing a cost-reduction program. To that end, recent results evinced a margin pick-up which drove bottom-line growth, despite a 7% contraction in sales.

This is good, but businesses need turnover to grow and cost-cuts can only go so far, particularly when you need to invest to fund a digital transformation. In addition, we worry that the group's core margin of 2% is increasingly vulnerable in a deflationary world. The group may well succeed in putting themselves at the centre of e-commerce supply-chains, but we think things could get rather messy while they re-engineer the business. We believe there may be an opportunity to come back to the company when the environment is clearer.

In hindsight, we should have owned less of the company given our growing uncertainty, but the group has many of the characteristics that we look for in businesses. For us, these things include a strong global and well-known franchise, a long-term track-record of success, multi-generational and family-backing, strong alignment, executive buying of shares and good governance, as well as decent cash-flow and dividend pay-out.

We tend to be rather forgiving in such situations. It is a weakness and a strength, but that is what is at the core of our philosophical beliefs. If their governance was poor we would have no doubt sold a long time ago, which perhaps proves the point that companies with good governance usually enjoy a lower cost of capital. Looking back, we believe L&F's executives were just as surprised as us at how difficult things would become in this winner-takes-all world. We certainly hope so.

Idea Cellular

Idea Cellular in India has been another problem company and is another good example of what can happen when a very well-funded competitor enters your business area. Reliance Jio's US$25bn start-up with free telecom services has unsurprisingly been traumatic for the incumbents. Idea's share price has been mashed. The obvious take-away in this case is that if a group with both large amounts of money and connections seeks to compete head-on with you, any minority investor would be well-advised to stand clear. In hindsight, we should have been more alert.

On the other hand, if you use only the yardstick of share-price appreciation, Idea Cellular has become less of a problem after its recent bounce. We had a long meeting with the CEO, very much appreciating his candour. In general, we added to Idea as it collapsed, but it has been psychologically difficult. It is a good example of our process, but hopefully such things do not happen too often.

While we do not yet believe that everything is rosy, we have always been confident that Idea's management team would find a way. The CEO is particularly good in our opinion. He has a 3D spreadsheet running in his head. It is impressive, but given the complexity of Indian telecoms, somewhat bewildering too. Though it is clearly difficult, the simple (and important) things are easy to understand.

Their merger with Vodafone is proceeding well and the market is consolidating quickly, from eight players probably down to the big three: Bharti, Jio and Idea. In other markets, when such things happen, prices generally improve and everybody can make a decent return on capital. Indeed, prices have risen, with Jio starting to behave more conventionally. Given Jio's investment, ARPU's should eventually settle at a materially higher level.

In the meantime however, Idea is likely to continue to lose market-share as they accommodate Jio, while in the 3G mobile market Bharti and Idea should end up with large market shares in a country with a population of 1.4bn people. Idea's operational leverage is high and they have a lot of debt, but our sense is that trading conditions have bottomed. The share price has bounced 50% in the last few months.

In respect of valuation, the numbers can be anything you want. Left a bit, right a bit and you are quickly in another universe. It is yet another company where everybody has given up; and when expectations are zero, any degree of improvement (no matter how modest) can produce outsized gains. Idea is held in only a few portfolios, but we have more recently bought Bharti Telecom for other portfolios on the same basis. Market conditions will no doubt remain tough and we think it likely that Idea may well even (and perhaps should) raise capital. For the record, our current fair market valuation for Idea is INR120/share. No doubt, if we get there it will again move higher.

Some disposals

On disposals, we have discussed Li & Fung, Infosys and Dr Reddy's. We also sold Ayala Corporation, having held the company for many years. The holding company is now trading at a premium to asset value which is unusual; the company's recent issue of shares tells you how insiders see the valuation.

We sold Shimano after meeting with the company in Japan, while for all-cap portfolios we exited Chroma, Hemas and Marico. In India, besides Marico, we sold Godrej Consumer on valuation concerns, although our view of the group remains rather positive.

Top 10 holdings

First State Dividend Advantage

	Fund Weight	Index Weight+
Taiwan Semiconductor (TSMC)	6.3%	3.6%
HDFC Bank Limited	4.3%	0.0%
CSL Limited	3.5%	0.9%
Midea Group Co Ltd	3.5%	0.0%
Samsung Electronics Co Ltd Pfd Non-Voting	3.3%	0.6%
CK Hutchison Holdings Ltd	3.1%	0.6%
Oversea-Chinese Banking Corporation Limited	3.0%	0.5%
Housing Development Finance Corporation Limited	2.4%	0.7%
AAC Technologies Holdings Inc.	2.1%	0.2%
Dairy Farm International Holdings	2.1%	0.0%

First State Asian Growth Fund

	Fund Weight	Index Weight*
Taiwan Semiconductor (TSMC)	5.7%	4.4%
Newcrest Mining Limited	4.8%	0.0%
Oversea-Chinese Banking Corporation Limited	4.7%	0.6%
Tata Consultancy Serv. Ltd	4.1%	0.4%
Housing Development Finance Corporation Limited	3.9%	0.9%
HDFC Bank Limited	3.9%	0.0%
CK Hutchison Holdings Ltd	3.8%	0.8%
Dairy Farm International Holdings	3.7%	0.0%
MediaTek Inc	3.5%	0.4%
Tech Mahindra Limited	3.0%	0.1%

Source: First State Investments as at 31 October 2017.
+Index: MSCI AC Asia Pacific ex Japan Index
*Index: MSCI AC Asia ex Japan Index

Australia & Newcrest

We own a number of what we believe are very high quality Australian companies (CSL, Brambles, Ramsay Healthcare, and Newcrest) and have been adding to Ramsay in particular. We have owned the group for a while, but bought more as the company had been de-rated post the death of founder Paul Ramsay some three years ago. His 32% shareholding has been passed to a charitable trust. 70% of profits come from Australia, with the group latterly moving into France (20% of profits) and the UK (10%).

Newcrest and gold will always be something of an outlier. As we have seen again this year, it tends to zig when the world zags and that is one reason why we like it. A lot of people like to talk about gold, though we are questioned less these days as to why we own it. We liken it to a fire insurance policy.

More significantly, we think the market has failed to appreciate the transformation of the company in the last three years under the CEO, Sandeep Biswas. The company is extremely focused on turning gold into cash and since he has been in charge, the company has generated free cash-flow of US$2.5bn.

In addition, output has gone up, capital expenditure has fallen and the financial position has improved substantially over that time. The group could well be debt-free in a couple of years, which is a material change from the rumoured need for an emergency rights issue right before Biswas joined. The board has been strengthened and alignment has improved.

Of course, gold has plenty of naysayers, with paper-gold (ETF's) supplanting physical purchase; and now there is talk of crypto-currencies being the new real asset. We don't fully understand these new currencies, but there seems to be many alternatives and the price-performance suggests a degree of speculative bubble pricing even if they are real.

Nobody knows, but we are still of the view that gold may do rather well and that one day we will have an opportunity to recycle the gains into lower-priced equities. It is certainly not a permanent holding, but in the meantime we believe that the group is one of the best-managed companies we own.

By contrast, our ownership of Brambles has been more challenging in the current year. We have been investing in Brambles over the last decade and are now on our third CEO in that time. It is probably fair to conclude that global pallet-pooling is a world-GDP-growth-type opportunity, which together with the dividend means the business should be capable of compounding at just about a double-digit rate. With a forward PER of 16x, we believe the group is comparatively attractively valued.

We met with the new CEO and CFO not too long ago and see Brambles as a reasonably strong franchise and where the new management should be able to improve things. Graham Chipchase, the CEO, is ex-Rexam where he sharply improved the business-metrics of what might be regarded as a similarly dull packaging business. The new CFO Nessa O'Sullivan came from Coca-Cola Amatil. We have a very high regard for her.

The new management team is aligned with us in terms of a focus on free cash-flow (where we had our concerns in the past) and return on capital employed, rather than simply growth. There should be no further acquisitions and even some disposals. The HQ and management team have relocated from Sydney to London, which we think is a good thing too, given that the US and Europe are its largest markets.

We believe the company to be relatively defensive, with the biggest customer-group being the fast-moving consumer goods sector. Recent results confirmed that the company is still growing, while on-market share purchases by the new CEO and an Independent Director (US$200-250k each) are additional positive signs. We recently added a little to Brambles at the current lower levels.

Outlook and conclusion

In our opening remarks, we noted that this economic cycle has been a long one and there has been plenty to worry about. We are not complacent about the risks to capital preservation, but at the same time recognise that some things are very different (look at Japan).

Today, the machines and those who trend-extrapolate look like geniuses. The rest of us seem flat-footed by comparison, but we know that the intoxication of success anesthetises the ability to think. Markets will continue to turn. We believe that no matter how different things seem, they are always ultimately the same.

That is why history is so helpful, as well as interesting, because the common factor is people and how we have behaved through the ages. It is why Shakespeare continues to be so relevant, beloved and endlessly redone. It is all about us with our manifold frailties of greed and fear. Today, greed is very clearly in the ascendancy and that may well roll on for some time.

> "It's impossible to produce superior performance unless you do something very different."
> - John Templeton

Markets are a human creation and will always be subject to emotion. Some, particularly the cohorts of the tech generation, disagree; they believe the answer to markets and stock prices is in the gathering of sufficient data. With more data, goes the aphorism, we will be able to understand everything.

Though we may mutter about the arrogance of youth and refer to the lessons of history, the iconoclasts draw our attention to the growing success of quantitative strategies and those who successfully operate at the cutting edge of finance. It's another version of that endless tension between science and art.

There was a time when we might have agreed, particularly when, in hindsight, we spent far too much of our time building complex Excel spreadsheets. Those models may have ended up being completely wrong, but they sure looked good. Lots of data. By contrast, these days we feel that time is spent much more productively talking to companies. After all it is seldom the spreadsheets that mess up the investment case; more often than not it is the assumptions that are used and the decisions that real people make.

Undoubtedly, someone is wrong. But the wisdom of people like John Templeton suggests that those who put all their confidence in science, data and the machines, assuming that things really are different this time, will likely end up being disappointed all over again. Maybe when big-data rules, it truly will be different one day (plenty of people seem to think so), but probably not just yet. That is what we are still counting on.

The last time we wrote, we concluded that it was probable that markets would have a last hurrah blow-off and that maybe even Emerging Markets would catch a bid. We thought that it was perhaps too much to hope for, but here we are: a full-scale bull-run.

While bull markets are thoroughly enjoyable, they are like having too much sugar – ultimately bad for you. History and our experience suggest that such conditions do not endure and we need to think hard about the potential downside. To that end, we continue to do something different and consider today's underperformance as a painful but necessary condition to ensure positive performance over time. We hope that does not sound complacent, because we are kicking our own and others' tyres harder than ever. It's what we do.