FSSA Investment Managers

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Client Update

FSSA Asian Growth

November 2022

> *"We are pragmatists. We don't stick to any ideology. Does it work? Let's try it and if it does work, fine, let's continue it. If it doesn't work, toss it out, try another one."*
>
> *Lee Kuan Yew, former prime minister of Singapore*

Singapore-times?

Lee Kuan Yew, although somewhat a polarising figure, perhaps understood state power and the human condition better than anybody. Consequently, Singapore has often been criticised as much as it has been greatly admired. Irrespectively and without question though, the country has gone from strength to strength.

Singapore's former prime minister well understood the source of the People's Action Party's (PAP's) legitimacy. As he said, "The ultimate test of the value of a political system is whether it helps that society to establish conditions which improve the standard of living for the majority of its people."

His qualifier says it all and has proven to be an enduring, as well as universal, template for successful economic development, regardless of the political overlay. Whether socialist or capitalist, it doesn't matter. These principles have been broadly embraced across Asia and the world. Consequently, we have enjoyed 30-40 years of strong economic tailwinds hereabouts. This has been positive for markets as well as investor returns.

But, across the world and for myriad reasons, societies have become more fractured and divided and increasingly ideological in recent years. Politics and security matters have come to trump economics, even in Asia, which is broadly not even rich. It is not yet entirely clear whether this marks a profound and lasting generational shift, but plenty of people think so (and you, dear reader, will necessarily have your own views).

The old certainties and the previous consensus seems in question. Capital is necessarily giving way to labour as inflation rises. Wealth is likely to become more evenly redistributed. At the very least, the outcome is likely to be slower growth and lower returns on capital. In turn, as the cost of capital has risen, valuations have come under pressure. As many have concluded, it doesn't seem too fanciful to believe that the economic future may look more like the 1970s, rather than resembling the recent past.

Investors apparently face a growing assortment of headwinds. Conditions look set to remain challenging. That said, we see grounds for longer-term optimism. Valuations have fallen substantially, while sentiment is now reassuringly negative. We are already living through yet another global reset, which will be the fifth in the last 30 years (the Asian crisis in 1997, tech-wreck in 2000, global financial crisis in 2008 and the Covid shock in 2020).

But this too shall pass, and the lesson is that the world, as well as our returns, roll on. Moreover, our enduring emphasis on financial strength, alongside quality of company leadership and franchises, means that our portfolio of businesses should continue to perform resiliently. None of them seem likely to need capital, while the recurrent nature of earnings should provide a further buffer against adversity.

Sharply-higher rates and tougher trading conditions favour stronger companies too. They may even gain share. A market wash-out is unlikely to prove entirely negative for the survivors. If the past is indeed prologue, we believe that high-quality equities are still one of the surest ways of preserving and growing wealth. The alternatives are not at all obvious, while high degrees of pessimism and low valuations are often a harbinger of higher future returns.

Portfolio activity

Portfolio activity has increased lately and was a relatively high 33% annualised to the end of September 2022. This is surprisingly elevated, given our typical holding period of 3-5 years and our preference for minimising activity. Name turnover has been much lower, which should reassure, and just a few months ago portfolio turnover in the year to July was a more typical 20%.

The explanation lies in the more active trimming of gainers, and adding to portfolio losers, alongside a more determined emphasis to shock-proof the portfolio. We anticipate doing much less for the rest of the year. In the past six months we added six new companies and sold two, taking the total number of holdings in the strategy up to 40. The top 10 companies still account for 41% of the portfolio (42% last time), meaning that concentration remains high.

OCBC, Infosys, ICICI Bank, LG Household & Health Care, Kalbe Farma and Singapore Telecom were the recent new purchases. Only OCBC was a material addition (3%), with the other companies being just 1% positions. We disposed entirely of Voltas in India and Seek in Australia, which had already been sharply trimmed per the discussion in our last update six months ago.

We have owned all of these company additions before, with only ICICI Bank being a completely new holding. A reduction in Axis Bank funded the purchase. Both banks continue to trade strongly, with ICICI's transformation mostly proven already, while Axis's rehabilitation remains a work in progress. Recent results from Axis have been encouraging, while ICICI Bank has continued to do well.

OCBC

OCBC has been a top holding in the past, but we have not owned the company for a number of years. Helen Wong, ex-HSBC Greater China, joined almost two years ago. It is fair to say there has been no big-bang, but we perceive a more purposeful push on growth and technology catch-up. DBS has been the clear leader while the other Singapore banks have lagged. This may well be changing and Covid, as well as their regulator, have no doubt added a greater sense of urgency.

Typically, we dislike banks with targets as they can be quite dangerous, but an increase in tempo seems warranted. OCBC recognises the gap with its nearest competitor, in business-delivery at least, while the valuation differential is wider than ever. Otherwise, Singapore is clearly gaining in wealth management, as Hong Kong continues to see outflows amid growing concern over the policy and political direction.

Banks in general, after more than a decade, are finally beginning to generate better returns from their core lending businesses. Money is scarce again, meaning there is a forward-curve as well as returns for taking risk. Against that, there's the credit cycle, which will affect everybody. Looking back, average credit costs have been circa 25bp and never structural, or persistent, such that you would question the credit culture.

It helps that the de-facto central bank, the Monetary Authority of Singapore (MAS), has oversight, while the recent lack of loan growth as well as a cautious approach through Covid provides something of a buffer. A 1% credit provision (S$3bn) would amount to half of annual profits, but would likely be a one-off, even if economic conditions were to materially deteriorate compared to today. Even in the darkest of recent times (during the 1997 Asian financial crisis), the credit cost peaked at just 1.43%. In our view OCBC appears to already be partly discounting more difficult times, with a price-to-book ratio (PBR) of just 1x.

That is a big gap to DBS; and in our view they are not that different. DBS is clearly generating much better returns, but in terms of valuation gap, if OCBC is able to lift its return on equity (ROE) we are likely to see a positive market reaction. We regard this as feasible. Assuming that OCBC can push the ROE up a couple of points, to say 12% (which is still short of where DBS is today), then the upside-downside calculus looks quite attractive.

Infosys

We have owned a number of IT services companies for over a decade, with Tata Consultancy Services (TCS) an enduring top-five position. Though the sector has been a prime beneficiary of Covid, revenues are proving to be surprisingly resilient. While the counterargument in respect of pulled-forward Covid demand is valid, we believe the technological intensity of our lives is still clearly accelerating.

It is all around us and the old truism about banks spending 6-7% of revenues on technology, compared to just 1-2% for businesses generally, suggests to an extent that the tailwinds will persist. For instance, TCS now manages Marks & Spencer (M&S) from the back-end to the front – including the floor layout to the mobile app and the logistics. That said, recession and cost pressures typically force businesses to defer and scrimp wherever they can.

Infosys are still guiding for 14-16% constant currency revenue growth to March '23, which seems positively reassuring, with cloud and the digitisation of more and more processes accelerating. Businesses need to catch up and governments are embracing more security and surveillance solutions. Life, everywhere, is imitating the old dystopian movies.

We believe the growth rate is likely to moderate, but then there's also the long-term tailwind of rupee depreciation which bolsters revenue for these exporters. We assume that the growth rate is likely to slow to more like 5-8% over the next three years, but believe that should be sufficient to underpin absolute returns.

LG Household & Health Care

LG Household & Health Care (LGH&H), like many China-focused businesses, has had a tough time. In the past we have profitably owned both Amorepacific and LGH&H, but latterly they have done equally badly. There is, to some extent, a fashion element to cosmetics which was no doubt reinforced by the Korean Wave (from music to fashion to film). This has now gone into reverse, but we believe a lot of negativity has been reflected in share prices.

LGH&H own a number of businesses, with its domestic household and beverages (the Coke franchise in Korea) continuing to hold up relatively well. The cosmetics business was overly dependent on China, especially the Whoo brand, which rose to account for two-thirds of cosmetics earnings. This was always likely to normalise, but the reversals can take some time.

Given its long-term track record, as well as an appreciation of the issues, in time we expect the management to successfully stabilise the business. The company has clear strengths, not least the brand and the broad franchise. Valuations have come down to 15-year lows and the cosmetics business is now trading at 1x sales.

Succession is an issue, with a new CEO after a long-term incumbent (Mr Cha), though perhaps this will also provide an opportunity for a fresh and reinvigorated approach. Otherwise, we own Shiseido, which is clearly a much stronger global brand but earnings have been similarly challenged by trading conditions in China.

Singapore Telecom

We have held Singapore Telecom (SingTel) previously, having sold a few years back. It was a modest negative contributor, with the business subsequently continuing to shrink. Fundamentally, the industry has become utility-like, as growth has fallen to rather low levels. In response, the group made a number of poor capital-allocation decisions in an attempt to boost growth and chase the new, new thing.

All change, with a new CEO appointed in 2021. His mandate is to unlock value and improve returns. Mr Moon is a company veteran, but previously ran the successful domestic consumer business, alongside being the Chief Digital Officer. His key target is to bolster the ROE through capital allocation, cost-cutting and disposals.

The group is a telecoms conglomerate and in this regard it has latterly been better at behaving counter-cyclically (subscribing to the Bharti rights issue at lows and reducing their stake at higher prices). This is encouraging, though the industry will continue to face growth headwinds.

We expect cash-flow to improve and the dividend yield should underpin the valuation. We expect the ROE to lift,

albeit from low levels, which should also help. The group trades at a significant (30%) discount to a reasonable sum-of-the-parts valuation, which means the risk-reward calculation seems comparatively attractive. The holding is currently just over 1% of the strategy.

Kalbe Farma

We owned Kalbe Farma many years ago, but the company has struggled to grow in recent years, as Indonesia has flat-lined. Consumption has generally been weak, while the successful roll-out of the national health insurance scheme has changed the pharmaceutical industry landscape for good.

Nonetheless, the company has managed to preserve margins (double-digit at the net profit level), and alignment with the family owners (60% holding) is strong. The balance sheet is net cash (8% of market cap) and the business generates decent cash-flow (with a free cash-flow yield of 3-4%).

The business is well balanced between prescription drugs, over-the-counter (OTC) consumer health, nutritionals and distribution. We believe government expenditure on healthcare is likely to accelerate and may now provide tailwinds, as opposed to the headwinds of a new regulatory regime.

Kalbe remains the biggest pharmaceutical company in the country and with some normalisation of conditions, we expect earnings growth to mark a return to its historic rate of progress. Assuming top-line growth of 10% (up from 6% CAGR over the last 5-7 years), unchanged margins and a forward price-to-earnings ratio (PER) of around 20x, we see reasonable upside from here.

Some trims… and portfolio metrics

We have been more active in this respect over the last few months, as remarked, with some reflections on the prevailing headwinds. We have trimmed Techtronic, Naver, Fanuc, Taiwan Semiconductor Manufacturing Company (TSMC) and Mediatek. We additionally reduced Mahindra & Mahindra, Jardine Cycle & Carriage and Shanghai International Airport, which have risen in falling markets.

We also reduced our holding in Housing Development Finance Corporation (HDFC) on the announcement of its merger with HDFC Bank, which together would have made a combined position of 11%. Typically, the largest holdings in the strategy have at most been 6-7% weightings and in any case there is a cap at 10%. Today, the combined weighting is a still meaty 8%.

By contrast we have added to China Resources Beer, Jardine Matheson, Nippon Paint and Shiseido on weakness. These are all companies that we have owned for quite some time, and where the longer-term outlook seems reasonable. All of them now appear more reasonably valued.

Overall, the strategy looks relatively attractively valued, in our view. The apparent PER is in the high teens (18-20x), compared with 25x a year or so ago. Of course, these earnings are still falling, which qualifies any statement about valuation. In mitigation, we believe the persistency of profits is relatively good, while our focus on absolute profitability (gross margin) should go some way in cushioning inflationary pressures.

The overall look-through ROE remains at 20%, with the top 10 holdings slightly higher at 23%. Though the strategy is materially more expensive than the market's comparable PER of 11-12x (based on the MSCI Asia ex-Japan index), we would counter that you typically get what you pay for, and the comparative absolute return proves the point. One of the temptations in markets like these is to migrate down the quality curve and substitute valuation for quality.

It seems an obvious and perhaps even sensible strategy, but experience shows that quality tends to hold up better than "cheap". More importantly, into any recovery it is the better-quality companies that can grow and compound wealth over time. Furthermore, we believe that it is difficult (or impossible?) to trade shareholdings using a macro-lens. It is immensely difficult to identify the market turning points, with our stance at the margin being to lean into adversity and against exuberance.

Country exposure…

The country exposure of the strategy is never entirely transparent, with MSCI typically using country-of-listing as convention rather than the economic exposure of the business. We have discussed this before, but Nippon Paint is far more a Chinese than it is a Japanese materials company. Similarly and obviously, the economics of many Hong Kong companies are dominated by China, while Taiwan tech companies are dependent on global (and China) demand.

As recently as 12 months ago we would seldom have client meetings where the lack of China was not highlighted as, at the very least, a curiosity. Today, it is the opposite and the apparent lack of a China weighting (currently 10%) is seen as a good thing. We have always disagreed with this observation, as the economic exposure to China remains significant.

With China's economy being similar in scale to the rest of Asia put together, in some ways it is easier to invert the observation and ask what isn't exposed or dependent on Chinese demand. The most obvious answer is India, which currently accounts for 35% of the strategy. Much of Southeast Asia could qualify too, but the Singapore banks have exposure to China, while the Jardine Matheson group companies (with the exception of Jardine Cycle & Carriage) are significantly exposed to the mainland.

In total our overt exposure to Southeast Asia is 17% of the strategy, with Singapore and Indonesia the two biggest weightings at 8% and 6% respectively. In North Asia, at least half of our Japan exposure (6% of the strategy) is dependent on China's economy. Our Hong Kong companies (15% weighting), are thoroughly dependent on China for visitors as well as economic demand, as is clear from the current ravages of the zero-Covid approach.

From a bottom-up point of view, we believe that at least half our Hong Kong exposure is directly tied to China. Putting all of this together, we estimate that the portfolio is at least 40% exposed to China from an economic interest perspective. This is clearly material. Indeed, with the scale of the Chinese economy, this may likely be an underestimate.

…and sector weightings

Just as for our country exposure, the same observations hold true in respect of our sector weightings. The consumer sector remains our largest exposure by far. In fact, since we last wrote six months ago, it has further increased from a third to circa 40% of the strategy. The MSCI classification

puts our consumer exposure at 27%, but we would add the Jardine Group, Techtronic and even Shanghai International Airport as being consumer-dependent.

The bulk (some 75%) of these companies belong to the Consumer Staples segment, with Midea (air-conditioners), Jardine Cycle & Carriage (vehicles) and Mahindra & Mahindra (tractors and cars) accounting for the remaining Consumer Discretionary businesses. In the last six months we have added as well to Kalbe Farma in Indonesia (pharmaceuticals but also OTC products and milk powder), along with LG Household & Health Care and China Resources Beer.

Exposure to Financials has edged up to 26% with the addition of OCBC and despite the reduction to the HDFC Group. The bulk of the holdings are straightforward retail banks, where there is growing evidence that returns from the core business are at last rising, while credit provisions remain muted for the time being. Our insurance company exposure amounts to 5%, being AIA Group in Hong Kong and Great Eastern in Singapore.

The increase in the consumer weighting has been mostly funded, perhaps unsurprisingly, from a commensurate reduction in exposure to technology. In our last write-up the technology exposure was 29%, compared with 23% today. Perhaps that still seems high, given what we know, but almost half is accounted for by IT services companies. Tata Consultancy remains the largest holding, but we have added to Infosys (a new holding) and Tech Mahindra.

Our Communication Services exposure, better known as the IT platform companies, has fallen further from 5% to 3%. Though we have added Singapore Telecom, Seek was fully sold, while we reduced Naver (and the share price has fallen sharply) after their Poshmark acquisition. Poshmark is a loss-making US e-commerce business.

While we just about appreciate the long-term industrial logic of the purchase, it will clearly dilute earnings and we were looking for more cost discipline and a greater focus on shorter-term returns from the new management team. It is a timely reminder too that cost discipline, as well as a returns focus, are low down in the corporate-DNA for these types of business. It's still all about growth; or "Move fast and break things," as Mark Zuckerberg famously said.

Laggards & mistakes

Everything has lagged, with only India and parts of Southeast Asia continuing to perform with any sense of resilience. This may be regarded as disappointing, but it is typical. The downdraft, grappling against US dollar strength, has been so overwhelming that few company share prices have made absolute gains.

As we have said before, in the early days of general reversals everything declines as the macro-tide of selling is generally overwhelming. Often, the largest and most liquid companies (marginally held by global funds and so on) get hit the hardest, initially. Subsequently over the next 6-12 months, things usually shake themselves out.

Dairy Farm in particular remains in a poor state with Hong Kong effectively closed to visitors. While the supermarkets business has recovered (which was the original problem), the hospitality, drugstores and convenience store businesses (7-11) rely broadly on tourists and general economic prosperity.

Hong Kong's domestic economy is in recession, with third-quarter GDP contracting by 4.5%. Where Hong Kong could be, post-Covid, is clear from the recovery (and boom) in Singapore. It is tough, but we are of the view that business conditions (and more importantly share prices) are already discounting the worst of conditions. However, we don't see any early rebound either.

Otherwise, we have reflected on the sizing of some of our top holdings in the context of a protracted reversal and a global recession. This is one explanation for the growing diversity (and lesser concentration) of the strategy. In particular, while we continue to think both Techtronic and Naver are high-quality businesses, growing headwinds suggest that 3% (rather than 5%) positions may well prove more appropriate over the next 12-18 months.

Outlook & conclusion

> *"Change is the very essence of life. The moment we cease to change, to be able to adapt, to adjust, to respond effectively to new situations, then we have begun to die."*
>
> *Lee Kuan Yew*

Investors and fund managers know this, all too well. Events mean that we have to adapt, adjust and respond all of the time to the world around us. The most effective way of dealing with this has been to admit that we cannot make accurate predictions about the future. In turn, we face that candidly and then try to hedge that risk by investing with proven management teams at great companies.

The belief is that whatever happens, in terms of events and subsequent adversity, they will find a way forward. In essence, we expect them to formulate the best corporate response to ensure the broad sustainability and prosperity of the companies in which we invest. This is why we engage with companies — to try to gain a better understanding of their culture. Of course, we are well diversified too.

Looking back, a lot has happened in a very short time over the last six months. Some of it has been entirely predictable and rather obvious (lower valuations; policy and regulatory pressures). But, with some of these things (inflation, interest rates, recession and politics), it looks like we are now possibly in the early days of a broad and probably long-lasting trend-reversal.

We will see, but clearly this has implications for portfolio positioning and likely absolute returns. Lee Kuan Yew was famously a keen fan of Machiavelli, though there was some tacit restraint on his exercise of power in Singapore. This is important, as there are few examples throughout history of unconstrained power being accompanied by sustainable economic prosperity.

Our expectation is that as economies come under increasing pressure, there is likely to be some rebalancing. It has just happened in the UK and very quickly, for instance. To be truly sustainable, we believe that politics and even ideology has to ultimately deliver prosperity to the people. Harking to the opening of this update, with Lee Kuan Yew's reflection: "Does it work?"

This is true everywhere, but it is probably also true that recalibration happens far more quickly in some places rather than others. We remain optimistic. We ended our last note with some observations on the need for a renewed focus on capital preservation, alongside the pressing need to invest in the best and highest quality companies that we can find.

There is a need to focus on not losing, rather than winning. These are two very different things. Times have since become more challenging, globally, but valuations are at least now more reflective of economic reality. We thank you for your patience, fortitude and support.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 October 2022 or otherwise noted.

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