PRUSIK

LONG ONLY ABSOLUTE RETURN INVESTING IN ASIA

Prusik Asian Equity Income Fund

Quarterly Investment Report
28 September 2012

FOR PROFESSIONAL INVESTORS ONLY

3Q12 Review and Outlook

The fund returned 15.7% in the quarter compared to a market return of 10%. Significant contributors during the quarter were **SK Telecom**, **Bangkok Expressway** and **TISCO Financial**. The biggest negative contributors were **Kangwon Land**, **Jiangsu Expressway** and **Hutchison Telecom**, although these three stocks detracted less than 50bps in total. It is worth noting that our relatively strong outperformance in 3Q12 (and this year) has come more from a lack of negative contributors than owning a large number of very high return stocks – only 4 of our positions returned more than 25% in the third quarter and so our outperformance was largely generated by our lack of losing positions. Broadly, we believe this lack of losing positions derives from the following factors:

- A focus on selecting stocks that operate in low risk areas (consumer, utilities) where downside risks are less common
- The desire to buy stocks that are trading as close as possible to “recession” or “worst case” valuation measures
- A focus on analysing the downside risk to every position
- The very low levels of financial risk for our holdings due to excess cash positions and moderate levels of debt
- An aversion to paying high P/E multiples for any stock regardless of how good it is
- Luck

The last point is important because while we have not had many positions “go wrong” so far, it would be foolish to assume that, over time, we will be able to avoid losses in all of our holdings as nothing we do is risk free. We are always making a judgement between risk and reward and from time to time this judgement will be incorrect. However, as long as we remember to follow the first 5 points, we minimise our reliance on the final one to help us prevent permanent loss of capital.

Our move into Korea proved profitable, leading to an 18.5% return on capital on the funds invested there, despite the market marginally underperforming the region in the quarter. The decision to allocate more capital to Korea was not due to any top down view (the macro economic situation there could euphemistically be described as “challenging”) but because we happened to find a handful of stocks with extremely strong risk/reward characteristics and little, if any, economic cyclicality. Singapore, Thailand, Taiwan and Hong Kong all produced returns on capital in excess of 15%. China, although a small weighting, is still a region where we struggle to generate alpha – this quarter we produced a negative return of capital of 5.0%. Improving our performance in China is a key area of focus for 2013. If there is a serious dislocation in the Chinese market it is possible that our allocation there might increase and it is imperative that we have the tools to be able to take advantage of that.

Is there a bubble in income stocks?

The short answer to the question is “Unlikely”. The longer answer is that there are some signs of a bubble emerging but not enough to mean that it is unattractive to invest. In fact for existing investors or for those who invest in the near to mid-term the formation of a bubble could be very positive. At present it is still possible to buy stocks at reasonable valuation levels without sacrificing the quality of those investments. From here we think there is possibility that as the demand for secure, real income streams increases the prices of our portfolio may well be bid up to excessively high levels, which would clearly benefit those already invested in the fund. Where the potential challenge comes is if this process of the portfolio being bid up happens very quickly. In that scenario valuations could force us to choose between either buying lower quality stocks and maintaining the yield or maintaining the quality of the portfolio and accepting a lower yield. Our intention would be to choose the latter option and accept a slightly lower dividend yield but with the security of knowing we are more likely to receive it.The question though is how to judge when that balance between risk and return is no longer in our favour. What are the signs of a bubble?

Greater Fool Theory: “It’s expensive but some other idiot will buy it from me at a higher price”

I do not believe that we have got to that stage. Investors seem to be buying yield stocks as an alternative to bonds rather than equities. They do not seem to be expecting to make a short term capital gain but would rather make a riskier 10-15% in a high dividend stock than buy a 10 year bond at 1.5% yield.

Herding: “Everyone else is buying yield, if I don’t I’ll get sacked”

This is certainly a factor and I would concede that this is occurring. Although the funds being run with an income focus on Asia are still small, there is clearly a move by the investment community to look for safe, quality yield stocks.

Overconfidence: “I’ll get out before the bubble ends”

I think this is also occurring in some cases. Investors are using lower and lower risk premiums and presuming (correctly in my view) that long term real rates will remain low for the next 12-24 months

Moral Hazard: “If there is a correction, the Fed will print more money”

I think to an extent this is occurring. Certainly, if the Fed’s aim is to push investors down the risk curve, it seems to be working. It is difficult to see the Fed risking a depression until growth is substantially stronger than it is today.

Leverage: “Why make 1x when I can leverage at zero cost and make 2x?”

I don’t think this is occurring in equities yet although it is clearly happening in corporate bonds with private banks in Asia aggressively promoting the leveraging of bond positions given the availability of cheap credit. A sudden rise in interest rates would certainly cause some market dislocations in this area.

Uncertainty: “The revenues for this company could grow 10x in the next 5 years”

There is a limit to how undervalued or overvalued dividend stocks can become as the range of potential valuations is more limited. Whereas a new internet stock has a small probability of becoming the next **Google** or **Facebook**, buying shares in a mature tobacco company is quite the opposite. It has a large chance of being a similarly sized tobacco stock in 5 to 10 years time and a small chance of being a lot smaller (possible if tobacco smoking is made illegal or reduces to near zero). So the only thing that investors can play around with is the discount rate. Should one discount the earnings by 15%/10%/5%/2%? This lessens the opportunity for significant overvaluation or bubble valuations given that it is difficult to create a scenario in which a tobacco stock is worth 30x earnings.

New valuation techniques: e.g. EV/Subscriber, Price/Sales etc

Bubbles are often formed when investors decide to value securities in a new way which often lacks, to put it mildly, a theoretically sound basis. EV/Subscriber for telecoms, EV/population, Price/Sales etc. I don't think this has occurred in dividend stocks yet but I do think that investors are placing too much emphasis on what the dividend yield is and not enough on what the intrinsic value of the entire company is.

Valuation: Stocks tend to be expensive at the peak of a bubble

To get a proper bubble it is necessary to get prices divorced from reality. Currently, PAEIF trades at a market multiple despite better growth, higher yield and higher margins. This does not suggest that we are paying a premium for safety - quite the reverse**. In fact, if PAEIF is in bubble territory, it will be the first ever bubble to peak out at 12x earnings and a 5.0% dividend yield!** I don't think our holdings will ever get to the Nasdaq range of 30-40x earnings (although it's possible) but until they get to 16-18x earnings, I don't think they are overvalued.

It is important to remember that dividend investing has two aspects –a safety/bond like characteristic and the valuation/contrarian characteristic. In dividend investing it is important to combine the two aspects as neither works well in isolation all the time. At present investors are tending to overpay for obviously safe, secure, high payout ratio stocks meaning that 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 those that 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.

Finally, it is worth thinking about how we would invest if this was indeed a bubble. What would be a sensible process to avoid losing too much money if/when the bubble deflated? Our thoughts would be:

- Pay as little as possible for assets
- Don't focus on areas that others are focused on
- Be very sceptical
- Rotate out of stocks that get popular and into unpopular ones even if that means leaving some upside on the table
- Be wary of stocks that have performed very well (up more than 50% in a year)
- Watch out for over-leverage – both at the asset level and investor level
- Worry about "safe" stocks – don't overpay for safety
- Be quick to admit mistakes

In practice, we in fact adhere to these principles already and believe that this approach will help us outperform if there is a significant move out of high yield stocks in the event of a bubble deflating or for any other reason.

One area of concern is the REIT sector. We feel there is a high degree of complacency in this sector, plenty of security issuance and stocks have already performed very well. So are they a sell? Well, let's take a look at the facts. Our best performing position in the sector this year is a suburban shopping mall owner in Hong Kong called **Fortune REIT**. The company has increased dividends by 29% so far this year due to strong rental reversions, although most analysts would assume real rental growth of close to zero going forward (5% nominal). It has a market capitalisation of US$1.3bn, net debt of US$550m and generates net cash flows before interest payments of approximately US$100m/year. In other words, the de-geared investment return is approximately 5.4%. Private market transactions in this sector are taking place at a cap rate of 3.5% which explains why the stock still trades at a 25% discount to its stated NAV. Given 10 year bond yields in Hong Kong of 0.8% and inflation of 4-5%, real yields are about -400bps a year. In that regard, a real yield of 5.5% is relatively attractive even allowing for depreciation and tenant credit risk. The fact that the assets are changing hands in the private market at even higher prices provides further comfort. So even though **Fortune REIT** is up by more than 50%, we struggle to see a huge degree of overvaluation here given there is almost a 1000bps yield spread versus real bond yields.

Portfolio Turnover

Although we do not control portfolio turnover, the investment process was designed to minimise the changes required. However, over the past 12 months, the turnover has been relatively high – out of the portfolio we owned a year ago, two thirds has been sold and replaced by other positions. Investors have asked us why that is and whether we expect it to continue. The reason it has been high is because the volatility of the past 12 months has allowed us to take advantage of the swings in sentiment to optimise the portfolio positioning. Also, because the search for yield is slowly but surely reaching the Asian equity markets, several of our positions were bid up to a level where the risk return profile was no longer attractive even though they were by no means poor investments at those levels. However, it is important to analyse whether the higher turnover has led to higher returns given the extra costs incurred. One simple way of testing this (suggested by our analyst, Anna Gallagher) is to calculate what the performance of the fund would have been over the past year had we simply decided not to trade at all and compare it to the actual fund performance.

	Performance from 30th September 2011 to 30th September 2012
MXAPJ	+21.1%
"30th Sep 2011 portfolio"	+32.4% (+11.3% outperformance)
PAEIF	+46.0% (+24.9% outperformance)

As can be seen from the table above, the portfolio we owned on 30th September 2011 would have outperformed the market by 11.3% over the past year (perhaps some comfort for those that worry about fund managers getting hit by buses) but PAEIF actually generated 24.9% outperformance, demonstrating that the higher portfolio turnover has significantly added to returns. In fact, the difference on a like for like basis would have been even greater as PAEIF returns are shown net of all fees whereas the “30th September 2011” portfolio is shown gross of fees.

Portfolio positioning

If there was one simple way of describing the changes in the portfolio over the past year it would be “sold consumer, bought banks”. Due to the significant increases in valuations over this period, several of our consumer companies have been sold including **Nagacorp**, **Merida**, **Major Cineplex**, **Thai Beverage**, **Guinness Anchor**, **TVB**, **BEC World** as their valuations reached levels where the risk reward no longer justified holding the positions (although we still believe they will provide good, if less spectacular, returns over the next several years). In their place we have purchased or increased positions in several high quality banks including **Tisco Financial**, **Bangkok Bank**, **Public Bank**, **HSBC** and **Standard Chartered**. Banks have not had a particularly good time of things over the past few years but, as a result, valuations are extremely attractive. Given that even a comparatively strong bank like **HSBC** cut dividends by almost 50% in 2009 and needed a rights issue it might be surprising to learn that **Bangkok Bank** actually maintained its dividend at THB3/share during the Lehman’s crisis, has since increased it each year and paid a THB6/share dividend in 2011 – double the rate of 3 years earlier. This is an important example to highlight as **HSBC**’s problems were caused by the supposedly low risk markets of the US and Europe whereas **Bangkok Bank**, which operates in a market commonly viewed as high risk. This invites the question, is Asia more or less risky than developed markets? Yet, **Bangkok Bank** still trades on 9.5x 2013e earnings, 1.4x book value and is expected to generate a 4.1% yield. Even if the stock is not re-rated upwards we believe that the stock will generate attractive returns and the downside is limited due to the rock solid balance sheet.

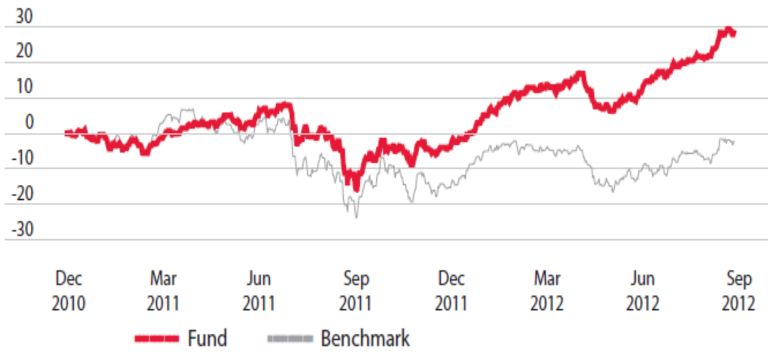
PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 28.09.2012

Class 1*	USD	GBP	SGD	Benchmark **
1 Month	6.36	6.13	6.23	5.96
3 Months	15.68	15.23	15.39	9.87
Year to Date	34.38	33.93	33.37	15.90
2011	-3.96	-3.60	-6.73	-15.20
Since Launch+	29.06	29.10	24.40	-1.73
Annualised since Inception	15.74	16.34	13.33	-1.00

* Class 1 is closed to new investors
**MSCI Asia Pacific ex Japan
+ Launch date: B 31.12.2010, C 21.01.2011, D 31.12.2010

Fund Performance - Class B USD (%)



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

Performance Summary (%)
Period ending 28.09.2012

Class 2	USD	GBP	SGD	Benchmark
1 Month	6.26	6.05	6.04	5.96
3 Months	14.96	14.58	14.64	9.87

Launch Date: 30.03.12
Source: Bloomberg

Class 1 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			
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 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			

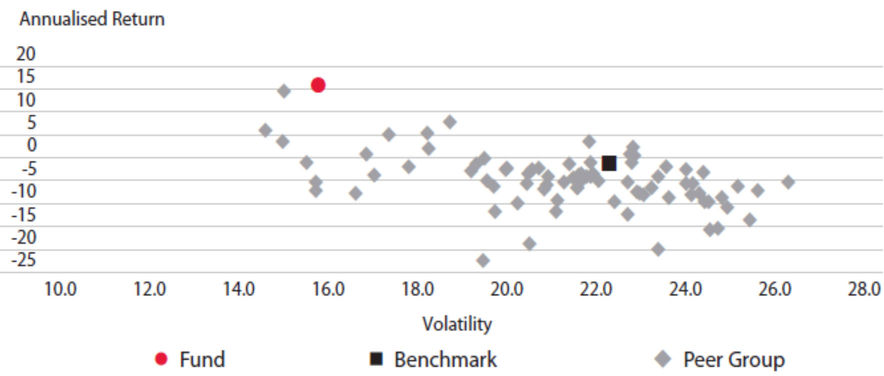
Source: Bloomberg

RISK ANALYSIS

Risk Metrics	Fund (%)
Tracking Error (% pa)	8.0
Beta	0.79
Alpha (%)	16.83
Volatility (%)	15.80

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 28.09.12

THEMATIC & GEOGRAPHICAL BREAKDOWN

Top 5 Holdings (%)

Top 5 Holdings (%)	
HSBC Holdings	4.7
PCCW	4.4
Hutchison Whampoa Ltd	4.4
SK Telecom Co Ltd	4.0
Bangkok Bank	3.9
Total Number of Holdings	41

Portfolio Financial Ratios*

Predicted Price/Earnings Ratio	11.6x
Predicted Return on Equity (%)	17.8
Predicted Dividend Yield (%)	5.1

*Fiscal year periods

Thematic Breakdown (%)

Thematic Breakdown (%)	
Core Infrastructure	38.6
Quality Financials	22.1
Asian Consumer	14.6
Real Estate Services	9.8
Retail Shopping Mall	5.7
Cash	4.4
Asian Export Brand	2.4
Niche Tech	2.3

Geographical Breakdown (%)

Geographical Breakdown (%)	
Hong Kong/China	32.6
Korea	18.5
Thailand	15.5
Singapore	9.9
Malaysia	8.2
Cash	4.4
Indonesia	3.1
Australia	2.4
Taiwan	2.3
New Zealand	2.0
Philippines	1.1

All data as at 28.09.12. Source: Prusik Investment Management LLP, unless otherwise stated.

FUND PARTICULARS

Fund Facts

Fund Size USD	213.5m
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	132.64
B USD	Unhedged	Distributing	B4QVD94	IE00B4QVD949	120.37
C GBP	Hedged	Distributing	B4Q6DB1	IE00B4Q6DB12	120.22
D SGD	Hedged	Distributing	B4NFJT1	IE00B4NFJT16	115.82

* Class 1 is closed to new investors

Class 2			SEDOL	ISIN	Month end NAV
X USD	Unhedged	Distributing	B4PYCL9	IE00B4PYCL99	112.73
Y GBP	Hedged	Distributing	B4TRL17	IE00B4TRL175	113.35
Z SGD	Hedged	Distributing	B6WDYZ1	IE00B6WDYZ18	112.57

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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