HALO Global Asian Consumer Fund

1st Quarter 2015

We thought in this letter we should expand on some of the activity within the fund over the last quarter and why this has occurred, with the aim of helping investors understand how we approach valuations of stocks with our focus more on an absolute, rather than relative value approach. In addition we will comment on the slowing Chinese GDP growth numbers and what this means for consumption.

Performance

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 Accumulation units inclusive of all costs. Past performance is not a guide to the future performance.

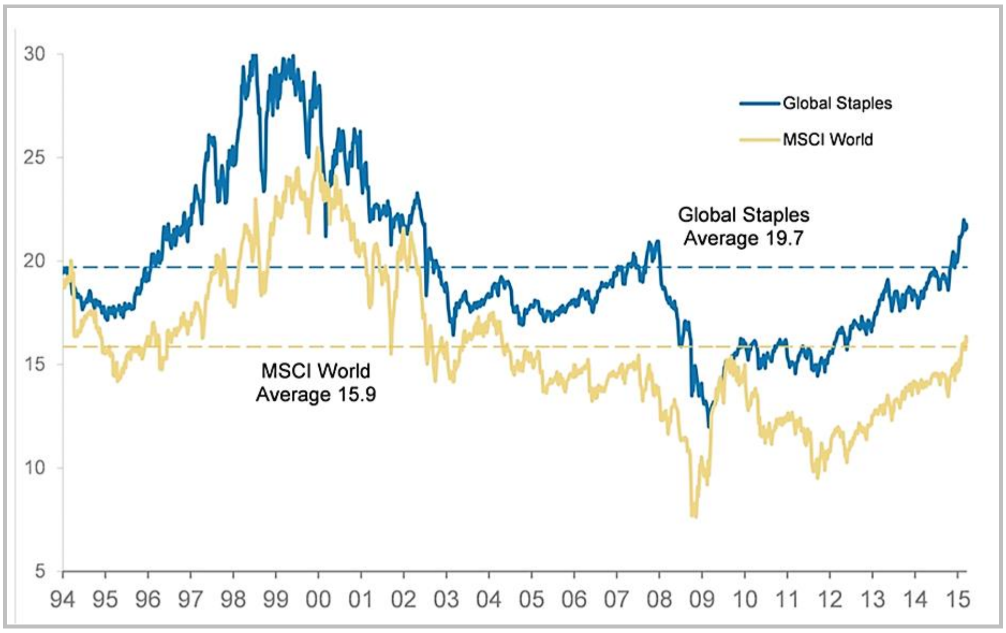
<u>Valuation arbitrage between European and Asian stocks and how we view it</u>

Since the day the fund went live back in November 2014, we, along with many other investors, had concerns over the valuation of consumer staple and discretionary stocks quoted in Europe and the US. This issue, since the announcement of QE in Europe, has become even more pronounced as the absolute valuations measured in PE multiples have reached extreme levels - the last time they reached this level was in 2002 on an absolute basis (see graph below). Whilst the bulls on the sector believe they can go higher, pointing out that the relative valuations to their European and US markets are within the normal valuation bands, it's just markets are more richly valued today. And where else do investors place their money when bond yields are somewhere between zero and two percent? With dividend yields on these stocks in the range of 1.5-3.0% and growing in real terms, the argument goes that these represent good value when compared to bonds. Coupled with the risk free rate (government bond yields) now say at 2%, the weighted average cost of capital (WACC) for these companies has fallen, so any valuation based on a discounted cash flow (DCF) has risen significantly and the share prices today can be justified.

What if bond yields rise in the next 3 years?

The concern we have is that in the medium term bond yields will move higher as QE ends. The WACC for a company therefore will rise, which in turn will depress the valuation of the company, as PE multiples contract and dividend yields look less enticing. This will result in all likelihood of little capital appreciation over the next few years. This concerns us since we aim to deliver 8-12% pa over the medium to long term.

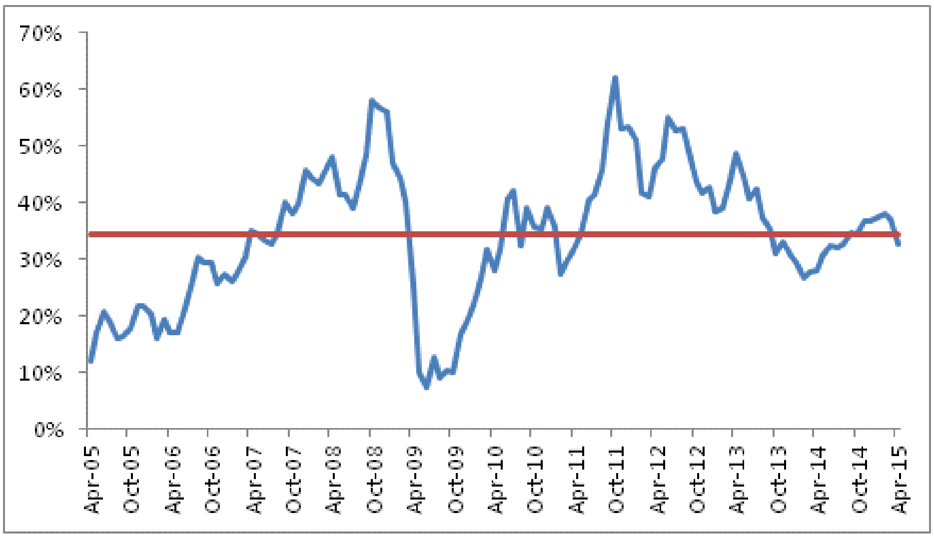
<u>Global Staples – Absolute P/E Valuations</u>



Source.Thomson One, IBES, Morgan Stanley Research

The chart below might surprise some when one looks at European consumer staples' relative PE premium to MSCI Europe. It is actually close to its 10 year average of 35% and it is this year that European markets have re-rated even more than staples themselves. In particular this has been driven by European cyclicals. The inference from here is that it is likely the absolute returns for staples in the short term will be driven by the performance of European markets as a whole, which in turn is likely to be driven by QE and bond yields.

<u>MSCI EU Staples v MSCI market PE premium over the last 10 years</u>



Source Soc Gen

The valuations of the Western quoted consumer companies are now also very close to Asian defensive names (on 2016 PE multiples) and with organic growth rates of European and US names typically running at 4-6% against the 15% or more for Asian stocks, we have taken the opportunity to add to the Asian names and reduce our European exposure.

Over the last three months we have sold **L'Oreal** which now trades on a PE of 26.5x 2016 with revenue growth of 6%. We used the funds raised to buy **Amorepacific**, the Korean Cosmetics company, which was trading on 27x 2016 with estimated revenue growth in the high teens, as it takes market share in China fuelled by the increasing popularity of Korean culture and products with Chinese consumers. This quarter we have also trimmed holdings in **Pernod, Linde, Nestle, Daimler** and **Yum Brands** as multiples for these stocks reach new highs, even taking into account the upgrades to earnings from Euro weakness against other major currencies. We are unable to call the top but as they continue to rally we shall carry on reducing the size of our holdings as in our view they are only bringing forward to today, returns of future years and at some point there will be a "payback".

As mentioned, we are finding stocks in Asia that we believe are core compounders which are on similar valuations to European/US equivalents but demonstrate significantly faster earnings growth rates. The unique feature of this fund is we are able to switch between our Western holdings and Asian names, since we are not benchmarked and do not have any fixed parameters as to what our weighting in any one geographic region should be, allowing us to find the best way to play the rise of the Asian middle class. In the quarter we bought **iKang Healthcare**, an operator of private preventive healthcare service centres catering to large corporate clients as well as high net worth individuals. They provide medical examinations and other value added services including disease screening. They have over 50 self-owned medical centres in 15 of the most affluent cities in China and have contracts with 300 hospitals and other service centres to provide care to their customers in areas where they do not have self-owned centres. The company trades on 20x 2015 earnings, with growth expected to remain above 20% in 2016 and so is cheaper than many Western defensive stocks and an excellent play on the rise of demand for healthcare services in China.

We also bought **Universal Robina**, a Philippine consumer staples company specialising in snack food and drinks, with 60% of its earnings from the Philippines and the rest from the ASEAN region. Its current valuation is not cheap at 28x 2016 but with profit growth expected to remain over 20% pa for the medium term we consider this valuation to be fair. It plays into the increasing number of consumers in the region due to the rise of the middle class and those who are willing to trade up to higher valued products. One should view a company like this in comparison to the Western consumer goods companies which trade at 20x or higher for high single digit growth over the medium term.

We also added to **Hengan**, a Chinese household products company, specialising in sanitary napkins, tissues and nappies, whose valuation is very similar if not cheaper than its Western competitors but growing at *twice* their pace, with double digit revenue growth and improving mix and pricing pushing their profit growth close to 20% pa over the next couple of years.

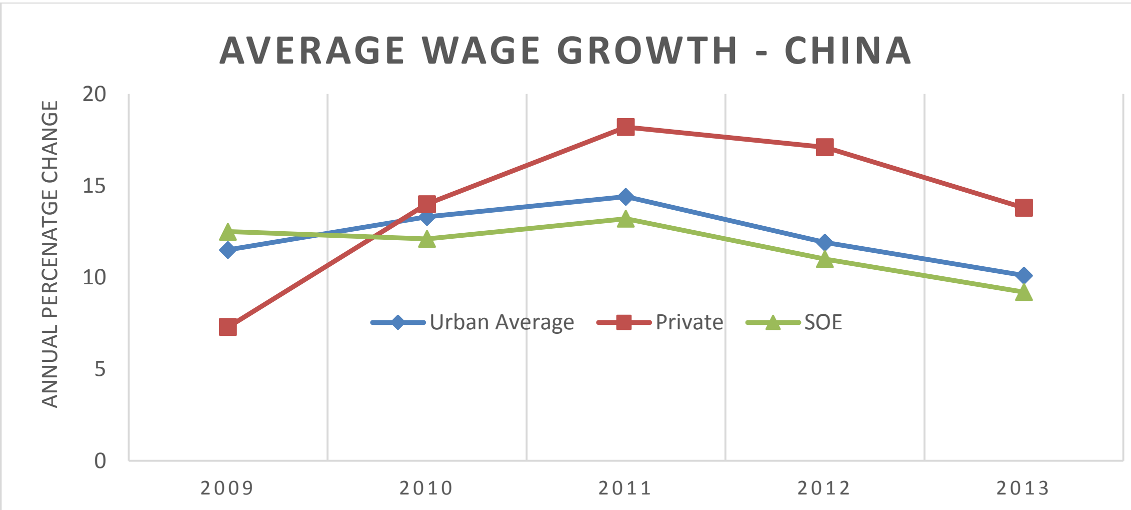
Other names we have bought over the quarter, which do not appear in our top ten are **Noah**, a Chinese wealth manager, playing the rise in the number of millionaires, with its focus on catering to them and their demand for alternative investment products (rather than buying yet more property). We have initiated a position in **Nagacorp**, the Cambodian casino operator which caters to gamblers from the ASEAN region and has seen rising revenue, as Macau has declined, but its shares having been dragged down with them - the market suggesting guilt by association. It was trading on a PE of 10x and a yield of 6.5% when we bought the shares and has since announced that revenue growth in the first quarter of this year will be 35%, in contrast to Macau which now expects a decline in revenues of around 30%.

One of the keys to how we run the fund is not being wedded to any particular split between Western holdings and direct Asian names and if European markets continue to rally we are likely to further reduce our weightings. We currently own **Burberry**, **Unilever**, **Reckitts**, **Linde**, **Daimler**, **Pernod**, **Swatch**, **Richemont** and **Nestle**. We cannot call the top and do not attempt to, but one should expect that every time these stocks climb another 10% or so, we will trim a bit more and happy for proceeds to go into cash if we have no immediate use for them. Our Western quoted weighting was 60% six months ago and today is close to 40%, with 55% in Asia and 5% in cash and there is no reason why this could not fall to 30% if the market moves another 20% in Europe and Asia does not participate.

China's slowing GDP growth rate

Another topic of discussion very popular with investors is the issue of China's GDP growth rate slowing and whether this should be a concern for us. What will it mean for consumption and the stock market?

Our quick response is: slower growth is better for the economy and markets since the quality of it improves and it also becomes more self-sustaining. Growth is slowing due to the deceleration of infrastructure investment and property over build (be it commercial or residential). This fact we don't dispute, but rather the general belief of a property bubble which must end in tears we question. We would argue it is not necessarily a bubble in the classic sense since prices have already been falling for a year now, but more accurately an oversupply prevalent in tier 3 cities and below, it being less of an issue in tier 1 and 2 cities where people actually want to live. Affordability is improving quickly, driven by the rise in nominal wages of close to 10% pa as illustrated below and new mortgages typically are less than 50% of the property's value and repaid within 5 years, hence the property sector is not built on a mountain of consumers' mortgage debt.

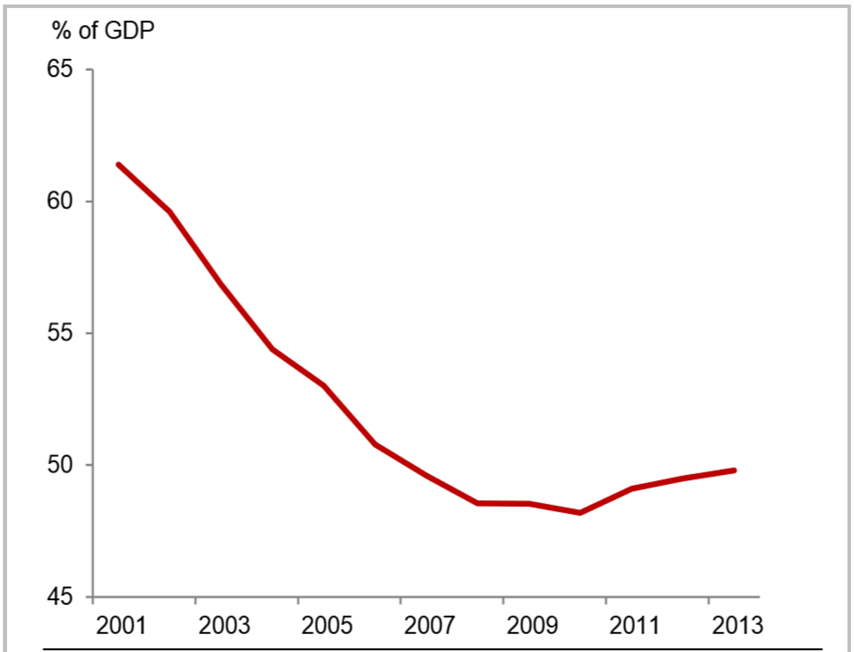


Source. National Bureau of Statistics of China

Admittedly if property prices continue to fall, there will be a secondary impact with regards to the wealth effect but you are not going to see mass bankruptcy of consumers. The issue is with the developers, who are sitting on a large amount of unsold property with the need to refinance their borrowings. This is where I would expect to see further bankruptcies with the majority in private rather than quoted developers. If this does happen over the next year or two one would expect some impact on consumption due to the negative wealth effect, but it will be contained.

With the focus on consumption in its many forms, I believe wage growth is a better indicator for consumption and barometer health for the underlying economy. Wages are rising close to 10% and with inflation at 1.5%, real wages remain strong and this is augmented by strong productivity growth in the private sector. The forthcoming SOE reforms will further improve the use of capital and enhance productivity. Consumer confidence as a result remains high and retail sales are expanding by 11% with consumption as percentage of GDP now growing again. See below.

Consumption as a percentage of GDP growth



Source: CEIC and Nomura Global Economics

We should expect GDP growth to slow, but the quality of the growth we witness will be better and more sustainable and we are optimistic about the improvements in economic structure over the coming years. As a result we are not in the bear camp, expecting Chinese economic growth to collapse but are believers it will slow, as it has to, due to the law of large numbers. The economic growth of the next 10 years will fall from 7% today to closer to 4%, but consumption as a share of GDP is likely to rise to 60-65% of GDP, a far more normalised percentage when compared to other developing and developed economies around the world. Our focus will shift from companies that can increases sales by shifting more volume in China (as they roll out their distribution networks) to those that can capture the up trading of consumers to higher, better quality end products. While in the countries such as India, Indonesia and the Philippines, where GDP per capita is less than half of China's, it is still very much still a volume game of capturing new consumers as they enter the middle class.

Conclusion

The first quarter of 2015 has been reasonable and April is off to a strong start as I write this. Companies' results for 2014 announced in the quarter have been broadly as expected, with more beating than missing. There is still a long way to go with the consumption story and it is not just about the consumer staples and discretionary sectors. As economies develop other industries benefit and we continue to move the portfolio towards these other sectors, whilst remaining mindful of the pitfalls such as the property sector in China and how to be best positioned to protect investors from any potential fallout.

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