PRUSIK

LONG ONLY ABSOLUTE RETURN INVESTING IN ASIA

Prusik Asian Equity Income Fund

Quarterly Investment Report
30 September 2016

FOR PROFESSIONAL INVESTORS ONLY

PAEIF 3Q2016 Review & Outlook

The fund returned +9.4% compared the index which rose +9.8%. The biggest contributors to returns were **Sun TV Network**, **CK Hutchison** and **Indiabulls Housing Finance**. The biggest detractors were **KEPCO**, **Man Wah** and **Glow Energy**.

Considering we underperformed the market this quarter, I am still very happy about how the portfolio performed. The two strongest sectors during the month were Technology and Materials which are two sectors that we have very limited exposure to. And the two worst performing sectors were Telecoms and Utilities – two sectors that we have a reasonable exposure to. Given that it was a largely cyclically driven rally with low quality stocks performing well and high quality stocks performing poorly, it was pleasing to keep pace with the market.

Over the past few months we have been frequently been asked the following question:

"If interest rates rise, is it the end of the road for the Equity Income investing?"

Given that PAEIF has been run during a time when interest rates have been zero, it reasonable to ask whether, if rates are now in an upward trend, that means our outperformance would be reversed. It is something that we are paranoid about too and so we did a little investigation.

The first point to note is that it is 5 years too late to ask that question! The table below shows how various factors have performed over time and you can see that **dividend yield as a strategy has underperformed the market on a 1, 3 and 5 year basis.** It is actually factors such as momentum, growth and quality that have been the strongest performers.

Type	Factor Name	Sep-16	3-Month	6-Month	YTD	1-Year	3-Year	5-Year	10-Year
Value	Book / Price	-2.5%	-0.9%	-3.3%	-3.1%	-6.4%	-4.0%	-1.4%	0.8%
	Dividend Yield	-2.3%	-4.4%	-2.5%	-0.3%	-3.3%	-4.4%	-2.3%	3.7%
	Earnings Yield	-1.2%	0.6%	-1.4%	-0.9%	-3.1%	-5.8%	-1.7%	-0.5%
	EBIT / EV	-0.9%	0.5%	-0.9%	0.8%	4.6%	-3.1%	-3.2%	0.8%
	Free Cash Flow Yield	-0.6%	-1.9%	-1.8%	-0.2%	-0.7%	-3.0%	-0.9%	2.5%
	Sales Yield	-2.2%	-2.9%	-9.3%	-6.9%	-10.6%	-9.8%	-8.4%	-2.0%
	PEG*	0.5%	3.9%	7.6%	7.3%	9.6%	0.4%	0.5%	-3.0%
	Value Composite	-2.1%	-5.3%	-7.0%	-2.9%	-0.4%	-5.4%	-4.5%	0.3%
Growth	Forecast Earnings Growth	0.8%	3.1%	7.2%	5.3%	5.9%	2.1%	0.8%	-2.8%
	Historical Earnings Growth	2.9%	4.8%	5.5%	2.5%	7.2%	4.9%	4.3%	1.9%
	Dividend Growth	0.9%	2.0%	5.5%	2.2%	4.0%	2.7%	0.9%	-0.4%
Momentum	Earnings Momentum	0.1%	2.7%	6.7%	7.3%	5.0%	6.5%	5.2%	3.8%
	12m Price Momentum	0.9%	-0.4%	4.0%	0.9%	3.7%	4.2%	4.4%	3.1%
	6m Price Momentum	0.8%	0.8%	1.1%	1.2%	1.3%	0.3%	-2.4%	0.8%
	1m Price Momentum	0.3%	2.5%	-0.2%	-0.6%	-4.0%	2.3%	-2.5%	3.6%
Quality	ROE	2.6%	3.5%	7.6%	7.4%	10.5%	4.2%	5.0%	3.6%
	ROIC	1.9%	3.3%	7.0%	7.0%	13.3%	6.9%	6.2%	4.5%
	Capex / Depreciation*	0.7%	-1.9%	-3.8%	-0.3%	-4.6%	-4.2%	-3.0%	0.5%
	Debt / EV*	1.8%	4.7%	7.1%	4.3%	9.5%	4.8%	4.9%	3.4%
	Dividend Cover	1.0%	6.4%	4.8%	1.9%	6.7%	3.8%	4.3%	1.9%
Size	Market Cap*	0.8%	-0.8%	-2.8%	-0.9%	-0.9%	-0.3%	0.4%	0.6%
Risk	Volatility 12M*	-1.0%	-0.4%	6.8%	8.5%	8.2%	4.6%	5.6%	4.0%

Source: UBS Quantitative Research

Because PAEIF is more flexible than many income funds, we have been able to rotate out of these underperforming, high dividend yield stocks and into both smaller cap stocks which still offer value and also lower yielding large cap stocks that share the "Buffett" like characteristics that we are

looking for, but are retaining a greater share of earnings to reinvest in the business. These include some of our largest positions such as **Power Grid**, **Samsung Electronics**, **CK Hutchison** and **AIA.**

So even though there is a perception that high yield stocks have been pushed higher in the "search for yield" the reality is that it is not the case. The impact has been to push up the valuations of "safe" and "growth" stocks instead and in fact, many of the high yield stocks are trading at historically cheap levels. As readers will know, we believe that it is not enough to buy high quality stocks – one needs to buy them at cheap prices in order to generate attractive returns. Hence we have taken a look below at how valuations compare to a time when interest rates were much higher. So, thus far, we have been able to have our cake and eat it by being exposed to stocks that have strong momentum, quality and growth but which also trade on low valuations.

What would happen to the valuations for PAEIF holdings if bond yields went to 5%?

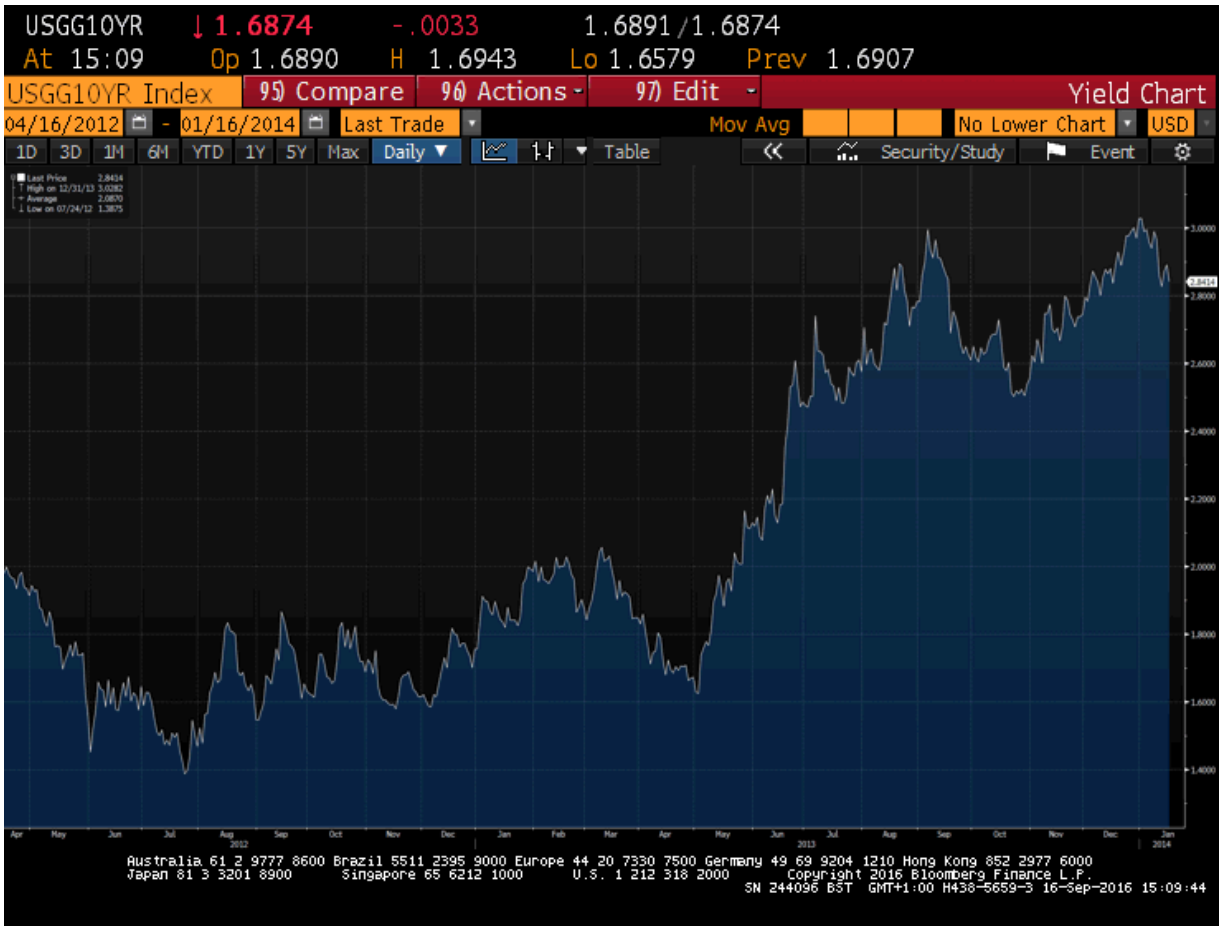
The table below compares the valuation for the stocks that we own today which were listed and had estimates 10 years ago, when US 10 year bond yields were almost 5%. We can see from the table below that, **on average, the stocks we own today trade at a 12% discount to the multiples that they traded on in 2006**. So from a pure historical analysis, it would appear that if rates went up to 4.8% then the portfolio would re-rate UPWARDS. Although this seems unlikely and contrary to perceived wisdom, it is interesting to see what the historical analysis suggests.

	Current P/E	October 2006 P/E	Premium/discount
SUN TV NETWORK	19.6	32.7	-40%
WULIANGYE YIBI-A	15.9	25.9	-38%
MACQUARIE KOREA	18.4	25.5	-28%
LINK REIT	24.9	23.2	7%
BEIJING CAP AI-H	16.2	17.5	-8%
KT&G CORP	13.8	14.9	-7%
PCCW LTD	16.2	14.3	13%
ZHEJIANGEXPRE-H	11.0	14.0	-21%
TSMC	14.2	12.4	15%
CPN RETAIL LEASE	15.9	12.3	29%
GREE ELECTRIC-A	8.8	10.6	-17%
UNITED BANK LTD	8.8	9.5	-7%
GLOW ENERGY-NVDR	12.5	9.3	34%
KOREA ELEC POWER	3.9	8.8	-56%
CKH HOLDINGS	11.2	8.1	39%
Average	**14.1**	**15.9**	**-12%**
US 10 year bond	**4.80%**	**1.72%**	

Source – Bloomberg/Prusik

What has happened during the previous periods in which long bond yields have risen?

We looked at what happened to the performance of the fund in 2012/2013 when interest rates rose substantially. The graph below shows the US 10 year bond yield bottomed at 1.39% on 24 July 2012 and peaked on 31 December 2013 at 3.03%. A period therefore when interest rates more than doubled and bond yields increased by 167bps.



Source – Bloomberg

So what happened to PAEIF in absolute terms and relative to the market during this time?

PAEIF returned 37.2% between these two dates compared to the M2APJ return of 21.7% and thus enjoyed annualised outperformance of 10 percentage points (24.6% compared to 14.6%).

Source - Bloomberg

So why is it that PAEIF, despite being supposedly very sensitive to interest rates does not underperform when rates rise?

There are lots of potential reasons but I believe the key reason is valuation discipline. Although we do own stocks that are affected by interest rates, because we focus on rotating out of "expensive" stocks and into "cheap" stocks, we have so far avoided the downside.

The key therefore is to retain VALUATION discipline. Although it is common to hear that valuations are not important in investing, if you have companies that have high return on capital, this is not strictly true. Of course, if you know with *100% certainty* that the companies you are investing in can grow earnings at 15-20% per year for the next 20 years then it doesn't matter if you pay 15x or 25x earnings but, if the companies you are investing in are growing at 5-10% then it makes a very big difference – regardless of the return on capital. It is also misleading to focus on the return on capital and assume that returns will be similar to that without considering the growth rate of those companies. If you have a portfolio of companies that are growing earnings at 6% per year[1] then

[1] Recall that long dividend growth in the US and UK has been 6% over the long term in nominal terms (<2% in real terms). **(Source Bloomberg/Prusik)**

unless your P/E expands your return will be 6% per year – regardless of what the return on capital of the business is**. On a 20 year view, if you pay 25x earnings for this portfolio today and sell at 15x earnings in 20 years' time, then your return will be just over 3% per year**. **Whereas if you buy the same portfolio at 10x earnings and sell at 15x earnings, your return will be over 8% per year.** This is why, in our view, neglecting valuation is extremely dangerous. When looking at the valuations of the classic defensive stocks in Asia (and globally) we believe the risk/return is extremely unattractive. You assume a high percentage chance of earning low, positive returns assuming that valuations stay elevated and the business performs according to expectations and a low percentage of significantly negative returns if valuations compress or business performs worse than expectations. This is exactly the opposite of the risk profile we are trying to achieve. There are plenty of stocks (particularly in the consumer and defensive sectors) that have performed extremely well over the past 5 years but this has largely been due to multiple expansion. It would be extremely unwise, in our view, to assume that this re-rating can continue indefinitely – particularly if interest rates begin to rise.

New Positions

Wuliangye Yibin

Wuliangye Yibin is the second largest producer of Baiju, a famous Chinese liquor distilled from fermented Sorghum which has an alcohol content of around 52%. According to Bernstein, it accounts for 70% of the pure alcohol consumed in China and a staggering 28% of the global spirits market by value. **Wuliangye**, founded in 1957, is the number two brand in China (after Moutai) but has excellent brand recognition.

Baijiu is produced via a continuous process of solid state fermentation which involves mixing fresh Sorghum with existing fermenting mash which is then deposited in mud lined pits for 90 days before being removed, distilled in a stream to extract the alcohol and then returned to the pit with additional fresh Sorghum. The quality and age of the pits determine the characteristics of the Baijiu.

As Chinese consumers become wealthier and older, we expect their consumption of high-end Baijiu to increase. The barriers to entry in this business are high as the brands are very established and it is difficult for foreign drinks companies to penetrate. Sales had been hit over recent years due to the government clamp down on corruption but have begun to recover as that excess demand has been washed out.

Trading on a P/E of 15x and with a dividend yield of 3%, we believe it offers extremely good value and excellent growth potential.

Transurban

Transurban (TCL) is an Australian based toll road operator that owns a portfolio of roads located largely in Australia but also in the US. They focus on owning roads with the following characteristics:

- Located in Australia/US (i.e. operating in a market with a strong legal system)
- Congested road systems
- Urban centre that people commute in and out of
- Low amount of truck traffic/high amount of passenger traffic (all their roads has positive traffic growth during the GFC)

- Inflation protection built into tolls

Typically, a new road doesn't justify the investment as toll revenues don't cover the cost of investment so **TCL has a unique advantage in Australia in that they can seek concession extensions on existing roads that they own to pay for new roads**. A recent project they were involved in was paid for in a three way split of 1/3 by tolls, 1/3 by government and 1/3 by concession extensions on other roads. This is something that other bidders cannot offer when bidding for new roads or extensions to existing roads. Because of this, they have a very strong negotiating position with the government and as a result, they tend to earn very attractive returns on new investments. The company is expected to achieve 2-4% traffic growth, 2-4% price growth and because of margin growth, high single digit/low double digit earnings growth.

The upside to valuation comes from the $20bn of new toll road investment that is expected over next 10 years – mainly via "exclusive negotiations" with the government. This is likely to lead to significant upgrades to valuation given the spread between the return they achieve (11-14%) and their cost of equity (7-8%).

One final point of interest is that they are a big beneficiary of the two trends of "big data" and driverless cars. They use advanced machine learning to see the impact of factors such as variable speed limits (e.g. reducing from 100 to 80 improves traffic flow as less bunching). Driverless cars are likely to be positive for traffic growth as it allows more efficient use of the road which improves asset utilisation.

What are the risks?

- Traffic growth disappoints
- The high level of leverage means that if markets dislocate, then this poses a potential challenge
- Complex structure to avoid generating a profit means accounting earnings are very low

Valuation

The forward yield is 5% and we expect this to increase at around 10% over the next 3 years. Further upside is expected from new projects which I believe can add 200-300bps per year in increased value. The dividend yield spread versus government bonds is at a 5 year high reflecting the concern that bond yields are too low. We estimate that the stock is pricing in bond yields of 3.5-4.0% compared to the current level of 2.0%.

Fonterra

Fonterra is a New Zealand based dairy co-operative collecting and processing close to 90% of NZ milk supplies. It produces a full range of commodity and consumer dairy products largely for international markets. It is the largest milk processor in the world.

Earnings are split 50/50 between milk processing and value added, consumer products (e.g. Cheese, infant milk formula, butter). The processing business is a utility-like business where the company

receives a “cost of capital” stream of earnings. It is hedged against movements in the milk price. It is structured so that the farmers (the largest owners of the co-operative) receive a transparent and fair price for their milk and so there is little room to improve profits from this segment. The key is moving volumes from commodity products into branded consumer, nutritional and food service operations in Asia and in particular, China.

The key strengths of the company include:

- Growing demand for dairy. Milk consumption is 96kg/capita in Asia compared to 230-280 in US/Europe
- NZ has very low production costs on a global basis
- Strong brands based on perception of quality
- Scale

Risks

- Milk price volatility can cause issues
- Cash flows very volatile
- Food safety scares
- Co-operative structure means that shareholders do not run the company

Structure

It’s complicated. There are 1.6bn shares outstanding which are split into “wet” and “dry” shares. “Wet” shares are backed by production. For every kg of milk produced, you need to own 1 wet share and so if you increase production you buy wet shares. “Dry” shares do not need to be backed by production but can only be bought by farmers, **Fonterra** or market makers. Up to 25% of the wet shares and 100% of dry shares can be converted into units of the Fonterra Shareholders Fund (FSF) which is the entity which we own units in. These can be thought of as non-voting shares. **Fonterra** targets a size of between 7% and 12% of shares on issue and it cannot exceed 20% of shares on issue. **Fonterra** can buy back shares or change the transfer limit.

Valuation

The stock trades on 10x earnings and a 7% dividend yield. Even if 100% of business was commodity milk production, this would be a very attractive multiple. But, given that half of their earnings come from higher margin, faster growth segment, we believe the stock should trade at a mid-teens multiple. Sum of the parts multiples which adjust for the fact that their international farming operations are currently loss making, suggests a price target of more than $10 compared the current share price of under $6. Book value is just under $5 and so the business is well supported by asset valuation.

Exited Positions

- **Premium Leisure**
  Following a visit to the company, we have slightly downgraded our valuation for the company due to lower revenues and also greater competition. As the share price has

performed very well this year on the back of a strong recovery in revenues, we have taken the opportunity to exit the position.

- **Jiangsu Expressway**
  The company reached our valuation target and we do not see any significant upside to that valuation in the medium term.

- **Sun Hung Kai Properties**
  The company approached our valuation target and we decided to exit as the fundamentals for the Hong Kong real estate market remain poor.

- **Credit Analysis & Research**
  The business has not performed as well as we expected and we have decided to exit.

- **IOOF Holdings**
  Our assumptions for the long term growth potential of this position have reduced and our confidence on their ability to maintain margins has also weakened.

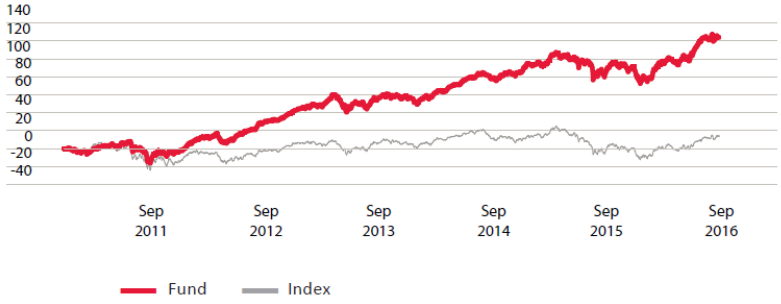
PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 30.09.2016

Class 1*	B USD	Benchmark **
1 Month	0.54	1.81
3 Months	9.44	9.79
YTD	16.41	12.53
2015	3.17	-9.12
2014	16.79	3.09
2013	13.45	3.65
2012	45.77	22.63
Since Launch+	122.75	13.40
Annualised since Inception	14.95	2.21

* 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.

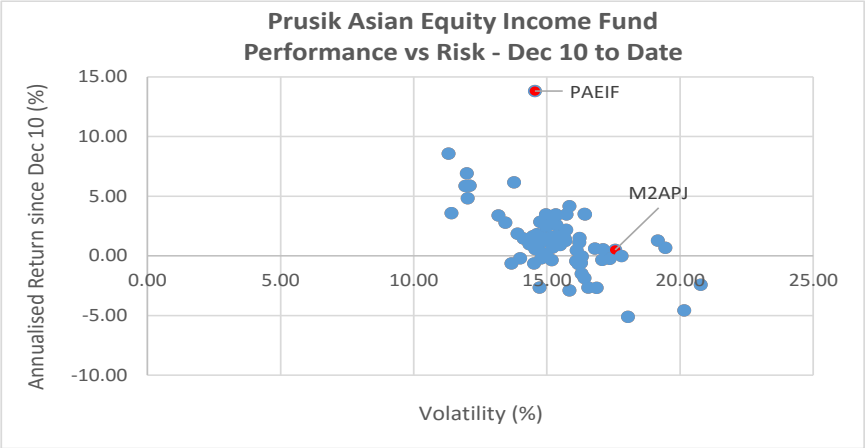
Class 1 B, USD Monthly Performance Summary (%)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
2016	-6.04	-0.37	10.28	0.95	-0.38	2.46	7.56	1.20	0.54				16.41
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)	9.87
Beta	0.78
Alpha (%)	12.35
Volatility (%)	14.39

Source: Morningstar
Since inception: B 31.12.2010



Source: Morningstar

THEMATIC & GEOGRAPHICAL BREAKDOWN

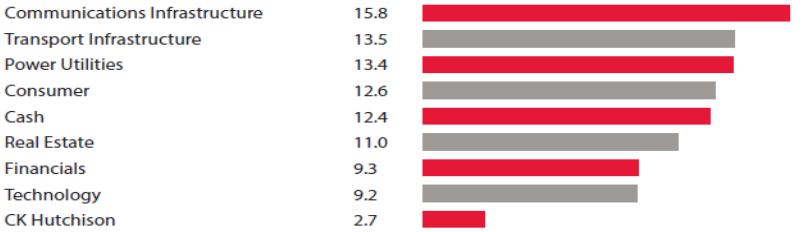
Top 5 Holdings (%)

HKBN LTD	6.8
Samsung Electronics Co Ltd	6.4
Power Grid Corp of India Ltd	4.8
Indiabulls Housing Finance	4.2
Macquarie Korea Infra Fund	4.2
Total Number of Holdings	33

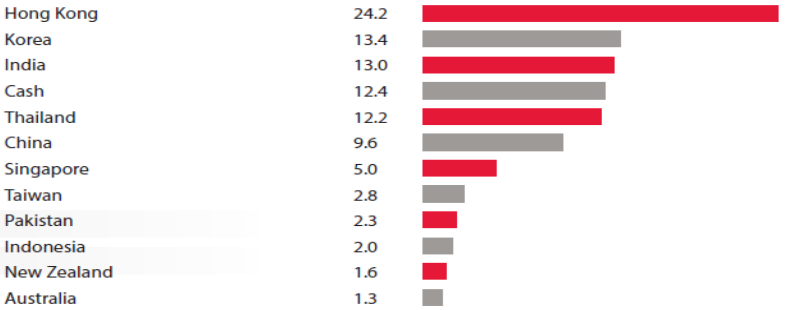
Portfolio Financial Ratios

Predicted Price/Earnings Ratio	12.6x
Predicted Return on Equity (%)	15.2
Predicted Dividend Yield (%)	4.5

Thematic Breakdown (%)



Geographical Breakdown (%)



All data as at 30.09.16. Source: Prusik Investment Management LLP, unless otherwise stated.

FUND PARTICULARS

Fund Facts

Fund Size USD	820.9m
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	229.14
B USD	Unhedged	Distributing	B4QVD94	IE00B4QVD949	176.52
C GBP	Hedged	Distributing	B4Q6DB1	IE00B4Q6DB12	177.66
D SGD	Hedged	Distributing	B4NFJT1	IE00B4NFJT16	171.08

*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	158.01
Y GBP	Hedged	Distributing	B4TRL17	IE00B4TRL175	159.62
Z SGD	Hedged	Distributing	B6WDYZ1	IE00B6WDYZ18	159.04

* 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	153.45

* 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)

Fund Manager

Tom Naughton
Tel: +44 (0)20 7493 1331
Email: tom.naughton@prusikim.com

Sales & Marketing

Mark Dwerryhouse
Tel: +44 (0)20 7297 6854
Mob: +44 (0)7831 856 066
Email: mark.dwerryhouse@prusikim.com

Jack Barham
Tel: +44 (0)20 7297 6858
Fax: +44 (0)20 7493 1770
Email: jack.barham@prusikim.com

Prusik Investment Management LLP
6th Floor
15–16 Brook's Mews
London W1K 4DS

Web: www.prusikim.co.uk
Email: enquiries@prusikim.com