PRUSIK

LONG ONLY ABSOLUTE RETURN INVESTING IN ASIA

# Prusik Asian Equity Income Fund

Quarterly Investment Report
31 December 2012

FOR PROFESSIONAL INVESTORS ONLY

**4Q12 Review and Outlook**

The fund rose by 8.6% in the quarter compared to a market rise of 6.1%. The top 3 contributors were **Hite Jinro** (Korean beverage company), **HSBC** (Global bank) and **Macquarie Group** (Australian investment bank and fund manager). The biggest 3 detractors were **Midland Holdings** (Hong Kong estate agency), **Chorus** (New Zealand telecom infrastructure operator) and **PT Telkom** (Indonesian telecoms operator).

2012 was a strong year from a performance perspective with returns aided by a general re-rating of high quality dividend stocks throughout the year. We were also assisted by our structural underweight in cyclicals and overweight in defensives and ASEAN. It is unlikely that those factors will repeat in 2013 and so we would caution that we would not expect our performance this year to come close to that of 2012. However, we still believe our portfolio offers strong valuation upside and steady dividend growth and is substantially less risky than the overall market.

**Fund Size**

Readers will note the significant increase in fund size since the last quarterly report. In this section we aim to explain what we are doing to prevent fund inflows from compromising performance and also the impact of the larger fund size on our portfolio construction.

We have always let investors know that we believe an ideal size for the fund is between US$300m and US$500m. Below that, it would struggle to remain commercially viable, significantly above that, returns would begin to suffer as we would be more restricted in how we could operate. Given the increase in fund size towards the higher end of the range in November, we took the decision to hard close the Class 1 shares and soft close the entire fund to new investors as of 1st December 2012. We are not actively marketing the fund to new investors and are not starting discussions with any investors not already in the fund. We believe that this should go some way towards slowing the rate of inflows. Given that the Class 1 shares are now hard closed to all investors, we would expect a natural decline in the assets from this share class as it is now effectively “redemption only”. In addition we would expect to lose 2-3% of assets each year due to the dividend payments that are not reinvested in the fund. Combined, these will likely add up to outflows in the mid to high single digit range as a percentage of the total fund and will offset some of the inflows into Class 2.

**A Note on Performance**

When we started the fund, we indicated that we aimed to outperform the market by 5-10% a year and generate a total return in the range of 10-15% (or a 10% real return). It is very difficult to make any comments on performance over such a short space of time but clearly our results so far have been ahead of both those targets. What is more important, however, is what we do over the next several years. We would like to reiterate that the performance we saw in 2012 is extremely unlikely to be repeated. The combination of a re-rating period for high quality dividend stocks together with some good recycling of capital led to an unusually high degree of alpha. It is unlikely that we will have the same combination of circumstances and luck going forward. However, this doesn’t mean that we believe we cannot continue to generate outperformance. We believe that outperformance of 5-10% is an appropriate benchmark going forward and we continue to judge ourselves against that. That said, we feel as bullish towards the portfolio at the beginning of 2013 as we did in 2012 and I continue to add to my personal investment in the fund. My exposure to the fund is now such that I can continue to look investors in the eye and say I have "skin in the game" and in addition, as a co-investor, underline my focus is on performance rather than asset gathering.

**Liquidity**

Our primary measure of liquidity risk is to analyse the proportion of the fund that would take more than 3 days and more than 10 days to sell (using 6 month historical data and assuming 50% of that volume is tradable). In the table below we give the target and actual data.

| | **Target** | **Actual** |
|---|---|---|
| ➢ **3 days volume** | <25% | 22.0% |
| ➢ **10 days volume** | Aim for 0% | 1.4% |

So the fund is within the 3 day volume limit and very close to our 10 day volume target. In very rough terms we would be able to liquidate 78% of our fund in 3 days and 98.6% within 2 weeks. We could liquidate just under 50% of the fund in 1 day.

Although liquidity data is notoriously difficult to rely on, we believe that we are not taking on excessive liquidity risk and we are pleased at how we have been able to scale the portfolio whilst not increasing this risk.

**Portfolio Allocation between Small, Mid and Large Cap Stocks**

One of the main reasons that we wanted to keep the fund size at a manageable level is that we want to be able to invest in small and mid cap stocks without compromising our liquidity targets. Implicit in this is that we are able to achieve higher alpha in mid and small cap stocks. It is, therefore, important to analyse the alpha and weightings to judge the impact of a larger fund size on performance.

| | **Dec 2011** | **Mar 2012** | **Jun 2012** | **Sep 2012** | **Dec 2012** |
|---|---|---|---|---|---|
| **Large Cap (>$5bn)** | 30% | 31% | 44% | 47% | 57% |
| **Mid Cap ($2-5bn)** | 22% | 21% | 25% | 21.5% | 20% |
| **Small Cap (<$2bn)** | 48% | 48% | 31% | 31% | 23% |

*PAEIF market cap weightings since Q4 2011 using Bloomberg's mid and small cap definitions*

As can be seen from the table above, we have increased our exposure to large caps from 30% to 57% and decreased our exposure to small caps from 48% to 23%. The mid cap exposure has remained around the same level during this period.

The reason for this increase in large caps is twofold. The first reason is that the larger fund size means we are unable to have the same sized positions in small caps as we did before. This was always part of our expectation for the fund as it grew. The second point is that we also saw more opportunities in large caps versus small caps given the relative price performance and valuations.

Analysing the alpha for Q4 2012 shows some surprising results. As the numbers in the table below show in Q4 2012, we made a higher return in our large cap stocks than small cap stocks. So if anything, our higher weighting in large caps increased rather than decreased returns over that period.

| | |
|---|---|
| **Large Caps** | + 7.6% |
| **Mid Caps** | + 15.6% |
| **Small Caps** | + 4.9% |

*PAEIF Q4 2012 returns for Large, Mid and Small Cap stocks. Source: Bloomberg*

However, over the longer term we would expect small caps to return around 5-10% more than our large and mid-cap exposure. For instance, for every 10% reduction in the small-cap weighting, we would expect to see alpha lowered by 50-100bps at the fund level. That is why we explained that at a fund size of US$50-100m it is possible to achieve 10-15% alpha whereas at a fund size of circa US$500m, 5-10% alpha is more likely.

| | |
|---|---|
| **Large Caps** | + 39.8% |
| **Mid Caps** | + 50.7% |
| **Small Caps** | + 56.7% |

*PAEIF full year 2012 returns for Large, Mid and Small Cap stocks. Source: Bloomberg*

Nothwithstanding small cap stocks generating significant alpha for the fund in 2012, even if we had invested 100% of the fund in our large cap portfolio we would still have returned almost 40% in 2012. The important difference between our large cap portfolio and other traditional long only funds is that we run a very concentrated portfolio invested in our best ideas rather than just owning well known names. For example, we own only one large cap stock in Singapore and only two in Thailand. By being selective we aim to ensure that we can differentiate ourselves from the market. Although we believe that there is always likely to be more inefficiently priced stocks in the small and mid-cap market, there will be mispricings in the large-cap sector too. At the moment, we have very high conviction in our larger holdings and would not be surprised to see higher alpha being generated from them in 2013.

Over the medium term we don't have a fixed target for the percentage split between large-cap and mid/small cap stocks but we broadly expect about a 50/50 mix between the two. Assuming our estimates for alpha are correct, a 50/50 mix between large-cap and mid/small cap stocks would mean a 100-200bps lower alpha compared to the 30/70 mix we had in 2012 when then smaller fund size allowed it. To reiterate, this is in line with our expectations.

**Portfolio Positioning for 2013**

As usual, we don't construct a portfolio with any particular scenario in mind. We want a portfolio that will be both defensive in a bear market but has enough valuation upside and free optionality that it can produce attractive returns in a more buoyant market. The perfect environment for the fund tends to be range-bound or trending markets. Very severe market declines do not suit the fund owing to its mid and small cap exposure, which is often hit hard by market dislocations. Although we would likely outperform the market in such an environment, our beta to the market has historically been a little higher than average. Equally, very strong bull markets (moving more than 5-10% a month, 15-20% a quarter or 25-30% a year) do not suit the fund as we simply do not have enough upside beta to participate.

We can examine the current portfolio positioning in a little more detail. This of course can change over the course of the year but to start with we have the following exposure:

**15-20% of the fund is in Telecoms Operators**. It is important to note that we do not have exposure to the expensive markets of Thailand, Singapore, Taiwan and Malaysia. Our exposure is to the cheaper markets in Hong Kong, Korea and Indonesia and all of our stocks trade well below the Asian average. On average, our stocks in this sector trade on 12.7x earnings, 1.4x price to book and a 5.4% dividend yield. This compares to a sector average of 15.5x earnings, 2.9x price to book and a 5.1% dividend yield. Of particular note here are the Korean telecoms stocks which comprise almost 8% of our fund. Given the extreme value in this sector and lack of investor interest in the stocks, companies like **SK Telecom** trade at less than 3.0x EV/EBITDA despite dominating the sector and facing the prospect of booming free cash flow and rising ARPUs. The stock trades at book value compared to **Advanced Info Services** in Thailand which trades at 17x price to book. **SK Telecom's** market capitalisation is US$12bn and it has revenues of U$15bn. **Advanced Info Services** has a market capitalisation of US$20bn and revenues of US$4bn. **Advanced Info Services** has been a firm favourite of investors for many years due to their strong track record in returning cash to shareholders but at some point they will have to invest in their network. **SK Telecom**, on the other hand, has arguably over invested, having almost fully built out its 4G network, but equally this means that it will soon have nothing more to spend money on. This is very different to **Advanced Info** who has yet to start building its 3G network! This of course vastly simplifies a much more complicated argument but sometimes it is important to look at what "might" happen. If **SK Telecom** achieved **Advanced Info Services's** EBITDA margin and rating, the stock price could appreciate by 500-600%!

**20% of the fund is in high quality Banks**. This is all in the large multinational Hong Kong banks (**HSBC** and **Standard Chartered**) and Thailand (**Bangkok Bank**, **Bank of Ayudhya** and **TISCO**). We continue to have zero exposure to banks in China, Australia, Malaysia, Singapore, India, Indonesia, Philippines, Taiwan or Korea where we view the risk reward profile to be either moderately or extremely unattractive. Importantly, it follows that the portfolio's exposure to high quality banks is very concentrated. Valuations in this sector have increased in the last 6 months but are still good value in our view. **HSBC** and **Standard Chartered** will benefit from the pickup in trade and general lending growth throughout the region. The Thai banks offer a unique combination of high levels of profitability (ROE in the mid to high teens), high loan growth (10-15% as the Thai economy accelerates) and low valuations (<1.5x book value and low double digit P/E multiples).

**8% of the fund in Auto and Auto Component Companies**. We have two relatively new positions in the sector – both the preference shares of **Hyundai Motor** and **Tata Motors**. **Tata Motors** is particularly interesting as most of its value is due to its ownership of Jaguar Land Rover. Jaguar is performing exceptionally well at the moment – particularly in China – and has a net cash balance sheet and high levels of profitability. As it is a European car brand owned by an Indian company it trades at a very low valuation reflecting the fact that no one that wants to invest in a European car brand looks at India and no one that wants to invest in an Indian company wants European exposure. Therefore, one can buy exposure to one of the strongest brands in the world at an extremely cheap price (4x March 2014 earnings).

**9% of the fund in Toll Road Operators**. High margins, monopoly businesses, some inflation protection and trading at extremely cheap valuations.

**3-4% of the fund in Malaysian Lottery Operators**. The Malaysian lottery business is a classic stable, cash generative business with a regulatory risk attached. The business is low growth but might benefit from hikes in the minimum wage rate if some of this additional pay is spent on lottery tickets. The cash flows are fixed by the government and the company constantly has to deal with the usual pressure of a government operating in a Muslim country which has to justify why it allows "gambling" to occur. The answer of course is that otherwise gambling takes place in the black market where the government cannot control it and does not gain any revenue from it. So the Malaysian government continues to have this uneasy truce with the lottery operators. Both of the listed operators, **Berjaya Sports Toto** and **Multi-Purpose Holdings**, are seeking to spin off their gaming divisions which we believe will highlight the value in this sector and lead to special dividends being paid in 2013.

Overall, we are very comfortable with the fund in terms of valuation, risk profile and upside potential. It does continue to get harder to find attractive replacement candidates for our portfolio but we have extremely rigorous criteria and so that is perhaps because we are too demanding.

**Turnover**

Although we have designed an investment process that should not experience high turnover we don't actively seek to achieve a certain level of turnover. All other things being equal, lower turnover is better and generally translates into better investment performance; however, if we are able to take advantage of market moves to recycle capital from positions that have become less attractive into those that are more attractive then we will do so. It is not something that we can control as we merely look at the risk reward profile of the fund and each position and decide whether we should make any changes. In very rough terms, this turnover created another 1000bps of return in 2012 and so we believe it makes sense to continue with this strategy. However, we are certainly from the school of thought that higher turnover equals lower investment performance and so would review this process if we fail to see higher turnover leading to strong investment performance.

**Risks**

**Corporate bond yields.** We are very nervous about the flows into corporate bonds in Asia and the increasing risk tolerance of investors in this market. However, we continue to follow the process outlined in our 3Q12 report to try and deal with these issues.

**Real bond yields**. As touched on in previous reports, very low real bond yields are a key part of our argument for a weighting in high quality, high dividend equities. We don't think that the argument for being invested here is weakened if real yields move back up into the 0-1% range (from -1 to 0%) but we think that if real yields begin to move towards 2-3% then the undervaluation argument disappears. However, if this occurs because global growth has recovered then we believe the fund will not suffer a de-rating. If it occurs without a recovery in global growth then it is possible that the outcome may not be as positive. However, given that most people (including us) believe that real bond yields cannot remain this low it is worth thinking about what would happen if they did. If real yields remained negative for a 5 or 10 year period then we believe the prices we pay today for our stocks should be substantially higher to reflect the growth.

**Cyclical recovery leading to a de-rating of high yield stocks**. If there is a substantial recovery in regional and global economic growth it is possible that some dividend stocks will lose some of their premium rating as investors are no longer as keen to pay up for safety. This does have the potential to hit some of our holdings but we aim to minimize this risk by rotating out of stocks that become too expensive and into those with lower downside risk. This is evident to some extent in the P/E rating of our portfolio and the fact that, outside the REIT sector, we only own 2 stocks that trade at more than 15x earnings.

## PORTFOLIO PERFORMANCE

**Performance Summary (%)**
**Period ending 31.12.2012**

| Class 1* | USD | GBP | SGD | Benchmark ** |
|---|---|---|---|---|
| 1 Month | 3.63 | 3.54 | 3.61 | 3.09 |
| 3 Months | 8.57 | 8.52 | 8.48 | 6.09 |
| Year to Date | 45.90 | 45.34 | 44.69 | 22.96 |
| 2012 | 45.90 | 45.34 | 44.69 | 22.96 |
| 2011 | -3.96 | -3.60 | -6.73 | -15.20 |
| Since Launch+ | 40.13 | 40.10 | 34.95 | 4.25 |
| Annualised since Inception | 18.35 | 18.93 | 16.15 | 2.10 |

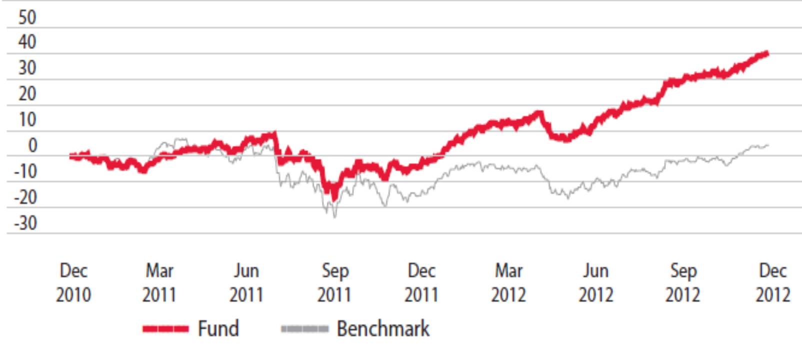
* Class 1 shares were closed to further investment on 30th November 2012
**MSCI Asia Pacific ex Japan
\+ Launch date: B 31.12.2010, C 21.01.2011, D 31.12.2010

**Performance Summary (%)**
**Period ending 31.12.2012**

| Class 2* | USD | GBP | SGD | Benchmark |
|---|---|---|---|---|
| 1 Month | 3.58 | 3.51 | 3.61 | 3.09 |
| 3 Months | 8.40 | 8.63 | 8.19 | 6.09 |
| Year to date** | 22.48 | 23.17 | 22.60 | 22.96 |

* 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 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 |

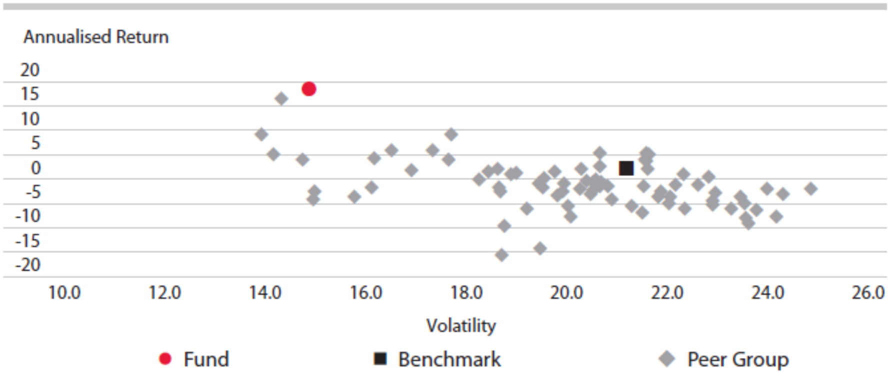
Source: Bloomberg

## RISK ANALYSIS

| Risk Metrics | Fund (%) |
|---|---|
| Tracking Error (% pa) | 7.4 |
| Beta | 0.8 |
| Alpha (%) | 16.7 |
| Volatility (%) | 14.9 |

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 31.12.12

## THEMATIC & GEOGRAPHICAL BREAKDOWN

### Top 5 Holdings (%)

| | |
|---|---|
| HSBC Holdings | 4.9 |
| KT&G | 4.5 |
| SK Telecom Co Ltd | 4.1 |
| Hutchison Whampoa Ltd | 4.0 |
| Telekomunikasi Indonesia | 3.8 |
| Total Number of Holdings | 41 |

### Portfolio Financial Ratios*

| | |
|---|---|
| Predicted Price/Earnings Ratio | 10.9x |
| Predicted Return on Equity (%) | 16.3 |
| Predicted Dividend Yield (%) | 4.7 |

*Fiscal year periods

### Thematic Breakdown (%)

| | |
|---|---|
| Core Infrastructure | 42.9 |
| Quality Financials | 18.2 |
| Asian Consumer | 11.1 |
| Real Estate Services | 7.8 |
| Asian Export Brand | 7.4 |
| Retail Shopping Mall | 5.2 |
| Niche Tech | 4.6 |
| Cash | 2.9 |

### Geographical Breakdown (%)

| | |
|---|---|
| Hong Kong/China | 39.8 |
| Korea | 17.5 |
| Thailand | 16.5 |
| Singapore | 8.6 |
| Taiwan | 4.6 |
| Malaysia | 3.9 |
| Indonesia | 3.8 |
| Cash | 2.9 |
| India | 2.4 |
| Australia | 0.0 |
| New Zealand | 0.0 |

All data as at 31.12.12. Source: Prusik Investment Management LLP, unless otherwise stated.

## FUND PARTICULARS

### Fund Facts

| | |
|---|---|
| Fund Size USD | 524.3m |
| 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 | 144.01 |
| B USD | Unhedged | Distributing | B4QVD94 | IE00B4QVD949 | 130.69 |
| C GBP | Hedged | Distributing | B4Q6DB1 | IE00B4Q6DB12 | 130.46 |
| D SGD | Hedged | Distributing | B4NFJT1 | IE00B4NFJT16 | 125.64 |

*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 | 122.21 |
| Y GBP | Hedged | Distributing | B4TRL17 | IE00B4TRL175 | 123.13 |
| Z SGD | Hedged | Distributing | B6WDYZ1 | IE00B6WDYZ18 | 121.80 |

* 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)

## Fund Manager

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