First State Stewart

First State Stewart Asia
– Asia Pacific Equities
Client Update
August 2018

FIRST STATE STEWART ASIA – ASIA PACIFIC EQUITIES

> "Failure is so important. We speak about success all the time. It is the ability to resist failure or use failure that often leads to greater success."
> J.K. Rowling

There have been times, over the last couple of years, when we have felt like a complete *muggle*[1]. Darker forces (QE[2] and the rise of the machines), have clearly been in the ascendancy. But, we believe in the old ways; and, as if by magic, the last six months have been considerably better. Of course, it is far too soon to declare victory.

Discipline and stubbornness are sometimes hard to tell apart. Some might say, the more so in this supposed age of disruption. We wonder when it wasn't so, but such is the hubris of modernity. The pressure to capitulate, agree that it really is different this time, follow the crowd and buy into popularity are the most intense at turning points.

It is only in the final reckoning, with the benefit of hindsight, that observers are able to adjudicate discipline from stubbornness and success from failure. We are fortunate that we have a philosophy, a proven process and a long-term track-record. Even so, despite these touchstones and finger posts along the way, there is still much room for doubt.

Our last letter concluded in a similar fashion. Human nature and the emotions that drive the investment cycle remain unchanged though the ages. This cycle has been extended, but it is nothing novel. Maybe the rise of hyper-active passives is something new, but they probably do little more than exaggerate our existing human frailties.

> "Success is not final, failure is not fatal; it is the courage to continue that counts."
> Winston Churchill

And so all change; and yet no change. In the real world, despite all the excitable commentary, it is worth remembering that nothing bad or too unexpected has happened. Earnings per share (EPS) growth has, if anything, been better than expected. And yet, returns-dispersion has widened sharply.

For now, it seems, the market-gods are merely shuffling their feet. It does not take that much when, in all of history, interest rates have never been lower and debts are ever higher. Just imagine if events start to take on something of their own volition. Imagine that passives can compound negatively, just as they have positively leveraged recent trends.

All seems relatively calm for now, but there is a sense that the macro-plates are shifting. Our absolute returns remain respectable, while the relative gains are ticking along incrementally month-by-month. It is a slow way to get rich, perhaps unconsciously echoing Hemingway's quip about how you go bankrupt: "Two ways; gradually and then suddenly."

In America, in seeking to explain what is going on, there has been much vapid commentary about the renewed outperformance of value versus growth. In Benjamin Graham's Bible (of investing, that is) the epigraph in *Security Analysis* reads: "*Many shall be restored that now are fallen, and many shall fall that now are in honor*." Horace, Ars Poetica.

In our view, this is a distinction without a difference. One is very simply the product of the other. With no growth, there is no value, especially in Asia. Why bother, otherwise? And, let's not get ahead of ourselves. In the US, growth stocks – however defined – have outperformed value stocks in nine out of the last eleven years.

That is essentially a decade and the whole of the post '08 GFC[3] period. By contrast, our own performance suggests that something different has been going on only in the last two-to-three years. To the bulls, the world has irrevocably changed; we are all technology investors now. To others it is the same age-old investment cycle. Asset allocators will allocate accordingly.

1 From J.K. Rowling's *Harry Potter* series, a *muggle* is an ordinary human being who lacks any magical ability

2 Quantitative easing

3 Global Financial Crisis

Portfolio activity

Since our last letter, there has been more activity in our Asia portfolios than usual, particularly in respect of new names and with our all-cap strategies. This is not surprising at the smaller capitalisation end of the spectrum, with portfolio turnover still generally in the 25-30% range per our typical holding period of three-to-five years.

For the larger-cap strategies, it is more unusual, but the changes reflect efforts to focus even more on absolute quality above all else. In the mix of odds and consequences that drive any portfolio decision, our focus on capital preservation has trumped valuation for companies like Global Brands, Lupin and Asustek Computer.

We have, in the past six months or so, bought Shanghai International Airport (SIA), Public Bank, Cognizant Technology, DBS Group, Techtronic Industries, Hanssem, Universal Robina Corporation and Axis Bank. All purchases remain relatively small positions, but we added to Hanssem which had fallen and reduced Shanghai International Airport as it rose.

We disposed completely of Singapore Telecom, LG Corporation, Giant Manufacturing, Global Brands, Lupin, Cathay Pacific, Asustek and Ryohin Keikaku. Some of these positions were sold at a loss; however, we believed prospects had deteriorated and the quality of our portfolios have improved by selling them.

What we bought

We bought Shanghai International Airport earlier in the year. It is a mainland-listed China A-share, with many of our strategies now having the flexibility to buy through the Stock Connect facility. We already own Midea, the air-conditioner and white-goods manufacturer. We have benefited from the research and meetings that the team has had with these companies over the last ten years.

Both companies have prospered since we bought them, though we suspect not least because of the inclusion of China A-shares into various MSCI indices (in June and soon in September '18 in a two-stage process). It is a truism that you sell, rather than buy, on such big announcements; and indeed that has seemingly again proven to be the case.

We have never paid attention to these indices; but, in the shorter-term, the decision to include A-shares has meant that general valuations have escalated. Nevertheless, we believe that the longer-term prospects for both companies remain positive. Shanghai International Airport is an SOE[4], which should always give pause, but the company is run commercially.

SIA owns the bulk of Pudong International Airport in Shanghai. The story is straightforward, with duty-free shopping getting in the way of travellers, to the benefit of shareholders' returns. Traffic growth is strong, landing fees have risen and non-aeronautical revenue (two-thirds of which is shopping) is now half the business.

The main duty-free concessions have just been renewed with a higher profit-share for the company, the group generates decent free cash-flow and it has no debt. However, a huge terminal expansion plan is underway, with the capital-spend of RMB20bn exceeding the company's existing fixed asset base.

The expansion is expected to be completed post-2020. The likelihood of a sharp rise in depreciation and amortisation charges, versus higher revenues, has been the subject of robust debate on the team. In the meantime, with defensive qualities, the price-to-earnings ratio (PER) has moved from teens to mid-20's.

We have trimmed our holdings as a consequence, perhaps more quickly than we would have liked, but the shares have escalated sharply. For Midea, the experience has been much the same, with the company executing well and still growing at a high-teens rate. With a similar sharp re-rating, we had trimmed, but are now more inclined to add.

Korea and Japan

Owning Hanssem Corporation, in Korea, has been a much less positive experience. Hanssem is a full service interior design, decoration and installation company. They provide furniture, appliances, fabrics and design from kitchens to bathrooms. The

4 State-owned enterprise

track record and the balance sheet are both strong; and with family ownership and a teens-multiple, it seemed attractive.

When we met with the company earlier in the year, they were experiencing tough trading conditions with a slow-down in the Korean housing market. In addition, they had opened a large store in Shanghai, with start-up losses reducing overall group profits by 20%, though the new store is moving quickly towards break-even.

In the meantime, the company, like many in Korea, has over the years bought back shares and failed to cancel them. In Hanssem's case these shares now amount to 25% of their share base. It seems unlikely that they will act proactively, after much debate and prompting, but perhaps it is possible one day.

Our overall position is small, with the longer-term story being the opportunities from upgrading Korea's general housing stock. They tell us it is poor, but in the meantime the downturn in housing transactions is a far more important driver of their fortunes. The shares meanwhile trade on a high-teens multiple. We have added.

Nippon Paint, though listed in Japan, is considered an Asian company with half of their sales and profits derived in Asia ex-Japan. China is the biggest contributor, being around 40% of net profit and where the company has around 30% market share. Nippon Paint had been at the centre of a dispute with their largest shareholder, but it is now resolved positively.

We have held the company for some time. The largest shareholder is a Singaporean family who essentially built the Asia ex-Japan business in a joint-venture structure. Over the past sixty-plus years, the Goh's have accumulated a 40% stake, but the board of the group has remained Japanese-controlled and focused purely on the domestic market.

With the growth that has been delivered outside of Japan, as well as the catalyst of a pricey M&A bid earlier this year, a tussle for control (which we supported) resulted in the Goh family taking full control of the board. We expect a restructuring to improve alignment, with the new CEO likely to grow the company substantially in the years to come.

Indian IT services and banks

We bought Cognizant Technology, which, though listed in the US, is similarly an Asian company. The group competes with Tata Consultancy Services (TCS) and Infosys, providing IT services to the world. Like the others, Cognizant's growth has been held back by lack of spending in the banking industry. Financial services accounts for 40% of sales.

In particular, their shorter-term growth has been hindered by a couple of European bank customers moving some business back in-house. Such things are broadly deflationary, but we believe this is shorter-term noise, with the longer-term drivers of digitalisation (of everything) providing a strong structural tailwind for the sector and the company.

Banks and insurance companies apparently spend 5-6% of sales on IT and technology, while the corporate average is just 1-2%. We believe the longer-term opportunity is therefore quite substantial. Cognizant have a large presence in healthcare too (30% of sales) and the group has a public commitment to lifting margins.

This digital transition is something that we have already experienced with Tata Consultancy Services. We believe TCS is the furthest ahead in embracing the new opportunities, per the US$1bn deals they have announced with the likes of Marks & Spencer and Transamerica. TCS has become one of our largest holdings in the last twelve months. Our position in Cognizant remains small for the time being, with one constraint being our already large holdings in TCS and Tech Mahindra.

In a somewhat similar way, we bought Axis Bank, in India, for the first time last December. We have previously focused our India private bank holdings on HDFC Corporation, HDFC Bank and Kotak Mahindra.

Axis is clearly less-good than those best banks. Banking is rightly one area where compromising over quality is fraught with danger. The debate around the group has been rigorous, but the bank is now broadly owned across a number of our strategies. Essentially, the marks of quality are reflected in their deposit franchise, from a CASA ratio[5] and cost point-of-view.

The current CEO, Shikha Sharma, joined nine years ago (from ICICI group) and has built up a good retail bank. Axis's deposit-cost and market share is not too different from HDFC, which is clearly quite an achievement. If that was its business, the bank would probably trade on 4x book, rather than the 2x that it does today. Unfortunately, there is a wholesale book too.

Their wholesale loans have produced a sharp rise in credit cost. Worse, there has been a debate around ultimate responsibility, as well as an ugly tangle with India's central bank, the Reserve Bank of India (RBI), over the recognition of these losses. After RBI intervention, the bank has raised capital and reported a 1Q18 loss. A new CEO is to be appointed by the year-end.

We believe that the issues are now largely behind them. We see little reason why the institution

5 Current and savings accounts ratio – the ratio of deposits in current and savings accounts vs. total deposits. A higher CASA ratio implies a lower cost of funds as banks tend to pay little or no interest on these accounts.

should not be capable of returning to a high-teens return-on-equity (ROE) again within the next three years. People have short memories and the institution has a good underlying pedigree. It is a relatively small positon in comparison to the other Indian private banks.

HDFC and Kotak Mahindra are continuing to do well and despite their scale, we believe that the long-term structural trends are still quite positive. In fact, with the RBI being more determined to force recognition of losses such that half the publicly-linked banks are currently prohibited from lending, their competitive position has been improved.

A Hong Kong industrial and Singapore banks

Another company that we have known for a long time is Techtronic Industries. It is HK-listed, owned by Germans, but operates mainly in America. Their primary customer is Home Depot, at 50% of sales. The growth driver has been Milwaukee power tools, where they compete directly with Stanley Black & Decker and Makita of Japan.

The business has continued to grow strongly, with product innovation and expansion into new product areas supporting sales. The Pudwill family own 30% of the company, with a professional CEO already in place for some time. It is one of the few smaller companies in Hong Kong that has continued to scale and grow over the last twenty years.

The valuation is now quite full (high teens PER) and the business is quite dependent on the US housing market. We have little idea how that will unfold in the shorter-term, but the company generates decent cash-flow and now has a net-cash balance sheet. This provides great comfort.

In Singapore, we have bought back into DBS Group after a number of years, in hindsight mistakenly selling the company on sharply-higher credit costs in their oil and gas book. We still have a large weighting in OCBC and the returns have not been dissimilar over time. They are far more similar than they are different, but the quality of DBS has improved.

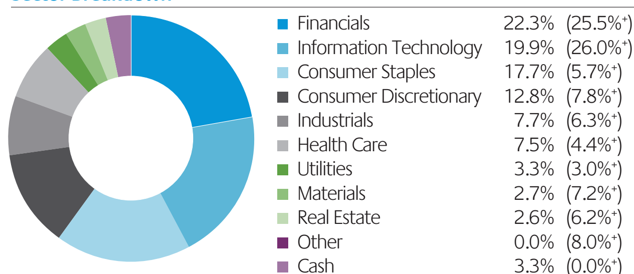
We believe OCBC to be a more conservative bank, but DBS has made a significant commitment to technology, embedding the approach throughout the organisation. For now, it is difficult to tell the banks apart; but, on a medium-term view, DBS are optimistic that IT will reduce costs and they envisage ROE lifting from 12% to 14%.

Both banks remain attractively-valued, at around 1.3x book for ROE of circa 11-12%. DBS may have some funding advantage, with a higher CASA ratio given their ownership of POSB Bank, but each should benefit from higher interest rates. Both are, we believe, conservatively-managed and very tightly regulated by the Monetary Authority of Singapore (MAS).

Sector allocation

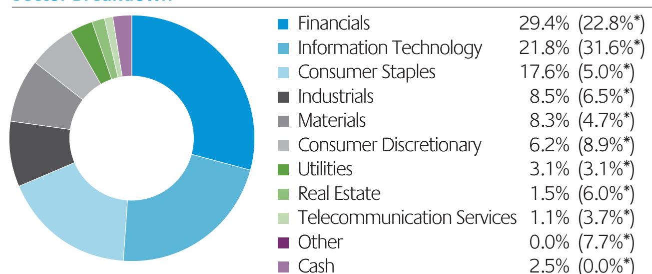
First State Dividend Advantage

Sector Breakdown



First State Asian Growth Fund

Sector Breakdown



Source: First State Investments as at 30 June 2018. Allocation percentage is rounded to the nearest one decimal place and the total allocation percentage may not add up to 100%.
+Index: MSCI AC Asia Pacific ex Japan Index
*Index: MSCI AC Asia ex Japan Index

Malaysia and the Philippines

Across the causeway, we added Public Bank, another bank that we have known for many years and own for clients in some of our dedicated country funds. Malaysia has long been a pariah for Asian investors, but a tumultuous election result has perhaps brought the country another chance. We are watching with keen interest.

Public Bank is managed very conservatively. It banks one segment of the population, has a fabulous deposit franchise and is still controlled by the founder-shareholder, Teh Hong Piow. The bank continues to grow steadily, with an ROE of 14-15% and a price-to-book ratio (PBR) of around 2x. We regard Bank Central Asia (BCA) in Indonesia similarly, but with better growth prospects.

In the Philippines, we initiated a small position in Universal Robina Corporation (URC) and have been adding slowly. It is another company that we have followed for a long time, having failed to buy it when it was smaller. Recently, they have experienced some difficulties, with profits falling by a third. That has given us an opportunity.

Their problems are substantial in the shorter-term, but not insurmountable and are in some ways familiar. It is a family-owned and operated company. They scaled too fast and are now experiencing growing pains, as well as greater competition, particularly in the domestic coffee market. Alleged quality problems in Vietnam have also been a factor.

The founder's son, Lance Gokongwei, is stepping up as chairman; and a professional CEO, ex- Procter & Gamble, has been hired via Dairy Farm Philippines, as the broader Dairy Farm group has become a joint-venture partner. Their priorities will be to bring MNC[6] discipline to the company's production, distribution and innovation efforts. It is a well-established pattern. We have seen it before.

Jyothy Laboratories, Britannia Industries and Marico in India all provide ready examples of similar family businesses that have gone on to grow substantially after the injection of professional management. Cutting SKUs[7], concentrating manufacturing, improving logistics and enhancing product innovation are some of the more obvious things to do.

What we sold

We talked at length about Global Brands in our last letter. After halving the position, we finally sold the remainder, incurring a loss. It has been a costly mistake, as well as a reminder of why we tend not to invest in the retail sector. Fashion is perhaps one of the most difficult areas to make money. No cost-discipline was the final tell, given the lack of growth.

We discussed Giant Manufacturing in some detail too, with shared bikes being the most obvious manifestation of the difficulties facing the sector. Though such bikes do not compete directly with Giant, the free capital thrown at this new industry has distorted returns for all. Earnings remain under pressure even now and we exited entirely.

Lupin was always a much smaller position than Dr Reddy's. We bought Lupin after the industry had already begun discounting the impact of US FDA[8] inspections, as well as the tightening terms from US distributors. The CFO has always been very enthusiastic as well as highly plausible about pipeline prospects and the likelihood of a rebound.

Despite all that pharma-expertise, earnings for these companies have fallen as quickly as the share prices, which means that there is not even the comfort of the sector being attractively-rated. We believe that the US distributor changes are structural and US drug prices are very politically-exposed. We sold Lupin on a modest sector bounce.

Telecoms

Singapore Telecom (SingTel) used to be a larger position for us, but we have been reducing exposure gradually over the last couple of years. We sold the last of the position in January, following a meeting with their largest 35%-owned associate investment and profit contributor, Telkomsel Indonesia.

SingTel, like telecom companies everywhere, has been struggling for growth for some time as voice and SMS carriage is substituted for digital services. With the recent release of poor 1H18 results from Telkomsel Indonesia, SingTel's growth and cash-flow seems likely to slow even further. In addition, new entrants mean more competition at home.

In Australia, wholly-owned Optus's position is not likely to get any easier, after the recent value-destruction at Telstra. It would not be surprising to see profits fall; and the 5%-plus yield does not in our view offer sufficient recompense. SingTel may prove relatively defensive from here, but we should be able to do better than that.

6 Multinational Corporation

7 Stock keeping unit – or an individual item for sale

8 US Food and Drug Administration

After much drama, as well as far too much excitement, we sold Cathay Pacific. Their cost-reduction programs and roll-off of fuel-hedging combined to propel the share price, but it is a brutal way to make money. Wonderful company, terrible business sums up the situation. We retain exposure through Swire Pacific, with Cathay being about 15% of the NAV[9].

We sold Asustek Computer for much the same reasons. Like Cathay Pacific, Asustek remains cheap, but manufacturing computer notebooks and competing in a tough industry is an unrelenting way to make money. We think we can surely find better franchises, despite the high dividend yield and low valuation (5x core PER).

Korea and Japan again

We sold out completely of LG Corporation last December, too. We had held the company for a number of years, with cheapness (50% discount to RNAV) hardly compensating for the lack of a franchise. Like living vicariously, the returns were contributed entirely by others, via the major holdings in LG Chemical and LG Household & Health Care (LGH&H).

We still hold both LG Chemical and LGH&H in any case. The outcome from owning LG Corporation was reasonable, but we have always considered it one of our lower-quality holdings, with no real operating business. This is ironic, as we think very highly of both LG Chemical and LGH&H, the more so given the opportunity set in Korea.

We have held three companies in Japan over the last few years. As per Nippon Paint, Asia contributes at least 50% of the business for Unicharm and Ryohin Keikaku. We used to own Pigeon, too. Like many Japanese stocks they seem quite expensive. Ryohin Keikaku own Muji, which has done very well in China. We sold on valuation grounds at 30x PER.

Ryohin Keikaku has seen some slowdown in their China business, per recent results, but the long-term outlook still seems favourable. As we have added to Nippon Paint and Unicharm at lower levels, so we might buy back into Muji too, if valuations permit. We would be happy to own Pigeon again, as well.

Portfolio positioning

Our overall portfolio positioning has not changed very much. India remains the largest exposure and still seems the easiest place to find high quality companies with decent growth. In particular, our returns over the last twelve months have been helped by the rebound in the IT services companies, as their growth has reaccelerated.

While Tech Mahindra's margins have recovered and the company has returned to growth after a period of poor execution, the telecom sector (50% of their business) remains weak and the group continues to trade at something of a discount.

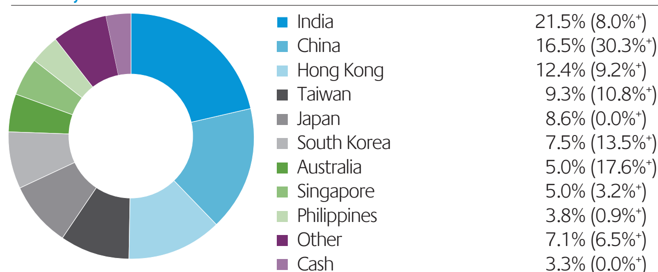
These IT companies have benefited from the more difficult environment in domestic stock-market India, with a big sell-off in mid-cap companies. The rotation is a reflection on overall valuations and marks a return to the more dependable, as opposed to the exotic. The reversal in the rupee, given India's ongoing twin-deficits, has probably helped.

As discussed, we have trimmed our direct China exposure, but on account of bottom-up valuations rather than because of any premonitions. Our concerns about China remain broadly the same. Too much debt and a highly opaque financial system. These are things we thought should be associated with a weaker, rather than strong currency.

Country allocation

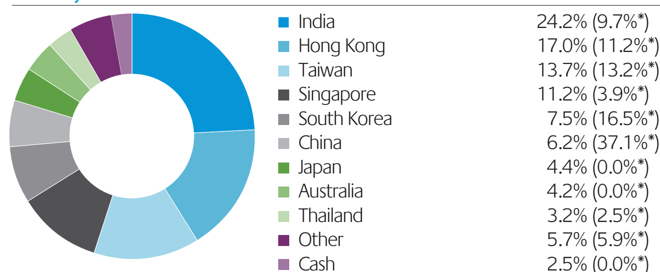
First State Dividend Advantage

Country Breakdown



First State Asian Growth Fund

Country Breakdown



Source: First State Investments as at 30 June 2018. Allocation percentage is rounded to the nearest one decimal place and the total allocation percentage may not add up to 100%.

+Index: MSCI AC Asia Pacific ex Japan Index

*Index: MSCI AC Asia ex Japan Index

9 NAV/RNAV = Net asset value/revalued net asset value

Other ideas

We operate such that our all-cap strategies invest in much of the same companies as our larger-cap strategies, but with the added flexibility of being able to add smaller companies too. Our transactions have accordingly followed those detailed above; but on a small-cap basis we also bought TOA Paint in Thailand, Wuxi Little Swan in China and Bosch Limited in India.

Conversely, we sold Integrated Micro-Electronics in the Philippines, V-Tech Holdings in Hong Kong and FPT Corporation in Vietnam. We discussed Integrated Micro-Electronics in our last note, with the auto-components company having been sharply re-rated.

V-Tech is a wonderful toy manufacturing company, but the industry is not that attractive. The position was moderately positive; but the implosion of Toys"R"Us and the power of internet giants like Amazon means that it is difficult to do well, even with their leading products. FPT was a small position, with the complications around access and illiquidity that investing in Vietnam bring. We are perhaps entering a less forgiving environment.

The purchases are all relatively small positions. Wuxi Little Swan is a subsidiary of Midea and is the second-largest washing machine company in China. We own the B-share, which is listed in Shenzhen in Hong Kong dollars. It is a curious remnant of the PRC's[10] early opening-up to foreign investors, with the company originally founded back in 1993.

Midea became the largest shareholder in 2008 and launched a tender offer for control in 2014. We assume that they are likely to privatise the company sometime in the future, but it does not matter. We are comfortable with Midea; and Little Swan's B-shares trade at a large discount to both its own A-share listing and the valuation of the parent.

Furthermore, net cash accounts for around 45% of the market capitalisation, which means that this rather strange capital markets fossil is trading on a real PER of not much more than 5-6x. We presume it is not a value-trap, as the group remains Midea's sole washing machine manufacturing platform.

Thailand and India

Our interest in TOA Paint came after our investment into Nippon Paint. TOA was established in 1964, but only listed in 2017. It is the biggest paint company in Thailand, with roughly 50% market share. The business has expanded into Vietnam (10% share) as well as Myanmar, Cambodia and Indonesia. It remains 75% family-owned.

At present, around 15% of sales are derived from outside Thailand, but they target 25% of the business to come from overseas sales. The business is richly-valued, at a mid-20's PER, but growth should be strong and the overall scale of the company (US$2.5bn) seems relatively small given the opportunity.

Bosch India is another historical anomaly, like many 1970's MNC's listings in India. It is the only part of the global group that is listed and is 70% owned by parent company Robert Bosch. The group has a strong track record and has compounded value at a high-teens rate. The main product historically was electronic fuel-injection systems.

Today, incorporating that, 70% of sales come from powertrain components. The group is already producing powertrains for electric vehicles. Given their research and development (R&D) expenditure, as well as their track-record, the expectation is that they will be a major producer in the next five-to-ten years as the industry shifts.

The main issue is its demanding valuation. The group trades on a forward PER multiple of circa 30x, while the market capitalisation is already US$8.5bn. As India modernises, in particular the truck fleet sector, we would expect annual double-digit growth over the next few years. With returns more reminiscent of a consumer company, we expect the multiple to be sustained. The position is small.

Mistakes

We outlined our views about Idea Cellular in our last note, highlighting the difficulties of the Indian telecom industry. Despite Idea having around 35% industry market share at the time of the merger with Vodafone, their market capitalisation has fallen to just US$8bn. At least the merger has been approved, with synergies to follow.

There has been no let-up from Reliance-owned Jio, with Bharti feeling the pressure too. Bharti has more room to manoeuvre, as they have a valuable asset in their Africa franchise, as well as towers and other interests that can be turned into cash. Neither company is producing free cash-flow, but Bharti's position is clearly stronger.

Both companies appear to be burning circa US$1-2bn per annum, after capital expenditure and interest servicing costs. Idea has raised another US$2bn, with proceeds from tower sales and equity on the company merger. Arguably, the shareholders, Vodafone and the Birla family, are strong holders but the equity-base of US$7bn compares with debt of US$16bn.

There is no further news on a putative Jio listing, but the total invested capital as well as accumulated losses must be heading towards US$50bn. There can be few greater examples of the times in which we live, in terms of cash-out versus the opportunity cost suffered to date. With such leverage, the numbers can be anything you like.

Idea probably has sufficient resources to keep operating for the next couple of years, but if Jio does not start to think about profitability before then, the group will face some difficult choices. The implied dilution would be significant as well. The position is now 1%, with some trimming at higher levels, but we remain hopeful of market-repair.

10 People's Republic of China

Ten Largest Company Holdings

First State Dividend Advantage

Stock name	%	Stock name	%
Taiwan Semiconductor (TSMC)	4.7	Oversea-Chinese Banking Corporation	2.9
HDFC Bank	4.6	Samsung Electronics	2.6
CSL	3.8	ENN Energy Holdings	2.4
Housing Development Finance Corporation	3.5	AIA Group	2.3
Midea Group	3.0	Dairy Farm International Holdings	2.1

First State Asian Growth Fund

Stock name	%	Stock name	%
Tata Consultancy Services (TCS)	5.3	Newcrest Mining	4.2
Housing Development Finance Corporation	5.1	Dairy Farm International Holdings	4.1
Oversea-Chinese Banking Corporation	4.6	Kotak Mahindra Bank	3.5
HDFC Bank	4.4	Uni-President Enterprises Corp.	3.3
Taiwan Semiconductor (TSMC)	4.4	Tech Mahindra	3.1

Source: First State Investments as at 30 June 2018.
Note: The Fund may hold multiple equity securities in the same company, which have been combined to provide the Fund's total position in that company. The above Fund weightings may or may not include reference to multiple securities.

Outlook and conclusion

As noted earlier, if we were to be forced into a box, we would consider ourselves a growth investor despite our emphasis on capital preservation. In that respect, the last few years have been challenging, but in an age of zero interest rates and free capital perhaps that is not entirely surprising.

> “Failures.. are finger posts on the road to achievement.”
> C.S. Lewis

That reminds me, that our former managing partner told me shortly after the team split in 2015 that he “rather feared our style was going to be out of favour for quite some time.” And here we are, three years later. He managed to magically retire at the top, after Stewart Ivory was famously acquired in 2000 – post the tech-wreck and at the bottom of the cycle.

You could not make it up, but on we go; and neither our philosophy nor the process have changed. It may be fanciful, but the current and rather long post-'08 bull market does seem increasingly exhausted. Profits growth is strong for now, but the supporting arguments for enthusiasm appear to be folding one-by-one.

Still in bed with an elephant

Investing in this part of the world has long been all about China. We have remarked before that we are all in bed with an increasingly irritable elephant. It didn't used to be like this. India, being mainly a domestic and consumer-driven economy, offers a ready alternative. But, the valuations there are already rather high.

China's financial system often reminds us of that famous Churchill aphorism about Russia: “It is a riddle, wrapped in a mystery, inside an enigma.” There are few signposts as to where we are going. Like America, China is big enough, such that you can always find an anecdote or indeed even real evidence to support whatever opinion you care to advance.

These China scares come along fairly regularly, but one day we may indeed have a more significant and long-lasting reversal. Maybe even now? Nobody knows, but it would hardly be surprising, either hereabouts or indeed globally. There is very little margin of safety in the system, whether you consider the world on a top-down or on a bottom-up basis.

The past few years have been rather benign, markets-wise, which is all the more surprising because the real world has become ever more fraught. We have become immune to unaccustomed and unusual things, as well as perhaps anesthetised to the risks, so often have we charged onward through myriad false alarms.

Only time will tell, but today we are comfortable with our portfolio positioning. If normal service resumes, we will continue to produce respectable absolute returns, while a more dramatic reversal would probably flatter our relative performance numbers.

With history supposedly on our side, we hope to use ongoing market weakness to buy into higher growth companies. That remains the key challenge. In the meantime, we remind ourselves that those *muggles* declaring victory, after but a wrinkle in the tide of returns, are just as likely to be consumed by *Death Eaters*[11] as saved by compounding-magic.

11 From J.K. Rowling's *Harry Potter* series, Death Eaters are a group of wizards and witches who practise dark magic and seek to eliminate *muggles* and *muggle-borns* (magical folk with human parents) from the community

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