

## First State Stewart Asia - Asia Pacific Equities

### Asia Update

January 2017

We last wrote to you well over six months ago, but we have been struggling to keep up with events. And then, of course, there's the second-derivative of the market response. It has been anything but dull, of late.

In the real world, the likes of the GBP4.5m pay-out on a GBP1 treble-bet that Leicester City would win the Premier League; that the UK would vote to leave the European Union; and that Donald Trump would go on to win America's presidency, suggest that we are hardly alone in market-land.

“There are decades where nothing happens; and there are weeks where decades happen.”

Vladimir Ilyich Lenin

Lenin had it right. These events together mark something of a revolution. Trump's election appears to have called time on the neo-liberal consensus, market fundamentalism and all the existing certainties, just as much as the cosy Reagan-Thatcher axis did for market-socialism in the early 1980s.

Despite all the hand-wringing, latterly somewhat soothed by the market's giddy ascent, it's not as if the current system is working. QE, in particular, seems anything but sustainable. We now have another opportunity to suspend disbelief and, more importantly, something new to believe in.

That it has taken the “deplorables”, better known as the populace, so long to up-end the status quo is more surprising. But whatever transpires, we suspect that in the months ahead we are going to find ourselves remembering that we should indeed be very careful what we wish for.

The following commentary is designed to provide an update on some of our current views. It will aim to cover the following issues:

- Review of the last six months
- Asia Pacific positioning
- Realised and unrealised mistakes
- Outlook and conclusions
- Appendix

### Performance review

These days it seems that the quicker the dominoes tumble and the old-certainties crumble, the greater the collective euphoria. This is hard to understand, but probably provides a good example of bull-market psychology 101. I suppose we should just be thankful that we finally have animal spirits. And so, the most miserable bull-market in history has been transformed just like that. Sadly, such market conditions usually end with a bang and not a whimper. Hold on for the ride.

The high-priests of the old economic orthodoxies and the TINA-experts are in full-scale retreat. Moreover, it turns out, and who would have thought it, that actually: There Is An Alternative. And it's bullish, of course. Trumponomics may, in fact, be the best thing that has ever happened. Economic revisionism is having a full-scale revival and those who told us that all is "doom" are now falling over themselves to reassure us that all is "boom". Who knew?

Well, not us, as is evident from our recent performance. We find such periods of underperformance regretful, but on the other hand not that surprising. We have always gone out of our way to point out that in more ebullient market conditions, we will do less well. On the other hand, we think the bigger surprise, more positively, is the scale of the absolute gains in recent years. We continue to compound, despite the low growth environment.

Those who are more familiar with us will understand that we have never been investors for all seasons. We know that we cannot outperform all the time and indeed it is not even a conscious objective. On the other hand, we do appreciate that such a stance is better appreciated in theory, as well as in hindsight, as opposed to when it directly impacts client wallets.

Despite our overt candour about our failings, some clients have inevitably expressed concern, which is only right. We always ask ourselves whether we could have done better in such circumstances. The answer is always and inevitably: yes. But as we have remarked before and as Kierkegaard famously summed up human affairs (and fund management): "Life can only be understood backwards, but it must be lived forwards."

### No great rotation

In that regard, you should not be surprised to learn that while we are open to the idea of everything now being turned on its head, we have continued to invest as we have always done. And so there has been no grand rotation, or top-down sector reallocation. Recent events have again firmly demonstrated that really, "nobody knows anything" at all.

Why too, we wonder, would we turn our back on something that has been proven to work over long periods of time for the sake of avoiding shorter-term embarrassment? In fact, there is a very good reason that we try not to focus too much on short-term performance. You simply, we believe, end up chasing your tail in an ever-dizzying spectacle that has sometimes been likened to driving at speed, whilst fixated on the rear-view mirror. It is unlikely to end well. Performance is an outcome of our process.

Our focus remains on finding high-quality management teams and businesses. When we find them, we want to hold on to them for as long as we are able. That this is the case should not

be surprising in the current environment of little growth and negligible interest rates. Of course, until last month everybody else was a 'quality investor' too and that is a concern. The obvious parallels with the US nifty-fifty environment of the 1960s and 1970s, when people invested in the 'best' companies and then had their heads handed to them should not be overlooked.

### Valuations matter

When everybody ends up doing the same, you know that it will usually end badly. Such herding has been further compounded by passive strategies, in particular those that have piled into consumer franchises (the most obvious short-hand for quality). We have always been mindful of valuations, the more so when the tide is so clearly pulling strongly in one direction. As a result, we have leant firmly against such exuberance in the last six months. It is one reason why our recent portfolio turnover is higher than you would expect. Company or name turnover is much, much lower.

In hindsight, such re-positioning is never enough, at least in the shorter-term. But then again, the latest all-in on cyclicals may just as easily, in the fullness of time, be seen as only the latest example of the collective folly of herding investors. It is too soon to say, but markets can be pretty random in the shorter-term. We suspect that it is particularly likely to be the case when political and economic tectonic plates are shifting, as they appear to be doing so today.

### It's macro, all over again

As bottom-up investors, we do not invest on the basis of what we believe might happen in the world of macro, but we are not complacent about the top-down risks to client portfolios either. We think a lot about what is going on, what the companies we meet with are seeing in terms of cyclical changes and what might help or hinder them. We invest in people and companies.

We don't think it is complacency, or arrogance, but just a frank recognition (as recent events must surely have once again proven) that the future is thoroughly unpredictable. But, it is worse than that too, as we believe that much time and analytical effort can actually be wasted on an endeavour that will always by definition end in failure. Such efforts remind us of Oscar Wilde's old adage on fox-hunting: "the unspeakable in pursuit of the inedible."

In this world of 'expected surprises', a favourite oxymoron if ever there was one, we are of the view that we're much better off devoting our time and effort to something much more prosaic. Namely, trying to find those management teams and businesses that have over time and in a proven manner managed to navigate the swings and roundabouts of various cycles and Government policies. It is a hard enough task.

We think that the ability to generate an ROE consistently in excess of the cost of capital, as well as a proven track-record of dealing with the vicissitudes of what the world has to throw at us, says much about the general quality of a business as well as management-thinking and behaviour. We believe that these things are the most important quantitative and qualitative foundation stones for compounding financial value over time.

“The ark was built by amateurs, but professionals built the Titanic.”

Anonymous

That is not to say that other approaches are destined to fail. As we know, there are many roads to investment success. Some people are good at macro and catching the whirling swings of sentiment and enthusiasm. We know that we are not and consequently we don't try. Other approaches sometimes wax and wane with fashion, but we try to remain steadfast.

It was Keynes who said that markets can remain irrational for longer than an investor can remain solvent, a truism endured by those who are leveraged. Thankfully, there are no such financial imperatives that drive our behaviour and we believe that this improves the quality of our long-term decision making.

On the contrary, we are financially aligned with our clients as co-investors in our funds and we are incentivised on three-year-plus performance. We believe this enables us to look through the shorter-term noise and to perhaps better focus on the things that really matter.

In fact, as markets have become less serially correlated and everybody has decided that they want 'value' rather than 'growth', we are hoping that we may have some better opportunities to add to companies that we already know well at lower prices. That will help provide a good basis for future outperformance, in our view.

On that point, we have always believed that without growth there is usually no value; and we periodically remind ourselves that there is little that is truly new under the sun. As James Grant of *Grant's Interest Rate Observer* memorably summed up: "Progress is cumulative in science and engineering, but cyclical in finance." In a similar vein, there has lately been a justifiable reaction against the value of experts.

That is understandable. With Donald Trump in the White House, we are firmly of the view that the supposedly predictable has just become even more unpredictable. After all, it is not that often in a fifty-fifty wager, like the US presidential election, or 'Brexit' for that matter, that you can make the right prediction but still end up losing the bet. Markets swooned on the Trump victory as everybody predicted, before then ascending to new highs.

We wonder how often in history such prognosticators of apocalyptic doom ended up being right, only to see their pessimism swiftly followed by a heady period of irrational exuberance. These conditions might well roll on for some time, in which case our absolute returns will remain reasonable, but nobody would be surprised either if the world hits an iceberg any time soon. Our view is that we are reasonably positioned whatever happens. Right now, betting on whatever-happening seems like as reasonable a stance as any other.

### Asia Pacific positioning

We are all reflationists now. But higher levels of inflation and interest rates are not kind to equities. Throw in the rising differences of opinion between the great powers and it is quite

easy to find oneself thinking about the 1970s. Such concerns are compounded by the fact that valuations are generally demanding and growth is already elusive. Sure, we might enjoy something of a kicker from US growth and we may get dragged upwards with general US bullishness, but it is difficult to see either as being particularly sustainable.

That is why this supposed shift from 'growth' to 'value' and into cyclicals is so difficult. In the shorter-term, it perhaps makes market-sense, but on any longer-term timeframe it is harder to be enthusiastic. We believe that Asia's high debt-load, as well as the rather tricky (at best, delayed?) transition currently underway in the PRC economy, means that we should still be far more focused on capital preservation rather than swinging for the fences.

Our general cautious stance and positioning across our Asia Pacific portfolios have not changed very much at all over the last six-to-nine months. Turnover levels have fallen and our top-ten concentration has probably increased, as we have been adding to our existing key holdings at generally lower prices. We have tried to double-down on our higher quality holdings. As we remarked last time, we continue to have a healthy appetite for exporters and US dollar-earners in general. In particular this means we have high exposure to Taiwan and technology.

Almost by definition, US dollar-earners are amongst Asia's more competitive companies. There is generally a focus on returns, perhaps a better understanding of the role of shareholders and usually some form of competitive moat. We believe that local currency weakness may well persist, with China now experiencing substantial capital outflows. Exporters, the likes of Taiwan Semiconductor (TSMC), TCS, Dr Reddy's, Giant, Mediatek and LG Chemicals to name a handful, are some of the best companies in Asia and primarily compete for global customers.

In summary, we continue to have a preference for globally competitive companies and North over Southeast Asia; India remains our biggest single-country exposure; and we remain less exposed to the more localised Asean economies. A Trumpian view of the world should prompt concern at the rising risks around trade, technology and Taiwan in particular. We are thinking hard about how these risks might unfold and the potential impact on our Asia portfolios.

The problem is that all of Asia, with the possible exceptions of the Philippines and India (which are largely domestically-driven economies), lives mostly off of trade with America. In other words, we do not believe that domestic companies will provide a hiding place, with the added burden of all of the attendant individual country macro and political risks; they are mostly of the second-derivative and are often less competitive, as well as reliant on more localised advantages.

Across Asia, macro and country risks seem quite high, with peak debt levels, failing institutions, sclerotic political reform, budget and often current account deficits, as well as high levels of foreign ownership of relatively small equity and bond markets. By contrast, some commentators have argued that inter-Asian trade has increased as domestic economies have grown and that vulnerability to the external sector has decreased. We believe that

this is only partly true, as many of these trade flows ultimately end up being re-exported to final customers in the West.

Domestic consumption is generally subdued in any case, with little scope for further domestic stimulus should exports stumble. Given these factors, we believe that there is probably greater risk for these economies, as well as domestic companies, on any general Trump-driven trade-conflagration. Generally, these companies typically tend to trade at higher valuations as well, given a broad-based belief in higher long-term growth on the true but already very well discounted theme of an ever-rising middle-class and growing consumption.

### The Philippines

The Philippines is an interesting case, as the economy and even more so the stock market is dominated by domestic consumption. Furthermore, debt levels are considerably lower than the rest of Asia generally, they too have a new purposeful leader and many commentators are rather positive about future prospects. The real issue though, from past observation, is that when capital leaves Asia, the country has been unable to withstand the reverse outflows. The Philippines has historically been characterised by boom and bust, late to the party and ultimately no better off.

As a relatively small and illiquid stock market that is consensually as well as heavily owned by foreigners, the de-rating risks seem quite high. To some extent, they are already underway and underlying growth has clearly slowed. Valuations are high too; and President Duterte is anything but considered. When governance goes wrong in the Philippines, it usually goes very wrong, in our view, given the weakness of the underlying institutions. The reburial of Ferdinand Marcos in the National Heroes' Cemetery is hardly encouraging.

However, we still own a number of companies in the Philippines, being particularly keen on the now seventh generation-run Ayala group as well as the SM group of companies. Though we have lately trimmed back our Ayala exposure, more recently we have added to the likes of Ayala group-company Manila Water, as well as DMCI. We also recently bought Universal Robina for the first time in many years, with the company now de-rating to more reasonable levels on lower growth as well as concerns over a couple of foreign acquisitions.

### Protectionism

On the matter of rising protectionism and faltering trade, we are of the view that bi-lateral rows seem likely to escalate given the characters of the new global leadership. The world seems ever more divided along trade block lines and global trade flows are already weak. China's response to all of this, for instance, has been the launch of the famed One-Belt, One-Road initiative.

While we expect (and hope) political pragmatism may defer the branding of China as a 'currency manipulator', we assume that tariffs will ultimately be imposed on a range of products. Such measures will, we believe, be designed for political consumption, as much as anything else, with more basic products likely to be the easiest (besides being well-practised) targets. Bi-lateral ties between

Taiwan and China are also likely to suffer and there are already signs of China adopting a tougher line on matters like taxation.

Tariffs on the likes of Chinese-manufactured textiles, shoes and autos would no doubt be politically popular in America, but from an economic viewpoint would perhaps be more symbolic than real. Low-end manufacturing is already leaving China, (to the likes of Vietnam), as the country moves up the value curve. The risks however, seem real, and we remain rather sceptical about the prospects for some of the HK-listed, but PRC-based manufacturing companies. Textile companies look particularly vulnerable.

A broader move, say against the technology industry, would be much more significant and damaging. Everybody would suffer, but it is hard to countenance the introduction of such measures given the leading global position of US businesses. While marginal (and likely modest) investment may now be directed outside China, as the likes of Apple and Foxconn add facilities in America, the technology sector is a leading employer in China as well as a very substantial investor. We assume that neither country will be able to stomach a breakdown in such a symbiotic relationship.

### Incredible India

And so to Incredible India, per the tourism tag, which has certainly been an apt description of late. As if the US election were not sufficient, a day ahead of that, India decided to embark on a major economic experiment in demonetisation (cancellation of old money and replacement with new notes). It would be quite something in most countries and for such reasons is only generally seen post-war (such as in Europe), or in economic basket-cases like Zimbabwe.

The impact has been substantial as India is largely a cash economy; 86% of the notes in circulation were overnight declared null and to be compulsorily exchanged at the banks. The motivation was, per Prime Minister Modi, to squeeze black money (usually held in cash) out of the economy and to facilitate a clampdown on corruption. It has always been assumed that the black economy accounts for at least a third of business activity.

But the exchange of old notes for new, (virtually 100% back into the system), suggests that either everybody was wrong, or (and this is frankly far more likely) that new ways have been found to turn old bad money into good new notes. The negative impact on economic activity is likely to be significant, but presumably only short-term and probably transient. For instance, sales of mobile phones have collapsed by 50% in short-order.

The longer-term effect should be broadly positive, we believe, but perhaps not as great as was initially suggested. In general, we had already sharply reduced our exposure to domestic India (arguably too early), largely on valuation grounds. But conversely, export companies have to-date not benefited as much as we had expected.

Nevertheless, we believe that the generally still high multiples look rather vulnerable on potentially lower growth. In addition, the exit of the highly regarded central bank governor, as well as some macro uncertainties, suggest that the currency may be more likely to weaken rather than strengthen from here.

In the longer-term we believe that the argument for the private sector banks has strengthened considerably, with a sharp increase in the banked percentage of the population. It used to be that around two-thirds of the broad population was unbanked and that should have fallen by quite a lot. In the shorter-term, it means pain as un-deployed deposits pile up, but longer-term the growth of digital banking should benefit the leading banks.

We have added modestly to HDFC Bank, while Kotak Mahindra remains a significant weighting across many of our regional Asia portfolios. As far as longer-term economic development and the ten-year-plus story goes, the demonetisation process should facilitate better fiscal collection as well as the introduction of the Goods & Services Tax. These structural reforms should help to regularise India's ramshackle economy and should, ultimately, drive economic growth as well as the banks.

Despite the shock factor, our enthusiasm for India remains high. As we have often said, it is the country that offers the broadest mix of family-owned but professionally-managed companies. Such a combination often leads to superior results, in our experience. A long-term focus on strategy, with a view to inter-generational transfer of wealth, balanced by efficient business execution is a powerful combination. Companies like the Godrej and Mahindra groups come to mind. We own them broadly across our portfolios.

### IT services companies

Otherwise in India, the IT services companies have been de-rated somewhat over the last six months. We have been adding to them. Growth has certainly slowed across the sector, with business from the Western banking, finance and insurance (BFI) sector in particular under pressure.

Across the IT services industry, the BFI sector is the biggest customer and growth rates have broadly slowed from double-digit to a more probable mid-to-high single-digit range. In addition, there is a sense that the old 'body-shop' arbitrage model, (utilising relatively lowly skilled and much cheaper Indian engineers), is becoming less sustainable.

The digitalisation of businesses is arguably more complex, while costs, ease of securing working visas for these engineers in the US and growing protectionism means that there are certainly more headwinds than in the past. Despite all of this, the best companies seem to be flexing to meet the new market reality. Their own services are digitising, while the complexity and intensity of what they offer is rising to meet the growing opportunities in an increasingly digital world.

Our relatively basic view is that digital and IT intensity is likely to increase in the next ten years and the best companies will find a way to service that growth. It is another reason why we continue to like TSMC, as chips end up being incorporated into devices more broadly.

One of our least favourite IT industry acronyms, apparently coined by Cognizant, is SMAC. It is a contraction of Social, Mobile, Analytics and Cloud. All the IT Services companies have overt plans to benefit from these future structural industry drivers. And

then, of course, there is the Internet of Things (IoT) where you can happily let your imagination run riot.

We have been adding to TCS and Tech Mahindra in the last six months, with TCS in particular further punished by the governance row at Tata Sons. We have added to Infosys too, but more moderately, with the prospective PER declining to just 14x.

For the IT services industry, the Trump effect, as for much of Asia, seems rather double-edged. On the one hand, work visas are likely to remain difficult and outsourcers will surely attract negative commentary, but on the other hand, it looks like the unrelenting pressure on the BFI sector may well begin to reverse. Perhaps this will provide something of a tailwind in the future. US bank share prices have been strong and if the legislative stranglehold is relaxed, you might expect bank expenditure to begin to grow again.

### Tata group conflict

Our exposure to the broad Tata group is much lower today than it has been in past years. Outside of TCS, as we highlighted in our last write-up, we have struggled with the more recent management track record in terms of value-accretion. We used to own Tata Power, Tata Chemicals and Tata Global Beverages. We understand, but struggle to sympathise with the Ratan Tata versus Cyrus Mistry fall-out. Our concerns over the preservation of group stability contrast with the implicit need for change.

While we tend to like long-term family shareholders, we are far more ambivalent about the more anonymous and multi-generational nature of trusts. In our view, they can sometimes be much less satisfactory owners of businesses. Resistance to change, an overly paternalistic, conservative, or even a thoroughly hands-off approach can become embedded to the detriment of orderly progress. Several examples spring to mind. Tata Sons is 66% owned by Tata charitable trusts.

Trusts can often have too many different and conflicting objectives. That is true for Tata Sons, in our view. It is a great shame, as the group clearly stands for so much that is good. We are only materially exposed to the group through our holding in TCS, which has been run quite separately for many years.

TCS are housed in a modern building and the Ducati motorbike (which they helped design) parked assuredly in the middle of their reception says a lot, particularly by comparison to the bust of J Tata and the stray dogs that greet you on entering Tata Group's head office at Bombay House. We are confident that the negative impact is likely to be short-term. For a number of portfolios, we have added Wipro, another IT outsourcer, which has new ex-TCS management in charge and a forward PER of only 13x.

### Generic drug companies

Otherwise, in India we have added to the generic drug manufacturers, in particular Dr Reddy's and Lupin. As we have noted previously, India's drug manufacturers have been under pressure lately. It is a back-handed compliment, but as their share of the US market has risen so the American regulator has taken a growing interest. This is good. The Food & Drug Administration

(FDA) has stepped up inspections and unsurprisingly has raised questions about a host of issues including data integrity, drug quality and even packaging.

The drug companies have scrambled to comply and our sense is that these issues are akin to growing pains. Of course, it should have been better in the first place, but often it takes such jolts to embed a better compliance culture. It is difficult to see the answer to the US healthcare industry, as people get older and richer, as anything other than generics. While Trump will certainly be no push-over, it seems unlikely that he is going to go after the pharmaceuticals business with anything of the vehemence of Obama or Hillary Clinton. We believe the headwinds may abate somewhat.

In the medium-term and longer-term, we believe that the obvious price-gouging and profiteering by the broad industry (and some Indian companies have been named) should play into the hands of the generic manufacturers. We have added to Dr Reddy's, alongside company share buy-backs and family buying, and re-initiated a position in Lupin. We have owned Lupin before. These companies trade on a low-to-mid-20s PER, with a high teens-plus ROE; we believe they should continue to grow at a double-digit rate over the next five and ten years.

For some Asia portfolios, we have added Cipla as well. The company has a venerable history (incorporated in 1935) and was one of India's first generics companies. We have followed the group for many years, but added it more recently on the back of a promising change in management. The new leadership comes from Dr Reddy's which should help international expansion; 40% of the business is domestic India.

### China is finely balanced

In China, by contrast, growth remains elusive and we have struggled to find new ideas. And there has been little opportunity to add to existing holdings at lower prices. China's economy seems rather finely balanced, with around three times as much debt required these days (15-20% money/credit growth) per unit of economic growth (GDP +5-6%). A surge in credit in 2016 has kept the economy moving, but has also produced unfortunate side-effects in the form of even higher property prices and capital outflows (due to the weaker currency).

Such an approach is ultimately unsustainable, but in the meantime debt levels could continue to climb. Rather more unfortunately, reform seems to have been fully subordinated to politics. And so the world goes. Xi Jinping is now the 'core' of the Communist Party and the very necessary clampdown on corruption continues. But the juxtaposition of ever tighter political control with the required economic liberalisation to drive the next phase of growth looks like an increasingly impossible circle to square. When it comes to a trade-off, quite clearly, politics will win every time. This is concerning, but hardly surprising.

In the meantime, the State is effectively (and to an ever growing extent) on both sides of the balance sheet. State-controlled businesses' bad loans have been securitised and are often sold to state-backed asset-management companies, financed by the issuance of bonds, which are in turn then sold to the banks

controlled by the State. These things can run on in a Ponzi-like manner for much longer than you might have thought possible (while the monetary printing presses are still rolling) and certainly a lot longer than desirable. It is unlikely that the banks will ever go under, but equity investors are likely to be significantly diluted. Look what happened to Citibank and AIG in the US.

What eventually happens is that the cycle ends and there is a wash-out. At the moment, the authorities are playing a high-stakes game of financial whack-a-mole. Every time the regulators clamp down on one area of hot-money flows (previously in areas such as peer-to-peer lending, wealth management products, city banks, casinos, over-invoicing and Union-Pay cards), the liquidity flows pop up somewhere else (lately corporate M&A and insurance companies). This is clearly not sustainable.

The most visible casualty is the currency, as with a growing reversal of confidence, China is subject to the infamous impossible trinity. The PRC cannot have it all: a managed currency, independent monetary policy and an open capital account. Accordingly, the authorities are clamping down on capital flows to get a grip on the currency and monetary policy. The last thing the authorities want to do is tighten policy and raise interest rates.

Given such an environment, acknowledging that it may go on for some time, it is difficult to be optimistic about corporate prospects. We continue to own China Mengniu though have been reducing on recent share price strength, with the latest management changes perhaps not wholly encouraging. As we noted previously, the company has US\$1bn of wealth management products on their balance sheet too. Like PRC macro, such products will be absolutely fine, until they aren't.

One of our other holdings, Sun-Art Retail, has perked up of late. We wrote in our last newsletter about how we had added significantly only to see it drop away on the challenges of e-commerce, slowing growth and an aggressive expansion plan. Our view was, while much of this is a fair reflection of reality, that there should be a place for at least one national supermarket chain in China. Today, the market capitalisation is US\$8.5bn and this still seems fine in the context of the opportunity. The stock has re-rated to 24x forward PER, and we continue to hold it.

### Korea and some opportunities

One other area of interest lately has been Korea. Korea is always a famously challenging place to invest, but the country usually emerges stronger from adversity. The recent travails of President Park, as well as the Chaebols, are rather familiar. The Korean economy desperately needs reform, but the institutions and regulations are second-rate. In some ways it seems like a modern twenty-first century economy or country shackled to a nineteenth century political/institutional structure. So, unfortunately, goes much of Asia to a greater or lesser extent.

In that sense, Korea is not unlike Japan. That is not surprising as it was set up in Japan's image, with allocation of capital mostly state-controlled and made on the basis of export-prowess rather than returns. The Chaebols were set up to nation-build, not to make returns for shareholders. Most companies are, accordingly,

product-obsessed, with shareholders often regarded as little better than carpet-baggers. The still incestuous interplay between the State and businesses has been laid bare all over again by this latest in a long line of scandals.

We do not hold out much hope for broad reform, but perhaps at the margin things will get less-bad for a while. Many Korean businesses are in some ways amongst the most impressive and aggressively competitive in the world. They make beautiful products (such as cars and TVs), but you mostly would not want to invest in their manufacturers at any price. The challenge therefore is to find businesses with this drive for excellence coupled with an alignment with shareholders, as well as a greater focus on returns.

We think there are a number of candidates, which includes some LG group companies, AmorePacific Group and Naver. We have owned a number of LG companies over the years and have lately been adding to LG Chemical. The shares trade at 1.2x book, with the share price having suffered on a badly explained plan to buy connected group company LG Life Sciences. The company benchmarks well against global competitors and appears to be broadly run in the interests of shareholders.

We have increased our exposure to LG Household & Health (LGH&H) latterly too, having earlier sold on previous ebullience around duty-free cosmetics sales to PRC visitors (even Xi Jinping's wife was supposedly a fan of one of their products).

With the arrival of THAAD missiles in South Korea, China has objected and restricted the flow of group travellers to Korea; and have decided that they have had enough of the Korean Wave (of products, pop stars, films and soap operas). Both AmorePacific and LGH&H have since sold off sharply, as visitor arrivals collapsed and sales growth has naturally fallen. We used to have significant holdings in both companies and they now seem much more reasonably valued to us.

AmorePacific trades on a forward PER of 23x, while LGH&H is trading at around 20x. Around a third of LGH&H's profits are contributed by household products, with the rest coming from cosmetics. Both companies used to trade at materially higher multiples.

We continue to own Samsung Electronics, but have struggled with the broader restructuring across the group. The ability of the Lee family to shuffle assets, increasing control for no cash down, highlights how poor Korean regulations remain in relation to minority shareholders.

### Singapore and some additions

In Singapore, we have added to a number of existing holdings, particularly across the Jardine Group. We recently met with Jardine in Vietnam, where they have a growing presence. Most of their businesses are already active in the country and have been there for twenty years.

Their biggest interest by far is Truong Hai Auto (Thaco), with the original 30% stake acquired by Jardine Cycle & Carriage in 2008 for US\$77m. Today the business makes US\$300m in profits p.a. and is Vietnam's biggest private company; a conservative valuation for Jardine's stake could be towards US\$2bn. Jardine is

a good example of a professionally-managed company with the family (the Keswick's) still in control.

We have added to Jardine Cycle & Carriage (JC&C), Jardine Matheson (JM) and Dairy Farm in the last six months. Although the bulk of JC&C's value is still accounted for by Indonesia's Astra group, the other businesses (especially Vietnam) now account for around 25% (and a growing share) of profits. Vietnam amounts cumulatively to around 5% of Jardine Matheson's group profits. JC&C and JM both trade at forward multiples of circa 14x PER, while JM trades at book value.

Dairy Farm is expanding in Vietnam via Guardian Pharmacy, with the business continuing to improve. Vietnam is one of few Asian countries where Watson's (owned by CK Hutchison) is not present, having exited a few years ago. Dairy Farm's CEO has reorganised the company on product, rather than geographical lines and has made overdue investments in the group's logistics and IT infrastructure. Recent results suggest that the company is beginning to turn around and profits are starting to rise again. The shares trade on a forward multiple of 20x.

Otherwise, we have broadly added to what we consider some of our highest quality current holdings, with additions to CK Hutchison, Mediatek and Global Brands in particular. CK Hutchison has struggled of late, with concerns around their exposure to Europe and the UK in particular. The UK accounts for around 35% of profits. Taking a longer-term view, we believe it to be extremely attractive as a strong collection of globally competitive businesses. It is noteworthy too that the company has bought back shares for the first time in over ten years; and directors have also added to their holdings.

In that regard, we were heartened by the recent insider buying at Global Brands. Global Brands was spun-out from Li & Fung in late 2014 and promptly swooned, as those who held the parent shares dumped their allocation. The shares more than halved and the valuation slumped to only 5-6x PER. We added sharply (and too early) to our shareholding on the way down and have recently added more. The recent results, with 15% top-line growth as well as CEO Bruce Rockowitz's acquisition of US\$10m-worth of shares are encouraging. Today it trades on a forward PER of 9x.

In Singapore, Singapore Telecom remains a significant holding, with the group just about managing to grow. The bulk, some 75%, of group profits are derived from outside the country with Optus in Australia and Telkomsel in Indonesia being the biggest value-drivers. Concerns over the entry of a new competitor (the fourth) seem somewhat overblown, with only 7% of net profits derived from the Singapore mobile business.

In hindsight, we may have reduced our exposure to the Singapore banks prematurely, though we are still inclined to be more concerned about the credit-cycle than reassured that everything is now good. We continue to have significant exposure to OCBC as well as their listed insurance subsidiary Great Eastern Holdings. We sold and reduced DBS Group for a number of our regional portfolios, after concluding that their credit process (as well as recognition of NPLs) might have been better, given poor experiences with a number of oil & gas creditors.

## Realised and unrealised mistakes

Looking at the attribution data for our Asia Pacific portfolios, it is clear that Li & Fung and Idea have both been significant performance detractors. At this point, they look like mistakes. In hindsight, the error was to own so much of a company, only to see the share price halve. But, without making excuses, it is not altogether surprising to see such a thing happen from time-to-time, given our process.

We have very robust investment discussions and it is not unusual, (in fact, quite frequent as well as encouraged), to see a piece of internal research with opposing recommendations. We relentlessly question everything, but sometimes we make mistakes. It is a truism that our perceived skill and ability level waxes and wanes with our shorter-term performance figures.

In hindsight, the times we do best for our clients and generate the most value for our portfolios is when we fly in the face of conventional wisdom. It is when we look through the shorter-term market noise, both good and bad, and invest with a view on the long-term opportunity. We have something of a contrarian approach, but on the other hand, we acknowledge that there is always much to learn and things change all the time.

It is perhaps a form of arrogance to be so different, but we hope (and think) that our analytically-backed purposefulness is coupled with a high degree of insecurity. We always wonder if we are completely wrong about things, but in quality we trust. We have found over the years that this is what saves our reputation, when everything else is collapsing around us.

Keynes summed up this dilemma when he noted that: "Worldly wisdom teaches us that it is far better for reputation to fail conventionally, than to succeed unconventionally." It is certainly much easier, but inevitably you confine yourself to an at best humdrum result. As we have said many times, we will underperform in rising markets (because of our style and usually one or two outliers), but we should better preserve capital (and always hope to) in more difficult market conditions.

## Li & Fung

In respect of Li & Fung, we have been wrong about their ability to insert themselves into the e-commerce supply chain. But, they are trying, though they have been unable to move quickly enough to offset the decline of their conventional core customers (the likes of Kohl's and Macy's). Furthermore, the macro forces of rising costs on the supply-side in China (labour and currency), coupled with lack of inflation and pricing power on the demand-side in America, have curbed both their top-line and margins. It has been something of a perfect storm in recent times.

We should have been more alert to these risks, with more than a few people arguing that the business is fundamentally broken. Now we have Trump to contend with as well; Li & Fung being the epitome of a globalised company. That said, we still believe there are reasons to be hopeful. Absent an implosion of current profitability, the shares now seem attractively priced. A PER of 12x and a dividend yield of 7% with a double-digit cash-flow yield offers some compensation for the risks.

Furthermore, costs are now declining in China and inflation appears to be returning to the West. These are the tailwinds that Li & Fung needs. Tariffs might further improve both sides of the equation too. With rising costs in China, Li & Fung have moved to a multi-sourcing model in recent years and in a less-flattened, more complex world we have the view that the company may well benefit, at least relative to their competitors. US consumption may be picking up and we are hopeful that the group will have more future success in the e-commerce channel.

Finally, we have confidence that the family will do what is necessary to restore their fortunes. They have been big buyers of the shares in recent years. We see signs of a more aggressive approach to costs, as well as a willingness to flex their old business model. We have not added further to the existing position but are comfortable to continue holding.

## Idea Cellular

Idea Cellular in India has been our other problem company. The entrance of Reliance Jio into the market-place, with a US\$25bn investment and subsequent offering of free telecom services, has perhaps unsurprisingly been highly traumatic. Idea's share price has halved.

In hindsight, we should have been more alert to the potential impact of a well-funded and very well-connected new entrant (with the PM as their chief marketing officer, as somebody remarked). To the contrary, we have always been very impressed by the quality of the Idea management and assumed that they would find a way to respond.

After all, the cumulative scale of the enterprise value of the Indian Telecom sector is around US\$50bn compared with US\$300bn in China. China's economy is roughly five-times bigger on a GDP basis; so if you dare to dream, arguably there is still plenty to go for. That's a five-to-six multiple on a per-capita basis, if you believe that India will be able to get anywhere near to fulfilling its economic potential.

Today, the value of Idea's spectrum and telecom towers is roughly equivalent to its current enterprise value. This is a business that has around 20% market share in India, 180m customers and still generates US\$2bn EBITDA p.a. We are currently paying nothing for future profits and cash-flow. Some may argue that it might be worth nothing, if Reliance Jio continue to give away their services for free, but lots of debt and a track-record of being reasonably financially disciplined suggest that this is unlikely.

From a share-price point of view, as Idea's CEO remarked, in a business sense it is difficult for things to get much worse when your competitor is giving away their service for free. It is too early to say, but it may well be that Reliance Jio has done everyone a favour by popularising and enfranchising data-services as opposed to just voice. Maybe everybody will be able to charge more in the future, although telecoms is never just about price.

The service, the billing and customer experience are all important. Idea is strong in these areas and has been gaining incremental share in recent years. Reliance Jio may find the mechanics of running a retail consumer-facing business



somewhat more difficult when they start to charge. Rumours of a merger with Vodafone, as well as of a rights issue, are supposedly additional hurdles for Idea too. The market would likely respond positively to both scenarios.

### Some disposals

During the year we trimmed back our positions in AIA, Newcrest, CSL, Brambles and Godrej Consumer. We continue to hold these companies across our regional Asia portfolios, but felt that valuations had generally got ahead of things. For AIA, our concerns were heightened by the obvious capital flows into insurance products from China. Whenever something becomes excessive, it is a fair assumption that the PRC authorities will subsequently clamp down. And they have. AIA is still demandingly valued, but is clearly a high quality business.

CSL is a fabulous business, but they have been experiencing some delays in integrating their new vaccines business which was acquired from Novartis at a very attractive price. Renamed Seqirus, the group believes that the business should contribute 20% of group revenues by 2020. Meanwhile, the core blood products business continues to grow at a high single-digit growth rate and their R&D department is making progress with other significant therapies. The shares have fallen and now trade on low 20s PER.

Brambles is still managing to grow too, with their global pallet business benefiting from the US recovery. We reduced the position in some portfolios, with the announcement of the retirement of the relatively long-standing (seven years) CEO Tom Gorman. He has done a good job, but the prior early exit of the CFO after quite a short stint at the company meant that we thought it prudent to take some profit at relatively high valuations. Brambles now trades on a forward PER of 20x.

### Outlook and conclusion

If we are returning to a world that looks politically (and maybe economically) more like the 1970s, it is not good news. Some commentators believe that Trump is merely more of the same and that the world will continue to be characterised by deflation and low interest rates, because other far more powerful forces (such as demographics) are at work. This is possible, but taking everything that we know about him at face value, as well as what he has said, that seems a less likely outcome.

The current economic cycle has been a long one, despite being interrupted by the '08 melt-down, but there are plenty of signs that it is already collapsing under the weight of its own contradictions. The political process has just made explicit what we should already know. The world's leaders look like they are about to try a different approach, that is if they want to get

elected or stay in power (which of course they do). Trump and his hybrid policies are something new. But a lot of it looks pretty familiar. Lenin knew something about politics too.

**“A lie told often enough becomes the truth.”**  
Vladimir Ilyich Lenin

Sadly, we don't think these policies, as well as the coming primacy of politics over economics, inspire confidence in sustained high valuations. In the meantime, it seems likely and perhaps even probable that markets may well have a last hurrah blow-off bull market created by our prior monetary profligacy. Maybe, even Emerging Markets will catch a bid beyond the latest grand rotation, though that is probably too much to hope for.

If the supposed pick-up in Western growth does not prove to be sustainable and moreover does not spill over into Asia, or the world's strongmen end up squaring-off (seems pretty likely), then everybody is going to end up quickly rotating right back to where they started. Cyclicals, banks and everything else will be dumped all over again. We will save ourselves the trouble. Such frenetic activity usually ends up being regretted, rather than celebrated.

We have sometimes likened our portfolios to an herbaceous border, with something that is flowering whatever the time of the year. The herbaceous gardening style remains our preference when it comes to portfolio construction. Quite clearly though, our view is that the next season is more likely to be winter than it is to be spring.

We think it will be fine if we are wrong. After all, who doesn't enjoy spring! But that means that our neighbours will probably win the flower-arrangement prizes. On the other hand, if winter is around the corner, we are hopeful that our hardy perennials will again come back into their own.

Politics is sometimes described as the art of the possible. Trump, with his “Art of the Deal” style, is likely to challenge many of the existing assumptions. The political and economic cycle is eternal. That will result in fall-out, but the system, at least in the West, looks likely to flex and will no doubt adjust.

The trouble is that experience teaches us that economics, despite being a very dismal science, does have some eternal laws which means the world might be heading back towards where it came from. Looking forward, per Lenin, it may well be that nothing happening for the next decade might end up being a very good result indeed. After all, you can have too much excitement.

## Appendix: A revolution?

In our last review, we concluded that things were about to get messy. In hindsight, the right analysis, but sadly the wrong conclusion. So much for the fund manager view. We keep saying that we don't know anything. Charitably, you could conclude that it is still too early to say, but in markets that often amounts to the same thing as being wrong. What seems uncontroversial is that the world remains a mess. Economic activity is moribund, trade has slumped and debt continues to rise everywhere.

We went on to observe that although the broad populace knew that it had been disenfranchised, the predictable reaction had hitherto been confined to an understandable sense of rage against the political and economic elite. The real surprise is that since then, these feelings have been rapidly and successfully transmuted into a practical political outcome.

But the absorption (as well as the eventual neutering) of such underlying tensions is a defining feature of the Western political system. It is a beautiful thing. Who, in any case, is able to say that the current situation is satisfactory? QE has not worked. A cabal of unelected central bankers have effectively held the world to ransom with 5000 year-low interest rates, resulting in anaemic growth and massive systemic distortion, as well as immense political dissatisfaction.

The Trump election does not mean that people now trust the Government and politicians, by contrast, to solve their problems; but it does reflect an appetite for a real alternative. This seems entirely reasonable and the likelihood of a sometime reality-TV host being better able to exploit such feelings, in contrast to the likes of Hillary Clinton, is not at all surprising.

In hindsight, the recent rash of policy-making by referendum simply reflects that the politicians have lost not only confidence in their own ability to lead, but also the broad support of the people. History has turned and the leaders have changed. Europe has yet to receive the memo, but clearly they will capitulate too. As for the liberal hand-wringing, led by the metropolitan media, surely it is much better to see the system flex through the ballot box rather than via other means. Trump is just the belated political consequence of '08's financial implosion.

### Against market fundamentalism

Just as the early 1980s of Reagan and Thatcher was a reaction against the way Socialism had permeated every sphere of life, so "Trumpism" seems to mark a similar reaction against market fundamentalism. It has been clear for at least the last few years that such market absolutism has outstayed its original welcome. As Mark Twain rightly put it: "Too much of anything is bad".

The preconditions for a broad shift in our political and economic culture are now in place. Narrowly, it is hard to

believe that this will be positive for capitalism, with the likely reversal, for instance, of labour's all-time low share of US national income. But this could, on the other hand, probably be good for society more broadly and may even make capitalism more sustainable.

Michael Sandel has made these points forcibly in recent years. Market economics has become such a mantra that we now live in market societies, where economic forces are the arbiter of too many things. At least in principle, Trump appears to stand against some of this, as well as for the obverse of much of what went before. His MAGA-trend (Make America Great Again) arguments could not be more different to Obama's liberal globalisation and the politics of inclusion. It might not work, but it is something new.

Just as Reagan could tell us then that the five most terrifying words in the English language were, "I'm from the Government and I'm here to help," so today we are now seeing the reaction against unfettered economic liberalism and the supposed omniscient and unelected central bankers and financiers.

It is ironic that removing politicians – with the best of intentions – from the control of interest rates, in favour of supposedly independent central bankers, has ended up distorting the entire global economy to a far greater extent than any bunch of parochial politicians could have achieved. As somebody once said, revolutions always end up eating their own children. And so, Donald Trump.

### President Trump

If the liberal orthodoxies of the last 30-plus years could be handily summed up in just two books, "The World is Flat" and "The End of History" would probably be two good contenders. Trump seems to want to be seen as representing the counterpoint. He is something of an iconoclast. But nobody really knows what he stands for or believes, specifically. He's been a Democrat; he's now a Republican.

He is an eclectic mix, which is perhaps not surprising as he is not a product of either party. He is a populist, but he is foremost a rapacious businessman. He is an old-fashioned straight-forward conservative pro-business, anti-regulation, anti-big-government and low-tax politician from the Reagan era. But on the other hand, he is a reactionary demagogue, a strongman; and is anti-globalisation, anti-trade, market sceptical and seemingly pro- direct political intervention into corporate affairs.

What seems most likely (not least because of his obvious ego and tweeting style) is that Government, as opposed to markets, are about to move right back to the centre of resource allocation. Look at the recently tweeted examples involving Carrier Corp, Lockheed Martin and Boeing. And, he is still only the President-elect.

Trump is a mass of contradictions. What is just politicking and what is real economics? What is being said for show and what is actually real? For the time being, he offers something for nearly everybody, but it is hard to believe that he is really going to overthrow the old economic order with tax cuts that will disproportionately benefit the rich. Meanwhile, many of his top advisers and likely state officials are ex-Goldman Sachs and the US military (a.k.a. The Establishment).

Perhaps it is just more good politics, but recent actions speak more tellingly than his emptier electioneering. It looks like we are seeing the politicisation, rather than the financialisation, of policy-making. The rule of a man, rather than the rule of markets. He appears to believe in protectionism and a proactive industrial policy, something that flies firmly in the face of America's broadly non-interventionist stance of many years. The TPP is already gone.

As for economics, he seems to believe in the power of a Keynesian fiscal stimulus and infrastructure works, as opposed to the QE shibboleths of the monetarists. His remarks about Janet Yellen suggest that he believes that the politicians are back in charge, signifying the end of the old order and a more captive rather than an independent central bank.

It's very retro. There is something nostalgic and backward-looking about much of what he says. He is reaching into the past for policy. His is a world that seems to hanker for the America of yesteryear, with his immigration policies certainly most redolent of less-enlightened and olden times.

### **Trumpian economics...**

But what does all this mean for Emerging Markets, and Asia in particular? It is probably not good, as the asset-class has arguably been the biggest beneficiary of globalisation and the break-down of the old antagonisms of the Cold War. It is not a coincidence that emerging markets have boomed since the early 1990s as the world has flattened and opened.

In the shorter-term though, the impact is perhaps likely to be more nuanced. For a start, it seems likely that Trump's fiscal stimulus may well jump-start American economic growth. This is clearly positive for Asia and the world. Furthermore, there is a new 'narrative' to believe in. Markets love this sort of thing, particularly when we are still just about high on the fumes of QE.

Many are inclined to argue that everybody should just relax. Apparently, the President-elect and the President are different people. On that basis, we are supposed to dismiss the sabre-rattling over Taiwan for instance, as nothing more than a typical "Art of the Deal" sleight of hand, an attempt to shift the negotiating stance in future discussions with China. In power, he will supposedly be

different and more Presidential. This is unlikely, but who knows. A few further reflections might give pause.

Firstly, while possible, it would seem something of a Herculean task to reinvigorate America's Mid-Western industrial or manufacturing economy. Some would go on to say that demographics, automation, technology and robotics are just some of the key structural reasons why it is impossible, as well as probably not desirable. Furthermore, from a more practical point of view the country is already running a substantial fiscal deficit, at around 3%. There is not a lot of headroom, surely, before the bond markets take even greater fright and interest rates escalate.

The US economy is already running at relatively high levels of capacity utilisation, with unemployment at just 4%. Yes, there are many who are under-employed and bar jobs have grown at the expense of industrial jobs, but there does not appear to be great scope for increasing growth without inflation beginning to reaccelerate. Again, that would clearly have implications for interest rates and everybody knows that levels of indebtedness are unprecedented across the world.

In the shorter-term, it seems likely that both inflation and interest rates have bottomed. Perhaps they will not rise quickly from here, but the risks are clear. In turn, that has implications for the US dollar which will probably continue to strengthen. That is not a positive for US business, which is the most globalised in the world, and will further erode the competitive position of Middle America.

### **...and politics**

Given all of that complexity, as well as the scale of the economic task ahead, the one thing we should be able to clearly bet on is a significant ratcheting up of the political rhetoric. Reagan had the "Evil Empire" and it seems a reasonable bet that "Red China" will fill in for Trump.

In fact, it is already happening and it would seem likely that this new muscular politics will run concurrent with economic stimulus. China, as we all know, has a similar strongman figure in charge (not to mention Russia). It does not look like it will be too long before there is some form of altercation, be it trade, One-China, currency manipulation, the South China Sea or any other of half-a-dozen flash-points.

Asia will have to bear all of these headwinds. A stronger US currency will likely (already happening) result in accelerating capital flows to the West as well as weaker local currencies. Higher inflation and higher interest rates will be additional burdens given that Asia has never been more indebted than it is today. For China, the debt-to-GDP figures range between 250-300% and debt servicing is anecdotally already a problem. All of these factors will further crimp growth, which remains elusive per all of the companies that we meet.

In any case, Asia has many of the same issues as the West in respect of populace dissatisfaction and poor policy. Though it is harder to see such sentiment being expressed through the ballot-box, ruling Governments as well as governance appears broadly to be in retreat across the region. Such an environment is hardly conducive to calm markets. From Korea to the Philippines, Thailand, Hong Kong, Taiwan and Malaysia, things look messy and an economic transition is unlikely to make the going any easier.

Putting all of this together, it would seem that the world is set for a period of greater political belligerence. Nationalism is on the rise everywhere and politicians will likely pander to our baser instincts. Engagement looks like it is going into reverse and when economics fails, we can be reasonably sure that the leaders will find somebody else (usually foreign) to blame. The opposite of engagement is confrontation and containment. We have been here before. I remember it well. It was the 1970s.

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