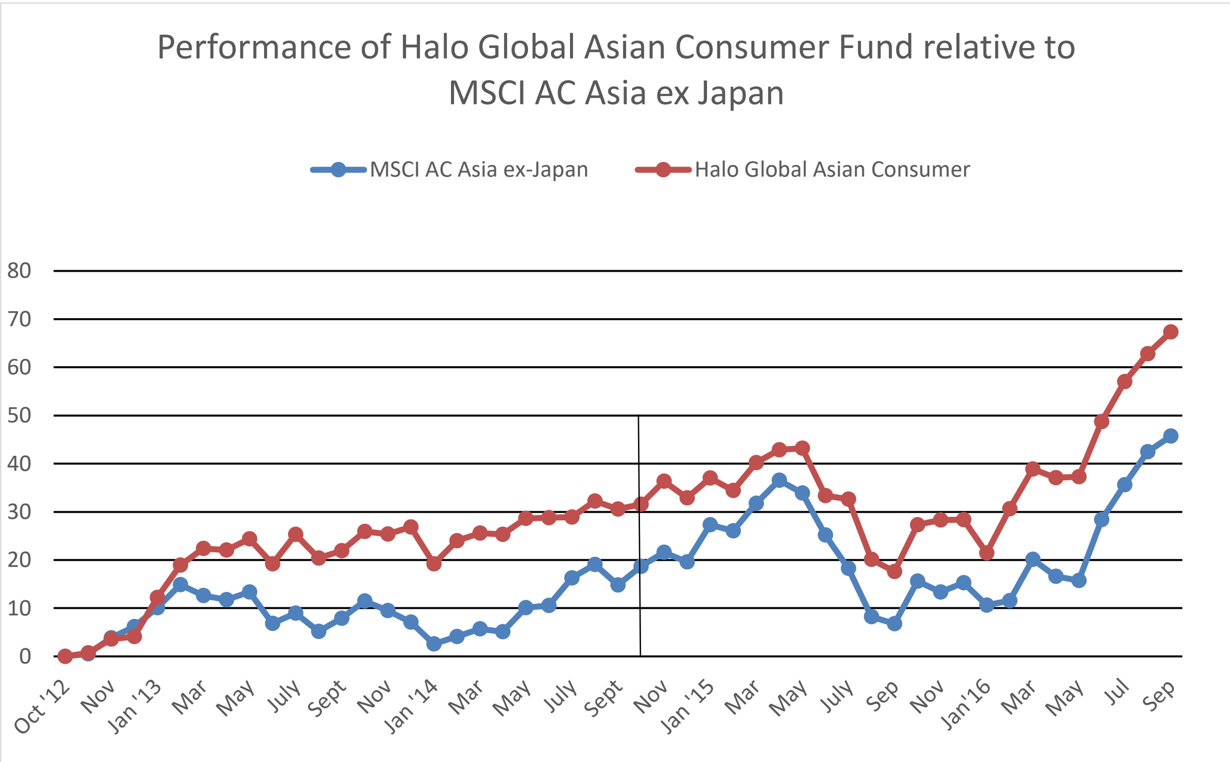
VT HALO Global Asian Consumer Fund

3rd Quarter 2016

Markets have been in a positive mood over the last quarter with the fund up some 12.5% in Sterling terms, which is just behind the MSCI Asia ex Japan index and is respectable given the factors driving the index higher, which I wish to touch on later. I thought it also might be worthwhile providing the returns in USD terms given the large moves we have seen in Sterling post Brexit and could be considered a truer reflection of performance. The fund was up 9.4% in USD terms, so Sterling did not have as big an impact as might be expected and the performance for Halo was driven in particular by some good results from some of our key holdings.

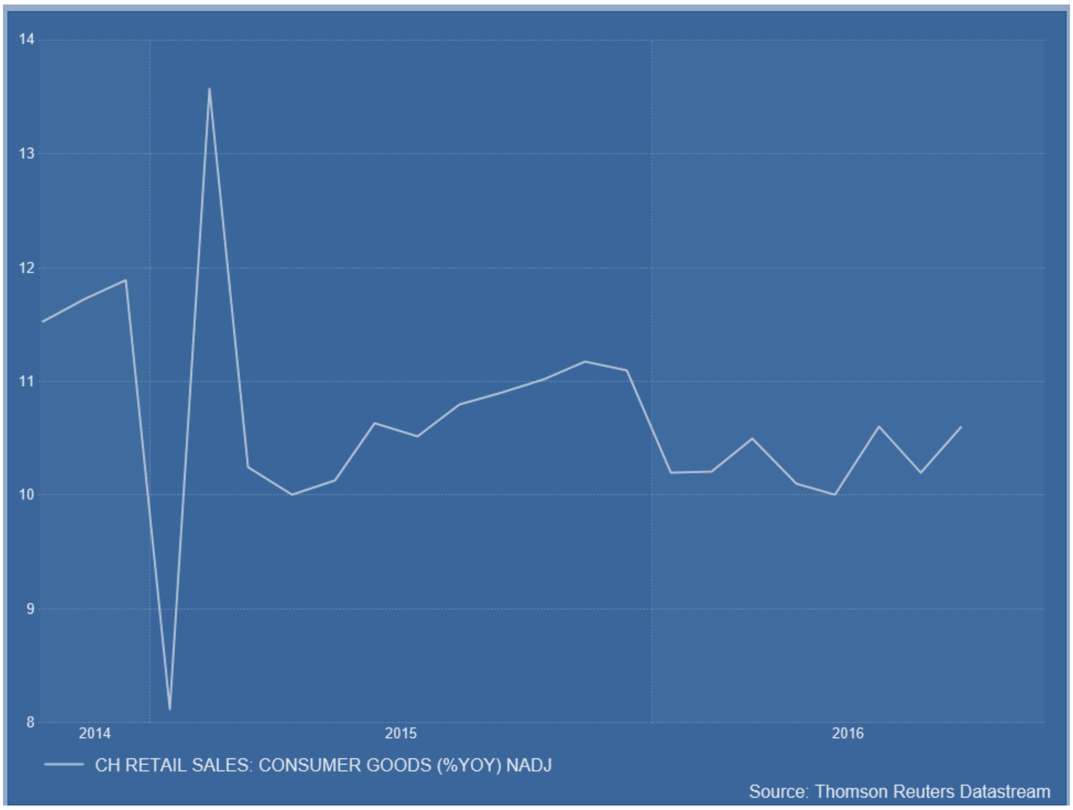
As mentioned in June's quarterly letter, we thought markets would remain robust, as the USD was unlikely to strengthen further with a US interest rate increase being delayed until December this year. The currency concerns of a falling Renminbi earlier in the year receded, with calm restored over the Chinese capital account.



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.

If we delve deeper into our performance then the returns for the quarter were very much driven by our holdings in Asia. Asian stocks were up 13.4% in Sterling terms, our European holdings were up 7.4% and our US stocks rose 5.9%. The current split between Asia and the Rest of the World with regards to where our stocks are quoted is 76% and 24% respectively. The Asia ex Japan index was up 13.3% and so our Asian performance is OK but nothing to write home about. The key issue though, I thought worth highlighting is what has driven markets higher. Over the last three months, we have seen the first meaningful inflows into Asian funds for some time both through active and passive strategies. With Chinese macro concerns fading as the currency stabilised against the US Dollar, GDP growth numbers have on balance been revised higher, Purchasing Managers Index numbers and retail sales have remained resilient. China retail sales, as shown below, continue to grow in the 10-11% range throughout most of 2015 and through all of 2016, which is part of China's move away from fixed asset investment lead growth towards consumption.

China Retail Sales Growth over the last 2 years



Over the last three months we have also seen rising commodity prices, benefitting the Commodity, Industrials and Financials sectors, together with the Asian Index heavyweights such as Samsung and TSMC, who in our eyes are predominately exporters to the West and not Asian plays. These are sectors that we do not own given our emerging consumer focus and so in periods such as this, we would expect to lag the relevant indices. As a reminder, we are not benchmark aware and will continue to focus on delivering returns of 8-12% pa and so there will be points in the short term where our returns can diverge away from an index. What is pleasing in this instance, having expected this divergence to occur given our lack of holdings in the sectors mentioned above that it has not been the case. This is due to having had some very strong individual stock performances on the back of their results during our third quarter and is something I wish to expand on below.

Our top 5 contributors in absolute performance terms over the last quarter with them all being up 25% or more have been Li Ning, the Chinese sportswear brand, China Aircraft Leasing, Alibaba the ecommerce retailer, Sands China the Macau Casino operator and lastly CP All, the Thai convenience store operator. Our worst performer which I will also comment on was Universal Robina the Philippine consumer goods company.

So just delving a bit deeper into the Winners**: Li Ning** was up 40% on the back of its first half results which were in line with expectation. The reason for the move in the share price is on the back of rising expectations of its turnaround actually becoming reality. There has been a lot of scepticism as to whether management could execute. It could be said that in 2012/13 the company lost its way in trying to take its brand up-market to compete against Nike and Adidas. This move failed as the brand was not strong enough to compete and sales fell when they increased prices closer to Nike and Adidas and what was once a profitable company started making losses as inventory ballooned. Post a rights issue and new management, it has now gone back to its roots as a mid-market brand, with better control over its products and inventory and is now making money again.

The Chinese government has put policies in place to encourage more participation in sports and running in particular is proving very popular, but also as can be witnessed by ever more Chinese billionaires buying up football clubs in Europe, there is a big push to improve the standard of football. This plays well into sports shoes and apparel manufacturers and Li Ning should benefit from this over the next 5 years.

With the shares up 40%, we still believe there is more to go for. They are currently on a PE of 18x 2017, with expected profit margins of just over 8%. Given its improved products, better inventory management, and promising ecommerce strategy, where it can operate an omni-channel solution due to having over 6,000 stores, margins should continue to grow. Historically it had margins of 16%, which are double the margins expected next year and the market is only expecting these to get back to 10% in 2018. We certainly believe with the increased interest in fitness and sport by the consumer, the revenue growth should continue to grow at over 10% for the foreseeable future and margins can continue to grow beyond 2018. If Li Ning can achieve margins at anywhere close to their history then the shares over the next 5 years can double from here.

The next best performer was **China Aircraft Leasing Company**, which as the name suggests leases planes, with over 80% of its planes leased to Chinese Airlines and the rest to other emerging market airlines. Profits for the first half were up 105% year on year but this was driven by selling a number of the leases it has on its books to 3rd party investors. Simplistically the company leases planes to airlines at an interest rate of 8% per annum and given the desire right now for US Dollar yielding assets, it is able to sell on these leases at a yield of close to 4% and make close to a $5m profit on each sale. It is then using this money to place further deposits with Airbus for planes to be delivered in 2-3 years' time. It is currently growing its fleet by close to 20 planes a year and due to demand for yield from investors, is planning on selling up to 15 planes each year and keeping the rest. Naturally if demand for yield falls and they can't sell the planes on then they will hold them for the life of the lease, which provides a good long term visibility on their profit and cash flow growth.

Air travel typically grows at close to twice the level of GDP and proves fairly resilient, as shown below, even when there are crises. We like aircraft leasing companies as a way to play the rise in tourism in Asia. During the recent Golden Week holiday period in China the number of trips abroad was up 12% and as the rest of Asia's GDP grows, they too will see an increase in the demand for travel. As you can see below the demand for air travel globally remains resilient, even in times of crises. Asia, with its strong GDP growth, accounts for a large proportion of the increase in miles flown globally and will account for over 40% of new aircraft demand in the next 20 years as forecast by Ascend.

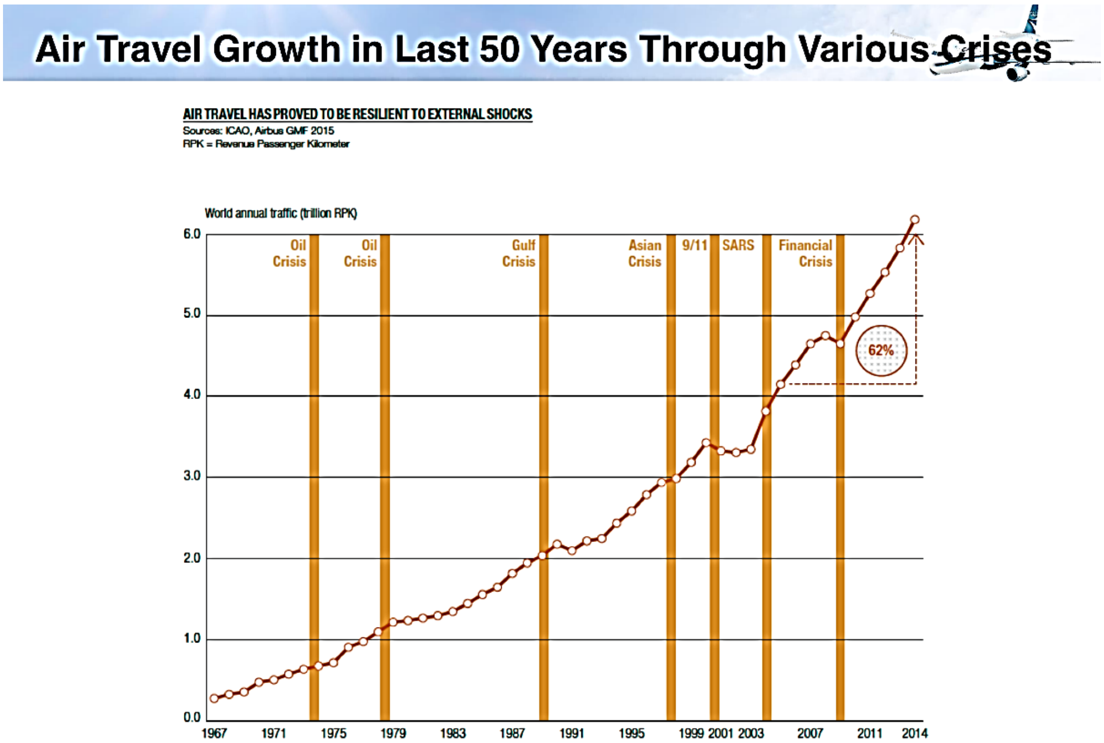


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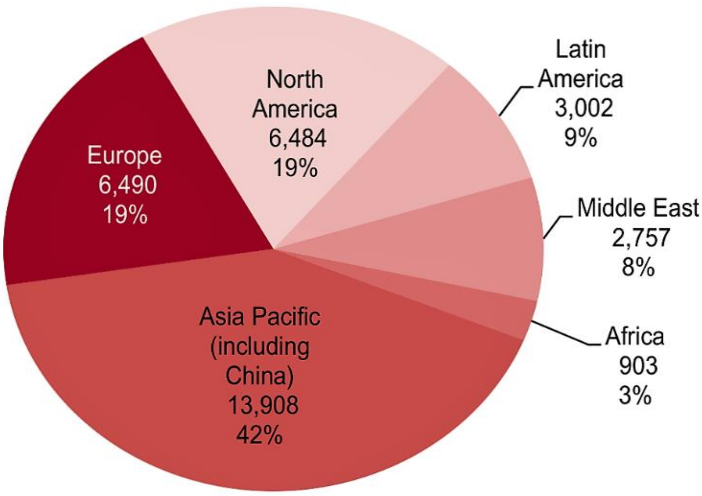
Figure 51. Forecasted Aircraft Deliveries by No. of Aircraft (2015-34)



Source: Ascend Flightglobal Fleets Analyzer, BOCI Research

We like the aircraft leasing companies for their lower cyclicality of profits. Airline profits are subject to bouts of volatility, for instance, if oil prices suddenly rise or there is excess capacity and thus ticket pricing comes under pressure and profits can disappear very quickly. The leases are typically 10-12 years in length and if the airline goes bust, the leasing company will take back the plane and lease it to someone else. China Aircraft Leasing currently trades on PE of 8, paying a 3.5% yield, which is similar to other aircraft leasing companies but has greater growth prospects over the next few years and so we continue to like it.

Tourism and its growth across Asia is a theme that we are playing in numerous ways, not only through aircraft leasing companies, but also through Gaming companies Sands China in Macau, Nagacorp in Phnom Penh, and with duty free operators and cosmetic companies geared towards Asian tourists, as well as Samsonite the luggage manufacturer.

Alibaba, which grew to be our largest holding over the third quarter, was up 33%. Its performance before this quarter had been flat for the first six months even though it had delivered good results. It is viewed by a number of US investors as a China proxy and succumbed to a bout of US investors nervousness on China, hitting a low of $60 in the first quarter of this year. We stuck to the long term story and today they are trading at $103.

The reasons for the strong run in the last quarter are due to upgrades to profit forecasts for this year on the back of stronger revenue growth, having beaten expectations by 10% and also due to investors starting to look at the sum of its parts. Alibaba is not just a platform for selling goods either through Taobao, the EBay of China or Tmall, which is similar to Amazon. But it also has 2 other key parts to its business, Ant Financial and AliCloud, as well as numerous minority investments in other online businesses.

Ant Financial can be regarded as Aliababa's finance arm, and Alipay is similar to PayPal, which has 450m active users. But it also includes other financial business such as a wealth management division with Yuebao, which has over $100bn in assets under management, principally in cash management products, ZhaoCaiBao, which distributes third party investment products and financing with MYbank and various insurance brands. Currently it is estimated that Ant Financial is worth around $60bn and a third of this will be owned by Alibaba when Ant Financial floats, which is expected to be at the end of 2017.

AliCloud leads China's cloud market by some significant margin, which is in very early days of development compared to the US and is currently growing at over 100% per annum. This division is in an investment phase at the moment and is still loss making, but it is certainly starting to capture investors' attention. Looking across at Amazon Web Services as a comparator, we expect this division to contribute strong revenue growth over the next few years and become a more meaningful part of Alibaba's market valuation.

Alibaba today trades on a PE of 24x March 2018, which we deem as fair but not expensive, given its growth is likely to be maintained above 20% pa over the medium term as it further monetises its online platform and highlights the value in its other businesses as it IPOs some of them over the next few years.

CP All, the Thai convenience store retailer which has over 8,000 stores today with the aim of ultimately having 12,000 outlets by the end of 2020, was another strong performer on the back of its results, with upgrades of 5% to its numbers for this year and next. This was driven by better margins, with sales in line with expectations. They are currently growing their store count by 700 units per annum and with same store sales rising low to mid-single digits, revenue growth should be maintained above 10%. Over the long term the management are very focused on improving their margins, as gross margins are just above 20% and they compare themselves to the Japanese convenience store market who operate at gross margins levels of 40%.

CP All net margins are only expected to be 4% in 2017, so if they can only partly achieve margins closer to their Japanese comparators, then this will provide a very large boost to their profits over the long term.

In addition, CP All appear to be in a unique space for ecommerce as it becomes a pick up point for any click and collect deliveries, given the number of outlets they have across the country. As consumers start to use ecommerce in greater numbers this should further drive footfall into their shops and hence be able to capture further impulse purchases. It is one retailer we believe will benefit from ecommerce rather than seeing it as a threat.

Lastly on the positive performers is **Sands China**, a Macau gaming company which we own to capture the increased tourist traffic from mainland China. We initially bought it after the shares had fallen back to their lows for this year and were yielding 8%. Based just on the dividend yield we could achieve the bottom end of our targeted return range of 8-12% and so we thought with them opening their new casino this year in Macau, called the Parisian, the risk reward was very much in our favour. The Parisian is aimed at the mass market gambler and has a half size replica of the Eiffel Tower next to the casino and we believed the profits from the Parisian would enable the company to be able to maintain its dividend and also grow its earnings over the medium to long term, so providing our targeted 12% plus return for our Asian holdings.

The Sands Macau Parisian Casino and its half sized replica of the Eiffel Tower.

The shares have recovered from their lows and are up over 30%, with the stock now yielding only 5.5%, having witnessed a recovery in visitor numbers and in the most recent Golden Week, revenues in Macau were up over 10% year on year. The Parisian opened on 13th September and has 3,000 hotel rooms, which represents 9% of all the hotel rooms in Macau. The reports are that it is busy and it should drive greater visitation to Sands other casinos which are in close proximity. Given the bounce in its shares, one cannot say they are cheap any more but with the strong dividend yield, focus on the mass market, which is less volatile than the VIP Gamblers and expected steady growth in visitation numbers, we see this as a steady compounder with good returns on capital.

Now with all of these stocks producing returns of at least 25% or more over the last quarter, it is fair to say not all the stocks we own produced positive performance numbers. Out worst performing stock has been **Universal Robina (URC)**, a Philippines consumer goods company. The shares were down 16% over the 3 month period principally due to factors largely outside their control.

Firstly, in May of this year, the Vietnamese health authorities claimed they found one batch of C2 tea drink and Rong Do energy drink which had excessive lead content. This naturally forced a recall of such products on May 21st and sales of all of URC's drinks in Vietnam duly collapsed. Vietnam represented some 25% of their international business. URC then had the same batch of products tested by 3 different testing firms and all 3 said they found no traces of lead. The Vietnam authorities then gave the all clear on 4th August after the product recall had been completed, but the damage had been done. This has had a material impact on URC earnings and they are now having to spend to rebuild the trust and brand awareness and it will take time to recover the lost sales.

The second factor is President Duterte has announced he wishes to reform taxes in the Philippines and is targeting to reduce income taxes for the poor but also place a sugar tax on soft drinks. The proposed level is PHP 10 per litre, which equates to US 20c and is considered a lot for the average Filipino. If the law is passed we can expect the tax to be passed onto the consumer, so as a result we are likely to see a volume decline in the first year of the tax. The tax is still being debated and it is still not certain when or if or how much the tax will be. As you can imagine there is some fierce lobbying going on from the manufacturers. Naturally this negative uncertainty is affecting the share price. We continue to believe though that URC is well positioned to capture the growth in the ASEAN middle class and the valuation today at a PE of 25x does not reflect its long term potential and we remain a holder.

Other Macro snippets

I am regularly asked what concerns us within the region. There are some obvious ones such as China and its claims to the South China Sea based on the 9 Dash Line. Governments around the world comment that its claim is rather arbitrary but China refuses to see it this way, even if they find it hard to justify in any court. It is based on little provenance and they continue to build man-made islands to house military bases throughout the South China sea, which no one is able to prevent. This has certainly increased political tensions between China and the ASEAN nations as well as with the US, who are keen to protect the freedom of movement in international waters and airspace.

In addition having just visited Thailand, one point of concern for me would be the impact of death of the King, which has sadly now occurred and he was highly revered by the Thai people. We will now expect 3 months of very subdued consumption and it may last longer. His son who is due to take the throne does not have a good reputation and we will have to wait and see what impact he has on the political situation in due course. This uncertainty may actually present some buying opportunities for us and others who take a longer term view.

Indonesia on the other hand appears to have few political issues. The President is now firmly in control and his popularity ratings have never been better. His key policy of a tax amnesty to those who have undeclared wealth, in particular those holding it offshore, to declare the assets and bring them home for a very reasonable penalty of 2% of the assets declared, if done by 30th September, can be regarded as a success. The assets declared will then broaden the tax base, help the balance of payments and increase cash available to finance the infrastructure plans of the government. Growth this year has been close to 5%, which is slightly less than we had hoped for at the beginning of the year but one would expect to see an acceleration in this growth rate in 2017 due to the repatriation of assets and its positive knock on effects.

Lastly in the Philippines, to Western readers, President Duterte appears rather coarse, undiplomatic in the way he conducts himself and the use of his language can be said to be rather colourful. But in the Philippines he remains popular and there is a lot of support for his drug policy as well as his plans for the economy. He recognises that infrastructure spending is a priority, the tax system as it currently stands is unfair and he is determined to help the poor. This goes down well with the local electorate, but we have to be careful he does not scare away foreign investors as the Philippines needs their capital. China appears more than happy to step into the breach if the West turns away, as this will further increase their influence in the region.

Conclusion

Through all of this we remain focused on the medium to long term drivers of the individual stocks we own and their ability to grow their earnings from year to year. Yes, we do have to remain cognisant of the risks of macro effects in the short term and how the macro may drive the valuations of the underlying stocks. But if we are investing on a 5-year view you find the correlation of the stock performance is much more driven by the ability to grow the earnings number and less to do with the political or macro back drop. Given the strong earnings growth we are currently witnessing from our portfolio, we remain positive about the outlook for continued performance in a world that is lacking earnings growth.