

Asia ex Japan strategy

Mid-Q3 update

Markets have been particularly weak in early August, for reasons that have been well documented. We thought it would be helpful to provide a brief summary of how we are reacting to these events, outlining the changes we have made to the portfolio.

Positioning at end Q2 2011

At the end of June the portfolio was positioned for a rise in Asian markets in H2 2011. We thought markets would move higher because:

- we expected continued, if modest, growth in the West
- we expected a healthy rate of growth in China (i.e. fears for growth were overdone)
- we expected an easing in inflationary pressures in Asia
- equity market valuations looked reasonably attractive, even if we assumed earnings came in a little below consensus.

How has our current thinking changed?

- the risks to growth in the West have clearly increased, though we still think that the greater probability is that a double dip will be avoided
- the picture for inflation and local policy tightening should be better than earlier
- the steep fall in risk appetite and share prices bears the hallmark of an overall loss of confidence and therefore a possible over-reaction in the short term

There has been no significant change in our view on the Chinese economy.

Should we be more defensively positioned?

The key problem, it seems, is the lack of policy credibility. Both in Europe and in the US, the markets need to be convinced that the politicians are ready to solve the fiscal problems properly and also that the central banks are able to enact policies that will at least buy sufficient time for longer term policy credibility to be restored.

Although some further steps have been made and, thus far, credit markets and banking liquidity have held up well enough, there is clearly a lot more that needs to be done. There is also a risk that the fiscal challenges will become close to insuperable if the world returns to recession/deflation.

In the event, although we recognise these risks, we have decided not increase cash or like-cash at this stage. Focusing on the stock level, we made a number of changes the effect of which will, we think, insure the portfolio against economic and market risks, whilst also preserving the upside to a market recovery should sentiment turn even a little more positive.

That said, because the economic risks have risen, we are keeping the idea of turning more overtly defensive under review. In addition to following the politicians' and central bankers' actions, we are, inter alia, keeping a close watch on credit spreads (both for corporates and lower levels of government) and banking shares for evidence that financial conditions are holding, as well as on the level of Italian and Spanish government bond yields.

All things being equal, a recovery in equity markets might also present an opportunity to increase defence on better terms than are available to us today. This is something we will continue to watch closely.

Recent changes to the portfolio

We have cut our IT exposure from a small overweighting to a 2% underweighting. We have done this by selling out of Siliconware Precision in Taiwan and out of LG Electronics in Korea. Part of the proceeds from LG Electronics have been reinvested into LG Display.

We have taken some money out of Mongolian Mining (coking coal) and Anhui Conch Cement, two industrials that have held up to the market turmoil relatively well.

We have used the net proceeds from these sales to add to Perusahaan Gas, United Overseas Bank, Olam International and China Resources Enterprises. We have bought a position in Fraser & Neave.

Perusahaan Gas has been especially weak on reports in the Indonesian newspapers it will be pressured to pay more for its gas and on concerns that it will be unable to pass higher costs to its (mostly industrial) customers. Following interaction with the company, we think these concerns are more than fully reflected in the price. In the long term, we think gas prices will have to rise to overcome upstream companies' evident reluctance to invest in exploration, but note that, even at the higher prices reported in the papers, gas will be highly competitive compared to alternative fuels. This supports the company's pricing power. We also see the possibility of Perusahaan Gas receiving better security of supply/higher volumes to distribute down its underutilised pipelines as a *quid pro quo* for higher prices, which its customers should receive positively.

Olam (a supply manager of agricultural commodities) has been weak, we think on concerns that it will be frozen out of credit markets. At this stage, we think the risks of this are overdone and note that at the end of July the company raised USD 1.25bn through a 3yr to 5yr syndicated loan. For now, its financial needs are well-covered. Steady demand growth for its products, supported by market share gains and increasing returns from significant recent investments in upstream production and midstream processing should drive strong EPS growth in the coming 3 to 4 years even if the external environment weakens further.

Fraser & Neave is the only new company to the portfolio. Its two main businesses are consumer staples (a controlling stake, with Heineken, in one of SE Asia's leading brewing companies, together with soft drinks and a dairy business) and a mix of residential and commercial property. Although the immediate outlook for residential property in Singapore is lacklustre, the stock has fallen in the recent market drop to very much the bottom end of its trading range and, on our estimates, was acquired at a little over 1x P/BV, a PER for the year to 9/2012 of c.12.5x, a FCF yield of c. 7% and a dividend yield of 3%. RoE is expected to hold at around 10%.

The following is a summary of the position of the portfolio at the sector/country level, reflecting these stock adjustments:

Sector exposures

We are most overweight Asian consumption themes (c.11% by our definitions). This overweighting more than offsets our underweighting to the defensive telco sector (where we have no exposure and are 6% underweight).

Within other traditionally defensive sectors, we are slightly overweight utilities and consumer staples, by our definitions.

We are underweight banks outside SE Asia (1.5% underweight banks overall), and underweight non-banking financials (-3.5%) and real estate (-2.5%).

We are neutrally weighted to commodities (including energy) but 2% underweight technology and 1% underweight transport/ports.

Country exposures

We are c.4% overweight in SE Asia and c.3.5% overweight in HK/China.

We remain 1.5% underweight in India (no change).

Our underweight to Korea has risen from 1% to 2% and our underweight to Taiwan has risen to just over 6%.