First State Stewart Asia – Asia Pacific Equities

Client Update

January 2018

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-fueled-boom contributing 55% of cumulative global GDP growth since 2008's 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 skepticism, 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.

Most businesses have some version of a founding myth which grow in the retelling 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, he 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.

Cumulative performance in USD (%) to 31 December 2017

Period	3 months	YTD	1 year	3 years	5 years	Since inception
First State Asian Equity Plus Fund	8.9	36.8	36.8	35.7	61.0	329.6
MSCI AC Asia Pacific ex Japan Index	7.9	37.0	37.0	33.1	42.2	209.6
First State Asian Growth Fund	7.7	24.3	24.3	20.0	31.2	369.1
MSCI AC Asia ex Japan Index	8.2	41.7	41.7	36.3	48.0	297.3

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than USD, the return may increase or decrease as a result of currency fluctuations. Since inception performance figures have been calculated from 25 February 2005. All performance data for the First State Asian Equity Plus Fund Class I (Accumulation) USD as at 31 December 2017. Source for fund – Lipper IM / First State Investments (UK) Limited. Performance data is calculated on a net basis by deducting fees incurred at fund level (e.g. the management and administration fee) and other costs charged to the fund (e.g. transaction and custody costs), save that it does not take account of initial charges or switching fees (if any). Income reinvested is included on a gross of tax basis. Source for benchmark – MSCI, income reinvested net of tax.

Past performance is not indicative of future performance. The above referenced funds are not available for investment by US persons. Fund information is being provided as an example of First States Investments' expertise in the strategy. Differences between fund-specific constraints or fees and those of a similarly managed mandate would affect performance results.

While the Asia Pacific ex-Japan index rose by 37% in 2017, a third of that uplift was due to the performance of just four large technology stocks. For the first time ever, the technology sector has surpassed financials in scale, quite a thing for Asia. Those four stocks alone now account for around 15% 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 expect to do much better when the tide reverses. We have no idea when that will be and given the profitability of some of these companies, as well as their alignment with government, their elevated status does for now appear rather unassailable.

Clients who have been with us for a long time will recognize 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.

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 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 behavior (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 rely 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 revisited and re-examined the big ecommerce companies. We have focused even more intently on bottom-up stock opportunities, irrespective of the top-down macro-environment.

Just as the market bifurcated 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. 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.

The Tech sector

As the Technology sector has pulled away, many investors have asked us why we don't own the large Chinese tech companies. Firstly, we do; however, in general we have not bought them for our regional Asia Pacific portfolios. In hindsight, we have been surprised by these companies' 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.

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.

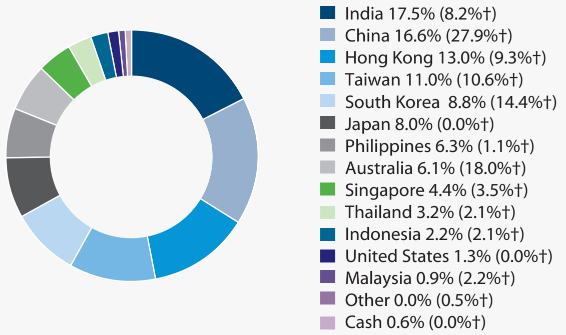
What that means, in extremis, is that if there is ever a confrontation, foreign investors have no title or effective equity interest in the operating company that holds the assets. This, arguably, doesn't matter until it is the only thing that matters. But, such structures have been well-tested since 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?

That said, Jack Ma is clearly a visionary and we pay close attention to what he says and what his company is doing. For instance, his foray into omni-channel and ownership of physical assets were made quite some time before Amazon's[1] 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.

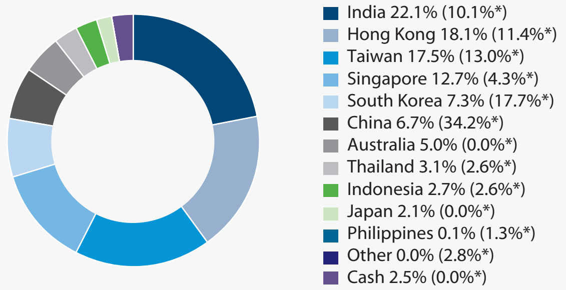
In conclusion, we struggle with the complexity of some of these companies, as well as the decisions they have taken in terms of ownership and alignment with minority shareholders. Although there have been campaigns against "brushing" (fake orders) to inflate sales figures, as well as counterfeiting on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

Country allocation

First State Asian Equity Plus Fund



First State Asian Growth Fund



Source: First State Investments as at 31 December 2017.
† Index: MSCI AC Asia ex Japan index
* Index: MSCI AC Asia Pacific ex Japan index

India

India is always incredible. Having looked through and found the structural positives in both demonetization and the more recent Goods and Services Tax (GST) introduction, after seemingly running increasingly on fumes, we finally have something to celebrate with the planned recapitalization 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 finalized, 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 recapitalization 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 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.

Generic drugs companies

Rather less positively, the performance of the Indian generic drugs manufacturers has deteriorated, going from bad to worse. We revaluated our holdings with fresh eyes recently to question whether the investment case remains sufficient.

Our conclusion is that there has been a permanent and structural change in the market place. 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.

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 politicized 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. Putting all of this together, it looks like this is an industry that is moving from tailwinds to headwinds.

[1] For illustrative purposes only. Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy, and should not be construed as investment advice or investment recommendation of those companies. Companies mentioned herein may or may not form part of the holdings of First State Investments.

China is finely balanced, all over again

All hail China, again proving 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 favorable manner. And they have, despite rising levels of debt and slowing GDP growth.

A clamp-down on some very high profile local investors 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 rumors 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.

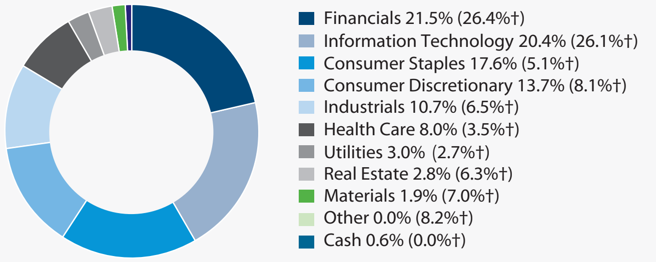
On a big picture basis, the economy is clearly subordinate to politics, but we should still be able to find some qualifying investments. In particular, given our debt-concerns, we are mindful of looking for companies that have an international perspective and export-earnings.

As we have pointed out previously, 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.

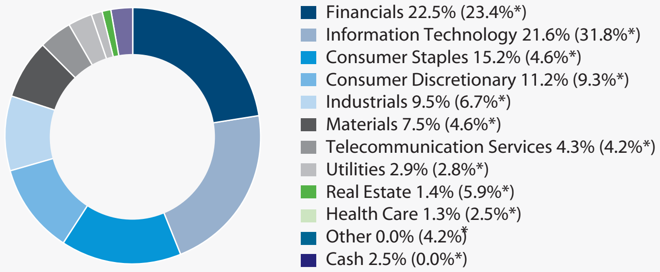
With the wider opening-up of the A-share market via Stock Connect, we have increasingly been able to invest directly into A-share companies across our regional portfolios. Collectively, we now have around US$2bn invested in this market. Out of some 3,200 companies, our A-share portfolio holds only twenty-three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

Sector allocation

First State Asian Equity Plus Fund



First State Asian Growth Fund



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Portfolio positioning

Our cautious stance, as well as overall portfolio positioning, has not changed very much over the last 12 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 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.

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 add value.

Our enthusiasm remains for exporters and US dollar earners in general (despite the new US president), as being amongst Asia's more competitive companies. In particular, we continue to have a relatively high exposure to Taiwan and technology (excluding ecommerce). 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.

Top 10 holdings

First State Asian Equity Plus Fund

	Fund Weight	Index Weight*
Taiwan Semiconductor (TSMC)	5.6%	3.3%
HDFC Bank Limited	4.2%	0.0%
Midea Group Co Ltd	3.6%	0.0%
CSL Limited	3.5%	0.9%
Samsung Electronics Co Ltd Pfd Non-Voting	3.0%	0.6%
Oversea-Chinese Banking Corporation	3.0%	0.5%
Housing Development Finance Corporation Limited	2.3%	0.7%
CK Hutchison Holdings Ltd	2.0%	0.6%
AIA Group Limited	1.9%	1.8%
ENN Energy Holdings Limited	1.9%	0.1%

First State Asian Growth Fund

	Fund Weight	Index Weight*
Taiwan Semiconductor (TSMC)	5.4%	4.0%
Newcrest Mining Limited	5.0%	0.0%
Oversea-Chinese Banking Corporation	4.9%	0.6%
Tata Consultancy Serv. Ltd	4.2%	0.4%
HDFC Bank Limited	4.1%	0.0%
Housing Development Finance Corporation Limited	4.0%	0.9%
Dairy Farm International Holdings	3.8%	0.0%
CK Hutchison Holdings Ltd	3.7%	0.7%
Tech Mahindra Limited	3.2%	0.1%
Midea Group Co Ltd	3.1%	0.0%

Source: First State Investments as at 31 December 2017.
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Mistakes

We have a number of holdings that may be considered problematic. Sometimes, the world changes in permanent ways and that is much more difficult to counter. 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.

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. Sadly then, the negative performance contribution is permanent. On the other hand, and far more importantly, capital can be deployed into companies that have done materially better. And that is the point. It is all about opportunity cost.

We should own less of a company given growing uncertainties, but often a 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 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.

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 recognize 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 anesthetizes 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.

Twelve months ago, 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 superior performance over time. We hope that does not sound complacent, because we are kicking our own and others' tires harder than ever. It's what we do.