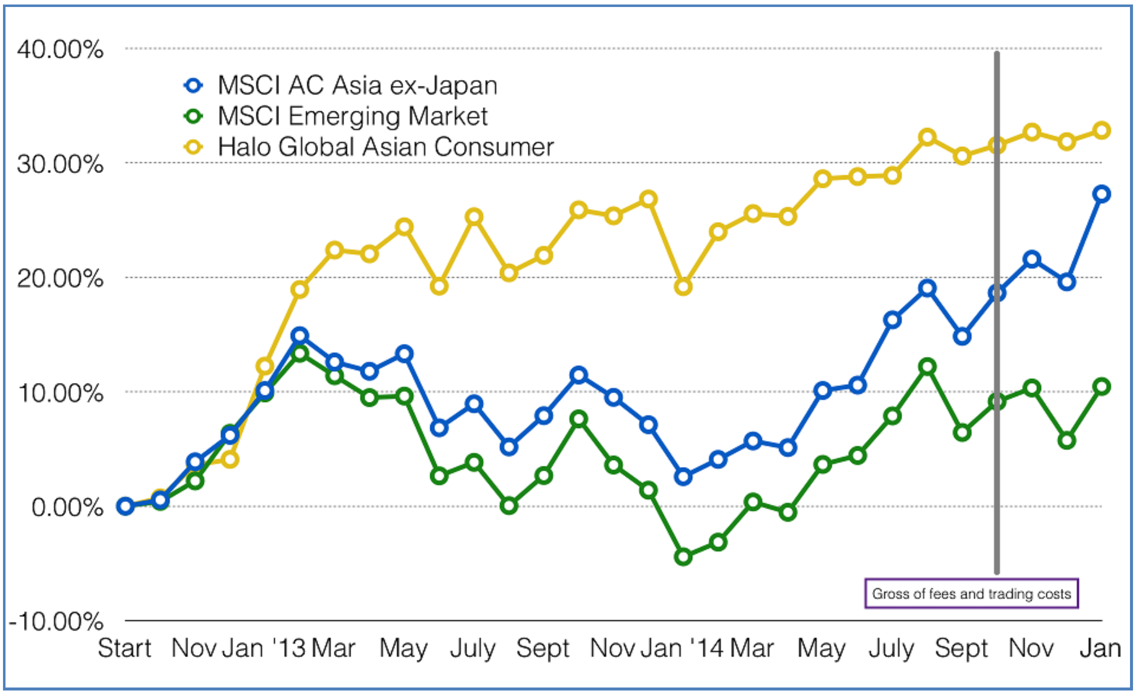
HALO Global Asian Consumer Fund

4rd Quarter 2014

By combining one month's performance of the paper portfolio in October with the two months of running a live portfolio, we have produced a return of 1.6% for the quarter and using 10 months of the paper portfolio and the two months running the live portfolio we have returned 4.7% against 6.1% for MSCI AC Asia ex-Japan. Since inception (26th Oct. 2012) the returns have been more worthwhile with the fund up 32.9% against and MSCI AC Asia ex Japan up 19.6%



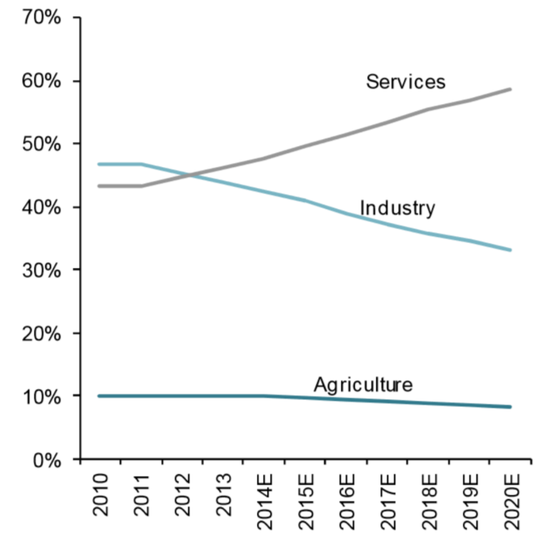
Performance shown to the left of the grey bar is of the model portfolio gross of fees and trading costs. To the right is the performance of the VT Halo Global Asian Consumer Fund £B Acc. Units inclusive of all costs. Past performance is not a guide to future performance.

I am going to resist the urge to write a piece about the oil price as I am sure the readers of this investment letter have read enough about it already but since Asia is a large importer of commodities, the fall in the price can only be good news.

China is slowing, should we be concerned?

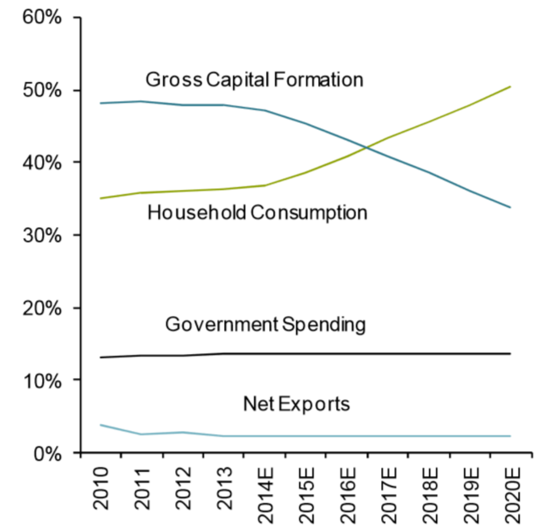
This is a popular topic of conversation and one that needs to be addressed. China is indeed slowing, something which we expect and want to see. We would far rather China grew at 6% with consumption being a bigger driver of the growth with fixed asset investment slowing, so that its contribution to GDP growth falls from the currently 45% to something closer to 25%. China has over the last 5 years built something like 33 new airports, 11000 kilometres of new high speed rail lines, 175,000 km of new high voltage transmission lines, 44,000 km of new highways, over 6000 new port berths… The total cost was circa USD 5.5 trillion and the utilisation and return on invested capital is low, but this by design in that it allows them room to grow. It is a lot more productive to build in advance of the need rather than the rear view mirror approach in this country, of building when there are chronic bottlenecks in the current infrastructure.

Chinese GDP by Sector 2010-2020E



Source: Haver, Bernstein estimates and analysis

Chinese GDP by Expenditure: 2010-2020E



Source: Haver, Bernstein estimates and analysis

This investment led growth is now slowing and, with interest rates now being cut, the cost of servicing this debt is falling just as utilisation of these fixed assets start to rise, as China moves to consumption led growth. Crises occur when there are bubbles, poor fiscal balances (typically financed by foreign currency debt), large amounts of consumer debt and an open account. China does not have *any* of these. Consumer debt is low, it operates a closed capital account, has little foreign debt and the property market has been in the doldrums for the last 12 months already.

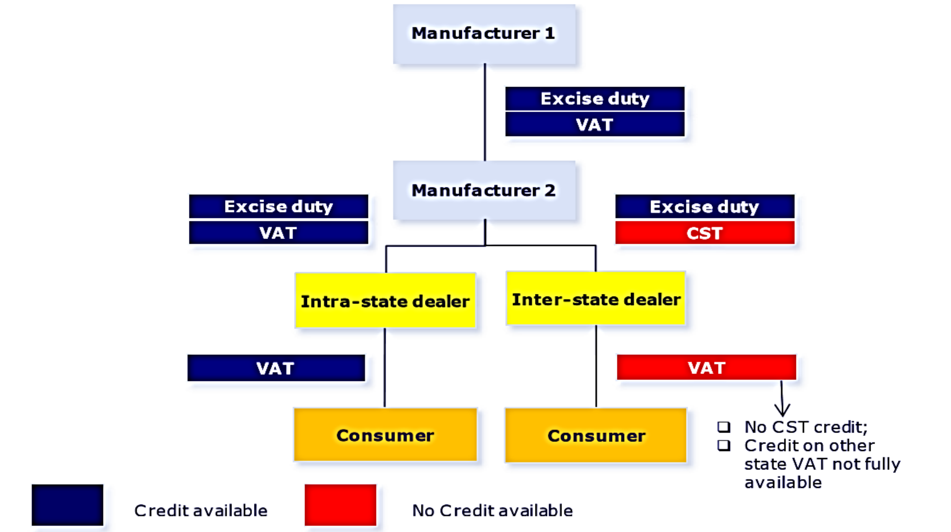
Another point to consider, China is currently growing close to 7.5% and this is expected to slow to 7% in 2015. Virtually any country in the world would give their right arm to grow at this rate and investors in Europe get excited if they see European growth move from 0% to 1%, so let's put it into perspective. 7% growth on a $10 trillion economy is adding some $700bn pa to global GDP and will be the biggest contributor to world growth next year. Retail sales are growing at over 11% and wage growth is 6-10% pa, depending which industry you work in. GDP per capita is likely to double in real terms in the next 12 years from $6500 to $13,000 per capita.

Reforming India

India is another country where the outlook continues to improve and we expect GDP to double in the next 10 years from $1500 to $3000 per capita, if it can achieve its potential of growing at 7% pa. Reforms are continuing at pace and although there are a number of commentators saying that perhaps these reforms are not happening as quickly as one would like/expect, they are at least happening. Given the notorious Indian bureaucracy I think Modi is moving as quickly as he can, whilst ensuring the electorate and the members of his own party move along with him.

There are many reforms one could comment on but one of the key reforms and most complex due to be implemented over the next couple of years is the reform of indirect taxes. We have used an exhibit below from CLSA to illustrate the complexity of the current system.

Current indirect tax trail in India on sale of goods



Note: Excise duty is levied by central government while VAT is levied by states; Source: CLSA

The current indirect tax system has some states levying taxes on manufactured goods and allowing no offset, while there are other states which *do* allow some taxes to be offset. Also the state government collect the VAT on the sale on intra-state goods and Central Sales Tax (CST) on inter-state sales such as services. There are also luxury taxes, a property tax, entertainment tax etc. which are collected by local authorities.

All this creates huge costs and is time consuming to manage. In addition, there are taxes on taxes adding to the end cost to the consumer. It is not uncommon for companies to design operations based on tax optimisation rather than economic considerations. Consumer companies will set up distribution centres across all states if they want to have a national network to avoid CST, which results in lack of economies of scale in distribution and sub optimal logistics.

Once this is all simplified, which will take another couple of years as all interested parties need to agree on the split of revenue from the national VAT, then we should see a vast improvement in productivity. This will result in lower prices of goods and services which will subsequently increase consumption of those goods.

There are also numerous other reforms one could highlight, whether it be reforms to Foreign Direct Investment (FDI), land acquisition, rural wages and labour laws, public sector banks and infrastructure and power sectors. We are playing the long game and understand patience is required and as long as we see continuous movement along the path of reforms we are likely to remain positive towards the Indian market. With these reforms in place, we would expect long term inflation rates to drop to the central bank's target of 4% (from current 7-8%), which might also allow for a rerating of the market, on top of any earnings growth.

One way we continue to play an improving Indian economy is through the private sector banks, namely **HDFC Bank** and **ICICI** which have strong capital ratios and high amount of deposits in both current and savings accounts allowing them cheap financing for loans to individuals. They continue to roll out their branch network nationwide and they have high and improving returns on equity. We continue to expect these banks to compound earnings growth over the next five years in the mid to high teens with a corresponding uplift in their dividends. These are core earnings compounders for us.

Asian earnings compounders

Other Asian holdings which we regard as solid core earnings compounders are names such as **Bank Rakyat** in Indonesia, a specialist in micro finance. It typically will lend $1000-$5000 to the new emerging middle-class through its network of branches spread through all the Islands that make up Indonesia. They have an unassailable lead in the branch network, including "mobile branches" run out of the back of minivans across the islands of Indonesia. Typical interest rates on these loans are above 20% and the net interest margin for them is 8%, with an ROE (return on equity) of over 25%. We expect loan growth to be maintained in the mid-teens even with the economy slowing to close to 6% GDP growth over the next few years. It currently trades on a PE of 11x with a yield of 2.6%. In the short term though, Indonesia will benefit from the fall in the oil price as they are a net importer and oil price subsidies take a large chunk out of the government budget. These government savings, if the oil price stays at current levels, can be spent on infrastructure investment - something Indonesia needs in abundance.

Another stock which might well be viewed as European but is actually quoted in Hong Kong (its biggest area of sales being Asia), is **Samsonite**. The luggage manufacturer also owns *American Tourister*, a lower priced brand than Samsonite, as well as *Hartmann*, a US luxury brand, and a couple of other small accessory and luggage manufacturers. They have a global distribution network that no other luggage maker can match and invest more in R&D and marketing than anyone else. This has enabled them to take market share every year since it IPO'd in 2011, with the travel market *itself* growing at twice world GDP growth rates, this has provided top line sales growth in the mid-teens and has also translated into mid-teens EPS growth. They have stated they wish to double earnings over the next 5 years and are increasing their dividend payout ratio towards 50%. With no debt and cash on their balance sheet they can also enhance their organic growth by buying smaller brands and putting the acquired company's products through their own distribution network. It currently trades on 17x, less than the global staples sector, with faster revenue and earnings growth and a similar yield.

Conclusion

Reforms implemented by governments is certainly a topic that will continue to make headlines in Asia over the next few years, whether China, India or other countries in the region. We do believe it to be a long term positive if this momentum continues and we will certainly be increasing our focus on areas that will benefit from these reforms in our portfolio. We believe the outlook for Asia is improving in 2015 with a combination of falling commodity prices and productivity reforms boosting consumer and business confidence, which should follow through to equity markets.

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