

Client Update

FSSA Asian Growth

June 2021

“Optimism is the madness of insisting that all is well when we are miserable.”

Voltaire

Overview

Though Covid hasn't yet finished with us, the markets have finished with Covid. In real life, there is still plenty of misery to go around, but things have seldom been better for investors. Optimism has served us well, as the money-printing presses have rolled to counter the “unprecedented” threat. In investment, perhaps it is better to be a stupid optimist than a clever pessimist. And, markets do indeed go up most of the time.

So here we are, in a world that continues to lurch from Covid-surges to reflexive and localised lock-downs. But, with the exception of what have become known as “recovery plays”, everybody is now looking through to a mythical status quo *ante bellum* – the before-Covid-times, when the world was just hunky-dory. We are back in familiar territory and the new-old obsessions are the central banks, the rate of money-printing and inflation.

In our last update, we argued that it would not be surprising if markets were to sell off on the actual arrival, as opposed to just the mere expectation, of better times. We seem to have already arrived. Interest rates have moved upward, as bond markets have sold off and there has been quite a rotation in equity markets.

Rotation?

Bond-like equities, those that benefited most from lower discount rates, have fallen. The most speculative, Covid-bolstered, technological and crowded-end of the market has been hit the hardest. In particular, those requiring the greatest imagination and suspension of disbelief, such as the high revenue-multiple and total addressable market (TAM) dream plays, have been disproportionately affected.

Markets now seem reminiscent of where they were before Covid. The difference is that there is a load more corporate debt, public finances have been traduced and market valuations are broadly higher. Policy-wise, none of us will be that surprised if Covid proves in time to mark a broader shift to more government intervention in markets, alongside higher taxation and greater regulation.

Meanwhile, the West's latest social upheavals look like some version of a cultural revolution. While that hopefully proves to be temporal, these things could just as easily signal the start of a permanent generational shift in favour of labour over capital, the primacy of environmental, social and governance (ESG) issues over profits and a preference for societal as opposed to corporate solutions. I guess we will know in a decade.

As always, there is plenty to worry about. But, we know that most of this angst is wasted. As we have observed before, worrying clearly works because 90% of the things that we worry about never happen. In that vein, we are determined to remain positive about the likelihood of progress. This much is clear:

We believe most of the companies that we own are likely to be worth substantially more in three, five and ten years' time.

Admittedly, there are days when it feels like a kind of madness to remain optimistic in the face of such relentlessly-grim news flow. But, as a child of the 1970s, I can authoritatively say that things were a lot worse. Look at the innovation, human progress and corporate wealth that has been created since then. While we don't know much about the state of the macro-world, portfolio-wise we do believe that all is well.

Portfolio activity

Given that view, we have been determined to do as little as possible. That might sound rather defeatist, unimpressive and somewhat complacent, but over-activity and constant trading are a real, if under-appreciated, tax on investor returns. In this current age of limited growth, that is even more true than usual. So, we have tried to do nothing. As others have said, it is remarkably difficult and a tough discipline to adhere to. The good news is that we have been successful, at least in that endeavour.

We have added no new names to the portfolio since our last write-up. The portfolio has been concentrated further, with the number of holdings falling by four to 38 and the top 10 holdings now accounting for 45% of the portfolio. Last time, we talked about ASM Pacific and AAC Technologies together accounting for only 1% of the portfolio. Both were sold in the first half of this year. Otherwise, we sold China Resources Land and LG Chemical.

LG Chemical has done extremely well over a number of years, but the hype around electric vehicles (EV) and battery suppliers pushed the share price up to our long-term fair market valuation (FMV). That degree of confidence reflects a rather exuberant consensus, in our view. The shares have since fallen back and now look more reasonably valued.

China Resources Land was, by contrast, a less successful investment. Residential property development is a tough way to make a living, alongside growing China policy risk. Recurrent income, though growing, remains a small part (less than 15%) of earnings. Some businesses are just better, as well as more predictable than others. China Resources Land looks attractively valued, but we have always lost more money buying cheap businesses than we have through paying up for really good companies.

The other notable portfolio activity was to halve our Mediatek holding, from 6% to 3%, with the business (and share price) having performed very well over the last five years. We bought Mediatek when all was gloomy, relying on their 20-year track record of innovation and success. Much of what we expected (and hoped for) has come to pass and the 5G replacement-cycle has begun to kick in.

Mediatek's revenue and profits have rebounded; and the recent strong results have seen the company commit to a materially more generous dividend distribution. This is gratifying but now well discounted, in our view. We are retaining a decent-sized holding, on the basis that we

believe growth will continue to be strong over the next three years. High operating leverage means that margin estimates may still lift from here.

We have recycled the capital into other existing positions. In particular, we added to JD.com, Godrej Consumer Products, Shiseido, Largan, Voltas and Cognizant. JD.com and Godrej Consumer are of the most significance, being just under 3% positions and now in the top 20 holdings.

Shiseido remains an obvious, but yet-to-be-proven recovery play, while Taiwanese smartphone lenses manufacturer Largan is still struggling. Voltas and Cognizant appear to be executing much as expected. While Voltas looks optically expensive, Cognizant by contrast looks attractively valued for an IT services group.

Investment philosophy

Nearly everybody agrees that the future is thoroughly unknowable. As the saying goes: *It's tough to make predictions, especially about the future.* We all know too, that often the best guide to the immediate future is the recent past. But, now everybody (and spread-sheets) can trend-extrapolate, while unfortunately the markets are highly and ruthlessly efficient at discounting news flow and these expectations.

Investment is all about laying out a definite and certain amount of money today in the hope and expectation of an indefinite and uncertain return in the future. In the meantime, consumption is foregone and gratification deferred. Value evolves over time, but prices bounce around and change every day. That is stressful; and to console ourselves, we construct stories. The financial services industry, to that end, is almost entirely focused on forecasting.

In attempting the improbable, much of our industry is rationally grounded in obfuscation and unnecessary complexity. Inevitably, we end up with the growing tyranny of precision over accuracy, ever-greater short-termism ("Great quarter, guys!") and the rise of experts. The answer is out there somewhere. Then there is the growing IT-powered preference for a far-out discounted cash flow (DCF)-driven calculation of great and vast complexity, rather than using simple back-of-the-envelope common sense.

But, just as people used to dismiss the newspaper headlines as the wrapping for tomorrow's fish and chips, most of this endless news flow, chatter and noise is thoroughly irrelevant. It is even worse today, with social media and 24/7 news, analysis and opinion. We should all know by now that little of this helps us to make better, or more considered, decisions.

That is not to say that there aren't powerful structural themes that course through life, propel society and underpin businesses – from the growing middle class to rising consumption, an ageing population, better healthcare and technological disruption, to name some of

them. We look for these rather obvious tailwinds (and try to avoid similar headwinds), just as much as anybody else.

Quality

Despite all of that, the very best (and we think somewhat proven) way that we have found to deal with this unpredictable future is to simply focus on buying high-quality companies. It is really a very simple idea: whatever happens, the best companies will either prosper in easier times or, contrarily, suffer the least in adversity.

We believe that the most obvious markers of a quality company are a high return-on-equity (ROE), alongside a reasonable growth rate in a relatively predictable and sustainable fashion. We consider these factors over a medium-to-longer term time-frame, by which we mean at least 3-5 years.

More specifically, we think people (and the management team in particular) are the key magic ingredient that make great franchises and drive returns. Everything matters; but some things matter more than others do. In addition, some businesses are just that much more predictable (think consumer staples, rather than capital goods). Then, there are some that are just too hard. There is, after all, nothing we have to do and no company that we have to own.

In our view, the sustainability of a business (which includes “hard” ESG data), refers broadly to a company’s staying power. It includes their licence to operate and thrive, as well as endure. Over the years, we have found that those companies that treat their staff well, pay their taxes and behave properly, unsurprisingly do better than those that don’t. If we can look out across the next decade, so much the better.

Valuation

On the other hand, we have never sought to systematically buy companies cheaply, appreciating that quality usually comes at a price. *You get what you pay for*, as they say. By contrast, we have always sought to pay a sensible, or a reasonable, price for the companies that we want to buy. Over the years, however, what we judge to be a reasonable price has changed, as interest (and capitalisation) rates have collapsed. Ultimately, the price of everything is determined, to some extent, by the price of money.

Assuming our analysis is correct and we manage to buy high-quality companies at sensible prices, to us the results and the outcome are clear. A few observations follow. Over the long term, we believe we should be able to compound client returns at an absolute rate of 8-10%+ per



annum (p.a.). Looking back at our 30-year track record that has indeed been true, though of course there is no guarantee of that in the future. Most imperatively for investors, that level of return is materially better than inflation, the market and a number of alternatives.

At first blush, that does not sound particularly impressive, but the power of compounding, as well as remaining fully invested, is the key to steady returns. The miracle of compounding means that at 8% p.a., you double your money every nine years. With a 10% annual return, the same uplift is achieved in just over seven years.

Capital preservation

It is equally important to recognise that we are often our own worst enemies when it comes to investing. As social creatures, people and especially investors often behave in a pro-cyclical manner. Stress, when cycles and prices go against you, often drives bad decisions.

Because of the nature of the high-quality companies that we own, top-down-driven downdrafts tend not to result in a permanent loss of capital. The impact is usually more transient. High-quality businesses usually recover more quickly and may even gain advantage in a more difficult environment. That tends to mean that our portfolios hold up relatively better in more difficult times. Some investors may find that reassuring.

When the market-tide goes out, as we saw most recently with Covid, it is much easier to resist your own panic-demons if you own high-quality, reasonably-valued and well-capitalised businesses. The hardest part is the essential discipline to do nothing, other than to consider the bargains being offered by the market. It is clearly much easier to do this from a position of strength and portfolio resilience.

In summary, we seek to buy high-quality business at reasonable valuations and then do as little as possible (in terms of portfolio changes). It is a simple and easy thing to say, but naturally it is much harder to walk this talk in real life, as the young say these days.

Portfolio ROE

Given the strictures highlighted above, unsurprisingly the portfolio looks quite different to the market, as well as the index. The most obvious variance and what everyone immediately looks at is the valuation. On the face of things, the portfolio looks dramatically more expensive than the market.

On a price-earnings-ratio (PER) basis, the portfolio trades at 24x fiscal year (FY)22 earnings, compared with a valuation of just 14x for the MSCI Asia ex-Japan Index. By comparison, the MSCI World Index trades at 18x PER. We would argue that the gap reflects the difference in the quality of the respective portfolio constituents. But, is this really true and how do you know?

The simplest approach is to compare the look-through financial metrics of the portfolio with those of the market. The forward ROE for the portfolio is 20%, while for the Asia market it is just 11% (and the MSCI World Index ROE is 12%). More importantly, the ROE for the top ten holdings (which is 45% of the portfolio), is 26%. The other driver of valuations, being growth, is forecast at 16% p.a. over the next couple of years for the portfolio, compared with 13% for the index.

These are consensus numbers and they overstate the underlying growth, with a sharp rebound expected against a low Covid-base. In our view, on a normalised basis, the portfolio is likely (and has historically produced) real underlying earnings growth of circa 8-12% p.a., with an additional dividend yield on top of around 2-3%. On that basis, in the next couple of years, we expect around a double-digit absolute return rate from the portfolio (assuming no change in the PER rating).

The overall market growth rate should, as suggested by the numbers, be quite reasonable over the next couple of years. That reflects an anticipated strong recovery by cyclical businesses from their Covid lows. What is more relevant is that in the five years prior to Covid, the market earnings' growth rate was zero. It is surprising, but true.

Timing the purchase and sale of cyclical companies is clearly very difficult.

Corporate profitability

In terms of discerning quality, it is far more interesting to try to understand what drives the difference in the ROE of the portfolio compared with the market. The answer, as you might expect, is that we try to systematically invest in companies that are structurally more profitable than the average business. That can be seen in the look-through gross profit margin of the portfolio, which is 41%, compared with just 23% for the market.

For the portfolio, that translates to an earnings before interest and taxation (EBIT) margin of 23%. At the net profit level, the look-through margin for the portfolio is 16% compared with just 9% for the index. This is a material difference. As we argued earlier, while these numbers are an outcome of our investment process, we tend (based on these characteristics) to prefer some companies and typically some sectors over others.

Sector exposure...

This can be seen in the concentrated sector breakdown of the portfolio. The largest exposure is to consumer companies, with Consumer Staples and Consumer Discretionary businesses amounting to 25% of the portfolio according to MSCI's categorisation. In our view though, you could easily consider Techtronic Industries, Jardine Matheson and Shanghai International Airport (SIA) as being consumer-driven companies. MSCI consider and classify them as Industrials.

Home Depot accounts for 50% of Techtronic sales; and Chinese tourism (both domestic and international) should give SIA a strong tailwind. Although Jardine Matheson is a conglomerate, its two largest businesses (Jardine Cycle & Carriage and Dairy Farm) are both consumer businesses. We would additionally consider Voltas, the Indian air-conditioning manufacturer, to be another consumer business. MSCI categorise Voltas as another Industrial company. If you add all of that together, consumer companies more broadly account for 35% of the portfolio.

Similarly, according to MSCI, Information Technology (IT) accounts for just 25% of the portfolio. However, Naver, Tencent and Seek are all categorised as Communications Services businesses. We think it is more correct to consider them as IT companies. But, even that is not really correct. All three are broad IT-platform businesses.

Together, they make up just under 10% of the portfolio. What really drives them is again the rising wealth of Asian consumers and the growing middle class. JD.com is already categorised by MSCI as a Consumer Discretionary business, which rather proves the point, in our view. Putting all of that together, IT accounts more correctly for around 35% of the portfolio.



...a matter of opinion

We have tended to segregate the portfolio's IT exposure into three segments: IT platforms, hard-tech and IT services companies. Hard-tech consists of those companies that manufacture and supply the global multi-nationals with components and services. The customers are all of us. Most obviously, this includes Taiwan Semiconductor (TSMC), Mediatek, Largan and Advantech, with an exposure collectively of circa 15% of the portfolio.

We have discussed the IT services companies many times in past client updates. Together, the exposure amounts to about 10% of the portfolio. These are Indian-based multi-national companies (MNCs) that are quite simply digitising the world. Covid has obviously given them multiple additional tailwinds. We believe they are collectively very high-quality companies, with high returns, strong cash flow and typically net cash balance sheets. We own Tata Consultancy Services (TCS), Tech Mahindra and Cognizant.

The other major sector exposure is to financials. These collectively account for approximately 25% of the portfolio. The main exposure is to the Indian private banks, which we have discussed in detail previously. We still see plenty of growth-runway for these high-ROE compounding businesses. Though the news from India has latterly been dire, at least in human terms, businesses appear to have mostly endured. We believe Covid has strengthened the competitive position of the banks as well, with competition diminishing.

Outside of these three broad sectors, other company holdings cumulatively account for just 5% of the portfolio. These are companies that we consider individually attractive, such as Fanuc (the Japanese manufacturer of robots), Indocement in Indonesia and Central Pattana (the shopping centre owner in Thailand). Fanuc's biggest source of growth has been China, with the business in particular benefiting from a recovery in the capital investment cycle in IT (particularly smartphones) and autos.

Update on existing holdings

In terms of significance, JD.com and Godrej Consumer are the only companies where we have added materially. JD.com's share price has fallen quite substantially over the last six months, as the Chinese IT platform companies have generally seen a barrage of negative news. The failure of the Ant Financial IPO and subsequent fall-out for parent company Alibaba has highlighted the policy risks for the sector.

We believe that tighter regulation and more scrutiny is not necessarily entirely negative for the existing big companies. In particular, the opening up and probable less-fervid competition from Alibaba should be considered as broadly positive. We have been encouraged by JD's improving corporate governance, increasing professionalisation (with owner Richard Liu stepping back) and ultimately by their profitability.

We find it rather difficult to invest in companies that do not make profits. Although JD.com is profitable, rather like Amazon back in the day, a key positive argument in favour of the company is their underlying free cash flow (FCF)-yield of circa 4%. It is better than the portfolio average of 3%.

Otherwise, we suspect that JD's forecasted linear margin progress is unlikely to happen. All of these companies are having to step up investment to underpin their market share, as well as in response to growing regulatory scrutiny (gig-worker rights, holidays, pensions and so on). It is the same in the West.

Same laggards

As for Godrej Consumer, while we have owned the business for a long time, the performance has been quite lacklustre in recent years. In our view, that reflects generational transition, growing competition and relatively poor execution in terms of the group achieving their own ambitious targets.

The main family shareholders are already into the fourth generation. As they now step back and hire more professionals to run the main businesses, we expect the group to recover. The group has recently appointed a well-regarded ex-Hindustan Unilever manager as CEO. This is good and the share price has bounced in anticipation of improvement.

Largan and Dairy Farm continue to be our most significant laggards, at least in terms of share price. We believe that Dairy Farm is continuing to execute well and the group CEO, Ian McLeod, is successfully transforming the business. But, it has obviously been tough for consumer retail businesses through Covid. While the share price appears to have bottomed, the business remains under pressure. Though it was not supposed to be like this, Dairy Farm is now our largest "reopening and recovery" play.

Largan has clearly lost market share in a broad sense, though they believe that their smartphone lenses are still peerless at the top end of the business. The company has been de-rated. We added, as it is now valued like an ordinary manufacturing company. It remains very (too?) profitable, with a fabulous balance sheet. We believe that better days lie ahead of them.

Outlook & conclusion

"Doubt is not a pleasant condition, but certainty is absurd."

Voltaire

They say that fund management, when practised well, requires an unusual combination of arrogance and insecurity. Managing these opposing forces remains the key to success, but having a very strong philosophy and process helps greatly. Reiterating our fundamental credo has, I think, certainly helped me make better (or just less?) decisions in the last eighteen months. It has been an interesting time.

As for certainty, it is even more absurd than usual these days, in an age where technological disruption and digitalisation continue to eviscerate an ever-longer list of household names. There seems unlikely to be any let up. These forces remain a significant threat to all businesses, as well as being an opportunity for others. To again paraphrase Lenin: *Absolutely nothing happens for decades and then decades happen in weeks.*

Covid has been a little like that, particularly for the technology-cult. As we remarked last time, it has moved the world ten years forward in just ten months. Although we remain broadly confident about the companies in the portfolio overall, at the same time we absolutely appreciate the dangers of complacency. Doubt, as has been said, might not be an entirely pleasant condition, but in this context it probably remains a constructive emotion.

As always and in all things, it's about balance. To that point, nearly all of us have been miserable at times over the last year, but we have also been very fortunate. In our investment lives, at the very least, the madness of our optimism has been more than reasonably rewarded with another year of decent absolute returns.

Once again, we wish you the best of health and luck for the years ahead. With thanks and as usual, we welcome your comments and feedback.

Source: Company data retrieved from company annual reports or other such investor reports. As at 31 May 2021.

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