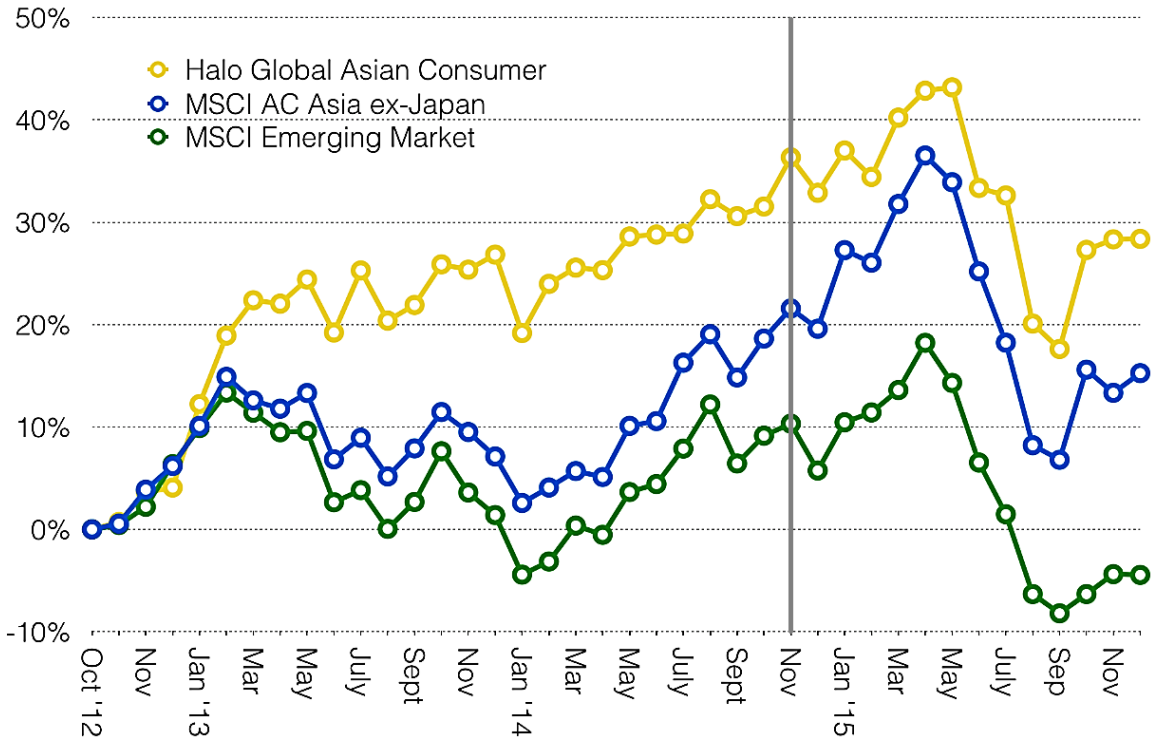
# VT HALO Global Asian Consumer Fund

## 4th Quarter 2015

Following the volatility in the third quarter, we saw markets recover their poise in the 4th quarter, only to start 2016 with a bout of nervousness over China and its currency. I am not a currency strategist and will not try to forecast where they go but I will talk about this later in the letter. Q4 saw a recovery in the net asset value of the fund from 89.3p to 97.5p. Which was driven by the PE multiple of the fund rising from 14x to 15.3x by the year end.

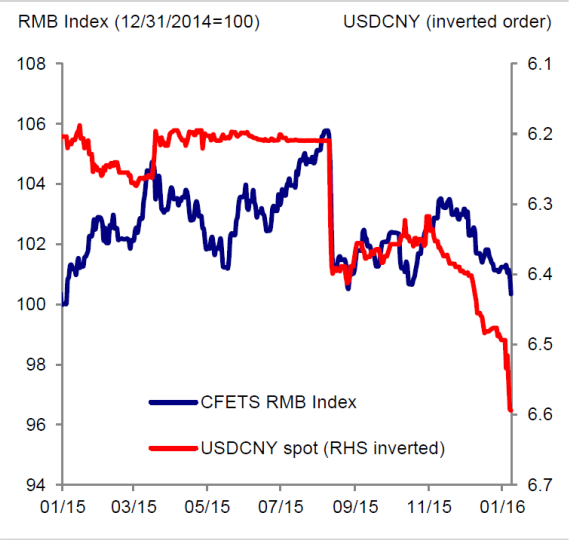
For the year we have seen the PE multiple of the fund fall from 17x to 15.3x, representing a 10% contraction but the NAV is only down 2.5%, indicating that the companies we own have continued to see decent earnings growth. As stated in the previous quarterly letter the consensus earnings growth for the stocks in the fund over the next 12 months was 15% and this is still the case today. So the outlook remains robust.




**Robust Outlook for the Thematic**

The outlook still remains solid with expected profit growth continuing in double digits, although the current market concern over China would suggest otherwise. It appears right now to be the Chinese currency that is upsetting markets as it manages the depreciation against the US Dollar. We believe these concerns are overdone as the government has indicated through the China Foreign Exchange Trading System (CFETS) that it is trying to manage the exchange rate against a basket of currencies, which includes the Euro, Sterling, Yen and others, as well as the USD. They highlight that against *this* basket, the effective exchange rate, starting at the beginning of 2015 at 100, remains just above 100 today as shown in the chart below.

**Figure 3: CNY index held relatively stable**



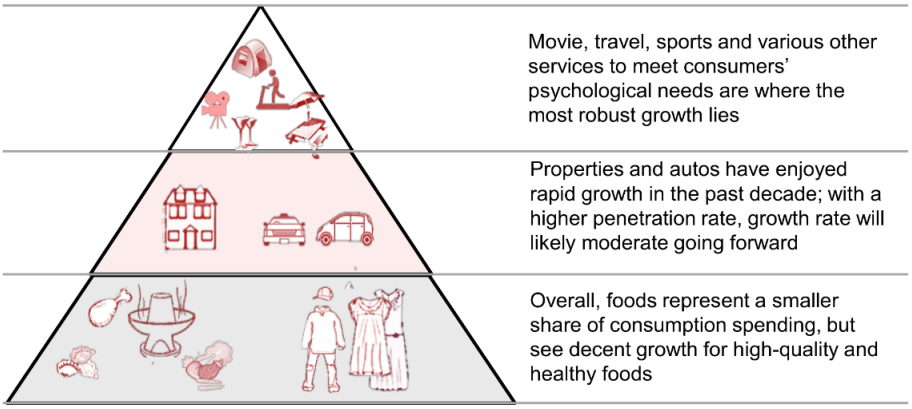

Source: Bloomberg, UBS estimates

Looking ahead for the rest of this quarter, we would expect that as we see other currencies depreciate against the US Dollar, China will follow suit. It is not trying to competitively devalue against other currencies but just to ensure it remains competitive and the effective exchange rate is stable. The exchange rate should not be a reading on the health of the Chinese economy and it would certainly help if the Chinese government were more communicative to the market in what they are trying to achieve. The current market sell-off is not therefore in our view warranted by the fundamentals.

**Chinese Macro Outlook**

Just because we reach a new calendar year, does not mean every view we have resets to zero and the clock starts ticking again on what countries, sectors and stocks we favour for 2016. We view January 1st as another day in the development of the trends witnessed over the preceding years. Namely China has seen its growth slow for a number of years now and 2016 will be no different, the areas of the economy that are growing faster than nominal GDP, will be the same as 2014, 2015 and no doubt 2017 as well. We shall continue to invest in the sectors that serve and sell to the consumer and are growing faster than the nominal GDP of the country. With the chart below illustrating how consumers move their consumption priorities as their income grows.

**Fig. 39: Chinese consumers moving up the pyramid: the Maslow's hierarchy of needs**

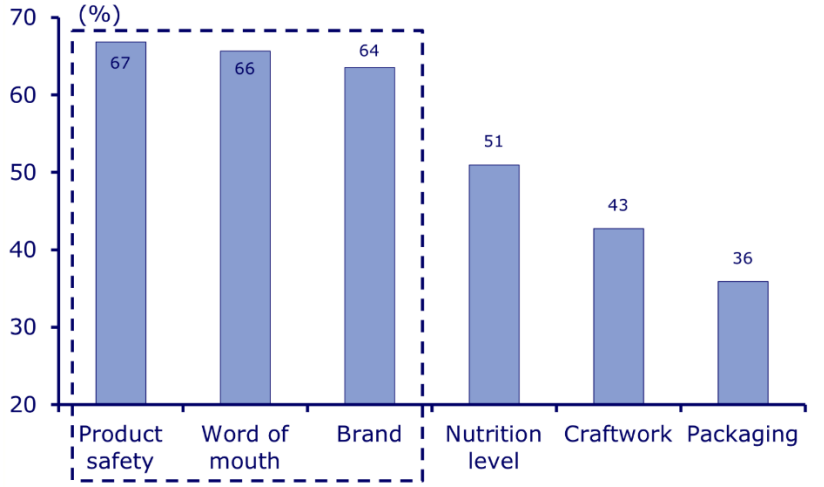



Source: Nomura research

One data point we continue to monitor closely is real wage growth, which looks to be robust with it having been in high single digits in 2014, perhaps nearer 7% in 2015 and it is likely to be only a little less in 2016. But even if it is slowing, it is still strong by many country comparisons and the increase in disposable income benefits spending on other areas outside necessities. We should therefore see leisure activities, healthcare, education and finance growing faster than nominal GDP growth in 2016, especially driven by the new middle and upper class in China.

A sector where we are seeing a change in trends is in consumer staples, which in previous years has been all about increasing your distribution throughout the country by opening new stores or adding more points of sale - with greater distribution came greater volumes. Certainly today the large consumer staples companies in China have improved their distribution immeasurably but volume growth is now harder to come by. Instead they have to change their focus to encourage consumers to trade up to higher price points and educate them to pay more for quality. Looking at a number of sell-side consumer surveys that have been done recently, this appears to be happening, with an example below.

**For which kind of improvement are you willing to pay more? (multiple choice)**

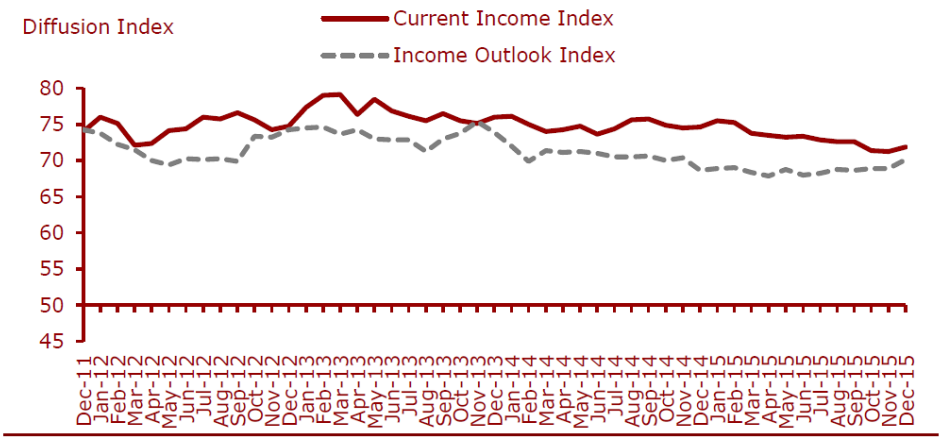



Source: CLSA

Within our portfolio this is particularly relevant for Hengan, the sanitary napkins, tissue and nappies producer, who has successfully taken on the multinationals and positioned itself in the mid to high end for sanitary napkins and continues to take share even as they raise prices, with turnover expected to grow at over 10% in this division in 2016.

Consumers' outlook remains strong as spending power by the middle class still looks healthy as shown below, but as we witness the current stock market turmoil one would have thought the outlook would look a lot worse. We also take the view that stock market gyrations will not impact this in the short to medium term as you can see the income outlook index has ticked up very recently and overall the last 5 years has been fairly stable, which again bodes well for 2016.

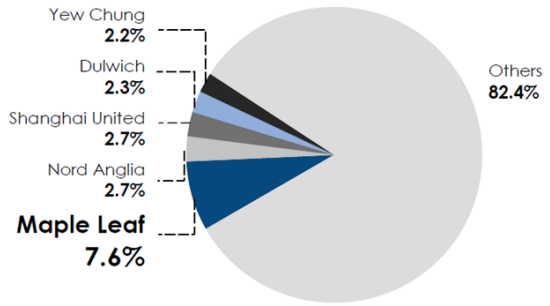
**CRR Middle Class Income Indices**




Note: The CRR Middle-Class Income Indices are composed of a current income index and an income 6M outlook index. The former is the sum of the responses that feel their income is "higher" plus half of the responses that feel it is the "same" as a year ago; the latter is the sum of the responses that expect their income to "rise" in the next six months plus half of the responses that expect it to be "same" as currently. An index reading above 50 indicates an overall increase on the income and income expectation. Source: CRR

We touched on Hengan as one of our holdings which is perceived as slightly more defensive and should benefit from the trading up in consumption, but another area with similar defensive characteristics that we are keen to focus on is education. As many of you will know parents do not wish to skimp on education for their children and will spend whatever they can afford to ensure children receive the best possible start in life. A stock we own which is outside the top ten holdings is China Maple Leaf, a company that has set up private schools in a number of provinces and currently has 46 altogether across the spectrum from pre-school, all the way up to high school. Its key selling point is the curriculum, which is based on British Columbia of Canada and has been certified by the Chinese government. Barriers to entry to the dual diploma international high school segment are high. School operators are required to design a program that is acceptable to provincial educational authorities in China, such that the foreign courses the students take can be counted towards a Chinese high-school diploma. Maple leaf offers students a pathway to overseas universities and colleges, with 95% of high school graduates in 2013-14 school year being admitted to Universities abroad.

MARKET SHARE OF CHINESE INTERNATIONAL SCHOOLS (2013/14 SCHOOL YEAR)




*Note: Based on student enrollment*
*Source: Frost & Sullivan*

Maple Leaf as shown in the chart above has a 7.6% share of the international schools market according to Frost and Sullivan and this will continue to increase. One of the key arguments for us is its ability to scale the business model as it moves into new cities due to its affordability. Please refer to the table below for comparisons of its fees to other private education establishments in China. It is substantially cheaper than peers and as a result is a great play on the middle class as it allows them also to have pricing power given the cost advantage they have. A combination of rising numbers of students both at existing schools and new ones, as well as increasing the

fees, allows us to view its top line growth of 20% pa as achievable and, with operational leverage, profit growth closer to 30% over the next 3 years. Given the current turmoil in markets we view education as a defensive area and that it is relatively immune to the economic cycle, especially as this sits at the value end of private education. This stock is currently valued at 13.7x PE based on the next 12 months forecast.

**AVERAGE ANNUAL TUITION FEES COMPARISON (2014/15 SCHOOL YEAR)**

| Top-5 international schools in China | Preschools (RMB) | Elementary schools (RMB) | Middle schools (RMB) | High schools (RMB) |
|---|---|---|---|---|
| Maple Leaf | 16,500 | 20,456 | 26,410 | 49,000 |
| Nord Anglia | 145,200 | 206,000 | 224,400 | 241,500 |
| Shanghai United | 95,500 | 93,000 | 109,800 | 147,000 |
| Dulwich | 155,800 | 193,600 | 212,600 | 186,700 |
| Yew Chung | 147,300 | 192,600 | 208,100 | 215,400 |

*Note: Data based on statistics as of 31 Aug 2014. Tuition fees do not include incidental expenses and are applicable to the 2014/2015 school year. Maple Leaf foreign national schools are not included in the table*

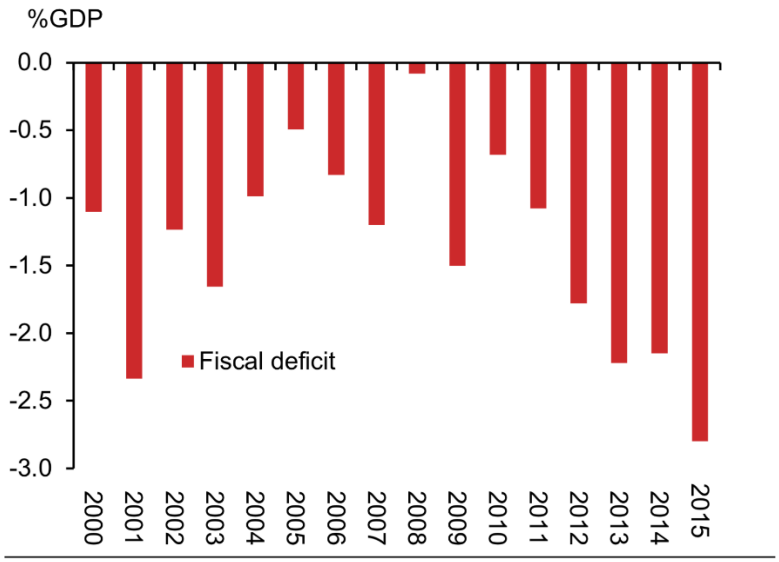
*Source: Frost and Sullivan*

China Mapleleaf is another excellent example of a company which, we believe has plenty of room to grow as the middle class in China expands the demand for quality education. We believe this is a company that has a strong outlook with a valuation that is very reasonable.

**Indonesia and an acceleration of GDP growth from 2015 levels**

This is an area that we have been adding to in the last couple of months as the market has sold off on fears of the falling exchange rate knocking consumer confidence and the corresponding slowing GDP growth. GDP growth has slowed to 4.7% in Q3 2015 and inflation has remained above 4% as import prices have been rising due to the just under 20% depreciation in the Indonesian Rupiah up to September 2015. The currency has since rebounded in the last 3 months of the year and inflation is now down below 4%. The government is also starting to implement reforms and an infrastructure stimulus has begun, which will impact 2016 growth in a positive way. As has been noted and shown in the graph below, they are prepared to let the fiscal deficit expand above the typical 2% level to enable infrastructure spending to accelerate. In the last few years if the deficit had been approaching 2%, they started to cut back on spending to stay within the target. We believe this is the right thing to do as it is productive investment, especially with the chronic under investment in the past few years. Together with the likelihood of interest rate cuts in 2016, with perhaps four 25bps cuts to come starting in January, now that the currency appears to have stabilised against the US Dollar and inflation is within the central banks target range. On the back of this the consumer is starting to feel more confident. Investors are now starting to view Indonesia more positively and GDP growth is likely to be back above 5% in 2016. Not be sniffed at given the struggles elsewhere in the world.

**Fig. 2: Central government fiscal deficit**




Source: Ministry of Finance; Nomura Global Economics.

As we are long term investors and believed growth, although slowing, was never going to experience a cataclysmic collapse, we did not reduce our existing holdings in 2015, but with cheaper valuations we started to add to them in the last quarter of the year. Indonesia now represents 8% of the fund, one stock which has performed well and we added to, was Bank Tabungan Negara or BTN for short. BTN specialises in mortgages and with only 2% of the population with a mortgage, there is huge upside as more Indonesians move onto the housing ladder. BTN offers both standard market rate mortgages as well as mortgages for the poor, which are subsidised by the government and who also provide insurance if the borrower is unable to repay the mortgage.

We were able to buy the stock on a forward PE of 6.5x and 0.8x price to book, as the company was coming out of a peak bad debt cycle driven by low introductory rates for mortgages which then reset to market rates after a couple of years and the borrowers were then unable to meet the new payments. All these mortgages have ceased to be marketed and the rate of bad debts are now declining and as a result we are expecting 60% earnings growth in 2015. Management have also commented that due to strong demand for mortgages they expect lending to grow in the high teens in 2016 and profits to grow by 25%. The market is only factoring in 40% growth for 2015 as they anticipate more general provisions for bad debts, since profitability is so strong and 20% for 2016 while management have reiterated they see 60% earnings growth in 2015 and 25% in 2016. Based on the market expectations it trades on a PE of 7.1 and a price to book of 1.0 looking 12 months out, with a return on equity expected to be 13-14%. This valuation appears to be pricing in a lot of negative news, which has not been forthcoming over 2015 and we believe the positive momentum can be maintained for a few more years yet.

**Conclusion**

This is likely to prove another year of market gyrations with continued debate on the global macro outlook and a lot of commentary and hours will be spent discussing the slow down in Chinese growth which, we have mentioned numerous times, is to be expected. We shall continue to focus on those sectors in China which are showing faster growth than the nominal GDP and are benefitting from the switch from fixed asset investment to consumption. The key for us is to find those stocks that will deliver solid earnings growth in this environment, as illustrated by the two stocks mentioned above. We hope that stock fundamentals win out over the next year and we can report an increase in the net asset value driven by the earnings growth, without a further derating of the stocks we hold.