PRUSIK

LONG ONLY ABSOLUTE RETURN INVESTING IN ASIA

Prusik Asian Equity Income Fund

Quarterly Investment Report

28 June 2013

FOR PROFESSIONAL INVESTORS ONLY

2Q 2013 Review and Outlook

The fund returned -1.1% in the second quarter compared to -7.4% return for the market. Although the alpha of the fund was only slightly above average, the raw outperformance was the highest in the life of the fund and it is pleasing to see that the fund has bounced back from the dip in relative performance experienced in 4Q12. Whether this performance is repeatable or not remains to be seen but we are happy to have generated good performance in what was a challenging period for the income fund portfolio. Although we often discuss the disadvantages of running a larger asset base, one of the advantages from a risk perspective is that we now have a smaller percentage of the portfolio in small cap stocks, which helped mitigate the fund's fall in the quarter. If we still had the same portfolio from 12 months ago then the fund would have fallen an additional 150bps in June, largely due to its greater exposure to small cap stocks.

Quarterly Returns for PAEIF and the MSCI Asia Pacific ex-Japan Index (MXAPJ)

	PAEIF	**MXAPJ**	**Outperformance**	**Alpha**[1]
1Q11	-1.7%	2.0%	**-3.7%**	-3.3%
2Q11	+5.9%	+0.1%	**+5.9%**	+5.9%
3Q11	-15.2%	-20.3%	**+5.1%**	+1.1%
4Q11	+8.6%	+4.7%	**+4.0%**	+4.9%
1Q12	+16.6%	+12.5%	**+4.1%**	+6.6%
2Q12	-1.1%	-6.3%	**+5.2%**	+4.0%
3Q12	+15.4%	+9.8%	**+5.6%**	+7.5%
4Q12	+8.6%	+6.2%	**+2.4%**	+3.6%
1Q13	+6.0%	+2.0%	**+4.0%**	+4.4%
2Q13	-1.1%	-7.4%	**+6.3%**	+4.8%
		Average	+3.9%	+4.0%

Source: Bloomberg

Although the consistency of the outperformance is of course pleasing it would be unwise to expect it to continue. Given the tracking error of the fund and the concentrated portfolio that we run, it is virtually certain that we will underperform the market in some of the future quarters.

[1] We have assumed a constant beta of 0.8

Income Fund Bubble

This is a topic we first addressed in the 3Q 2012 report and we think it will continue to be an issue as long as real rates stay at low levels and investors seek income and safety in equity markets. We stand by all of the comments we made in 3Q 2012 and don't think much has changed since then.

However, if there is one part of it that is worth repeating it is this:

"It is important to remember that dividend investing has two aspects – a safety/bond like characteristic and the valuation/contrarian characteristic.

It is important to combine the two as neither aspect works well in isolation all the time. At the moment investors are tending to overpay for obviously safe, secure, high payout ratio stocks; stocks that do not fulfil those criteria trade at much more attractive multiples. We are not looking to buy what the market considers to be safe stocks today, we are looking for what the market will think are safe stocks in several years time. This involves selectively taking on risk but also limits our downside as we are not paying up for security.

Remember we are not trying to buy stocks that people think are safe today. We are looking for stocks where the dividend paying potential is undervalued and underestimated. Once the market "discovers" these stocks they are generally sold and the capital is recycled into better ideas. So there is a natural tendency to avoid owning overvalued stocks built into the process.

The last time I studied this issue the analysis was largely qualitative. This time more analytical rigour has been added to the process and analysis of whether high yield stocks are indeed in a bubble.

First, let's consider what the statement "Asian income stocks are in a bubble" means. Many of the criteria are difficult to measure (e.g. sentiment, leverage) but there is one key criteria for a bubble which we can analyse: valuation. I believe that if Asian income stocks are in a bubble then it is a necessary condition that they are overvalued. So are they?

Valuation

Let us consider how Asian yield stocks are valued compared to the overall market. We have considered all stocks listed in Asia ex-Japan (including Australia but ex-China A shares) that have market caps of more than US$500m.The dividend universe is then defined as the top quartile of this universe when ranked by historic dividend yield. We have looked at the median stock to reduce the impact of outliers. There are 2,054 stocks in the overall universe and 514 stocks in our definition of the dividend universe.

	Dividend Universe Median	Overall Universe Median
Price earnings ratio	13.4x	15.8x
Dividend yield	4.9%	2.5%
Price to book	1.62x	1.81x
Net debt to equity	24%	24%
Return on equity	13.6%	13.3%

Source: Bloomberg

This suggests that dividend stocks are in fact cheaper than the overall universe – trading on average at a 10-15% valuation discount to the average stock and with almost double the dividend yield. The ROE and net debt to equity figures are similar to the overall universe suggesting, on a very simplistic basis, that these stocks are not lower quality.

Historical Analysis

	P/E	Dividend Yield	Price to Book
2013[2]	13.4x	4.9%	1.62x
2012	12.0x	6.2%	1.43x
2011	12.0x	5.2%	1.64x
2010	12.6x	5.2%	1.60x

Source: Bloomberg

This shows that dividend stocks are slightly more expensive than they were a few years ago but not substantially so. There is no obvious evidence of a bubble.

Remember that yield investing is by definition a mean reverting, value biased strategy. It is possible that the reason there is so much panic about high yields stocks is owing to a well known cognitive bias known as the *availability heuristic*[3]. By this we mean the way in which investors remember the obvious examples of overvalued stocks or poor quality IPOs with manufactured yields because they are well publicised and stir up emotions. However, no one talks about the stocks that are unpopular, unloved and trading at high dividend yields because they lack a “story”.

Of course there is an element of truth to the fear that income stocks are too expensive. For instance, there are numerous stocks in the universe which have been bid up by “bond refugees” who only focus on dividend yield and ignore the fundamental valuation metrics. These include companies that

[2] Data as of 30th June each year.

[3] The **availability heuristic** is a mental shortcut that occurs when people make judgments about the probability of events by how easy it is to think of examples (http://en.wikipedia.org/wiki/Availability_heuristic).

operate in industries or countries with low volatility (e.g. the consumer sector or the Australian market), low capital spending requirements and enough visibility to mean that they can operate at high payout ratios. In a market fixated with dividend yield these stocks often trade at very high valuation levels as long as they can generate an attractive dividend yield.

As an exercise we looked at the historical valuations of "quality" stocks in Asia. The table below shows how the top decile of "quality" stocks (defined as those with the least risky operating profit growth over the past 5 years) have been valued on a price to book basis relative to the overall market. **The current premium is a record high 46% compared to an average premium of 26%.** This implies that stocks with low volatility are very expensive compared to history. In absolute terms the valuation of these stocks is also at an all time high[4]. **This would indicate that extreme caution should be taken when buying stocks with low volatility to avoid overpaying.**

Year[5]	Top Decile P/B	Median P/B	Premium
2013	**2.52x**	**1.72x**	**46%**
2012	2.31x	1.61x	43%
2011	2.15x	1.86x	16%
2010	2.35x	1.80x	31%
2009	2.06x	1.56x	32%
2008	2.33x	1.99x	17%
2007	2.72x	2.67x	2%
2006	2.35x	1.83x	28%
2005	2.35x	1.94x	21%
2004	2.05x	1.72x	19%
Average	**2.32x**	**1.87**	**26%**

Source: Bloomberg

Fundamentally we believe that we are still in an uncertain world and that it is important not to be too dogmatic about what will happen to bond yields over the next several years. It is possible that rates stay extremely low (the "Japan scenario") in which case these high quality stocks will trade to even higher valuations. Alternatively, rates could normalise over the next few years back to a 3% Fed fund rate and 5-6% 10 year yields (in line with nominal GDP growth). Equally, rates could spike even higher as inflation fears return. We believe our portfolio needs to be able to cope with any of these scenarios. All we can do is attempt to put together a portfolio which has the best risk / reward

[4] Incidentally, the Chinese banks are all in the top decile as they have had very low volatility in underlying earnings since listing. This goes to show the dangers of relying exclusively on historic financial information in Asia .

[5] Data as of 30th June.

characteristics regardless of where bond yields settle. When the market panics about higher bond yields this means that some of the more "safe" stocks become more attractive again. When the market panics that global growth will collapse and bond yields will head back towards 1-1.5%, it means that some of the more cyclical stocks become attractive.

Changes to the Portfolio

Over the quarter the biggest change has been the increase of the Hong Kong and China portfolios and the decrease of the Korean and Singapore portfolios. This is largely due to the relative performance of those portfolios and markets. The Korean portfolio returned 7.5% during the quarter driven by the strong performance of **Halla Visteon Climate Control** and **SK Telecom** in particular. Although our Hong Kong and China portfolios held up well during the quarter (approximately flat), the Hang Seng Index and Hang Seng H-share Index fell by 6.6% and 14.5%, respectively, which meant that more ideas were appearing in those markets.

China is a market that is under a high degree of stress which is concerning investors. Although in many ways it is an extremely complex situation, it can be simplified into one main issue: debt. China has borrowed too much money in the last several years and there is a high degree of scepticism as to whether this money has been well spent or indeed can be paid back. It is almost certain, and in fact the market arguably appears to be pricing in, that China will undergo some degree of banking crisis over the next several years. The only questions are "when?" and "how much will it cost?"

We have increased our China exposure to 12% of the fund but do not expect it to grow substantially from here. We have a very strict criteria for the type of position we would consider and do not see many more potential candidates that past these tests. Several investors have wondered why we have increased our China exposure given the huge risks that the economy faces. The answer is that many Chinese stocks are trading at levels which already discount a high degree of bearishness about the future path of economic growth and therefore the risk / reward is becoming increasingly attractive.

It is important to note that over the medium term we remain very bearish on some aspects of the Chinese economy including fixed asset investment and resource demand but relatively sanguine about others such as consumer demand. The Chinese economy is making a transition from a high growth, capital intensive, debt driven economy to a low to medium growth, consumer focused, cash return focused economy. Although this transition is unlikely to be painless and there is no guarantee that they will be successful in achieving, it we believe it is not impossible to achieve. China has realised that it has enough capital stock and given the fact that the labour force is no longer growing they are focusing on improving income growth per capita rather than just attempting to create as many jobs as possible. Corporates are now focusing on improving returns on existing capital rather than just adding as much investment as they can afford. The central government is making a concerted effort to reduce pollution, improve the social safety net and make the transition from a poor to a middle income country. Although the transition might be rocky, the ultimate aim is of course extremely sensible. China wants to transition to an economy that can grow at 4-5%, has a reduced dependence on resource availability and can move up the value added curve in terms of economic output.

So which stocks would one want to own in such an environment? Banking, property, cement, resource and many cyclical stocks are unattractive as demand will collapse and debt levels will shrink. Consumer stocks are attractive but they generally trade at high valuation levels. **We believe that core infrastructure stocks in the power, airport, rail and road sectors are attractive** as they have the following characteristics:

- **Relatively non-cyclical demand** so they will not be as affected by the slowdown in growth.
- **High margins** so that even if demand slows, profits should be less affected. On average our portfolio has cash flow margins of 50%.
- **Strong balance sheets** so there is limited need for external financing as the banking sector shrinks.
- **Trading at distressed valuations** so that even if we are wrong our downside is limited.
- **Paying high dividends** as we want to focus on companies that are improving returns on existing capital rather than ploughing more capital into their businesses.

This is by no means a risk free investment. There are indeed several ways in which we may be proved wrong. Some of these include:

- Our holdings may decide to invest money (voluntarily or otherwise) in non-core projects.
- The government may change regulations to socialise the profits of these companies.
- China may have a full scale, disorderly banking crisis in which even the most pessimistic assumptions about demand growth prove to be wildly optimistic.

We can attempt to mitigate these risks by making sure that we, as minority investors, are aligned with the management and the majority owners of the company but we can never eliminate them.

If it is clear that our thesis on China is incorrect then we will aim to reduce our exposure. However, the market bearishness on China is at fairly extreme levels. As long as there is no systemic breakdown in the financial system, which given the fact that China runs large surpluses and has a closed financial system there need not be, then these stocks are very attractive.

We have reduced Korea purely because the stocks are relatively less attractive following their strong performance during the quarter. **Halla Visteon Climate Control** returned 26.9% during the quarter and although the valuation is still attractive the yield is at a level where we struggle to justify keeping it in the fund. The market still does not fully appreciate the impact of its recent acquisition though and we are reluctantly selling the name. **SK Telecom** returned 13% and we have also reduced the position a little, although it is somewhat tactical rather than strategic as we expect to remain in this name for some time to come.

Room for Improvement

The negative contributors were concentrated in our Australian and Indian portfolios. This was partly owing to market movements and partly owing to negative alpha in those markets. **Seven West Media** declined by 16.9% during the quarter owing in part to a sell down from a private equity owner and also because of fears that a slowing economy would crimp TV advertising spend. **Tata Motors** declined by 15.7% with little news but the weakness in the Indian Rupee and generally poor sentiment towards China (its biggest market) may have been the culprits. Although these stocks are amongst the more risky in our portfolio in terms of their economic cyclicality we have not meaningfully changed our position size in either.

Conclusion

We believe that once the current hysteria about tapering ends investors will be faced with the same problem as before, namely, how to preserve the real value of the capital and generate income in the face of very low government bond yields, a weak global economy and a financial system that is still in critical condition with most of the Western world reliant on zero interest rates to survive. Our strategy for selecting stocks is not particularly dependent on any one world view; we need an “all weather” portfolio that is as suited to a robust global economy with higher interest rates as we do to a weak or unstable economy with low rates. We continue to rotate capital as the market shifts to try and ensure that we minimise our risks and maximise our potential return. This will mean that often our portfolio is invested in areas that are unpopular but we believe that we are not exposing the fund to unnecessary risk.

PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 28.06.2013

Class 1*	B USD	C GBP	D SGD	Benchmark **
1 Month	-4.95	-4.85	-5.00	-5.85
3 Months	-1.13	-0.91	-1.09	-7.47
Year to Date	4.95	5.66	5.06	-5.61
2012	45.90	45.34	44.69	22.96
2011	-3.96	-3.60	-6.73	-15.20
Since Launch+	47.06	48.02	41.78	1.19
Annualised since Inception	20.86	21.63	18.94	3.79

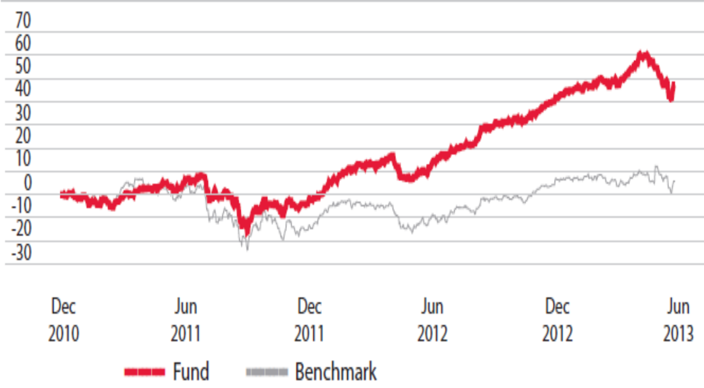
* Class 1 shares were closed to further investment on 30th November 2012
**MSCI Asia Pacific ex Japan
+ Launch date: B 31.12.2010, C 21.01.2011, D 31.12.2010

Performance Summary (%)
Period ending 28.06.2013

Class 2*	X USD	Y GBP	Z SGD	Benchmark
1 Month	-5.0	-4.97	-5.23	-5.85
3 Months	-1.70	-1.78	-1.85	-7.47
Year to date**	3.89	4.25	3.85	-5.61

* Class 2 shares were soft closed to new investors as of 30th November 2012
** Launch Date: 30.03.12
Source: Bloomberg

Fund Performance - Class B USD (%)



Source: Bloomberg. Total return net income reinvested. Since Launch: 31.12.10

Class 1 B, USD Monthly Performance Summary (%)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
2013	3.93	1.78	0.35	4.57	-0.53	-4.95						
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
2011	-2.68	-1.46	2.55	3.90	2.59	-0.60	3.56	-6.06	-12.80	10.62	-3.52	1.79

Class 2 X, USD Monthly Performance Summary (%)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
2012	-	-	-	2.91	-7.94	3.74	6.44	1.64	6.26	1.90	2.70	3.58

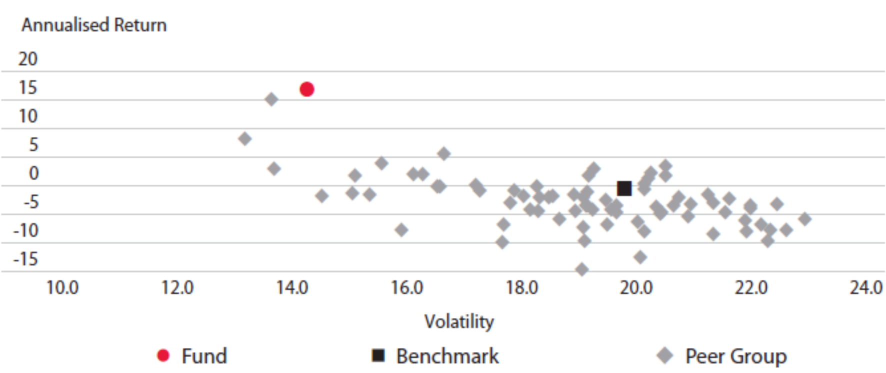
Source: Bloomberg

RISK ANALYSIS

Risk Metrics	Fund (%)
Tracking Error (% pa)	6.79
Beta	0.8
Alpha (%)	17.11
Volatility (%)	14.28

Source: Bloomberg
Since inception: B 31.12.2010

Risk Adjusted Performance - Class B USD (%)



Source: Bloomberg. Annualised return and 1 year volatility versus the peer group (open ended offshore Asia Pacific ex Japan Equity Fund Index), 31.12.10 to 28.06.13

THEMATIC & GEOGRAPHICAL BREAKDOWN

Top 5 Holdings (%)

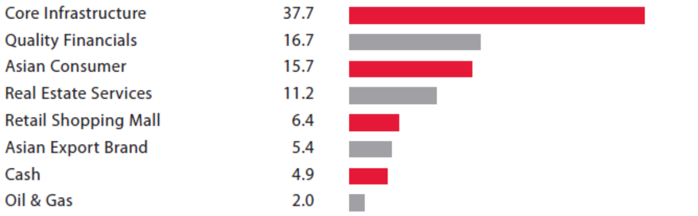
Cheng Kong Holdings	5.1
HSBC Holdings	4.8
Standard Chartered	4.2
Telekomunikasi Indonesia	4.0
SK Telecom Co Ltd	3.7
Total Number of Holdings	46

Portfolio Financial Ratios*

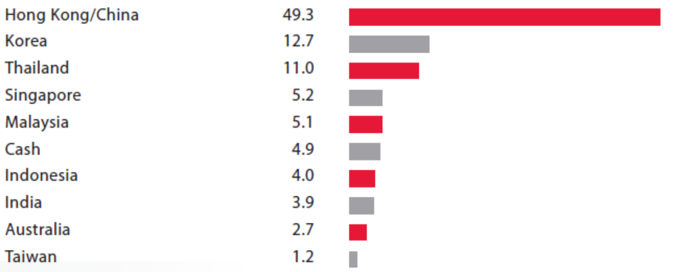
Predicted Price/Earnings Ratio	10.2x
Predicted Return on Equity (%)	16.4
Predicted Dividend Yield (%)	4.8

*Fiscal year periods

Thematic Breakdown (%)



Geographical Breakdown (%)



All data as at 28.06.13. Source: Prusik Investment Management LLP, unless otherwise stated.

FUND PARTICULARS

Fund Facts

Fund Size USD	723.1m
Launch Date	31st December 2010
Fund Structure	UCITS III
Domicile	Dublin
Currencies	USD (base), GDP, SGD

Share Class Details

Class 1*			SEDOL	ISIN	Month end NAV
A USD	Unhedged	Non Distributing	B4MK5Q6	IE00B4MK5Q67	151.14
B USD	Unhedged	Distributing	B4QVD94	IE00B4QVD949	134.41
C GBP	Hedged	Distributing	B4Q6DB1	IE00B4Q6DB12	135.11
D SGD	Hedged	Distributing	B4NFJT1	IE00B4NFJT16	129.38

*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	123.54
Y GBP	Hedged	Distributing	B4TRL17	IE00B4TRL175	124.88
Z SGD	Hedged	Distributing	B6WDYZ1	IE00B6WDYZ18	123.49

* Class 2 shares were soft closed to new investors as of 30th November 2012

Management Fees

Annual Management Fee
1% p.a Paid monthly in arrears

Performance Fee
Class 1: None
Class 2: 10% of the net out-performance of the MSCI Asia Pacific ex Japan Index with a high-water mark.

Dealing

Dealing Line	+353 1 603 6490
Administrator	Brown Brothers Harriman (Dublin)
Dealing Frequency	Daily
Min. Initial Subscription	USD 10,000
Min. Subsequent Subscription	USD 5,000
Subscription Notice	1 Day
Redemption Notice	1 Day

Dividend Dates

Dividends paid twice annually (January and July)

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