For professional clients only

First State Investments

Investment Case for Asian Fixed Income

July 2017

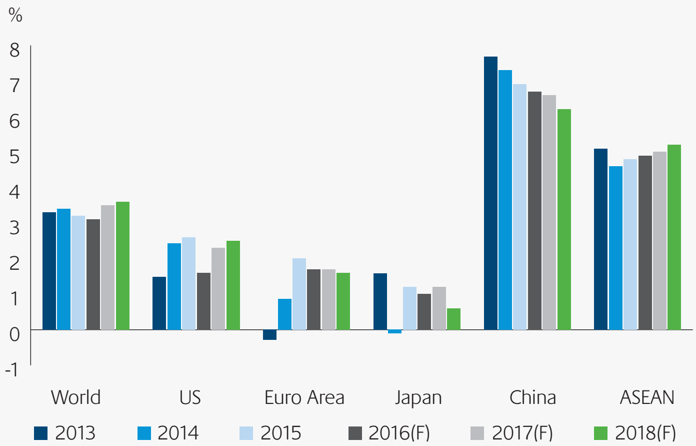
The Outlook for Asia

The market outlook for Asia and how it translates into bond market demand remains positive according to our analysis. On the positive growth outlook remains constructive, inflation contained and central bank rates are not at zero (thus providing flexibility should growth decline). On the negative side is a growing demographic pressure that will require the need to develop sustainable pension systems. We think about this in the context of a very strong growth in the size of the Asian USD credit market and the conclusion looking forward is that the demand dynamic for Asian Investment Grade credit should remain robust.

The Outlook for Economic Growth in Asia

No matter how you feel about Asia, the outlook for economic growth is inextricably connected to the fortunes of China. Early on in 2016 global financial markets have agonised at to the probability of a China 'hard landing'. Yet as we look to 2017 as a guide, we see cause for the Chinese economy to be on stronger footing, helping the outlook for Asian. Whilst developed market growth remains tepid at best (even after years of quantitative easing), the outlook for growth in 2017 for ASEAN continues (ASEAN refers to The Association of Southeast Asian Nations, is the regional intergovernmental organisation comprising ten Southeast Asian states formed in 1967) to outperform other regions. Latest International Monetary Fund ("IMF") projections look to a sustained economic outlook for the region outperforming developed markets (Chart 1).

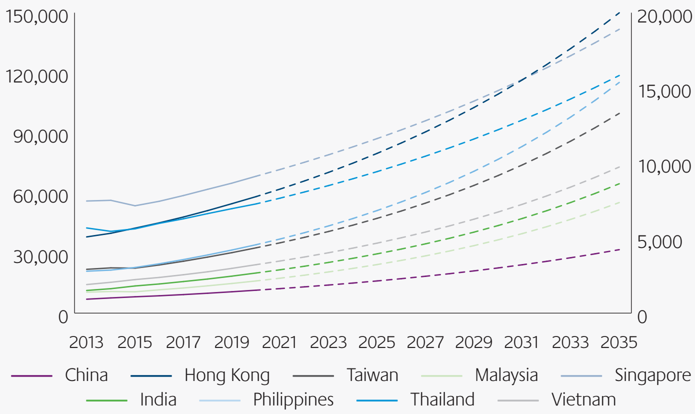
Chart 1: Projection of economic outlook between Asian countries and developed markets



Source: IMF Annual Outlook as at February 2017.

Along with this projected economic growth, GDP per capita's are projected to rise significantly, supporting the development of a middle class in Asia that is significant in terms of population (Chart 2).

Chart 2: Projected GDP per capita (USD)



Source: IMF, First State Investments as at July 2015.

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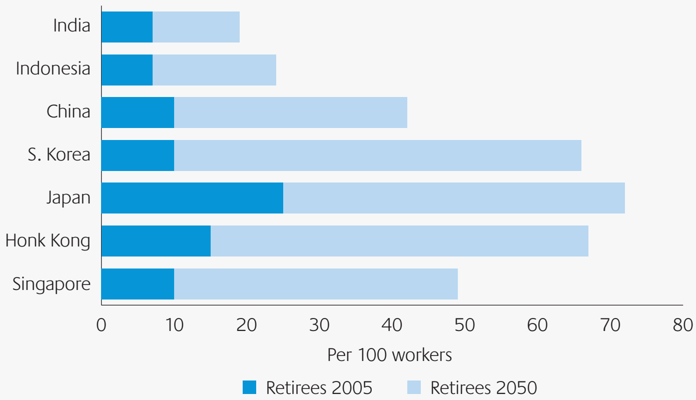
The Outlook for Demographics in Asia and Potential Implications

- Many of Asia's retirement systems are ill prepared for the rapid population ageing
- The demographic change to fewer babies and longer life expectancy took a century in Europe and North America
- In Asia this transition is happening in a generation. Asia's ageing will be at its peak between 2010 and 2030 according to the OECD
- Compared to OECD averages the percentage of those who contribute to pensions is low
- Pension reforms are on the agenda of Asian countries. Models in Singapore and Hong Kong are often used as guides
- A broader agenda exists now in recognition of the benefits a domestic pension system brings to the stability of demand for domestic bond markets

Chart 3: Number of retirees across Asian countries



Source: OECD 'Pensions in Asia/Pacific – Ageing Asia must face its pension problems", 2010.

The Outlook for the Development of Pensions Industry in Asia

The Hong Kong and Singapore's Pension systems are the most developed in the region. Using their growth as a guide for potential growth of new pension systems, a rapid development of pensions across the region presents significant opportunity.

1. HK's MPF – today approximately US$80bn – actuarial Society of Hong Kong paper 2015 predict this to be US$335bn - US$413bn by 2035 (over 300% growth)
2. SG's CPF – today US$195bn – last 15 years has averaged a growth in size of 8%. The actuarial assumptions predict growth to between US$900bn and US$1.1trn by 2035 (over 300% growth)

Other major economies in the region are coming off a lower base in terms of the pension system development. Arguably the pace of growth and development could or should be greater for said economies. The Asian Development Bank in a 2015 publication forecast that over the following 15 years, 500 million adults in Asia will begin a pension savings plan for the first time. This should be supportive of demand for Asian fixed income. Furthermore, this will further complete the positive household savings rates that exist throughout China. Something absent from many developed markets.

Regulatory Reform / Harmonisation in Asia

A challenge for Asia's financial markets has been harmonisation of financial markets. Lead regulators in the region collaborate and where feasible enact policy consistent with other regulators in the region. However there is much more than can be done to reform regulation and harmonise financial markets. An interesting recent development has been the announcement that the International Organisation of Securities Commissions (IOSCO), the world's leading body of capital market regulators that oversees markets worth over US$140tril, launched its first-ever Asia-Pacific hub in Malaysia. It will play a major role in developing capital markets, on a collaborative basis, which will help the capital markets grow even further. The hub is also expected to strengthen regulatory capabilities in the region.

China Onshore

A recent development that directly impacts the Asian bond market is the ongoing opening of the China onshore bond market. Whilst access is available within certain daily limits, the longer term objective is to support two way flows of capital, specifically between onshore China and Hong Kong. Initially the development is aimed at attracting international investors to its vast onshore markets (the world's third largest). By broadening the investor pool it should improve the quality of its onshore debt markets and ultimately stem outgoing capital flows. The next step would be larger two way flows that should be supportive of Asian bond markets.

Summary View

Asia remains the region with better economic growth and contained inflation. These two considerations would underpin a positive outlook for Asian USD Investment Grade demand. The demographics are deteriorating and requires focus from governments on pensions and savings which is being done so in countries such as Singapore and Hong Kong, but needs further action in many others. Pension growth should underpin support for Asian USD Investment Grade in the coming years. Lastly the announcement of IOSCO's first hub in Asia (we believe) is a significant step towards the promotion of more harmonisation across the countries in Asia.

When considering these factors, the demand point to a strengthening bias. This is why when we meet investors yet to allocate to Asian USD Investment Grade our suggestion is to consider it as a core holding going forward.

Why Asian Fixed Income

We believe we stand at a juncture where Asian Fixed Income (specifically USD credit) should be considered a strategic allocation instead of tactical. The market is maturing and consistently produces risk adjusted returns that compare well across other asset classes. Demand continues to grow for Asian Fixed Income yet globally, the asset class remains under allocated. The previous long held concerns about allocating to Asian Fixed Income have diminishing. Historically the primary concerns with Asian Fixed Income are:

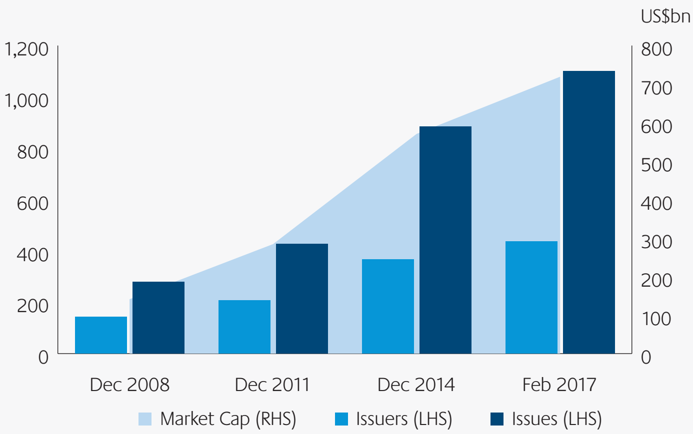
- Lack of Diversification
- Low Credit Quality
- Excessive Volatility
- Inadequate Returns

We believe that the growth and development of the Asian Fixed Income market in recent years will continue diminishing even further the concerns above.

Lack of Diversification

Asian Fixed Income markets have experienced significant growth since 2008. By way of example, we consider the growth in a widely used Asian Fixed Income Benchmark, JP Morgan Asia Credit Index ("JACI"). Since 2008, JACI has quadrupled its market capitalisation (Chart 4 below). Within that, the number of issuers in the benchmark has tripled. When considering the number of issuers and that Asian Fixed Income issuers (eligible for benchmark inclusion) originate from 16 different countries, this facilitates the construction of portfolios far more diversified than ever before. Today China issuers are the largest constituent of Asian Fixed Income, followed by South Korea, Hong Kong, Indonesia and India.

Chart 4: JP Morgan Asia Credit Index expanding investment universe



Source: JP Morgan Asia Credit Index, as at February 2017.

KEY STATS:

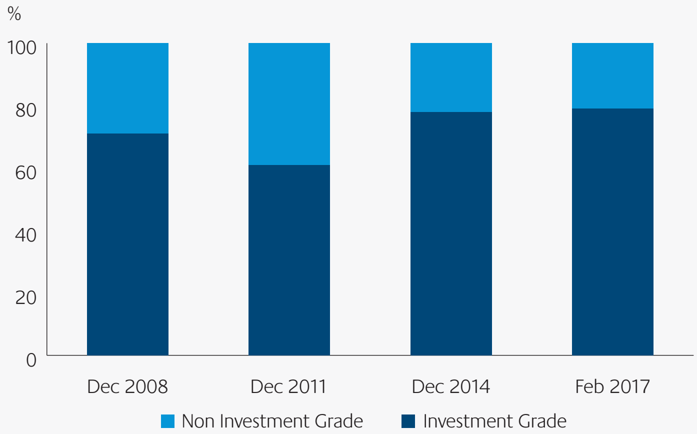
- Size of Index 2010 US$284bn – Feb 2017 US$719bn
- Number of eligible issuers in Index 2010 208 – 2017 437

Source: First State Investments and JP Morgan. Data as at 28 February 2017.

Low Credit Quality

The growth in issuance in Asian USD credit in general has been dominated by Investment Grade Corporates. In 2015 approximately 80% of the new issuance that came to market came from Investment Grade Corporates (Chart 5).

Chart 5: JP Morgan Asia Credit Index rating diversification dominated by Investment Grade

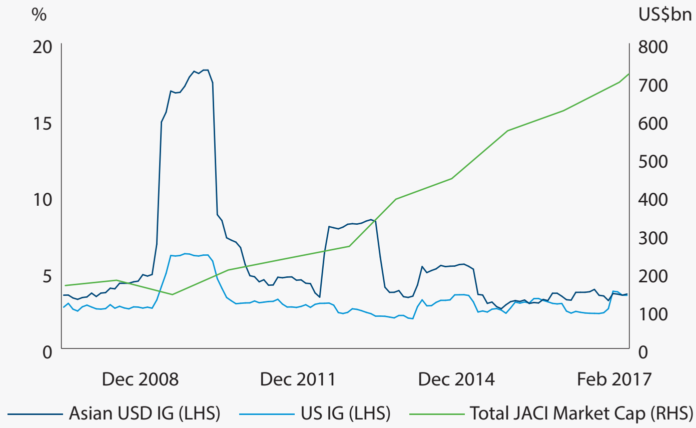


Source: First State Investments and JP Morgan. Data as at 28 February 2017.

Excessive Volatility

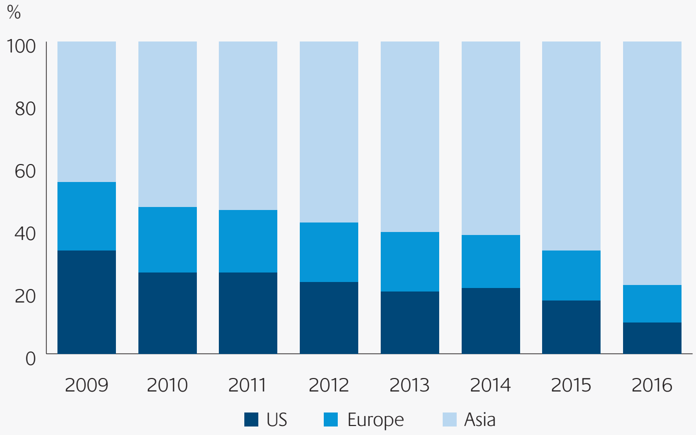
Asian Fixed Income had historically endured volatility greater than other investment grade markets. With the growth in the market creating a deeper, more diversified this volatility has begun to recede. However our research has pointed to an additional point that may contribute to the decreased volatility. Chart 6 compares annualised 12 month rolling volatility of Asian Investment Grade to US Investment Grade, overlaid with the total market capitalisation (RHS) of Asia Investment Grade. From 2009 (i.e post crisis) Asia Investment Grade has exhibited more volatility than US Investment Grade. Interestingly though from the end of 2014 until today, Asian Fixed Income volatility has largely mirrored that of US Investment Grade.

Chart 6: Annualised volatility of total returns



A recent study by KPMG looked at where the Asian Fixed Income Assets reside. Over the last five years the percentage of Fixed Income assets held within Asia has continued to grow, rather than being held in the US or Europe (Chart 7). We believe that this is a contributing factor to the reduction in volatility as Asian investors would be far more aware of the issues with respect Asian issuers, than foreigners.

Chart 7: New issue investor allocation by region



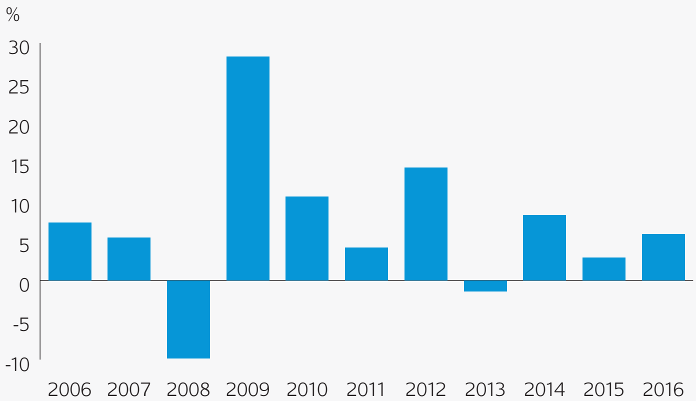
Source: First State Investments, JP Morgan, and Bond Radar. Data as at 31 December 2016.

As discussed we attribute this to market growth and greater participation by Asian based investors.

Inadequate Returns

Asian Fixed Income has delivered consistent returns year on year. Since inception (Chart 8) the JACI has provided consistent yearly positive returns except in 2008 (in line with most asset classes) and 2013 (as a result of taper tantrum). Additionally a common misconception is that Asian Fixed Income will underperform in a rate rising environment in the US. The JACI index was launched in September 2005, in the middle of the Federal Reserve's last rate rising cycle that lasted through to the middle of 2006. That cycle was quite aggressive yet Asian Fixed Income still generated positive returns.

Chart 8: JP Morgan Asia Credit Index annual total returns



Source: First State Investments, JP Morgan, and Bond Radar. Data as at 31 December 2016.

We have also considered Asian Fixed Income returns in the context of volatility (i.e. risk adjusted returns or Sharpe Ratio) and compare them to major asset classes as a comparison (Chart 9).

Asian Investment Grade credit returns and Sharpe Ratio when compared to other asset classes over a 5 year period to 28 February 2017, are favourable.

We see increasing probability of more investors allocating to Asian Fixed Income in the coming years. As Central Banks crowd out Fixed Income investors globally, Asian Fixed Income will grow in importance. With higher returns than US Investment Grade and Europe Investment Grade, and annualised volatility akin to US Investment Grade, we believe this makes it an attractive asset class.

Chart 9: Five year risk adjusted returns

	Asian USD IG	US IG	EM USD Sovereign	Asia Ex-JP Enquiries
Annualised Return	4.7%	2.2%	5.8%	3.7%
Annualised Volatility	4.0%	2.9%	6.6%	14.2%
Sharpe Ratio	**1.1%**	0.7%	0.9%	0.3%

Source: First State Investments, JP Morgan, Barclays, and MSCI as at 28 February 2017.

Why First State Investments for Asian Fixed Income

As an experienced global fixed income and credit manager providing stewardship to over US$58.7bn (as at 31 March 2017) in global fixed income assets and within that US$1bn Asian USD denominated Investment Grade credit, we are well placed to manage a portfolio incorporating single name credit security selection. Our focus on quality has through the cycle delivered consistent total and risk adjusted returns for our clients. We have been researching and investing in Asian USD Investment Grade Credit since 2003 (the launch of our flagship mutual fund the First State Asian Quality Bond Fund). Some key points about our approach are:

Local Knowledge Since 2003

Asian Fixed Income has been a key commitment for First State Investments since 2003. In 2003 we launched the First State Asian Quality Bond Fund ("AQBF") to invest in Asian Investment Grade credit. Whereas for many professional fund managers, Asian Fixed Income has only been of focus in recent years, we believed back in 2003 in the future of this asset class. Today AQBF is one of the largest wholesale Investment Grade only credit fund in the region, giving FSI unparalleled insight into Investment Grade Credit.

Dedicated Experienced Team

Asian Fixed Income is not just about the asset class, it is about the experience of the people investing in the asset class. Our investment team has average experience of over 15 years in Asian markets. Unlike other teams, we believe a more rounded approach comes from locating the team throughout the region, rather than focusing on one. Today team members are located in Jakarta, Singapore and Hong Kong. In the future we see scope for broadening this further. We believe this delivers a more rounded view of the many complexities of the region. Asian financial markets have been through a lot of cycles and our team have been here to experience most of them.

Credit Analysis Incorporating ESG

At the heart of our Asian Fixed Income investment process is our approach to credit analysis. We combine fundamental credit analysis with quantitative analysis, an Environmental, Social and Governance issues ("ESG") analysis and an assessment of the quality of information provided. This methodology enables us to focus on where the risks in a corporate are changing and has been behind our track record of never having an investment grade issuer default in our portfolios.

First State Investments Asian USD Investment Grade Approach

First State Asian Quality Bond Strategy is an actively managed strategy investing primarily in a diversified portfolio of investment grade Asian USD and local currency bonds, including sovereign, quasi sovereign and corporate bonds. The main sources of value add are:

- Country selection reflecting the output of Asian markets assessment which includes quantitative and qualitative analysis
- A focus on ensuring that portfolios are built in a balanced and diversified manner – where one particular view does not dominate –increasing the likelihood of accomplishing portfolio objectives
- Duration and yield curve management, reflecting our thematic, factor based approach

The result is a portfolio diversified by country, sector and issuer; focused on delivering consistent risk adjusted returns.

Asset allocation (%)[1]

Country	%	Sector	%	Credit rating	%
China	42.0	Govt Related	49.4	A	46.5
Singapore	11.5	Corporates	44.2	BBB	42.7
Hong Kong	10.2	Treasury	3.1	AA	4.5
South Korea	9.4	Securitised	0.0	AAA	3.0
India	6.5	Liquidity	3.3	Liquidity	3.3
Malaysia	5.3				
Indonesia	5.1				
Thailand	2.6				
USA	2.5				
Australia	1.6				
Liquidity	3.3				

Top 10 issuers (%)

Issuer name	%
China Overseas Land & Investment Ltd	3.9
Pertamina Persero PT	3.7
China Huarong	3.6
Overseas Chinese Bk Corp	3.4
Sinochem Hong Kong (Group) Co Ltd	3.3
Alibaba Group Holding Ltd	3.1
DBS Group Holdings Ltd	2.8
CNOOC Ltd	2.8
Hyundai Motor Co	2.6
United States Treasury	2.5

	Representative Portfolio[2]
Benchmark	JP Morgan Asia Credit Index – Investment Grade
Risk Profile (3yr annualised)	Tracking Error: 0.58% Standard Deviation: 3.33%
Sharpe Ratio (3yr)	1.35

Performance

	Cumulative Returns (%)			
	10 years	5 years	3 years	1 year
Composite[3]	64.15	26.37	14.23	4.28
Benchmark	75.09	26.59	13.83	3.73

	Calendar Returns (%)					
	2012	2013	2014	2015	2016	2017 YTD
Composite[3]	10.51	-2.09	7.90	2.04	4.67	4.21
Benchmark	11.27	-2.56	9.00	2.16	4.49	3.57

[1] First State Asian Quality Bond Fund. Past performance is not necessarily guide to future performance. Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same. Source: First State Investments. Data as at 31 May 2017. Gross (in USD term).

[2] The analysis on the First State Asian Quality Bond Fund assesses the performance of the fund versus it's benchmark, the J.P Morgan Investment Grade index.

[3] References on following page.

[3] Notes:

1 For the purpose of complying with the GIPS standards the firm is defined as the UK, Hong Kong, Singapore and US investment management operations of Colonial First State Global Asset Management ("CFSGAM") which includes First State Investment Management (UK) Limited, First State Investments International Limited, First State Investments (UK) Limited, First State Investments (Hong Kong) Limited, First State Investments (Singapore) and First State Investments (US) LLC. CFSGAM is the international asset management business of the Commonwealth Bank of Australia. CFSGAM includes business divisions operating as First State Investments, First State Stewart Asia and Stewart Investors.

2 The Asian Quality Bond Composite consists of portfolios in investment grade fixed income and similar transferable instruments issued primarily by government, supra-national entities and corporate issuers in the Asian debt and securities markets. Heavy exposures to Asian local currency bonds are allowed. Composite creation date: 31 December 2013.

3 Valuations are in US Dollars and priced using official closing prices, sourced from FT Interactive Data.

4 The benchmark for the composite is the JP Morgan Asia Credit Investment Grade index.

5 Performance total returns have been calculated before management fees & expenses and after all trading commissions.

6 Returns are calculated net of non-reclaimable taxes on dividends, interest, and capital gains. Reclaimable withholding taxes have been accrued.

7 A complete list and description of the firm's composites and performance results is available upon request.

8 First State Investments claims compliance with the Global Investment Performance Standards (GIPS) and has prepared and presented this report in compliance with the GIPS standards. First State Investments has been independently verified for the periods 1st January 2003 to 31st December 2014. The verification reports are available on request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

9 First State Investments does use hedging or leverage in the management of any funds within Fixed Income composites

10 The measure of dispersion is shown as the lowest and the highest annual return within the composite. Where there is only one mandate within the composite for the full period, the dispersion is not applicable.

11 Three-year annualised ex post standard deviation measures are not presented when there are less than 36 monthly observations available.

12 Additional information regarding policies for valuing portfolios and the calculation and reporting of returns is available upon request.

13 For all periods from 1 January 2010, the firm has had in place a significant cash flow policy whereby a portfolio will be removed from the composite if the cash flow is 10% or more of a portfolio's [or fund's] value. The firm has determined that an external cash flow of 10% or more may temporarily prevent the firm from implementing the intended investment strategy, thereby the fund is no longer representative of the composite strategy.

14 The client's return will be reduced by management fees and any other expenses incurred in the management of the account. The advisor's investment advisory fees are described in Part II of the advisor's Form ADV. The basic fee schedule, which is negotiable, is 0.75% p.a. Assume that $100m under the management of First State Investments achieves a 10% p.a. compounded gross annual return for 10 years. If an advisory fee of 0.8% p.a. of average assets under management were charged per year for the 10 year period, the annual return would be 9.2% p.a. and the US Dollar value of assets would be $241.1m net of fees compared with $259.4m gross of fees.

15 Source: First State Investments. All performance is expressed in USD. Data as at 31 May 2017.