PRUSIK

LONG ONLY ABSOLUTE RETURN INVESTING IN ASIA

Prusik Asian Equity Income Fund

Quarterly Investment Report
29 December 2017

FOR PROFESSIONAL INVESTORS ONLY

4Q17 Review and Outlook

The fund returned +5.5% in the 4th quarter compared to a market return of +8.0%. For the full year, the fund returned +32.8% compared to a market return of 37.3%. This was the first year since the inception of the fund that we have underperformed and so it is worth spending a little time on why that is and what the prospects are for the fund going forwards. Recall that we have both an absolute return and relative return target for the fund. In absolute terms, we target an annual return of 10-15% and in relative terms, we aim for 5 to 10% of outperformance of the benchmark. The way we deal with the "double-think" required to achieve both those objectives is that we focus purely on generating absolute returns and expect that process to be consistent with the outperformance target.

Although we aren't comparing ourselves to Warren Buffett, it is noteworthy that he has what might be described as a "benchmark unaware" process but always compares the returns of Berkshire Hathaway to the S&P 500 as, over the long term, he expects to beat it. However, as far as we are aware, he doesn't worry about being "underweight Google" or "overweight consumer products" when he constructs his portfolio. And his famous 2 rules on capital preservation are ones that we would of course agree with[1]. Nevertheless, he believes, as do we, that over the long term, the index is a relatively good approximation for our cost of capital. If we can't do better than the index over the long term, then it's difficult to argue that we earn our fees.

I do find it slightly disingenuous though when quality focused or defensive funds are quite happy to claim that outperformance during bear markets is due to their "robust process" or "stock picking ability"[2] whereas underperformance during bull markets is due to "irrational markets" or "momentum investors". It is inconsistent to claim that outperformance is *always* the result of factors within your control and underperformance is due to factors outside your control. So, we need to dig into our relative underperformance to try and dissect how much of it was due to bad luck or factors outside our control and how much was due to poor decision making. Even though we don't worry about our deviations from the benchmark, it is worth looking at what caused the underperformance.

Why did we underperform last year?

- **We didn't own technology stocks** (in particular Tencent and Alibaba). Being underweight IT cost 320bps from an allocation perspective.
- **We owned very few cyclical stocks**. Being underweight financials, materials, consumer discretionary and energy cost approx. cost 150bp.
- **We owned too many defensive stocks**. Being overweight utilities, telecoms and consumer staples cost 270bps.
- **We held too much cash**. Being overweight cost us 327bps.

Readers will note that this adds up to almost 1000bps, which is more than our underperformance in 2017. This is because our positive gains from stock selection prevented the year from being far worse. So, I would argue that our stock selection – given our conservative portfolio structure – was good. Regarding technology, I have written about Tencent and Alibaba in the last quarterly and so I won't repeat the reasons for not investing in those stocks here but, for different reasons, they are typically unlikely candidates for our portfolio.

The reason that we have a lot of "defensive" as opposed to "cyclical" stocks is not due to any view on future economic growth. It is merely that we seek stocks that have high barriers to entry in their business and can generate healthy, free cash flows which will grow steadily over time and enable a growing, but sustainable, dividend to be paid and stocks with these characteristics are generally described as being "defensive".

Our cash position was something we had more control over and this certainly was a detracting factor. That said, the level of cash in the portfolio is purely a by-product of our selling and buying decisions, rather than a conscious decision to hold cash. The reason the cash weight was high throughout the year was that we didn't find enough buy ideas, true to our discipline, to take the cash from the stocks that we were selling. **Had we not changed the portfolio during 2017 then the cash level would have remained at 4% and our returns would have matched the market.**

[1] "Rule #1: Never lose money. Rule #2: Never forget Rule #1"

[2] I am certainly guilty of this

The reason for not finding more stocks lay essentially in the view we were too pessimistic about the prospects for companies in general and too bearish when it came to assessing valuations. If there was one reason behind all of our problems with performance last year, it was that we were too risk averse and too bearish (especially regarding China). Any investor can run a big cash position and own low beta stocks but the skill is working out where risk is mispriced and when it is, that means sometimes taking on more risk or indeed less risk depending on the scenario. We also sold stocks at prices that, on reflection, were too cheap and our valuation approach was too conservative - in keeping with our focus on capital preservation. **We are reluctant to buy stocks at prices where, if we are wrong, we risk permanent loss of our investors' capital**.

Looking forward into 2018 and beyond, I am still confident that our approach can generate absolute and relative returns which are attractive and better than the index. There are 3 reasons for this:

- The dividend yield of our portfolio is attractive in absolute terms, relative to bond yields and relative to the market.
- Our portfolio of companies should be able to grow dividends in line with, or slightly above, the rate of nominal GDP growth in the region. Because our companies have higher margins and stronger businesses than the typical company, we believe they will grow faster than the market.
- Our portfolio trades at an attractive valuation in absolute terms, on a historical basis, relative to interest rates and relative to the market.

Dec 2017	PAEIF	MSCI Asia Pacific ex-Japan	MSCI World
P/E	12.9x	13.7x	16.9x
Dividend Yield	4.6%	2.9%	2.5%
Price to book	1.76x	1.83x	2.45x

Of course, we have no way of guaranteeing this but we believe that, at the very least, our portfolio is consistent with these objectives and if we don't achieve it, it will be our own fault. We will of course learn from our mistakes in 2017 to ensure that we are taking on the correct level of risk but we don't believe that our fundamental process is at fault and do not anticipate any change in the core of our strategy, which is to seek to buy strong, cash flow producing assets that can sustain and grow dividends for many years into the future, and not overpay for them.

Private vs Public Market Valuations

It is interesting to us to note that difference between public and private market valuations. Because institutional investors are keen to generate returns in a low yield world, they are increasingly paying higher prices for the types of non-cyclical, long duration, inflation linked assets that we favour. **For example, Fortune REIT has just sold a shopping mall in North Point, Hong Kong to a real estate fund at a 1.8% cap rate and a 90% premium to book value. Yet the stock itself trades at a 25% discount to book value.** If they liquidated their entire portfolio at a similar valuation this would imply a valuation for the trust of HK$25/share compared to a market price of HK$9.85. I don't believe for a moment that the 1.8% cap rate is an appropriate valuation for these assets but it is intriguing and telling how large the gap is. I believe the reason for this gap is because private investors do not need to worry about mark to market valuations and also are happy to accept lower returns for high quality, income producing assets as they value them relative to bonds. Public market investors however, value these assets relative to other equities (which often do not have the same quality of earnings) and therefore are much more reluctant to pay up for quality. In addition, private equity buyers can run these businesses with a lot more leverage than the public markets would allow. Finally, there has been a huge increase in the amount of private equity money raised to invest in the Asian region and therefore these funds face pressure to deploy those funds. Although it cannot be relied on to continue, I expect that several of our portfolio companies will continue to be targets for these funds in the coming years.

New Positions

Contact Energy

Contact Energy is an integrated New Zealand Power Company which produces, distributes and retails electricity. Because there are 5 (integrated) players in the market (which only has 2m customers) and the regulator wants to keep prices low, customer churn is high (21% compared to 12% in UK) which increases marketing costs but other than that, it is a relatively attractive market. The stocks are very affected by short term news flow (weather affecting hydro prices, customer churn, political dynamic) but ultimately these are relatively predictable, stable businesses which should grow at least at inflation rates over time.

Contact Energy has been underperforming for the past several years due to several factors (losing retail customers, Origin's decision to sell its 53% stake) and now looks very cheap. It is now trading at an 8% free cash flow yield and this should grow at 2-5% per year. The company has committed to increasing the pay-out ratio so that the dividend yield should reach 7-8% by 2019. Assuming 8% WACC (which is conservative as it assumes long-term NZ yields of 4.5%, when current yields are 3%, but it appears that most analysts value the company in this way) the stock is worth $6.50. Applying a more reasonable 7% WACC would result in a price of $7.50 which compares to a current share price of $5.50.

Macquarie Atlas Roads

Macquarie Atlas is an Australian toll road operator whose main asset is a 25% stake in the French Toll Road Group, APRR. APRR has 2,323kms of roads in Eastern France which have CPI linked tolls and a concession that lasts until 2035. Traffic growth for these roads has been robust and are continuing to pick up as European economy recovers.

The company recently agreed to internalise the management of the company (effectively removing Macquarie as manager) and this will be voted on at an AGM in May 2018. The NPV of the stock is around $7.00/share (compared to our purchase price of $6.00). The dividend is growing rapidly as cash flows from the underlying assets increase (due in part to a large refinancing of APRR debt at much lower rates) and is expected to yield 5.3% in 2019 and 6.5% in 2020. The removal of Macquarie as manager has the potential to lead to corporate activity which provides additional upside potential.

SCentre Group

SCentre Group is Westfield's Australian (and NZ) mall business. It is the dominant mall operator in Australia occupying the key sites and with double the floor space of its next largest competitor. It is an internally managed REIT and so there is no leakage of fees to an external manager and no corporate governance issues to worry about. It only pays out 85-90% of earnings as it is spending $500m developing existing assets and is expected to achieve a 15% equity IRR. We have owned this stock in the past but sold it due to valuation reasons around 18 months ago. **Since the stock peaked in July 2016 it has fallen 20% compared to the MXAPJ which has risen 27%.**

Why has stock underperformed recently? I think 3 main reasons:

- Fears over Amazon's entry into Australia
- Concerns over Australian retail spending, leading to negative re-leasing spreads (in other words new leases are being rented out at lower levels than existing ones)
- Rotation out of "bond proxy" stocks

The first point I think misunderstands why people visit Westfield malls. Although second tier malls and high streets are affected by Amazon, experience shows us (and Westfield London's strong performance backs up) that people still like visiting tier 1 malls even though they could save money by buying online. In addition, retailers such as Apple and Tesla need a physical presence and are increasingly looking to take larger spaces in tier 1 malls and cut out their exposure to secondary locations. I believe Westfield's malls which are located in densely populated areas, in high income markets, will prove resilient. The second point I think is valid as new leases are being re-leased at a -2.5% rate but I think we are coming to the end of this cycle as occupancy costs have fallen from 19% to 17.6% and the management has indicated that this decline has been arrested. The third point is certainly a valid concern and it is difficult to see the stock performing well during a time of rising bond yields.

The current stock price implies cap rates of 6.5% which would be consistent with long term Australian bond yields of 4.5% (currently 2.8%). The current cap rate in the market is 5% and malls are being bought at even tighter cap rates due to their attractiveness to institutional investors. Looking at previous negative cycles (early 1980s, late 2000s) we have never seen cap rates increase by more than 200bps during a downcycle. The current dividend yield is 5.8% but it would be 6.5% if they paid out all their earnings as dividends. Assuming that bond yields move up 100bps in the next 2 years, then I still think we can generate 10-12% returns (6% yield + 2% dividend growth + 2-4% valuation increase).

Exited Positions

SPCG

We exited this position as we are less confident on the company's desire to return excess capital to shareholders

PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 29.12.2017

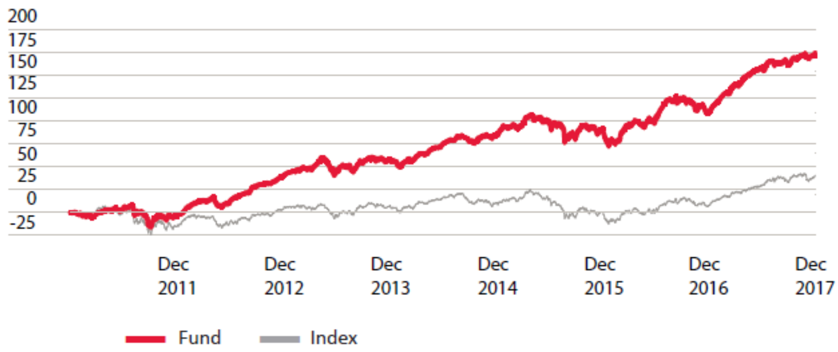
Class 1*	B USD	Benchmark **
1 Month	1.61	3.13
3 Months	5.46	7.98
2017	32.79	37.32
2016	10.36	7.06
2015	3.17	-9.12
2014	16.79	3.09
2013	13.45	3.65
2012	45.77	22.63
Since Launch+	180.43	48.15
Annualised since Inception	15.87	5.77

* Class 1 shares were closed to further investment on 30th November 2012

**MSCI Asia Pacific ex Japan

+ Launch date: B 31.12.2010

Fund Performance – Class B (USD) (%)



Source: Morningstar. Total return net income reinvested.

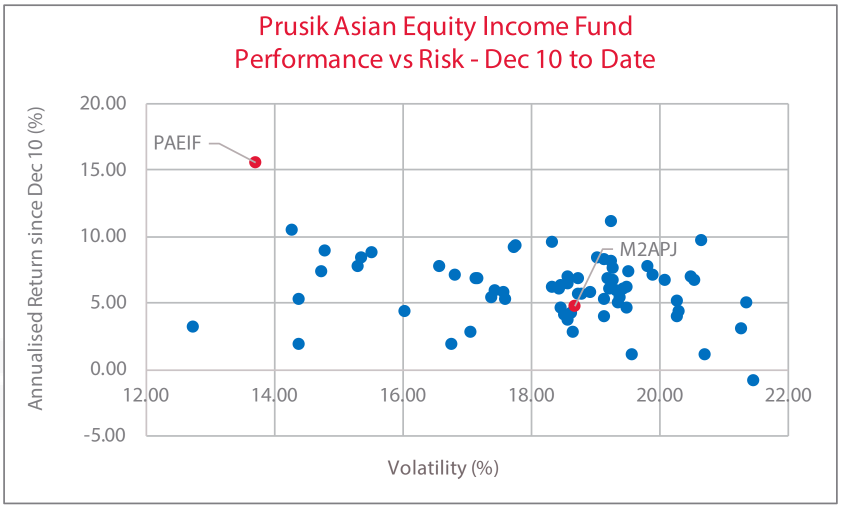
Class 1 B, USD Monthly Performance Summary (%)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
2017	5.49	4.77	3.98	2.69	3.25	1.11	2.71	0.06	-0.54	2.91	0.85	1.61	32.79
2016	-6.04	-0.37	10.28	0.95	-0.38	2.46	7.56	1.20	0.54	-1.43	-0.68	-3.16	10.36
2015	4.35	1.41	-0.70	6.01	-1.69	-1.97	-1.63	-6.01	-0.70	7.04	-1.91	-0.33	3.17
2014	-4.34	4.03	1.50	1.58	4.63	2.14	3.50	1.24	-2.54	2.31	2.00	-0.05	16.79
2013	3.93	1.78	0.35	4.57	-0.53	-4.95	1.87	-2.24	5.07	4.15	-0.56	-0.25	13.45
2012	8.12	6.54	1.92	3.20	-7.67	3.84	6.72	1.92	6.36	1.97	2.76	3.63	45.77
2011	-2.68	-1.46	2.55	3.90	2.58	-0.60	3.56	-6.06	-12.80	10.62	-3.52	1.79	-3.96

RISK ANALYSIS

Risk Metrics	Fund (%)
Tracking Error (% pa)	9.42
Beta	0.78
Alpha (%)	10.48
Volatility (%)	13.53

Source: Morningstar
Since inception: B 31.12.2010



Source: Morningstar

THEMATIC & GEOGRAPHICAL BREAKDOWN

Top 5 Holdings (%)

AIA Group Ltd	6.3
CK Hutchison Holdings Ltd	6.2
Samsung Electronics-Pref	5.8
Beijing Capital International Airport	4.9
Zhejiang Expressway	4.8
Total Number of Holdings	35

Thematic Breakdown (%)

Transport Infrastructure	19.5
Communications Infrastructure	14.8
Consumer	14.0
Cash	13.5
Power Utilities	11.9
Financials	9.9
Cheung Kong / Hutchison	6.2
Technology	5.8
Real Estate	4.5

Portfolio Financial Ratios

Predicted Price/Earnings Ratio	12.9x
Predicted Return on Equity (%)	14.5
Predicted Dividend Yield (%)	4.6

Geographical Breakdown (%)

Hong Kong	23.4
China	18.4
Cash	13.5
Korea	13.4
Thailand	9.0
New Zealand	6.3
India	5.6
Australia	4.4
Indonesia	2.6
Pakistan	1.5
Singapore	1.4
Cambodia	0.5

All data as at 29.12.17. Source Prusik Investment Management LLP, unless otherwise stated.

FUND PARTICULARS

Fund Facts

Fund Size USD	1018.5m
Launch Date	31st December 2010
Fund Structure	UCITS III
Domicile	Dublin
Currencies	USD (base), GDP, SGD

Management Fees

Annual Management Fee

1% p.a paid monthly in arrears

Performance Fee

Class 1: None
Class 2 and Class U: 10% of the net out-performance of the MSCI Asia Pacific ex Japan Index (MXAPJ) with a high-water mark.

Temporary Front End Charge: 3% introduced on 2nd December 2013 paid to the benefit of the fund.

Dealing

Dealing Line	+353 1 603 6490
Administrator	Brown Brothers Harriman (Dublin)
Dealing Frequency	Daily
Valuation Point	11am UK time
Dealing Cut - off	5pm UK time
Min. Initial Subscription	USD 10,000
Min. Subsequent Subscription	USD 5,000

Share Class Details

Class 1*			SEDOL	ISIN	Month end NAV
A USD	Unhedged	Non Distributing	B4MK5Q6	IE00B4MK5Q67	288.47
B USD	Unhedged	Distributing	B4QVD94	IE00B4QVD949	214.27
C GBP	Hedged	Distributing	B4Q6DB1	IE00B4Q6DB12	212.26
D SGD	Hedged	Distributing	B4NFJT1	IE00B4NFJT16	206.25

*Class 1 shares were closed to further investment on 30th November 2012.

Class 2*			SEDOL	ISIN	Month end NAV
X USD	Unhedged	Distributing	B4PYCL9	IE00B4PYCL99	191.42
Y GBP	Hedged	Distributing	B4TRL17	IE00B4TRL175	190.41
Z SGD	Hedged	Distributing	B6WDYZ1	IE00B6WDYZ18	191.45

*Class 2 shares were soft closed to new investors as of 30th November 2012. Performance fee based on individual investor's holding

Class U*			SEDOL	ISIN	Month end NAV
U GBP	Unhedged	Distributing	BBP6LK6	IE00BBP6LK66	178.69

*Class U shares are open to current investors only. Performance fee based on fund performance as a whole

Dividend Dates

Dividends paid twice annually (January and July)

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