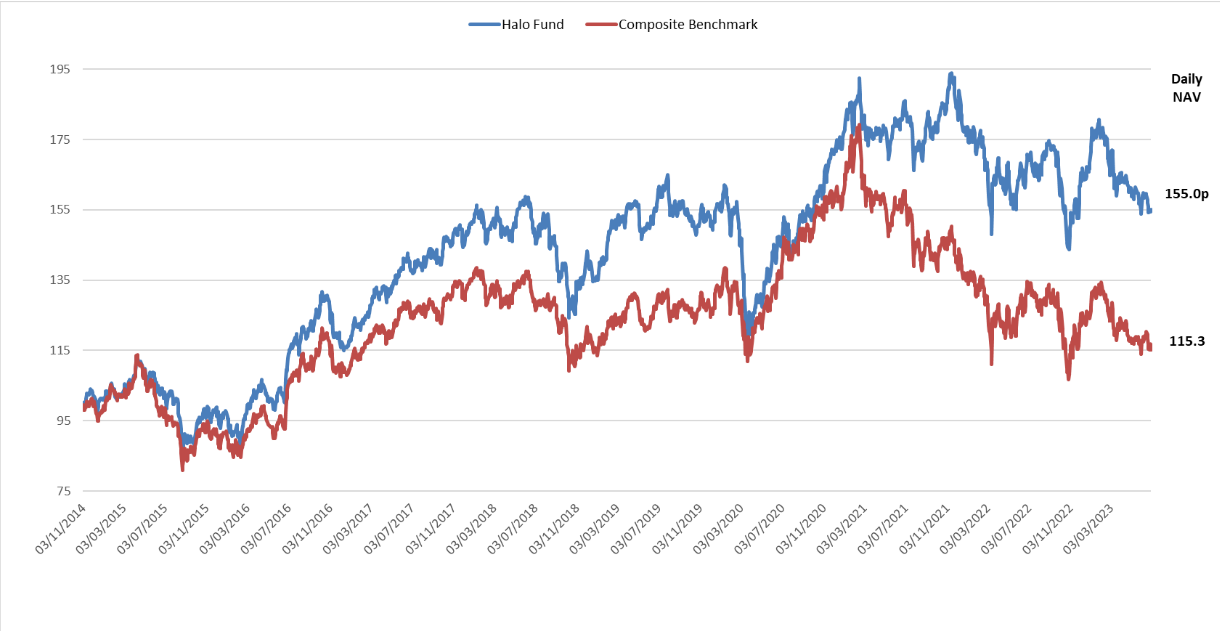
VT HALO Global Asian Consumer Fund

June 2023 Quarterly Letter

In Q2 the Sterling B Acc share class fell 6.3%, compared to our composite benchmark, which was down 7.2%. The market declines over the quarter could be characterised by increased political tensions between US and China having a negative impact on China's equity risk premium combined with concerns over the state of the recovery post reopening, leading to MSCI China Index falling some 13.2% over the quarter. Although ASEAN economies continued to show robust growth during the period, their markets were not immune to the Federal Reserve signalling that further rate rises were required over and above market expectations, which again dampened enthusiasm for equity markets in the region. Philippines, Indonesia, and Thai markets all fell. Vietnam which was the worst performer in 2022, was the only one to buck the trend as the Vietnamese government embarks on stimulating the economy through cutting interest rates, increasing government spending on infrastructure, cutting VAT by 2% and easing red tape on the corporate bond and property markets. The decline in markets has led to a PE contraction of the Fund over the first six months of this year, which is the opposite to MSCI Asia ex Japan, which has seen its PE ratio rise due to South Korea and Taiwanese markets climbing in anticipation of a better outlook for 2024 as tech hardware demand recovers.



Past performance is not a guarantee of future returns.

Performance data shown is of the B £ Net Acc. share class. Custom Benchmark, 30% MSCI AC Asia ex Jap Consumer Staples, 30% MSCI AC Asia ex Jap Consumer Discretionary, 10% MSCI Communication Services and 30% MSCI AC Asia ex Japan Index. From 01/12/18 Custom Benchmark reduced Consumer Discretionary to 30% and added 10% Communication Services, due to reclassification by MSCI. Data from Valu-Trac Administration Services and Bloomberg. This is for illustrative purposes only and in accordance with our Prospectus Halo does not benchmark against any index in accordance with our Information Memorandum and Prospectus.

The consumer in the ASEAN markets and India has seen confidence remaining robust and the relative GDP growth rates will widen compared to the US and EU in 2023 and 2024, so when investors start to look at Asia again, we expect the PE multiples to return close to their long run average. The only market that we invest in that has not experienced a PE multiple contraction of any magnitude is India. Both their PMI numbers for manufacturing and services remain in the high 50s. Our two largest holdings today in the Fund are Indian retail banking stocks, this does surprise people. This elicits some questions as to why we have such a large exposure to both them and the financial sector. So below is some further detail as to why we own a number of financial stocks and remain upbeat.

The financial sector at 25% is our second largest sector exposure, after consumer discretionary at 35%, and made up of two parts. These are retail banking and wealth management. Within the banking space, the focus is only on retail banking and microfinance. We do not invest in banks that are driven by corporate lending and the corresponding services. This has led us to not own banks in countries such as China, Thailand and Philippines as these banks are dominated by lending to corporates. Countries that have quoted banks whose focus is more retail are India, Indonesia and Vietnam and we have found banks that have and do demonstrate the ability to compound earnings through an economic cycle. These banks typically offer mortgages, 2 and 3-wheeler loans, personal loans, credit cards, as well as life insurance and wealth management products and demonstrate a high return on equity over and above the industry average in their respective countries.

India is a structural growth story with urbanisation at 34.5% and growing by 1.2% pa and demographics are amongst the best in Asia, with the median age of 28, and 2/3rds of the population being of working age. The government through tax reforms has given itself greater ability to invest in infrastructure creating room for further productive growth. Our two largest holdings are HDFC Bank and ICICI Bank, both the premier private retail focused banks in India. They have both gone through two credit cycles in the last 6 years and their balance sheets are strong, having cleared out any stressed loans post Covid. We own them as they have consistently demonstrated the ability to grow lending in the 15-20% range even if total industry credit is below 15%, as they continue to take market share from the more capital constrained state-owned banks. The loan growth has been led by retail and this is a high margin business. They are more digitally advanced with better user experience, have better risk controls, demonstrated by maintaining NPLs below the industry averages and lower cost income ratios than the state-owned banks. Going forward we expect both banks to continue to gain market share both in lending and gathering deposits.

Post HDFC Bank's merger with its sister company HDFC Ltd, mortgages are expected to be a key driver going forward. We anticipate post the merger with HDFC Ltd the company will deliver high teens earnings for a number of years even with its current size given the potential to cross sell more products to its customer base.

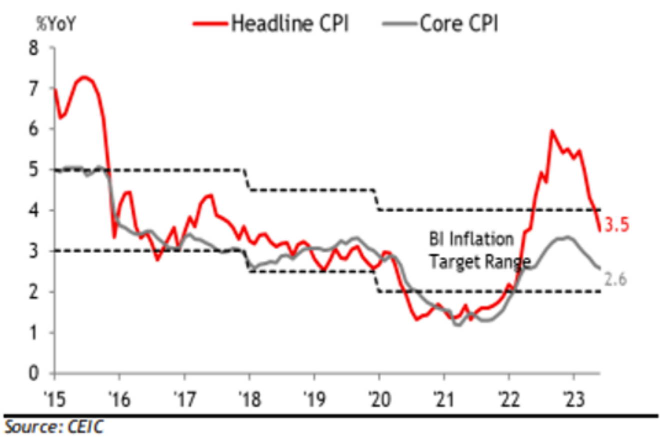
ICICI, India's second largest private sector bank by assets, has been firing on all cylinders recently. Asset quality has consistently improved coming out of Covid, and the bank has been delivering sector leading loan and pre-provision operating profit growth of 21% and 22% respectively. The bank's margins have also seen a structural improvement as they have de-risked their portfolio away from large corporates and reduced their lower margin overseas business. The bank's consistent delivery of earnings has led to a valuation re-rating; however, we believe that 2x Price to Book for the core bank is fair. From here the bank is well placed to leverage on the growth pick up we are seeing in India and to continue to deliver high teens compounding earnings growth. Both banks have ROEs close to 17% and we expect these to continue to trend higher over the next few years as they maintain strong lending growth to the consumer.

Another country exhibiting strong demographics is Indonesia with the median age at 29 and it is estimated out of an adult population of 181m the percentage of the unbanked is 51% and the underbanked is 26%. Part of the issue is Indonesia is made up of 6,000 islands and so traditional banks face a major challenge to cover them all. The opportunity though is obvious and there are many years of growth ahead for those that can offer banking to the retail customer.

We own Bank Central Asia, the number one bank in Indonesia, which has demonstrated the best asset quality over the Covid period and its annualised earnings per share growth from 2018 to 2022, when loan demand was depressed, has been close to 12.1%. They have the clear leadership among the large banks in digitalisation both through BCA mobile and MyBCA (a super app-styled platform) and set up their own digital bank Blu to compete with the digital start-ups. This strategy offers different customer groups different features depending on how tolerant they are for changes and feature requirements. Today over 99% of all transactions are done outside the branch network. During Covid the bank remained cautious and dialled back its lending to an extent that its loans to earning assets fell to 55%, having been historically in the 70-75% range. They now plan to take this back to its historic range over the next 2 years by taking share from other banks and penetrating its existing customer base. There is a particular focus on those customers who borrowed during Covid and demonstrated the ability to repay loans, with the conclusion these borrowers are safe given they were able to continue to service their loans during times of stress. This should lead to loan growth of around 12% pa and this will further enhance their return on equity. They are also very well capitalised, based on Basel III, their Common Equity Tier 1 (CET-1) stood at 27.9%, clearly showing they have excess capital and so they plan to increase their dividend payout ratio to 75% in the coming few years. A combination of rising growth in lending, strong cost control through digitalisation, higher dividend payout ratios, an ROE of 20%, even with CET-1 of 27%, we anticipate returns in the mid-teens over the medium term.

The second bank we own in Indonesia is Bank Rakyat, a specialist in micro lending, which represents 49% of their total loan book and results in net interest margins of between 7-8%. In the past some of their micro loan book was subsidised by the government to ensure capital was provided to those who might not be able to pay the cost of a loan at market interest rates, which are over 20% per annum. As the government appears not to be increasing the amount available for this subsidy this year, perhaps it believes more borrowers can afford to pay market rates. Thus Bank Rakyat is able to ramp up these non-subsidised loans, known at Kupedes, which are more profitable and have a higher return on assets. Indonesia today has inflation back to normal levels, see chart below, so we are likely to see interest rates being cut before the year is out.

Fig 1: Headline CPI (+3.5%) Eased to 14-Month Low in June, Core CPI Edged Down to 2.6%



Source: CEIC

Bank Rakyat, which has a higher cost of funding due to a large proportion of time deposits, will see an improvement in net interest margins when this happens. This will be in addition to improving net interest margins from higher loan growth in its Kupedes micro business, which might well see growth of over 30% this year. It is another bank with excess Tier 1 capital, currently at 22% and so they are proposing to increase their dividend payout ratio to 85% this year, which will provide a yield of over 5% based on the current share price. With total loan growth expected to be in the 10-12% range, rising net interest margins, falling non-performing loans, a high dividend payout ratio, we expect further strong returns over the next couple of years.

Our last key holding in the retail banking space is Technology and Commercial Bank of Vietnam, more commonly known as Techcom Bank. They have successfully built up their CASA (current and savings account) ratio to be one of the best in the industry, which allows them cheap funding and so commands a very strong net interest margin of 5%. The bank is focused on serving the needs of the mass affluent and affluent Vietnamese, with its main offering of mortgages, credit cards, wealth management and bancassurance products. With one of the highest market shares in these products amongst the joint-stock commercial banks, and a very strong offering through its digital app, these services generate very strong fee income delivering a return on assets (ROA) at 3.15% in 2022, the highest in the industry. Given the middle class as a percentage of the population is expected to see an acceleration over the next few years as GDP per capita moves towards $5,000, they are well placed to provide mortgages to the population that wish to move into modern housing, something that Vietnam is very short of. As the middle class grows, the penetration of life insurance and other financial products which, middle class consumers typically buy, will also grow and the bank has stated that it expects to see the number of products its customers buy from them to grow from 1.3 to 2 over the next few years. The valuation is ridiculously cheap in our view with its PB standing at 0.85x 2023 and a PE of 5.8x, for a bank that has a return of equity of 19.6% in 2022 and expects to grow its loan book at 15% pa and fee income at a faster pace than loan growth.

The other part that makes up the financial sector with a 6% weighting are holdings in the pan Asian life insurer AIA, and Noah the Chinese wealth manager to capture the growing savings in Asia. AIA operates across all the markets in Asia offering not just life insurance but critical illness cover, savings, investment, and retirement products, much of which is sold face to face. China and Hong Kong account for over 50% of their new business sales and now that the Chinese can travel again, AIA is seeing a rapid acceleration in premiums sold both in China but more importantly mainlanders buying products in Hong Kong in 2023. As China normalises, AIA should be on track in 2024 and beyond to return to their pre covid growth rates of low to mid-teens. This is a company which also has excess capital and has announced a $10bn buy back over the next 3 years and provides a dividend yield of 2% that will grow in line with earnings, so delivering a total return of low to mid-teens over the medium term.

Noah's shares have not performed particularly well over the last 12 months and this is due partly to it being a US ADR and the US investor's apathy of anything Chinese. The current market value of the company is $920m and it has $700m in cash after having recently spent $400m buying its head office in Shanghai. The free cash flow expected in 2023 is $140m and so trades on a free cash flow yield of 15% and if the shares remain at the current price the whole of its market cap will be equivalent to its cash on its balance sheet by the end of 2024. The company has over 1300, wealth managers in China across the top 20 cities and it caters to the clients who typically have more than Rmb10m to invest. Their main area of investment is private equity funds, which typically have a 10-year investment to maturity and this provides good visibility of its recurring income stream. Noah is now rapidly building out its presence in Singapore and Hong Kong to serve its customers who have money held outside China. Net income fell in 2022 due to poor markets and lack of demand for mutual fund products. They expect year on year profit growth to return in 2023, principally driven by insurance sales both onshore and offshore, which admittedly is regarded as low-quality income as it is one off in nature. Given their ever-expanding client base we regard it as a quality way to play the rising wealth in China and the structural move away from property as an investment.

Conclusion

The common theme running through all the retail banks mentioned is the relatively high loan growth, ranging from 10-12% in Indonesia to something close to 20% for the Indian private banks. This rate of loan growth is something not many other areas of the world are witnessing. With high net interest margins of around 4% for Indian banks and 5% for Techcom bank and even higher for the Indonesian players and Tier 1 capital of over 15% for these banks, they are still able to produce a return on equity ranging from a low of 16.9% for ICICI to as high as 20.1% for BCA in Indonesia. They are all capable of generating a lot of capital each year to finance their growth internally without having to come to the market for further equity. These banks can produce high teen shareholder returns through an economic cycle and having come out of Covid with clean balance sheets we are not expecting the start of a new cycle of non-performing loans anytime soon. These are the reasons why we like retail banking in some of the Emerging Asian countries and we maintain 25% weighting to the sector.

Andrew Williamson-Jones 10/07/23