Client Update
November 2019

For Qualified Investors Only

FSSA INVESTMENT MANAGERS

Asia Pacific Equities

"Industry is best at the intersection of science and art."
Edwin Land, co-founder of Polaroid

Modern life seems characterised by extremes, with division and discord the defining features. But, we are living in revolutionary times. Sweeping technological change impacts everything, everywhere. It is an age of accelerated disruption. From politics to trade, all is exaggerated and amplified by social media. Life and society are moving at an ever-faster pace. In the world of finance, the lowest interest rates in our two-thousand-year history have been similarly revolutionary and impactful.

Besides the arguable technological benefits, these things often produce unintended consequences. Just as the industrial revolution and emergence of the USA turned the world upside-down in the early twentieth century, so the rise of China and binary processing is bulldozing the way we live and how the world turns. One obvious outcome is the re-emergence of 1970's-style ideologues and a growing abhorrence of compromise. Much of this is probably progress; but, history suggests caution.

With the rise of the machines, the investment world has in turn been hammered. Most financial commentary is angst-laden and trauma-ridden. While China investing has, thankfully, long been part of FSSA's general focus, active fund management and the broad business model is under much pressure. Even the hedge fund titans have toppled. Growth investing has triumphed over value, all over again, while everybody believes that more low cost passive and machine-investing is inevitable. Algorithms and AI[1] are coming for all of us, with capitulation of many of the old certainties.

We have discussed some of these matters before, in particular the rise of China, the growing impact of technology and the investment opportunities in Asia. With our emphasis on capital preservation, we have previously pointed out the growing dangers for capitalism, and companies more generally. In such times, there remains a need for greater vigilance as new competition, business models, free capital and innovation overturn many long-held truths.

What to do? Most investment research, including our own, is numbers-based. There is a verity, as well as a comfort and crunchiness, in numbers that everybody can appreciate. Excel models, with their false precision, are a triumph of data availability and spreadsheets. They almost build themselves these days. Forecasts are fetishized ("great quarter, guys!") and everything increasingly revolves around short-term results versus expectations. This is hardly surprising, but it is almost wholly irrelevant.

In turn, we all think we know what "cheap" means too, whether it is a price-to-earnings (PER) or a price-to-book (PBR) ratio, in an absolute or relative sense. But, this is where things get tricky; or rather, more interesting, because business quality is by far the most important issue and often ends up getting lost in the mix. People nearly always ask whether something is cheap, long before they ask: is it good quality? After all, quality is a subjective issue and a discussion, while valuations are empirical and supposedly knowable.

The difference lies in the critical distinction between price and value. Price is just a number, but value encapsulates an attempt to look beyond the numbers into the qualitative aspects of a business, such as what the company could look like in three-to-five years and beyond. In this age of hyper-disruption and amid such uncertainty, we would argue that the difference matters more than ever. We have surely lost far more money selling expensive, but high quality businesses, than we have ever made buying cheap companies.

So, what is quality? On the one hand, it too can be reduced to a number, better known as return on equity (ROE). The science behind such formulaic ratios is deceptively simple. But, does it capture what really matters? Like for so many things: yes and no. If it were not so, humans would really have no chance versus the machines.

The central problem, as well as the opportunity, lies with the unpredictability of the future as well as the inherent nature of capitalism and capitalists. None of us know what is going to happen next. Meanwhile, whenever capitalism creates an attractive profit pool, capitalists will, in general, line up quickly to make it disappear.

The prima facie imperative for investors is therefore to not only find those businesses with high returns, but then to only buy and hold those that can continue to compound at high return rates, sustainably and into the distant future. That involves a second order of complexity, where the answer, in our experience, lies beyond the numbers and, at least for now, computers as well.

[1] Artificial intelligence

What matters most, and where our research efforts are most productively directed, lies in the decidedly less structured work and discussions about the capability of company management, persistency of competitive moats, sustainability of the business in general and the competitive environment. These are thinking, rather than calculative matters; and all the more irritatingly imprecise and nebulous compared with the arcane beauty of a spreadsheet.

Although machines are beginning to do some of these things, our best investments and biggest holdings are nearly always the product of such an approach. To that end, we often characterise our research process as being something like organised chaos, maybe like a winning football team. Yes, the numbers and the maths matter, but far more important is that trifecta of management, sustainability of franchise and financial strength, in particular the balance sheet.

With the trifecta in place, we ask only that the valuation is reasonable. We believe that markets, globally, still struggle to correctly value the world's very best businesses at a sufficient premium to the broader indexes (by definition the average). Our experience would suggest that this is indeed true. When we find these businesses, we want to hold onto them for as long as possible. If we are right about these things, we should be well positioned to produce attractive absolute and relative returns for our investors in the years to come.

Portfolio implications

In this turbulent world of broadly-rising valuations as interest rates have collapsed, the key criteria has been to again think rigorously about the absolute quality of each underlying company that we own. We have said before, that in times of escalating valuations, we are conscious of not going down the quality curve as a consequence of focusing on relative price rather than on value or absolute quality.

In fact, if anything, we have tried to do the opposite. We have doubled down on quality and, in the context of general liquidity concerns, this has seen fund concentration increase broadly as we have added to some of our existing larger holdings. One consequence over the past few months, of all these top-down concerns, has been increased volatility which has worked to our benefit. We have been able to add to some of the best companies that we own at attractive valuations.

Top down, India has probably seen the biggest reversal in sentiment. Fear of secondary banking failures, (at non-banking financial companies – or NBFCs), has resulted in a marked slowdown in domestic consumption and a broad contraction in valuations. The on-off trade talks have similarly seen China and the technology sector oscillate on vacuous headlines and Twitter-tantrums.

Meanwhile, Hong Kong has been mired in a world of pain, with trade woes compounded by civic insurrection and a lack of belief in the Government. Our trims have broadly reflected efforts to divert cash into our stronger ideas, with gold and Newcrest in particular finally catching a bid. Cash levels have fallen too.

Portfolio valuations

Just as the *Financial Times'* current series of India-bashing articles suggest that the problems are already well discounted, we trust that our low cash levels are not a reflection of another cyclical market top. To that end, we have had another look at our portfolio valuations in relation to history and returns. In our last note, we only looked at the valuation of the top-ten holdings. The outcome, given our view on the quality of the portfolio, is quite reassuring.

On a weighted average basis, the Asia Pacific portfolios are trading at a current forward PER of 22x FY20, a 20% premium to the ten-year average. Given general market valuations, interest rates, and the absolute quality of our portfolio companies, you might have expected the gap to have been bigger. By way of comparison, the PBR is 4.4x (a 6% premium to the 10-year average).

By contrast, the MSCI Asia Pacific ex-Japan index forward PER valuation is just 14x. The index is similarly trading at a premium to its ten-year average, but at just 10%. The index is trading on a PBR of only 1.6x, in line with its decade-average. Though our portfolios are in general a lot more expensive than the index, it is quite heartening that the premium is not much more than it was over the last ten post-financial crisis years.

The reasons for the higher valuation, we trust, lie in the quality of the portfolio and in particular the persistency of earnings given the current macro worries. As we have argued above, the rather more intangible but still verifiable ingredients of proven and aligned management, good governance, durable franchises and strong balance sheets are, we believe, what drive strong corporate and subsequent share price performance.

Reduced again to that one single number, the ROE of the Asia portfolios is 17%, whereas the index ROE is just 12%. Versus book valuation, you might argue that investors are certainly having to pay up for quality, but the premium is no more than usual. On that basis, given the economic and political state of the world, we suspect that it is probably a price well worth paying.

In terms of growth, the five-year earnings per share CAGR[2] for the portfolios has been 7%, compared with the MSCI at just 1%. Adding the dividend yield would boost this return to just about double-digits for our strategies. Looking forward, the consensus growth for the next two years is 15% for our portfolios, versus 12% for the index. We don't necessarily believe it, though we

[2] Compound annual growth rate

expect our investee companies to be less disappointing than businesses in general.

In summary, we do not believe that we are overpaying for quality, and the opportunity to continue compounding at a superior rate remains realistic. As we put it last time, if money-printing continues, we would hope to keep up with the indexes, while if the world ever normalises we would expect to protect capital and see our relative numbers jump, perhaps quite significantly.

Portfolio positioning and activity

Our overall portfolio positioning has not changed. Portfolio turnover remains low. A number of the more cyclical technology-driven companies that we added earlier in the year have done quite well on 5G investment hopes, but they are relatively smaller positions. India remains our biggest country exposure, while Taiwan has grown over the last couple of years as we added to technology names.

As we remarked in our last update, we felt that everybody already knew everything that was wrong with the smartphone sector, from saturation to a lack of innovation. We believed the negativity was already well discounted. Latterly, in respect of technology generally and 5G in particular, the market has indeed been prepared to look through shorter-term profit weakness.

While we believe that the upgrading of telecoms systems, from 4G to 5G, could provide much opportunity, we still wonder whether the telecoms operators will be prepared to reinvest all over again. You would think not, given that the internet companies walked off with most of 3G's returns. But, then again, once one starts we presume the others will follow. In Asia, without question, from China to Korea to Japan there is a strategic imperative too. You can understand why we do not, in general, like to invest in telecoms providers.

We made five sales since our May note, with three of them (Comfort-Delgro, Hanssem and Ryohin Keikaku) discussed in some detail last time. We often joke that the more we talk (and write) about a company, the less good it is; or at the very least the more problems there are. That is certainly the case at our weekly meetings. For Godrej Industries, we switched into underlying Godrej Consumer. Additionally, we sold KasikornBank in Thailand and Public Bank in Malaysia.

There was only one new position, Fanuc Corporation in Japan, while we added broadly to a large number of positions (including those in our top five). There was less activity on the sells side; in terms of materiality, we trimmed Newcrest, Jardine Matheson, Tech Mahindra and Uni-President Enterprises.

What we bought

We have admired Fanuc from afar for a long time. Fanuc is the world's largest maker of industrial robots, with the technology (in particular smartphones) and auto cycles both having propelled strong profits growth in recent years. The company is an obvious beneficiary of the trend toward greater factory automation, particularly in China.

The group has a strong franchise, but has always been something of an enigma. Fanuc has been largely closed-off, secretive, cult-like and very private when it comes to investors. With management engagement being a large part of our process, we have accordingly struggled to gain the requisite confidence. However, after faltering profits and persistent criticism, and perhaps in tune with Japan's greater embrace of shareholder value, the company appears to have changed direction in the last few years.

In FY16 the dividend pay-out was increased from 30% to 60% (maximum of 80%) and perhaps more significantly the group cancelled three-quarters of their outstanding treasury shares (almost 20% of capital). Furthermore, they set out a plan to buy back shares equivalent to 20% of profits over five years, while capping outstanding treasury shares at 5%. Of course, the share price surged, on top of what in hindsight was a cyclical peak for their main underlying customers.

Reform is, however, continuing, with the son of the founder stepping back from the CEO position in April of this year in favour of a non-family professional. The son remains on the board. The family holds only a token number of shares. In the meantime, despite initial enthusiasm, the share price has fallen sharply as profits have almost halved in the last five years with margins halving from 40% (FY15) to below 20%. The forward PER multiple, on depressed profits, is still in excess of 35x.

Meanwhile, net cash of almost USD5bn is more than 10% of its market capitalisation and we are even making progress in terms of management engagement. Given the sharp fall in profits, but the undoubted strength of its franchise and quality of the overall business, we initiated a small position. If our confidence increases, we may subsequently add to our holding.

With smartphone sales flat-lining globally, the technology sector has been challenging. The US embargo of Huawei, as well as general belligerence from both the US and China, have not helped either and company profitability and share prices have slumped. But, with China now aggressively pushing 5G technology, and new 5G smartphone models likely to be available more widely in second half of 2020, markets are already discounting a much stronger environment.

We acknowledge that our confidence around such cyclical businesses will always be less robust, but having followed these companies for many years, we are happy to be able to add to them in times of general aversion. In addition, we are comforted by the cash flows and strong balance sheets of the technology sector in general. Accordingly, we added further to the technology hardware names in the portfolio; though collectively, they still account for less than 5% of our portfolios.

We added to our largest holding, a Taiwanese semiconductor foundry, after meeting with them and reading the annual report. We believe their competitive position has improved, with Moore's Law now bumping up against the laws of physics. On a five-year view we expect China to ramp up competition, but for now their position seems to have strengthened versus the likes of Intel and Global Foundries. The company is now the largest holding across our Asia Pacific strategies.

Their main industry peer, a Korean company, is clearly competitive, but their fast-follower business model means that they will always struggle to supply customers at the leading edge. By contrast, the Taiwanese company has never competed with any of their customers. Their balance sheet remains strong, but the valuation is now somewhat stretched absent a sharp rebound in profitability.

In India, valuations for domestic companies have corrected quite sharply. Besides adding to our existing IT services holdings, we added to a few of our other key holdings in financials and consumer names. Our IT services holdings continue to benefit from the growing digitalisation of everyday life, while we appreciate the efforts of a new CEO at the Indian bank in restoring the group's fortunes. We see the bank as a good example of a somewhat faded franchise being reinvigorated by a proven CEO (ex-HDFC Life).

As a group, we have owned a number of Indian family-owned companies for many years. In particular for one of these groups, the flagship consumer business, like the consumer sector more broadly, has de-rated sharply over the last twelve months. While growth has slowed generally, the company has experienced some specific issues with their overseas businesses, in particular in Africa.

The management are confident of recovery, while the domestic Indian pest control business has been challenged by unregulated competition. We expect this will normalise too. However, while we believe the worst is already past, looking out three years the company is trading closer to 40x PER. In India, given the long-term growth opportunity, quality is even more highly priced than the rest of the region.

What we sold

In our last note, we discussed our misgivings about transport and taxi-operator Comfort-Delgro in some detail, with the group being a good example of what can happen to an incumbent when technological disruption is combined with access to abundant capital. We bought the business when it was somewhat distressed, with a free cash flow (FCF) yield of 10%, due to the entry of numerous competitors. Even though the business struggled, the exit of UBER from the Singapore market, as well as less intense competition, meant that we exited at a modest profit.

It is, however, a good example of the tyranny of valuation, versus a broader-based qualitative appreciation of the outlook for the business. Though we ultimately did not lose money, the outcome was due more to luck than judgement, with the entry price, in hindsight, sufficiently cheap despite the denuded outlook. Without question, the power of the franchise has been eroded, which means that prospects for the business are undoubtedly less good. It is a tough way to make money over the long term, in comparison to buying growth businesses.

We discussed Korea's Hanssem group too, noting that we were already trimming the position. Although the share price doubled from the bottom on rumours of a take-over, we still ended up booking a capital loss. Subsequent results demonstrated that the franchise has similarly been eroded by competition, as well as the overwhelmingly weak Korean housing market. The balance sheet reassured us, so we added at lower levels; but, ultimately Korea's regulatory framework and general opacity always increase the required burden of proof.

Otherwise, over the course of the last year, we have been focused on liquidity, in particular with the declining outlook for Southeast Asia. From a top-down point of view, we have also reflected on our exposure to the banking sector in a world of declining spreads, flattening interest rates and arguably rising risks. Credit costs have seldom been lower. To that end, we sold out of both KasikornBank in Thailand and Public Bank in Malaysia. Our banking exposure is now limited to India and Singapore.

Outlook and conclusion

"There is an art to science, and a science to art; the two are not enemies, but different aspects of the whole."
Isaac Asimov, author

After Hong Kong's last significant civic convulsions in 1968, the journalist Richard Hughes published a book famously titled: *Borrowed place, borrowed time*. With Hong Kong's equally infamous focus on money-making, he described a city that at the same time was entirely "devoid of self pity, regrets or fear of the future."

Well, 1997 came and went; and while Hong Kong is no longer a borrowed place, it is sadly a city increasingly mired in self-pity, as well as replete with regret and growing fear of the future as time rolls on. We are all prisoners of history, but it takes a certain level of fatalism to merely keep calm and carry on, with every weekend bringing dystopian street scenes to the city. These days, Hong Kong looks even more like a *Blade Runner* film-set than usual.

And yet, as we know, the city has always bounced back from adversity and everything always looks worse on TV. During the week, business rolls on as usual and most companies have long ago sharply reduced their exposure to the city, as China has opened and prospered. We are not complacent about the risks and nor do we disagree that there is indeed more to life than just business, but beyond Dairy Farm, we believe the impact is at least manageable for the companies that we own.

Irrespective of the political and social outcome, and as is always the case, economics ultimately works; and rents, property prices and the cycle will continue to turn. Although the human and emotional cost is already high, we do not expect Hong Kong's prospects to be permanently impaired. As we all know, analysis should always trump emotions. But, just as we attempt to blend art and science together to facilitate better decision-making, so too we hope that a resolution in Hong Kong will be reached through compromise and greater understanding.

The last decade has been a relatively benign period for equities and returns have broadly been good, as debt has accumulated and interest rates have collapsed. Volatility has fallen across all asset classes, as we have been anaesthetised with free money. Indeed, returns have compounded, as more and more investors have capitulated and ended up doing the same things.

Growth businesses have performed well in particular and we have been fortunate. Irrespectively, we still spend the majority of our time focused on the qualitative issues – in particular the human factor – that underpin such franchises rather than getting sidetracked by fixating on just the numbers.

We have always believed that quality, however you define it, is the ultimate driver of superior returns and today that viewpoint is probably more important than ever. It would not be at all surprising, given the excesses and divisions around the world, if markets were from here to experience periods of quite extreme volatility. From experience, though, we know that during such conditions, quality and certainty trump valuations every time. In turn, these things help us make sensible decisions.

Come what may, it is another example of the future being thoroughly unknowable. If the world continues to amble along, which is by far the most likely outcome most of the time, we are confident that our absolute returns should continue to be quite respectable. After all, given the quality, growth and returns of our current Asia Pacific portfolios, valuations still look reasonable.

However, if this turns out not to be the case, with our focus on capital preservation and a three-to-five year time-horizon we would expect our long-term relative returns could receive a substantial boost. That has certainly been the pattern in the thirty-year history of this team.

Strong absolute returns have generally compounded on the back of our emphasis on qualitative research, with relative returns bolstered by periodic market melt-downs, via the Asian crisis ('97), tech-wreck ('00) and most recently the global financial crisis ('08). That said, obviously we have no idea what happens next.

While maths and science sees an orderly progression of numbers into the future, a healthy degree of scepticism and a re-reading of history might well argue for a greater degree of caution. Per the human condition, we trust we can continue to have it both ways. With thanks, as always, to all of our clients for your active support.

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

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