Aberdeen Standard Asia Focus

AAS' high quality portfolio should be robust in a troubled economic environment...

Update
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Summary

Aberdeen Standard Asia Focus (AAS) invests in smaller companies in the Asia Pacific region, with a focus on finding market leaders with sustainable earnings growth and strong, resilient balance sheets.

AAS is managed by Hugh Young, one of the most experienced fund managers in the industry. In 2018 he took more personal control over the portfolio and initiated an overhaul at the board's request. This move led to three changes: an increased concentration, a more ruthless attitude to underperforming companies, and a greater balance between old economy sectors and new economy sectors such as information technology.

The new approach led to outperformance in 2018 and 2019, and although returns in 2020 have been behind the index, the weighting to technology and ecommerce has boosted returns. In addition, the quality element to the approach has been evident in the operational resilience of the portfolio in an extreme crisis.

The portfolio has structural gearing, which has been a hindrance in a sharp market correction – as we discuss in the **Gearing section**. But structural gearing is intended to boost returns over the course of a cycle and avoid the manager having to time taking on borrowings.

The discount is 14.5%, slightly wider than AAS' five year average of 13.5%. Small caps have largely been out of favour over that period as the market has focused on large caps, China and technology.

Dividend growth has been strong in recent years, as we discuss in the **Dividend section**, and the trust has around 2.5 years' revenue reserves on the balance sheet. The historic yield is 2%.

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Analyst's View

In our view AAS's focus on strong balance sheets and sustainable earnings is attractive in a troubled economic environment. The portfolio is now also more balanced in stylistic exposures following the 2018 revamp, with greater exposure to high growth technology companies. These have a tailwind behind them in the form of the coronavirus pandemic, and the increase in people working and shopping from home as a consequence of the virus. However we think having a counterweight in less highly valued companies less geared to increasing growth rates is now preferable; based on such a sustained period of performance, and the higher valuations typical in that segment of the market.

This is a strange crisis in that it has thrown individual countries back on their own medical, institutional and economic resources, which has resulted in some unlucky hits to AAS – given its highly active country positioning. However we would expect a lot of this to revert as the pandemic recedes, hopefully leaving the operational resilience of the portfolio as a more important driving factor.

On a wide discount and after a period of limited investor interest in small caps, AAS and Asian small caps in general would be easy to overlook. But we would note that trends can revert quickly, and the best returns are often made by being positioned early, with the shares trading significantly below par.

BULL
Focus on strong balance sheets and operational resilience should serve well in troubled environment
Strong secular growth potential in many of the region's economies
Extensive experience and resources in the Asian Equities Team

BEAR
Structural gearing increases the downside risks
Highly active country allocations can lead to large under or overperformance at times
Asia large cap is in a sustained period of outperformance over small cap

Portfolio

Aberdeen Standard Asia Focus (AAS), formerly known as Aberdeen Asian Smaller Companies, aims to invest in market-leading businesses in Asia at an early stage of their development. The investment process prizes sustainable earnings streams and strong balance sheets, which should provide operational resilience over the ups and downs of a market cycle. The manager, Hugh Young, draws on the work of a team of Asian specialist analyst / portfolio managers. The team aims to identify companies with the quality characteristics and track their valuations, to buy in when they are favourable. Great emphasis is placed on good quality governance too, which Hugh sees as important for the sustainability of a business.

The focus on quality has been an advantage in the current crisis. As we discuss in the **Performance section**, in the short term some country tilts and the gearing position have been a hindrance, but the portfolio companies have a net cash position in aggregate which has allowed them to continue to trade or survive local lockdowns. This is displayed in the table below, which also shows favourable growth characteristics relative to the index. While valuations are marginally above those of the index on a forward basis, there is considerably higher growth on both a Return on Assets and Return on Equity basis.

Portfolio Characteristics

	ABERDEEN STANDARD ASIA FOCUS	MSCI AC ASIA PACIFIC EX JAPAN SMALL CAP
Dividend Yield (%)	2.86	2.85
PE-19 (x)	13.72	19.72
PE-20 (x)	16.72	16.00
Price/Book (x)	1.16	1.33
ROA (%)	8.09	5.40
ROE (%)	15.49	10.09
Net Debt/Equity (%)	-7.42	22.77

Source: Aberdeen Standard

Traditionally the focus on valuations has led the portfolio to have a relatively low weight to technology and ecommerce companies. In 2018, however, Hugh took greater control of the portfolio and led a review of the process and approach, which has led to a greater weight to these areas. Hugh has attempted to make greater allowances for the growth potential in these businesses, when it comes to assessing valuation metrics, so while the principles remain the same, the implementation has shifted slightly. This overhaul has been successful, with the portfolio performing well in 2018 and 2019 – helped by the blend of old economy and new economy stocks. Some companies invested in as a result of this review have seen rapid share price growth, which means they have become major parts of the portfolio.

For example the largest holding Momo is Taiwan's leading online retailer, which has appreciated by more than 300% since it was first bought for AAS. The third largest position, AEM Holdings, is a chip manufacturer listed in Singapore which has appreciated by a similar amount. They sit at the top of the portfolio alongside more traditional Aberdeen holdings: Bank OCBC NISP of Indonesia and John Keells, a Sri Lankan conglomerate.

Top 10 Long Holdings

COMPANY	COUNTRY	WEIGHT (%)
Momo Com Inc.	Taiwan	4.7
Bank OCBC NISP	Indonesia	3.7
AEM Holdings	Singapore	3.5
John Keells Holdings	Sri Lanka	3.3
Asian Terminals Inc.	Philippines	3.1
Cebu Holdings	Philippines	3
Mega Lifesciences	Thailand	2.9
Ultrajaya Milk Industry Tbk	Indonesia	2.5
Oriental Holdings Berhad	Malaysia	2.5
Convenience Retail Asia Ltd.	Hong Kong	2.4
TOTAL		**31.6**

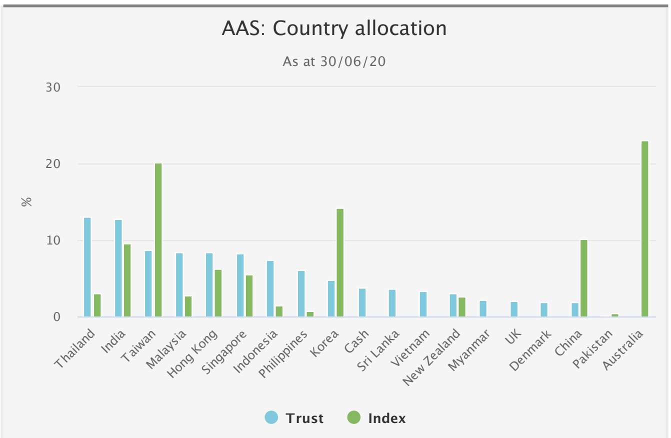
Source: Aberdeen Standard

This mixture of old and new is intended to create a more stylistically and economically balanced portfolio. The new economy stocks have certainly helped the portfolio recover from the COVID-19 crash, as tech and internet industries have rallied hard on the perceived strengthening of structural trends towards home-working and internet retailing.

John Keells illustrates one of the difficult tasks for Hugh in constructing a portfolio. It is the largest company by market cap in Sri Lanka, yet a candidate for inclusion in AAS, which has a limit of $1.5bn market cap on first investment. Some of the smaller countries in the universe have very few companies which are large enough to move the needle, without AAS taking too large a slice of the equity, while the larger countries may have very few companies small enough to qualify. This is the case with China, and is one of the reasons AAS has a long-standing underweight to the country.

Hugh is highly active with his approach, and since the MSCI AC Asia ex Japan Small Cap index is not a formal benchmark it is not taken into account in portfolio construction. As a result country and sector weights have widely diverged from the index, as the below chart shows. The underweight to China is persistent and can be explained by the liquidity issue discussed above, as well as weaker standards of corporate governance. India is a long-standing overweight, and generally Hugh finds better governance there, along with good secular trends supporting earning streams such as strong demographics. Indonesia is another major overweight supported by demographic trends. Although Hugh has trimmed his exposure there as the economy struggles in the short term.

Fig.1: Country Exposure



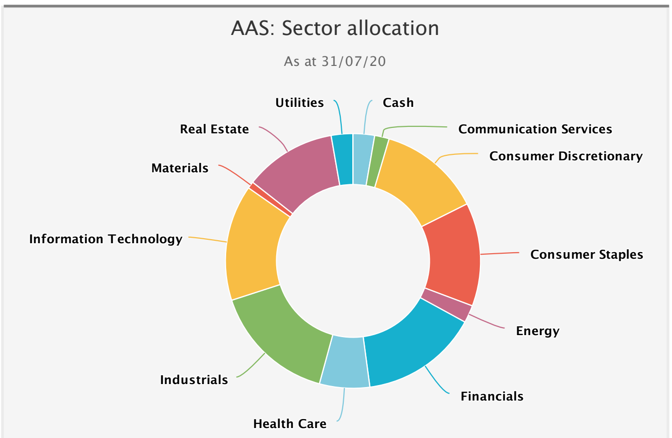
Source: Aberdeen Standard

The COVID-19 crisis has been a remarkable one, in that it has rolled back a lot of the interdependence of countries in the short term. With nations retreating into handling the pandemic and setting policy in a totally uncoordinated fashion. Different policy responses, geography, demography and all sorts of factors have been playing into the severity of the medical and economic impact. Consequently it has been a tricky period to be an active manager, and there is a lot of luck to short term performance versus the benchmark. For instance China's relative outperformance is all to do with the impact of the virus and nothing that could be foreseen by a fund manager. AAS has been unlucky with the underweight there and unlucky with the overweight to India, which has been perceived as struggling to control the virus and market down by international investors. Thailand, another major overweight, has been badly hit by the reduction of tourism.

However Hugh's focus is on the long run. Even if he believes the economy recovery could drag on, the long-term prospects for companies have changed little in his view; albeit there has clearly been the acceleration of certain technological trends in Asia as across the globe. Hugh owns New Zealand company Millennium & Copthorne Hotels. And, despite being hit by the lockdown and travel ban, its strong balance sheet and premium locations have seen it recover well, with business from domestic travelers picking up sharply.

As mentioned above, in 2018 a review of the management process was conducted. The upshot was greater personal involvement for Hugh, a more concentrated portfolio and a tweak to the methodology to better capture the growth potential in tech stocks. Information technology has risen to 11% of the portfolio, while many companies in the industrials and consumer discretionary buckets also play similar themes. However sector exposure is, like country exposure, an output of stock selection.

Fig.2: Sector Allocation



Source: Aberdeen Standard

Hugh's three decades of experience include the Asian financial crisis of 1997, where countries and companies with high levels of leverage were severely punished. The focus on low levels of leverage has helped during this crisis, and we think show the benefits of focusing on these quality metrics during the good times – crises can be unexpected and sudden. Hugh has been reasonably active in response by his standards: trimming Momo when it became too large a part of the portfolio, and topping up some other tech names in March after the initial market falls. Low liquidity has sometimes hampered his attempts to get into certain fast-moving stocks at the right price. Generally speaking the investment horizon is three to five years as a minimum, and the average turnover is just 16% over the past three years – according to Morningstar data.

One element of the long-term approach is the importance placed on ESG matters. Hugh and the team take a highly active approach to being a shareholder, aiming to improve the treatment and rights of minority shareholders which should improve their long-term prospects. They do not insist on perfection from portfolio companies but look for companies that are willing to listen, in the hope that the returns from their investment will be boosted through engagement. We discuss this more in the **ESG section**.

Gearing

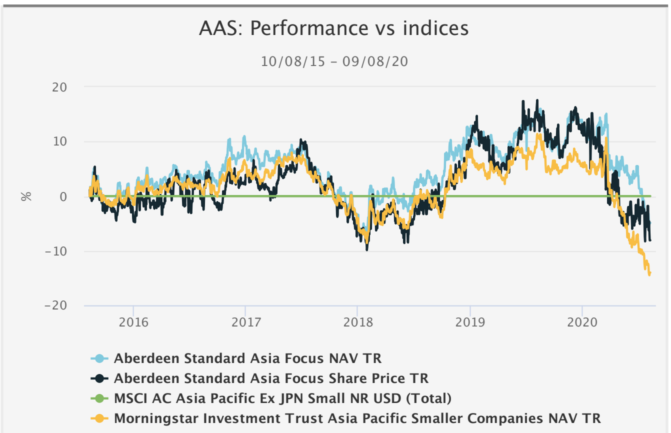
AAS has long-term debt in the form of convertible unsecured loan stock (CULS), which matures in 2025. Between now and then holders can convert units into shares every May and November. £37m of CULS was issued in May 2018, of which £36.7m remains, amounting to roughly 10% of net assets at current levels (c. £369m). The trust also has bank debt available through a revolving credit facility, and had a term loan which expired in June 2020. Hugh tells us he is comfortable running a significant level of gearing over the long run, given the low-beta nature of the portfolio and the low debt levels on the underlying companies.

Considering the sudden and unexpected emergence of the pandemic, high gearing was not helpful at the time. Since then the gearing has risen and fallen as the portfolio fell and then rose in value. Hugh also reduced market exposure by repaying the term loan and building up some cash. This strategy has seen net gearing fall to 9.7% of net assets.

Performance

Over the long term AAS's performance has been outstanding. Over ten years it has almost doubled the annualised returns of the MSCI AC Asia Pacific ex Japan Small Cap index, generating NAV total returns of 8.5% p.a. compared to the index' 4.5% (although not a formal benchmark, it is a reasonable approximation of the fund's investment universe). In the most recent five years, however, returns have been more mixed. There have been periods of outperformance of the index. In the cumulative relative chart below, an upwards sloping line denotes outperformance of the market and vice versa. However, thanks to underperformance in 2020, AAS' share price and NAV has returned less than the index – at 37.4% compared to 42.7%.

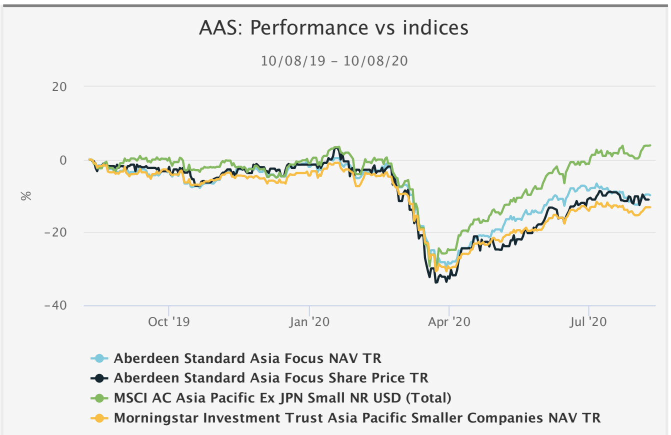
Fig.3: Five-Year Performance



Source: Morningstar

There have been two distinct periods of underperformance, the aftermath of the coronavirus and late 2017. In both cases the outperformance of China held AAS back in relative terms. AAS has always had relatively limited exposure to that country, which is partially due to corporate governance concerns. But this limited exposure is mainly due to liquidity, as there is a limited pool of companies small enough to meet the $1.5bn market cap threshold for AAS to be able to invest in. In the more recent period the structural gearing also hurt shareholder returns. While the more defensive element to the portfolio and some country positions – which has become extremely important due to the pandemic – such as being overweight India and underweight China, mean it hasn't rebounded quite so far so fast.

Fig.4: One-Year Performance



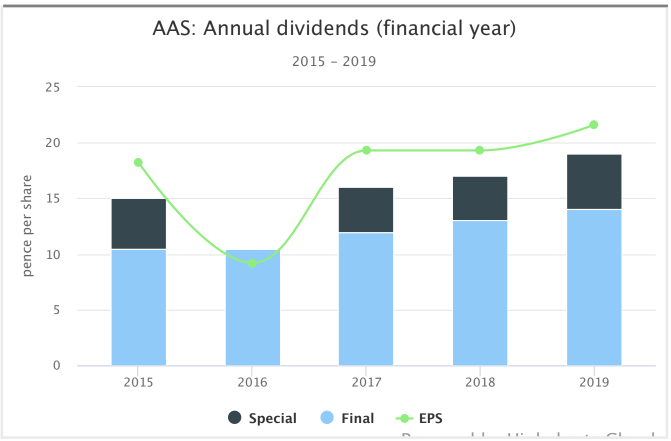
Source: Morningstar

Prior to the crisis, relative performance had been strong in 2018 and 2019. The focus on quality balance sheets helped the portfolio outperform in the falling market of 2018; which had a particularly vicious fourth quarter, wherein high growth stocks gave back some of their outperformance. Then in 2019 shareholders benefitted from some of the repositioning Hugh has done since taking more personal control of management in 2018. Exposures are now more balanced on a sector basis and there is greater exposure to growth, including technology and internet-related names. This includes Momo, Taiwan's leading online retailer, which was bought roughly two years ago and has since tripled in market cap, becoming the largest position in the portfolio. AEM Holdings, a chip manufacturer listed in Singapore, has grown by four times since it has added to the portfolio. These tech names have been good performers in the post-COVID market, which has rewarded those companies seen as benefitting from a shift to online shopping and working from home. However, roughly 70% of the portfolio remains invested in the more traditional, defensive industries the manager has historically preferred, so a style rotation back into quality and value (as happened in Q4 2018) is likely to be necessary for a sustained period of outperformance.

Dividend

AAS has a historic yield of 1.5%. Although it has a total return objective rather than an income objective, it has nevertheless delivered strong divided growth. In the five years up to 2019 dividend growth was 6% per annum, excluding specials. There have also been a substantial number of special dividends in recent years, as the chart below shows.

Fig.5: Dividends



Source: Morningstar

The ordinary dividend for 2019 was 14p a share, which is 1.4% of the current share price. The board has stated its intention to continue to maintain or grow the ordinary dividend each year, as it has done since the 1997 Asian crisis. Clearly the coronavirus pandemic will present a challenge to this objective, by reducing earnings substantially for some companies in the portfolio. Furthermore some investee companies' payout ratios are based on a percentage of net income, meaning that they are more likely to cut the dividend than companies with progressive dividend policies. That said, as the company's financial year ends at the end of July, the impact may not fully be felt in the income account until the 2021 financial year.

Given Hugh's investment process, portfolio companies generally have strong balance sheets which should give them extra flexibility to maintain or grow their payouts, and AAS itself is managed in such a prudent fashion, with 2.4 times last year's full dividend (including specials) in reserve as of the end of the 2019 financial year.

Management

Hugh Young is one of the most experienced Asian equity fund managers, having run Asian equity funds since 1985. He is head of Asia Pacific at Aberdeen Standard and has been based in Singapore since 1992. Hugh has been involved with the management of the trust since it was launched in 1995, and is also a shareholder. In 2018 the board requested Hugh take greater personal control over the trust, and he was named lead manager; previously, AAS had reported itself as 'team managed'. In reality, although Hugh has taken more personal control – and is supported by a couple of key fund managers – he continues to work within the Asian equities team with a process that is highly collaborative.

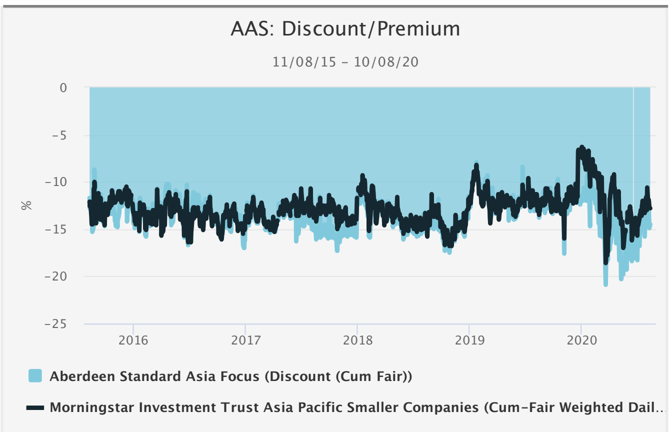
The approach is cautious and patient, with significant due diligence done by the firm's large team of analysts before companies receive a buy or sell recommendation. Since 2018 the team members have been assigned sectoral responsibilities in order to facilitate swifter decision-making, and they concluded they could have sold out of certain stocks earlier in their periods of underperformance. Nevertheless, the essentials of the process and what the team are looking for have remained the same.

Discount

AAS' current discount of 14.5% is only slightly wider than the five-year average of 13.5%, suggesting there is little of a covid effect remaining (it widened out to 20% in March). The discount is wider than both its sector peers despite it outperforming them over three years (albeit in a falling market) and outperforming one of the two over five years. However, the large cap sector average is on a much tighter average discount at 9.2%.

Large cap trusts have traded on a tighter discount than small cap specialists for the past five years, thanks to disappointing performance from small caps and the focus on fast-growing internet and tech names which are or have become very large very quickly. However, if the historical tendency for small caps to outperform large caps were to reassert itself, then the discount could look particularly attractive. We accept it may take some time for the recovery to properly take hold though, which means small caps could remain out of favour in the short term.

Fig.6: Discount



Source: Morningstar

The board can buyback shares in order to limit the discount and control its volatility, and employs those powers frequently and regularly to do so. The board has not given a discount level that it targets, but the last time the trust traded on a single-digit discount for a number of days (in January 2019), buybacks halted.

Charges

Ongoing charges are 1.16% compared to a weighted average of 1.06% for the three-strong AIC Asian Smaller Companies sector. These charges include a management fee of 0.96%, which is higher than that of both Fidelity Asian Values and Scottish Oriental Smaller Companies. However, it is on market cap rather than net assets, which incentivizes the manager to close the discount. There is no performance fee. The KID RIY is 1.61%, compared to a 1.43% sector average, although methodologies can vary.

ESG

Before ESG was fashionable, the Asian Equities Team at Aberdeen Asset Management (which merged with Standard Life in 2017) incorporated sustainability issues within its investment process., The team that Hugh leads have always viewed good governance as being an essential attribute of a 'quality' company. Good governance involves management taking a long-term view and aiming to protect the reputation of a company as well as ensuring it operates within society in a sustainable fashion. Environmental and social issues have become more significant to the assessment of sustainability as the years have gone by.

Asian equity team members conduct their own assessment of the performance of candidate companies on ESG grounds, but also consider the ratings of external analysts and try to understand the reasons for any differences. Another modern trend the team anticipated was a focus on active engagement to improve governance issues. The team work to encourage better ESG policies in portfolio companies and view themselves as being in partnership with the management of their portfolio companies. They believe this should lead to better long-term returns to shareholders, as they believe ESG issues are frequently material to long-term company performance.

Given the importance they place on these matters, the team will often not invest if they think governance practices are particularly poor and there is no or limited scope for them to improve this as management are unlikely to be receptive to their input. This means they have been happy to sit out the gains on a fashionable stock if they think its standards of behaviour are not acceptable and management have not indicated any willingness to change. As such we think AAS should appeal to investors who want a moral dimension to their investments.

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