FSSA Investment Managers

July 2021

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Manager Views

FSSA Asian Growth Fund

> *"Revenue is vanity, profit is sanity, but cash is reality."*
>
> *Anon*

In boom times like today, when cash costs nothing and capitalisation rates are zero, everybody is focused on growth and the future. Revenue is vanity in the sense that entrepreneurs, thank goodness, dare to dream and build businesses. We too, spend much of our time looking for the next opportunity and indeed thinking about how much businesses can grow.

But, valuations are most often anchored by current profitability, while businesses are theoretically worth only the present value of the cash that can ultimately be returned to shareholders. It has been said that in theory there is no difference between theory and practice; but in practice we know that this isn't true. It is largely a matter of risk appetite, which has lately been in retreat.

Recent rotation has witnessed the markets shift from their obsession with the vanity end of the spectrum to a more considered interest in profits, but there is still not that much regard for cash. These moves have been prompted by a very modest (from nothing) uptick in interest rates in response to inflation pressures. The political and economic environment has deteriorated too.

There is really nothing much to see. But, these moves have prompted us to think all over again about cash generation as a leading signifier of quality. Moreover, we wanted to look more closely at how our portfolio companies behaved collectively through Covid. After all, in terms of stress, a pandemic is surely many multiples beyond a sharp negative reversal of the inflation and interest-rate cycles. In particular, I am interested in how our companies treated shareholders.

RISK FACTORS

This is a financial promotion for The FSSA Asia Pacific ex-Japan Strategy. This information is for professional clients only in the UK and Switzerland and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **Single country / specific region risk:** investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.
- **Charges to capital risk:** The fees and expenses may be charged against the capital property. Deducting expenses from capital reduces the potential for capital growth.
- **Emerging market risk:** Emerging markets tend to be more sensitive to economic and political conditions than developed markets. Other factors include greater liquidity risk, restrictions on investment or transfer of assets, failed/delayed settlement and difficulties valuing securities.
- **Smaller companies risk:** Investments in smaller companies may be riskier and more difficult to buy and sell than investments in larger companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Portfolio resilience and quality markers

Their dividend payments should tell us a lot about their underlying resilience and persistency versus our expectations, as well as collectively about the overall quality of the portfolio. A plethora of emergency cash-calls would, for instance, suggest that we hold too many cyclical and lesser quality balance sheet businesses, providing something of a scorecard in terms of whether we are walking our well-rehearsed (and increasingly common) quality-talk.

Reviewing the portfolio and looking back through Covid, I was surprised to learn that the overall dividend amount paid to the strategy (on a holding-weighted basis) declined by only 5% over fiscal year (FY)2020. That is better than expected, as 15 companies reduced dividends, but clearly not that substantially. The overall figure was also underpinned by a sharp increase in dividends from Mediatek in particular. Even excluding that, though, the overall decline is still quite modest.

Out of roughly 40 companies (with some change in holdings), only four cut the dividend entirely. These were HDFC Bank, Axis Bank, Kotak Mahindra Bank and Shanghai International Airport (SIA). The Indian bank cuts, as around the world, were regulatory driven with policy-makers fearing another financial implosion. That SIA cut is hardly surprising, but the company has net cash and the reduction reflects prudence, as well as the fact that it is an SOE (state-owned enterprise).

That, as we have remarked before, is a double-edged sword. The state stands behind the business, but clearly, shareholders are not necessarily always in the vanguard of decision-making. At present the company is in negotiations to buy Shanghai's other domestic airport. It is a state-driven left-pocket, right-pocket type of deal*. We assume that shareholders will be treated fairly, but this latest deal illustrates why the company accounts for just a 1% holding.

Limited capital raisings (only the banks)

Through the very worst of Covid, globally, the Indian banks collectively fell to 10-year valuation lows. We have always regarded these banks favourably in terms of risk appetite and lending prudence. This seems to have been borne out by their subsequent bad-loans experience.

That said, many of them (including Axis Bank, HDFC Bank and Kotak Mahindra Bank) raised capital during this torrid period. In hindsight, this was probably unnecessary and somewhat dilutive, though perhaps urged by the regulator. Outside of the banking sector, none of the companies held within the portfolio had to resort to highly dilutive rights issues and capital calls. This was a relief.

Obviously, this is somewhat due to governments coming to the rescue across the world, with sharply-higher fiscal deficits a consequence of employment and rental subsidies. We do, however, regard the lack of capital raisings as a quality-marker in terms of balance sheet strength. We have always highlighted that most of the portfolio companies have net cash balance sheets. As has been said before: *Most of the time it doesn't matter, until it's the only thing that matters.*

Though cash is reality, it is true that dividends have always been something of an afterthought in Asia as well as in Emerging Markets generally. This is unsurprising, because investors rightly look to this part of the world for growth. There is not much point diversifying and taking on more, or at least different risks (currency, political, policy and legal to name some), without recompense. That said, we always engage on dividends, particularly if we believe companies are being churlish.

Dividends as a component of returns

We consider dividends an important component of investor returns. Looking back, dividends have amounted to around 20% of the overall portfolio return in the last decade. In the last five years it has been lower (at about 15%), as capital returns have surged with strong markets. The historic contribution from dividends has been much lower than in the West, with dividends being a very substantial component (40-50%) of overall returns in a market like London. That said, capital returns have powered the US markets in the last decade.

Looking forward, we expect dividends to grow at circa 8-10% per annum (p.a.) from here, roughly in line with earnings growth. If we look back, the portfolio's actual compounded dividend growth has been 7% and 8% p.a. respectively over the last five and 10 years. The strategy has likely (and has historically produced) real underlying earnings growth of circa 8-12% p.a., with an additional dividend yield on top of around 2-3%.

Composite Performance (to 31 May 2021)

	12mths to 31/05/2021	12mths to 31/05/2020	12mths to 31/05/2019	12mths to 31/05/2018	12mths to 31/05/2017
Far East Leaders Gross of Fees	50.63%	-7.34%	1.95%	12.32%	15.11%
Far East Leaders Net of Fees	49.35%	-8.13%	1.09%	11.37%	14.14%
MSCI AC Asia Pacific ex Japan	51.96%	0.30%	10.84%	17.60%	28.46%

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than USD, the return may increase or decrease as a result of currency fluctuations.

The strategy performance figures is the weighted average performance of FSSA IM's funds that contribute to the strategy in question, is based on monthly performances and are net of a default annual management fee of 0.85%. Source: Lipper IM / First Sentier Investors (UK) Limited.

In the context of other alternatives, such an outlook seems reasonably attractive in our view. Of course, it always matters what you pay for that expected growth. In that respect, the overall portfolio price-to-earnings ratio (PER) valuation of 23-25x, for a return on equity (ROE) of 20% does not seem unreasonable either.

Lessons learnt

If Covid can be rightly seen as an extreme version of a market quality assurance stress test, then in hindsight the portfolio appears to have earned a pass mark. That is, at least, reassuring. With the benefit of hindsight, the lessons learnt are mostly familiar and we have continued to concentrate the portfolio and eliminate some of the smaller peripheral positions.

Of course, we have no idea what happens next. That said, we would not be at all surprised to see markets continue to tilt more broadly in favour of reality over vanity. This trade-off is after all what makes us human, as markets always move from greed to fear and back again. We hope that we are firmly anchored in reality, while we believe that the portfolio is well balanced irrespective of the coming market season.

*A deal where neither company loses money.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 June 2021 or otherwise noted.