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Asian Equity Strategies:

Six Questions

Aberdeen Standard Investments

For Institutional Investors only – not for use by retail investors.

"We are committed to our investment philosophy, as we continue to enhance and refine our process. We are improving ideas generation to ensure that our portfolios don't turn stale and have adopted sector coverage to drive better insight into how structural trends are affecting industries and our holdings."

Flavia Cheong
Head of Asia Pacific Equities
Aberdeen Standard Investments

Some of our key Asian portfolios have struggled recently to beat their benchmarks and clients are asking why. We have collated answers to the most common questions, explaining why performance has been disappointing and what we have been doing about it.

Please explain the disappointing performance of the Aberdeen Global - Asia Pacific Equity Fund.

The portfolio has outperformed its benchmark over periods of 10 years or longer. Our style tends to outperform in bear markets and the portfolio has beaten its benchmark in seven out of eight bear markets in the past two decades. Since inception, the portfolio has outperformed its benchmark by 3.3 percentage points (gross terms) on an annualised basis.

That said, our short-term performance has been spotty. We acknowledge that a handful of stock selection missteps have cost us performance over the past five years. In 2016, we exited Australian insurer QBE Insurance, as we lost confidence in the management's ability to turn around the company after several slips overseas and in its home market.

We also scaled back our positions in **HSBC** and **Standard Chartered**, reflecting a challenging outlook characterised by weak credit growth, low volatility in financial markets and increasingly burdensome regulatory costs. We redeployed this capital into financial stocks elsewhere in the region such as **HDFC Bank** and **Kotak Mahindra Bank** in India, **Bank Central Asia** in Indonesia and China's **Ping An Insurance**.

Our underweight to the Chinese internet sector has been the single biggest source of relative underperformance over the past five years. Specifically **Tencent** and Alibaba have benefited from exuberant sentiment towards technology stocks, and not holding them cost us performance. We started investing in Tencent last year after a thorough review of the company and its use of a controversial corporate structure called the Variable Interest Entity (VIE). We became more comfortable after seeing the company's track record of treating minority shareholders fairly.

We have since increased our weighting to China. For example, we recently started investing in China-based **Wuxi Biologics**, a company that benefits from the growing trend to outsource the research and development of biologic drugs. Against this, we have pared our country exposure to Singapore following a re-rating of bank and property stocks in that market; and reduced our exposure to telecoms reflecting our lower conviction in this sector.

A notable initiation has been Korea-based **LG Chem**, which boasts at its core a cash-generative chemicals business that helps the company cement its position as a leading battery-maker for electric vehicles.

Please explain the disappointing performance of the Aberdeen Global - Asian Smaller Companies Fund.

The portfolio has struggled to beat the benchmark in recent years. A big reason for underperformance over one- and three years is the fund's underweight to Australia, a market that outpaced the rest of the region during these periods.

We don't have a large position in Australia because many of the smaller companies in that market are leveraged businesses in the metals and mining sectors. They tend to produce one commodity from a single mine, thereby exacerbating the volatility of an already cyclical industry.

Over the past 12 months, in addition to our underexposure to Australia, Indonesia and Singapore have also contributed to weakness. An overweight to Indonesia weighed on performance, given the challenging macro and consumer environment there. **Astra Otoparts** was weak on concerns over the spillover effects of rising competition on parent group Astra's auto sales.

Similarly, an overweight position and stock selection in Singapore weakened performance. For example, **Raffles Medical Group** corrected following weak results, as the company continued to incur costs in ramping up its hospital investments in China.

As US-China trade tensions, a stronger dollar and oil price volatility dampen investor sentiment, we have been taking advantage of share price weakness. For example, we started investing in **Q Technology Group**, which is among the largest makers of smartphone compact camera modules (CCMs) in China. It is poised to benefit from increasing demand for CCMs in autonomous cars, 3D sensing and optical fingerprint sensors.

We have been increasing our exposure to China, a market that we have grown more comfortable with in recent years. Within China's technology space, we see maturing smaller players reporting robust growth. We are also seeing a wider selection of small-cap technology companies that are gaining traction in a variety of business areas.

We have also been increasing our exposure to the technology sector as artificial intelligence, cloud computing and the Internet of Things, as well as the auto industry's electrification push, are shaping the new economy and transforming the way businesses operate.

Stock selection in the IT sector has been positive over one- and three-year periods, and it has been strong again this year. What has been pleasing is the positive contribution from our recent initiations. For example, **Chroma Ate**, a Taiwan-based provider of technology testing and automation turnkey solutions, has helped boost relative performance this year.

Although we have a big overweight position in Malaysia compared to the benchmark, we have been reducing our exposure from around 16 per cent in mid-2016 to 11.9 per cent as of end-June 2018. This compares with a country benchmark weighting of 2.7 per cent.

Please explain the disappointing performance of the Aberdeen Global - Japanese Equity Fund.

The portfolio has outperformed the benchmark by more than 25 percentage points in local currency terms since the fund's inception in April 1988. It has beaten the index over four-, five-, 10-, 15-, 20-, 25- and 30-year periods.

However, recent performance has been less notable. This is due to two things. Last year, global interest in the technology sector spilled into the domestic markets and indiscriminately rewarded firms linked to the internet, semiconductors and factory automation. While some of our holdings were beneficiaries, we are underweight this sector.

Performance has also suffered because of stock selection. The biggest stock detractors over three- and five years have been Suruga Bank, **Japan Tobacco** and **Yahoo! Japan**. We exited our position in Suruga Bank this year after employees were implicated in fraudulent applications for housing loans. This raised serious questions about governance standards, even though this lender is one of Japan's more innovative financial institutions.

A downturn in Japan Tobacco's domestic business has been behind its poor share performance. However, the company has pushed aggressively into overseas markets and is ramping up production of its new heated tobacco product to cater to changing consumer tastes. Meanwhile, Yahoo! Japan is a business in transition and earnings have been dragged down by heavy investments to push the business towards more data driven solutions.

These negatives outweighed the positive contribution from new investments such as **Shiseido**. Under President Masahiko Uotani, the first outsider to lead the company, the cosmetics firm has turned around its business by addressing underperforming brands, executing on cost structure reforms and aligning executives behind an incentive-based pay structure.

Recent market corrections also presented opportunities to initiate positions in companies with great growth potential. One example is **Hoshizaki Electric Co.**, which is known for its energy-efficient industrial refrigerators, ice machines, drinks dispensers and dishwashers. Already dominant in its home market, the firm has expanded overseas via a series of acquisitions.

Furthermore, we have identified firms at the epicenter of structural change. One example is **Stanley**, a car lamp manufacturer that's benefiting from the shift to energy efficient, higher margin LED lamps.

Please explain the disappointing performance of the Aberdeen Singapore Equity Fund.

The portfolio underperformed the benchmark in 2015, over the past 12 months, and during the second quarter. There are two main reasons.

First, our non-benchmark exposure to **Raffles Medical Group** was one of the biggest detractors over one and three years, as the share price was hit by softer-than-expected demand from foreign patients, while staff costs rose. The latest results were weak, as Raffles continued to incur costs in ramping up its hospital investments in China. However, we remain optimistic about its longer-term growth, which is supported by expansion in Singapore and China.

Second, we are underweight **DBS**, **UOB** and **OCBC**, as they continue to execute well on their operations and deliver good results. In the first quarter, for example, DBS' shares rose to new highs after a better-than-expected first-quarter earnings update.

Our underweight is due to the three lenders' heavy weighting on the benchmark. This is despite our investments in the Singapore banks representing the three largest holdings within the portfolio.

We are positive on the longer-term outlook for these lenders, which are in a sweet spot, benefiting from rising rates, stabilising credit cost and continued growth in wealth management-related fee income.

We have recalibrated our property exposure, exiting United Engineers (UE) and recycling the proceeds by adding to **CapitaLand**. We prefer the latter for its solid results across markets, strengthening recurring income streams, and acquisitions that are positive for growth. CapitaLand also trades at a wider discount to net asset value compared to UE, and is undertaking share buybacks.

We trimmed our investment in **City Developments**, exited Far East Hospitality Trust in favour of **CDL Hospitality Trust**. We are building our position in **Mapletree Commercial Trust**, which has a high-quality portfolio of retail and business-park assets.

In other sectors, we exited lower-conviction holdings, such as Hong Leong Finance and Straits Trading. We also exited Breadtalk, as our investment thesis has panned out as we had hoped.

How has your investment 'style' affected performance and why do you stick with it?

Quantitative easing (QE) policies have led to excess liquidity in markets, distorted asset prices and depressed yields. As a result, growth and momentum investment styles and the hunt for yield have come to the fore. This was evident last year, where the market rally across Asia was tech-centric, very narrow and very growth and momentum-driven.

Quality and value have been relegated to the sidelines, and this worked against us, given that we are an active manager with a quality style, focusing on companies with good underlying businesses, sound management, strong balance sheets and high levels of governance.

Over time, however, we have observed that style is cyclical and style is mean-reverting. At some stage quality and value will return to favour. This looks increasingly likely as major central banks start to normalise monetary policy and there is a more discerning refocus on fundamentals.

Underperformance is never good enough, but we continue to believe that buying quality stocks at a reasonable price and holding them for the long term is the crux of superior long-term returns. We focus on quality and price and construct high-conviction, active and diversified portfolios, and we remain confident of the companies that we invest in. We remain committed to our investment style and believe that we will be rewarded once again for our quality focus as borne out in our long term track record.

What actions are you taking to improve performance?

We are committed to our investment philosophy, as we continue to enhance and refine our process. We are improving ideas generation to ensure that our portfolios don't turn stale and have adopted sector coverage to drive better insight into how structural trends are affecting industries and our holdings.

Through the merger with Standard Life, we have also adopted new tools and techniques to aid our stock picking. In addition, we are looking at risks in a holistic manner, by embedding our analysis of environmental, social and corporate governance (ESG) risks and upping our shareholder engagement with companies.

We continue to devote substantial resources to onsite visits. In 2017, our fund managers went on nearly 1,600 trips to some 860 companies to check out potential new investments and check on existing ones for the Asia Pacific ex-Japan portfolios. These visits serve a dual purpose: we need to sniff out anything that may be a bit off; but we also like to think that, over time, we establish relationships that allow us to influence companies for the better, especially on ESG concerns.

Done well, engagement helps protect portfolios against downside risks and adds value, potentially helping the share price over the longer term. We focus on transparency and disclosure, checks and balances, composition of board and management team, incentives and capital management, by talking to management, non-executive directors and chairmen for the most part.

We hold the companies highlighted.

Source: Aberdeen Standard Investments, 30 June 2018.

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