# Aberdeen Standard Asia Focus

Update
**04 February 2019**

## Summary

Aberdeen Standard Asia Focus, formerly Aberdeen Asian Smaller Companies, aims to generate long-term capital growth by investing in Asian smaller companies with quality growth characteristics and holding these for the long run.

The trust returned to form last year with strong relative returns, as its focus on quality was rewarded in rough markets. In 2017 the trust had lagged as lower-quality, more speculative companies were bid up and China, a long-term underweight, outperformed. The manager, Hugh Young, believes that the current environment of rising global interest rates and the rolling back of QE is well-suited to his style.

Hugh, one of the most experienced fund managers in the market, was named lead manager in November as a part of an overhaul requested by the board. The number of holdings is being cut and the concentration in the highest-conviction names raised – the name change is intended to highlight this.

Hugh is focused on improving the speed of decision making and sharpening the focus on the strategy, which has served the company well over the long run. The basic strategy has not changed at all, with a focus on quality growth companies which are bought at attractive valuations and held for the long run, and a strong focus on corporate governance (the main reason for the low weighting to mainland China).

The discount has responded to the overhaul and the improving performance, almost halving from its wide point of 17.5% in October to the current level of 9.5%. However, it is worth pointing out that this is still twice as wide as the 4.8% sector average.

The trust yields 1.3%, and while this is not high the track record of dividend growth is strong, with 6.8% compound growth per annum over the past five years. In fact, the trust has managed to grow or maintain its dividend in each year since launch in 1995, except 1997 and 1998, and investors at launch would now be earning a 17p dividend on their initial investment.

## Portfolio

Aberdeen Standard Asia Focus, formerly Aberdeen Asian Smaller Companies, aims to generate long-term capital growth from a highly active portfolio of Asian smaller companies. In 2018, the managers conducted an overhaul of the portfolio in order to make it more concentrated, as well as give a higher profile to Hugh Young (now as lead manager) who has been the long-term head of the team in charge of the trust. The new name is a result of the same initiative.

The changes have now been largely implemented, with less than 10% of the portfolio's tail still to be jettisoned in Q1 2019. As a result, Hugh has sharpened the quality characteristics of the trust just as that style has come back into favour. The trust offers access to a portfolio on a similar valuation to the market but with far superior return on equity, return on assets and debt to equity ratios.

## Analysts:

**William Heathcoat Amory**
+44 (0)203 384 8795

**Pascal Dowling**
+44 (0)203 384 8869

**Thomas McMahon, CFA**
+44 (0)203 795 0070.

**William Sobczak**
+44 (0)203 598 6449

## Quality And Value Characteristics

| | P/E 2018 | P/E/2019 | PBV | DEBT/ EQUITY | ROE | ROA |
|---|---|---|---|---|---|---|
| Fund | 14.4 | 12.3 | 1.3 | -8.1 | 14.4 | 7.2 |
| MSCI Asia ex Japan Small Cap | 12.7 | 11.3 | 1.3 | 34.1 | 11.3 | 6.1 |

Source: Aberdeen Standard

Hugh makes clear that this is a "refresh" rather than anything more drastic: the trust will still be managed in line with the strategy which has generated outstanding long-term returns for the emerging market equity teams at Aberdeen (now part of Aberdeen Standard).

The key components of the approach are a low turnover, long-term approach, a focus on good corporate governance and a focus on quality – both in terms of financials and management teams. There is also great importance placed on the price that is paid, with the team covering a shortlist of candidate stocks which pass all their quality screens and waiting for valuations to be sensible before they buy.

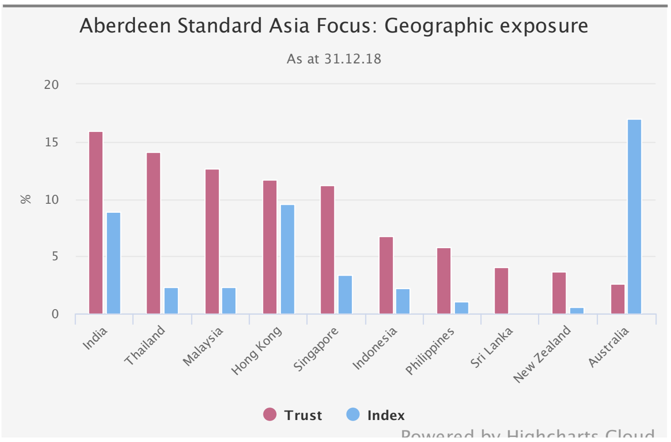
Following the overhaul, the trust will have around 60 holdings, down from the 70-80 in recent years. 30 of these, considered "core holdings", have been given greater weight. This should see the turnover figure move temporarily higher in 2018 than the 6% average figure between 2015 and 2017, according to Morningstar calculations. Hugh tells us that he has concentrated on selling the lowest conviction positions, particularly where exposures were doubled up – for example, the trust owned four plantation companies, of which he has sold those he had the least confidence in.

However, the long-term positioning, which is driven by bottom-up analysis of stock fundamentals, remains the same. For example, the trust has a long-term underweight to China based on corporate governance concerns. The managers refused to compromise on these grounds during the bull run in the country in 2016 and 2017.

Hugh appreciates the huge potential in China, but the influence of the Communist Party on companies and widespread corruption make it hard for him to be comfortable becoming a long-term investor in the market. However, he has added one Chinese stock: Precision Tsugami China. This is owned by a Japanese company, which influences management culture, although it sells into the vast Chinese market. Hugh stresses that many of his stocks also sell into China, so although there is minimal exposure to its stock market, the portfolio does benefit from Chinese economic growth. The trust continues to have its long-term overweight to Hong Kong, where corporate governance is generally stronger.

The highly-active nature of the trust comes through in the geographic allocations: there is an average difference of seven percentage points between the trust's top 10 exposures and their MSCI AC Asia Pacific ex Japan Small Cap Index weights, while one country, Sri Lanka, isn't represented in the index at all.

### Fig.1: Top Ten Geographic Exposures

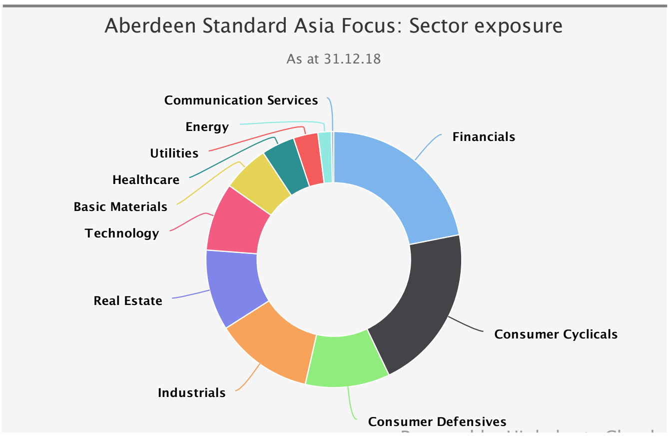



Source: Aberdeen Standard

The trust has a long-standing preference for the ASEAN countries: Thailand, Malaysia, Singapore, Indonesia and the Philippines are all substantial overweights. Malaysia, Singapore and Thailand all have highly significant exposure to Chinese growth, with an average of 9.6% of GDP accounted for by intermediate goods exports to China, according to the OECD. Although the trust is not necessarily directly exposed to these exporters, the financials and consumer stocks Hugh prefers depend on the growing wealth of these countries from trade for their revenue growth. This means that Hugh's main worry on the macroeconomic front is the trend to tariffs and protectionism.

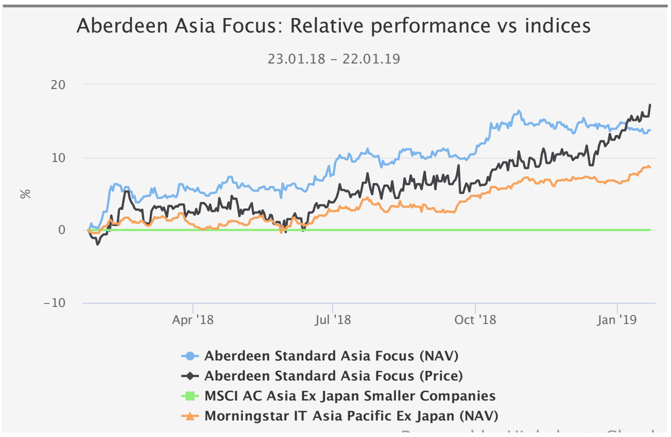
Financials are a long-term overweight of the trust, along with consumer defensives and consumer staples. One consequence of the overhaul of the trust has been an increased weighting to technology, which rose from 3% of NAV at the start of 2018 to 9% at the end of that year. Additions here include Australian software firm Citadel Group and South Korean software company Douzone Bizon. To pay for these acquisitions, the allocations to consumer defensives, financials and industrials have fallen slightly.

### Fig.2: Sector Exposures




Source: Aberdeen Standard

### Fig.3: One-Year Relative Performance




Source: Morningstar

A low allocation to technology has held the trust back in recent years. However, Hugh has had good reasons for avoiding significant parts of the sector, which have been riding the boom in smartphones. Many of these stocks are listed in Taiwan (a perennial underweight). Hugh believes they are too dependent on the whims of a handful of large customers and so have little pricing power and little scope to gain and maintain market leadership. Meanwhile, global smartphone sales peaked in 2017 and the trust's underweight to Taiwan became a tailwind in 2018 after years of holding it back.

In this context, it is worth considering the long-term time horizon of the trust – a 6% annual turnover implies a holding period of almost 17 years.

## Gearing

In May 2018, the trust issued £37m of convertible unsecured loan stock maturing in 2025, paying interest at a rate of 2.25%. Although this represents long-term, structural gearing worth 9% of NAV, CULS-holders can convert their stock into ordinary shares every six months, in May and November. The trust also has bank loan facilities which allow it to supplement the CULS with up to $25m (£19m) of gearing. The total £56m of gearing is fully employed as of the end of December, with the trust having geared up to take advantage of the sell off in Q4 2018.

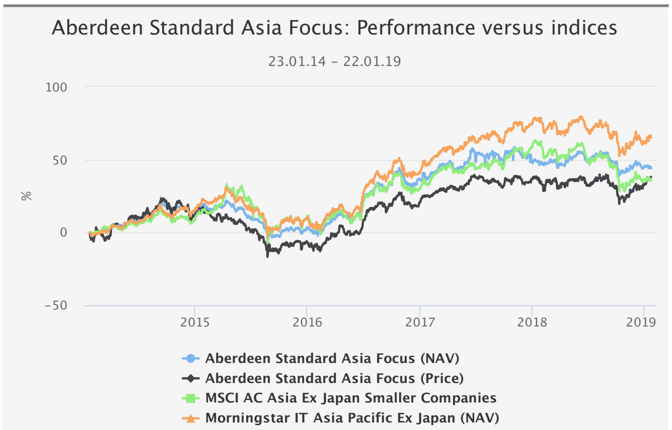
## Returns

Relative performance has been strong over the past year, with NAV down just 2.5% compared to a loss of 7.6% for the average trust and 16.2% for the index. In share price terms investors have made 1% thanks to the closing discount, a good result in an otherwise dreadful year for the market. The below graph shows the outperformance in relative terms, with an upward sloping line denoting a period of excess returns.

Analysed in terms of both geography and sector, the outperformance over 2018 was due to stock selection. In particular, stocks in the financials and consumer sectors outperformed, as well as those in Thailand, Hong Kong and the Philippines. Of the top ten contributors to performance, eight do not appear in the benchmark, highlighting the active nature of the strategy. This strong period reflects the growing preference for quality and value over the highest-growth, more speculative names which drove global markets in 2017.

The trust has also now outperformed the index over five years thanks to this strong period, with the trust up 43.8% compared to just 35.5% for the small-cap index. We note that the wider Asia ex Japan sector has done better, but it is dominated by large-cap trusts which have outperformed thanks to the strong run for large-cap tech stocks in 2016 and 2017.

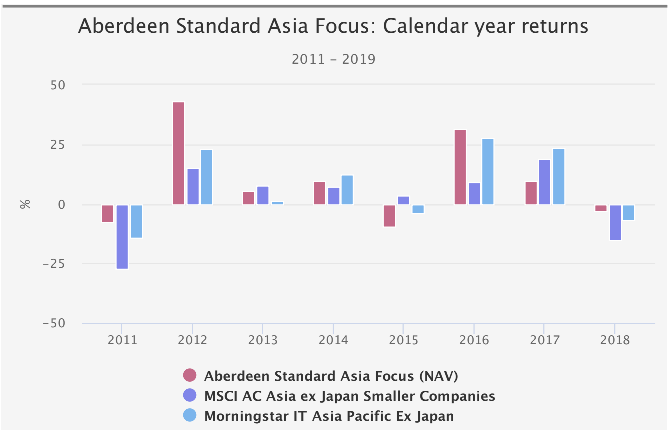
### Fig.4: Five-Year Performance




Source: Morningstar

Looking back over calendar years, the trust has had one really rough year in 2015, in which it lost 10% while the index was up 3%. At that time the trust had a high weighting to Malaysia and that market fell 15% during the year. The long-term underweight to China also hurt returns as that market rallied then crashed but ended the year up higher than the market. A third issue was the underweight to Taiwan, which hurt performance. It is important to note that it was not stock selection but geographic positioning which hurt returns, and in keeping with the conviction of the manager to follow the fundamentals of the companies rather than macro-economics, the positioning vis-à-vis these countries was not changed.

### Fig.5: Annual Returns

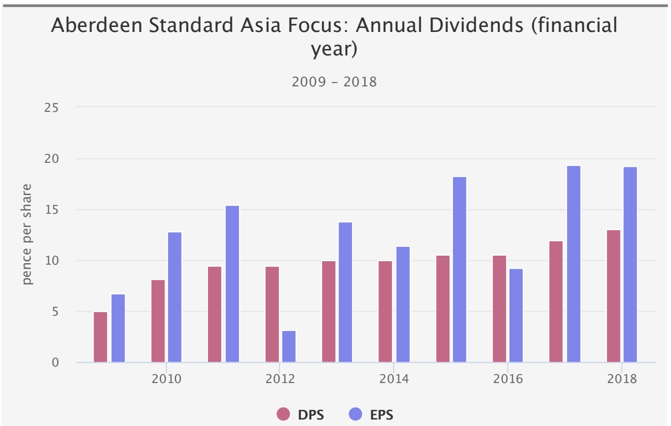



Source: Morningstar

# Dividend

The trust has a total return objective rather than an income one, and all expenses are charged to the revenue account. The trust yields just 1.3%, but has steadily grown its dividend by 6.8% a year over the past five years. We note that the trust has managed to grow or maintain its dividend in each year since launch in 1995, except in 1997 and 1998 in the midst of the Asian Crisis. This means that investors at launch are now earning a 17p dividend on their initial 100p investment.

### Fig.6: Discount




Source: Aberdeen Standard

# Management

Hugh Young is one of the most experienced Asia fund managers, having run Asian equity funds since 1985. He is head of Asia Pacific at Aberdeen Standard and has been based in Hong Kong since 1992. Hugh's appointment as named manager on this trust follows a period of rough performance across Aberdeen's emerging markets mandates. However, as we highlight above, this trust has been one of the better performers in the stable. Nonetheless, it is benefitting from some of the changes Aberdeen have made to their team-based approach.

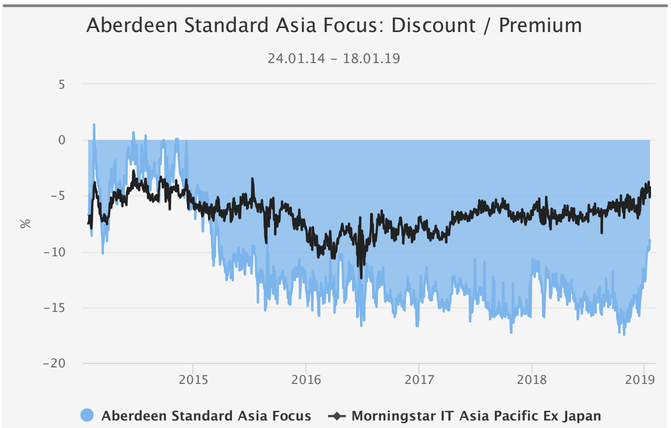
The teams have always operated by consensus, with all members having to agree on a stock to place a buy or sell recommendation on it. While this is not changing, the equity analysts are now assigned sectoral responsibilities to give clearer lines of responsibility. The intention, as with Hugh's greater personal control on this trust, is to facilitate swifter decision-making. The post mortem analysis suggested the teams had been too slow to cut their losses on some troubled or lower conviction stocks – hence the trimming of the tail of this portfolio.

We are reassured that nothing essential in the strategy will be changing and impressed that the team have stuck to their approach during a period which has been stylistically very hard for a valuation-sensitive quality growth mandate. In our view, as discussed elsewhere, we think the next few years will be much more hospitable to such a mandate given the change in market dynamics caused by global quantitative tightening.

# Discount

The discount widened following a disappointing year of performance in 2015, and despite improved performance in 2016 it has remained wider than the sector average through 2017 and 2018 - often trading wider than 15%. However, in 2018 the trust did much better in NAV total

### Fig.7: Discount




Source: Morningstar

return terms as the high growth and momentum rally of 2017 faded and markets sold off, and in the last few months the discount has narrowed to below 10%.

The board has been active with buybacks. In recent months it has been buying when the discount is around 12% or wider, but purchases have ceased after the discount narrowed in January.

## Charges

The OCF is 1.22%, compared to a sector average of 1.01%. This includes a management fee of 0.96%, which was reduced from 1% in November 2018 when the overhaul of the strategy was announced. At the same time, the management fee began to be charged to market value rather than NAV, incentivizing the manager to close the discount by improved performance.

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