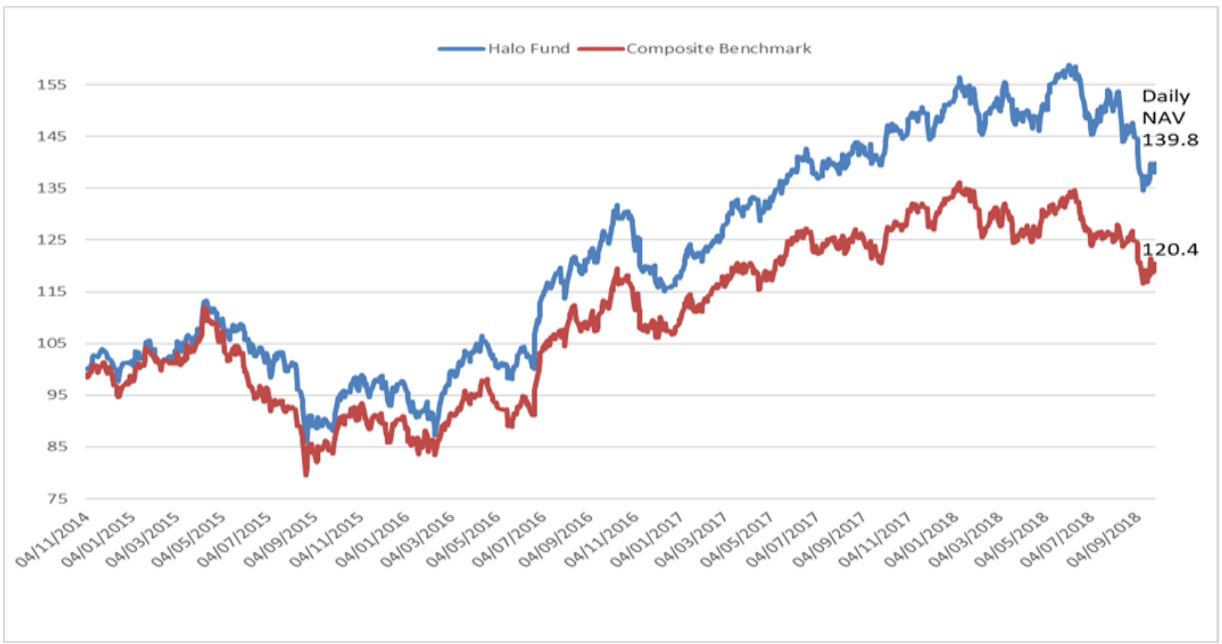
VT HALO Global Asian Consumer Fund

3rd Quarter 2018

The third quarter was a period of two halves, the first part until mid-August continuing from the previous months, with robust Asian growth and earnings and a feeling that US Federal Reserve tightening and a stronger US Dollar were manageable for Asia, given their better macro position than the Taper Tantrum of 2013. The focus post mid-August has been an about turn, due to contagion from the currency crises in Turkey and Argentina, having a knock on effect to those countries deemed to have weak fiscal positions with both current account and fiscal deficits. Key countries who have witnessed falling currencies and stock markets in Asia are India, Indonesia and the Philippines. We do have reasonable exposure to all three countries with weaker fiscal positions, given we focus solely on emerging Asia and the Fund has felt the full impact of the depreciating currencies, as well as market participants selling all three markets on the macro call rather than the bottom up factors. In addition the news flow and combative nature of China and US relations also unnerved markets as investors factored in expectations of 25% tariffs on all exports from China to the US. We continue to review the bottom up factors for the companies in these markets and we have yet to see any meaningful impact on their businesses, such as our tourism plays in the Philippines, who actually benefit from the Peso currency weakness. With our exposure in India and Indonesia primarily through retail banks and neither country witnessing any slowdown in lending and given that neither country has been through a strong investment cycle in the prior years, we do not anticipate a meaningful rise in bad debts and so were remain confident our retail bank holdings recovering from their price declines.



Performance data shown is of the B £ Net Acc. share class. Custom Benchmark, 30% MSCI AC Asia ex Jap Consumer Staples, 40% MSCI AC Asia ex Jap Consumer Discretionary and 30% MSCI AC Asia ex Japan Index. Past performance is not a guarantee of future returns. Data from Valu-Trac Administration Services and Reuters, 30th June 2018.

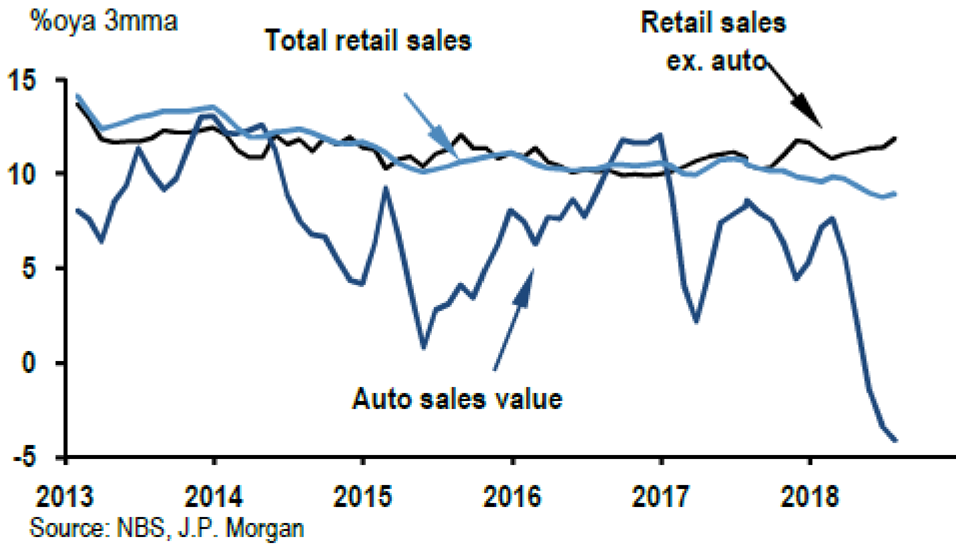
For illustration purposes only. Halo does not benchmark against any index in accordance with our Information Memorandum and Prospectus.

The other area which has been generating the majority of headlines around the world has been the US-China trade spat. As mentioned in the past we view this as more than just about trade, but also this is about political, military and financial influence around the globe and the US allowing China to develop to become a first world country. With the China hawks very much in ascendency in Washington the rhetoric has become more bellicose and is unlikely to ameliorate over the next few months. We therefore have to expect further market volatility over the next 3-6 months. What does this mean for consumption in China? We should expect GDP growth to slow from here into 2019. The sell side has estimated if 25% tariffs on all goods exported to the US are imposed, this will impact GDP in the region of 1.5%, assuming there are no offsetting policies from China. Additional policies, some of which have already been enacted, such as RRR cuts for the banks, to free up reserves to increase lending, accelerated PPP projects in certain industries such as those focused on improving the environment, a falling currency against the US Dollar, with the Renminbi having fallen from Rmb 6.3 to Rmb 6.9, income tax cuts for the middle class, which happened on 1st October this month, should all help mitigate the GDP slowdown. Based on these stimulative policies we would anticipate that GDP growth will be around 6% for 2019, which is not what we would regard as a recession. China GDP growth today is far less dependent on exports. Markets though are behaving as if we are going to enter a recession in China and you may say we are being too sanguine. Yes, consumption will slow down in coming years, as we will see weaker wage growth, lower expectations for house price inflation but as well as the income tax cuts, there is still room for the savings rate to fall and the government is likely to implement further policies to stimulate consumption in rural areas. Hence we are certain that total Chinese consumption spending will be higher next year compared to 2018 and the majority of the share price falls are due not to falling earnings but PE multiple compression.

There is evidence that the consumer is still willing to spend, such as Macau gaming revenues over Golden week, retail sales growth of 9.3% and Caixin service sector PMI rebounding to 53.1 in September on the back of the increase in new orders.

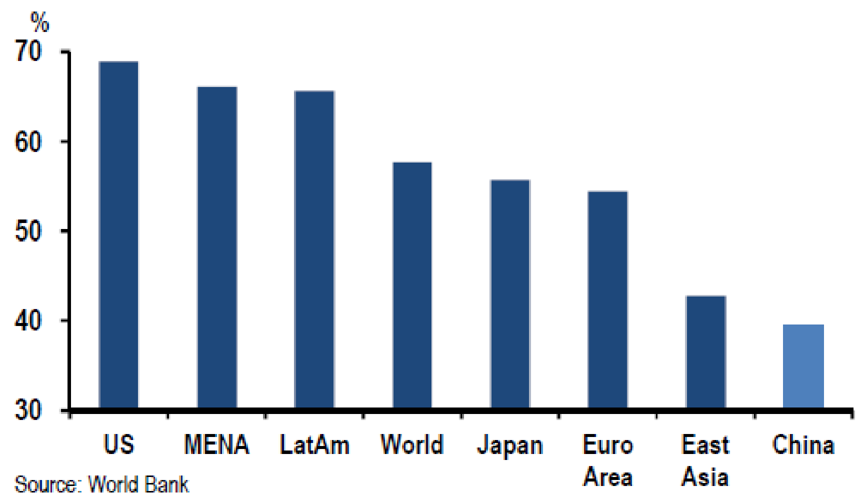
One area that has generated a lot of commentary is the slowing in retail sales year on year, which have slowed from 10.2% in 2017 to 9.3% for the first 8 months of this year. But the biggest drag has been auto sales which benefited from fiscal incentives in 2017 that are not there in 2018. If you strip out auto sales retail sales have remained robust as you can see from the chart below .

China Retail Sales



But for us, even more important is the issue that retail sales numbers do not capture the full picture of consumption, as service consumption is not included in retail sales. Areas such as tourism up 34% in H1 18, resident services 32%, healthcare 25% and education are not captured by the data and their growth rates are all running ahead of retail sales according to NBS and JP Morgan. With first half 2018 consumption contribution to GDP growth at 5.3% from 4.4% in H1 2017. But consumption as a share of GDP is still much lower than the world average. The government's focus on transforming the country to a more consumption driven economy still has some way to go. This trend of rising consumption as a percentage of GDP will continue for another decade or two.

Private consumption to GDP (2016)



Given this trend and the consumer focusing more on health and well being, we thought we would update you on a couple of stocks in this space both having yet to see any slowdown in demand, with their products very much affordable luxuries.

Health and Happiness

Health and Happiness (H&H), formally known as Biostime, is one of China's leading producers and sellers of premium infant milk formula and nutritional supplements. We like management for their vision and execution. Their decision to enter into infant formula and execution on distribution have been key to contributing to their success to date.

The business model has two main divisions, Baby Nutrition and Care of which infant milk formula is the largest category and Adult Nutrition & Care which comprises of vitamins, herbal and mineral supplements. Its adult nutrition brand Swisse, which they acquired in 2015 was Australia's number 1 player in the vitamins and dietary supplements market.

Health & Happiness partners with French dairy producer Laiterie de Montange and the company was an early mover in identifying a domestic need for high end imported milk formula at a time when the industry was suffering the fallout of the milk scandal in 2008. At that time, milk and infant formula was found to be tainted with melamine which led to a crisis in consumer confidence. The company was also early in choosing speciality baby stores as its main distribution channel, when many of its competitors' products were largely only available in supermarkets and hypermarkets.

China's per capita milk consumption is already reasonably high however rising disposable income and increasing consumer awareness is driving premiumisation across the country. China's infant milk formula market is highly fragmented, but this is changing post the implementation of a new policy in 2018. The new regulation include requirements that all infant formula brands which sell in China register with the Chinese FDA and this has in effect meant that the smaller players have exited the market. The number of products in the market is expected to decline from circa 2000 to 700 and we expect domestic players like H&H to benefit. H&H's differentiating factor is its strong brand pull, which is a result of the company's strong focus on branding and marketing. It has been a leader in innovation being one of the first companies to introduce probiotics and science-based innovations into its infant milk formula and it is also one of the first companies to use some of China's key opinion leaders (KOL's) as brand ambassadors in order to market its products.

China is the world's second largest nutritional supplements market, yet its per capita spend is only 15%-20% of that in developed Asian markets. China's rising disposable income and increasing health awareness is propelling consumers to increase spending on nutritional supplements as part of an effort to improve their living standards. Swisse has a strong reputation in Australia where there are strict regulations around nutritional products and, Australian products are regarded as high quality globally as a result. The online channel accounts for 25% of the total market and is its fastest growing channel. The Chinese vitamin and health supplement market is very fragmented but, we believe Swisse is well positioned as the largest player in Australia and the number one selling brand on Alibaba, China's largest e-commerce platform.

The risk with this name is that China comes out with overly restrictive regulation on the vitamins and health supplements business. The risk that competition intensifies in infant milk formula is less of an issue in our view as the business is already a highly competitive mature market. The Swisse business' main channel for imports is via cross border e-commerce and the government first announced a new policy in April 2016 which resulted in a lot of confusion. We have since seen several iterations and postponements of the policy as the government tried to minimize the resulting market disruption and ensure a smooth industry transition. We therefore believe the objective of the government is to be supportive of industry, whilst ensuring a level playing field with domestic operators by reducing any tax arbitrage. We expect new policies to introduce additional requirements on the importers which may impact growth in the very short term as companies make the necessary adjustments to comply with the new regulations. However, this does not change our investment case of rising demand for health and nutritional supplements. The company has experience in dealing with China's health food registration and filing system, which should give it an edge over its competitors. We believe investors have over extrapolated an adverse outcome and that the shares present good value trading on 14.5x fwd P/E for an expected +25% earnings growth.

Li-Ning

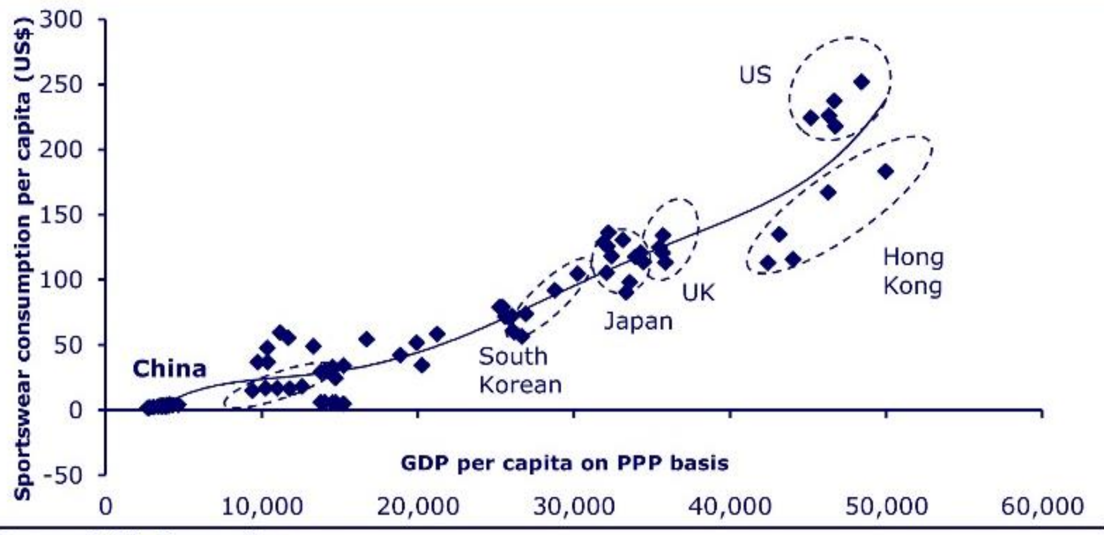
Li-Ning is a leading Chinese domestic sportwear brand specialising in the design and distribution of footwear and sportswear. It was founded in 1990 by the decorated Olympic gymnast of the same name Mr Li-Ning. Mr. Li-Ning's vision was to provide Chinese athletes with a national brand to wear on the world stage. Almost 30 years later Li-Ning is entering into the final stages of its transformation from a struggling mass market sportswear brand into an athleisure brand, targeting the increasingly sophisticated consumer looking to re-embrace Chinese originality. Trade wars aside, we believe the Chinese consumer is increasingly becoming more sophisticated. No longer willing to pay a premium only for foreign brands, there is a new fashion-conscious generation of Chinese who are proud of their national heritage, and we believe the time is now for a Chinese heritage brand to be reasserting itself. The Li-Ning design team has almost 3 decades of brand history, which they can lean on for inspiration and, we feel that this gives them an edge over foreign brands who may also be trying to embrace Chinese culture. We believe the increasingly negative trade war rhetoric from the US will only serve to exaggerate the trend of Chinese consumers taking a more patriotic turn.

Li-Ning New York Fashion Week

After a series of missteps due to over expansion, poor brand positioning and heightened competition, Li-Ning faced a mounting crisis suffering 3 consecutive years of losses. From 2013-2017 Li-Ning management focused on the turnaround of finances, fixing its working capital and balance sheet, and increasing store efficiency. We believe we are now entering the third stage of its turnaround, where it now has the bandwidth to invest in growth and margin enhancing initiatives such as R&D and talent.

The company designs all of its products and outsources the majority of production. The company sells its products through both franchised stores operated by distributors and directly operated retail stores. It is focusing on opening more directly operated stores, giving it more control over store layout, experience and new product launches.

We believe that sales growth should continue to accelerate driven by the company's re-positioning and marketing efforts together with its continued improvement in store efficiency. We believe that sportswear consumption is still at an early stage in China. In terms of per capita consumption, China is still far behind developed countries and, with rising incomes and health awareness, we believe that the Chinese consumer is now more willing to spend on this category. We also believe that the global "athleisure" trend is emerging in China too, as indicated by the robust sales growth of fashionable sporting brands. We like Li-Ning's focus on store productivity versus absolute store numbers and we believe profitability will continue to increase as the company cuts back on discounts and sells more full priced athletic gear this year. These full priced items made up to 80% of the company's retail revenue in the first half this year compared to 56% five years ago and this has boosted gross margins by more than four percentage points during that period.



Source: CLSA, Euromonitor

The company posted 18% top line growth in the first half of 2018, which positively surprised the market and we believe that the positive momentum will continue for the medium term, driven by the company's strong brand and improving execution. The market appears to be overly discounting a consumption slowdown in China however, an operating report from Li-Ning's peer Anta, has showed a quarterly acceleration for 3Q. The 2019 P/E valuation today is 15x, and we are fundamentally positive about the company and seeing significant value emerging post the recent correction.

Conclusion

Our Fund's current PE of 12.4x is now at its all-time low and the Fund's PE premium to MSCI Asia ex Japan has also fallen to 15% from an average historic premium of 25%. Earnings growth for the Fund's holdings over the next 12 months is forecast to be 16%, the same as it was three months ago, although we had said previously we would expect this to come down a few percentage points between now and the year end. Markets though have more than discounted this, with investors punishing stocks who are expected to witness slower growth with large PE multiple contractions. In the short term though market volatility is likely to persist until they see both Trump's rhetoric against China ease and there is greater visibility as to when the US Federal Reserve will finish raising interest rates. We continue to remind investors that this is marathon not a sprint and the factors driving consumption growth both today and in future years remains unchanged.