PRUSIK

LONG ONLY ABSOLUTE RETURN INVESTING IN ASIA

Prusik Asian Equity Income Fund

Quarterly Investment Report
31 December 2019

FOR PROFESSIONAL INVESTORS ONLY

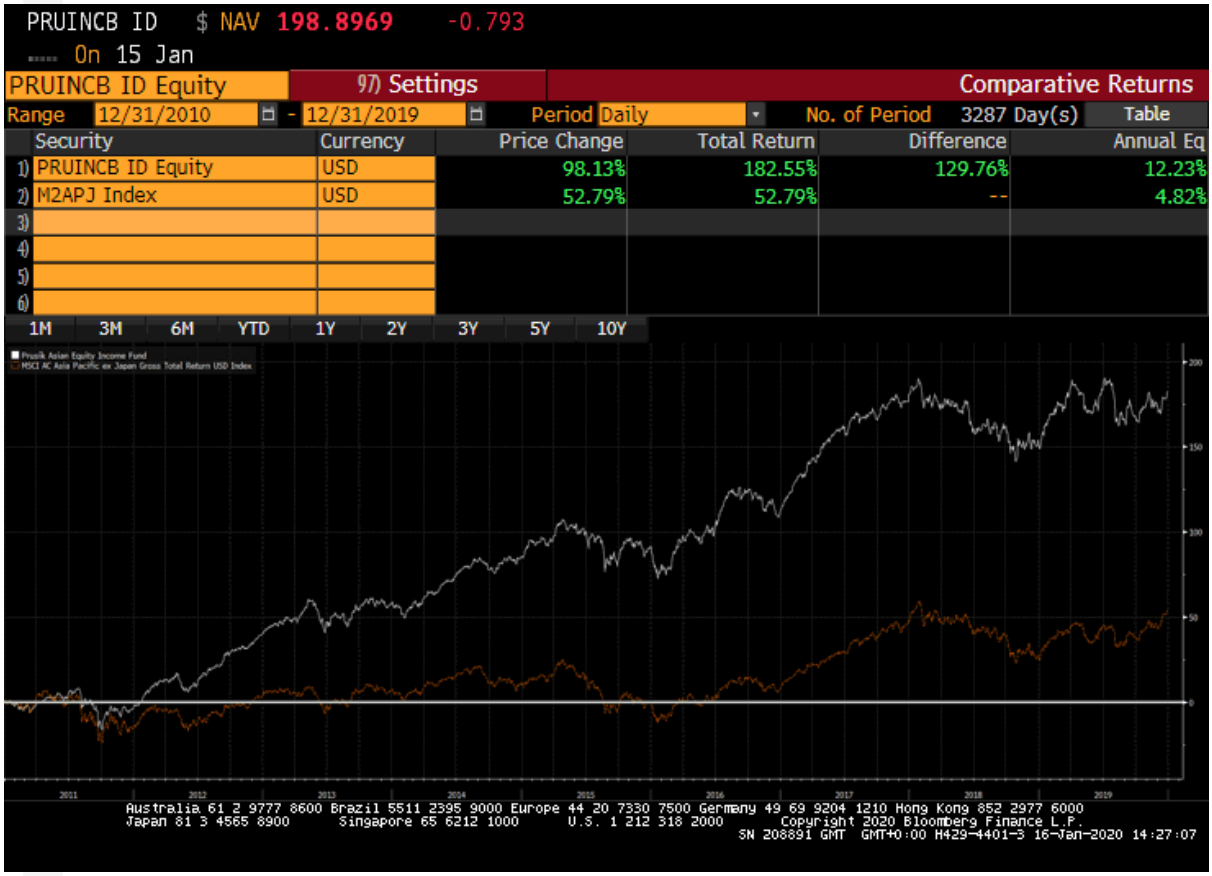
4Q19 Performance Commentary

The fund rose by 5.4% compared to the market which rose by 10.6%. The top 3 contributors to returns were **Samsung Electronics**, **Sarana Menara Nusantara** and **Sands China**. The bottom 3 detractors were **First Pacific**, **Power Grid** and **Metro Pacific**.

For the full year, PAEIF rose by 11.3% compared to the index which returned +19.5%. At the risk of trying to excuse the performance, it is worth noting that if you look at the performance from the end of 3Q18 up to the end of 2019 then the underperformance is <1% (PAEIF + 8.0% vs MXAPJ +8.9%) because PAEIF didn't fall as much at the end of 2018 and thus it didn't bounce as much in 2019.

Source: Bloomberg

Since inception, the fund has compounded at 12.2% a year compared to the index which has returned 4.8%.



Source: Bloomberg

2019 Attribution Analysis

	Avg % Wgt			Contribution			Total Return (%)			Alloc	Selec	Tot Attr
	Port	Bench	+/-	Port	Bench	+/-	Port	Bench	+/-			
South Korea	6.9%	12.0%	-5.1%	3.0%	1.4%	1.6%	44.1%	11.1%	33.0%	25	204	259
Singapore	6.7%	3.2%	3.5%	1.6%	0.5%	1.1%	26.5%	15.7%	10.8%	-28	81	60
Macau	5.8%	0.3%	5.5%	1.5%	0.1%	1.4%	19.7%	24.0%	-4.4%	41	-10	37
Indonesia	6.0%	2.0%	4.0%	0.8%	0.2%	0.6%	13.2%	10.2%	3.1%	-51	17	-17
Thailand	4.2%	2.6%	1.6%	0.4%	0.3%	0.1%	19.4%	10.1%	9.3%	-55	16	-25
Australia	6.3%	16.5%	-10.2%	1.1%	3.6%	-2.4%	14.7%	22.1%	-7.3%	-20	-47	-66
Philippines	3.1%	1.1%	2.0%	-0.7%	0.1%	-0.8%	-20.5%	10.9%	-31.4%	-24	-109	-125
Taiwan	0.0%	10.8%	-10.8%	0.0%	3.7%	-3.7%	0.0%	36.9%	-36.9%	-151	0	-177
India	12.5%	8.5%	4.0%	-0.7%	0.7%	-1.4%	-4.6%	7.9%	-12.4%	-36	-132	-191
China	12.1%	26.9%	-14.8%	2.0%	7.0%	-5.0%	8.5%	26.5%	-17.9%	-52	-222	-276
Hong Kong	31.0%	12.9%	18.1%	1.9%	1.3%	0.5%	5.9%	9.9%	-4.0%	-179	-136	-303
Total										-530	-338	-824

Source: Bloomberg/Prusik

As can be seen from the table above, ranked by total attribution, we underperformed by around 8%[1]. Approximately 5% of that came from country allocation and the remainder from stock selection. The main reasons for the underperformance were:

[1] The attribution analysis is done gross (before fees and transaction costs) and therefore does not correspond directly to the NAV return.

- **Overweighting Hong Kong** (2nd worst performing market) and negative alpha from stock picking due to high weight in conglomerates.
- **Underweighting China** (2nd best performing market) and negative alpha due to a lack of large cap tech exposure (e.g. Alibaba).
- **Zero weight in Taiwan** (Best performing market).
- **Poor stock selection in India and Philippines.**

"Trading"[2] added 400bps to performance this year – largely due to changes made to our India portfolio.

In summary, our tilt towards "value" areas of the market and away from the more glamourous areas of the market (largely technology) proved costly. However, it is worth re-iterating that, although we provide attribution analysis to allow investors to measure us compared to the market, **we don't construct the portfolio with the index in mind.** Our approach is to put together a portfolio of high-quality stocks with limited economic cyclicality that can sustain and grow their dividends over time. We don't think about stocks in terms of whether they are value or growth stocks or whether they will outperform the index over the next 12 months. We concentrate on trying to put together a portfolio of companies which generate and sustain a healthy dividend yield and are likely to grow that dividend by 5-10%/year. Finally, and crucially, we seek to buy companies at a valuation which means our downside risk is limited (if we are wrong) and our upside risk is meaningful (if we are right). By doing this we aim to compound capital at an attractive rate and avoid substantial drawdowns[3]. However, the disadvantage of this strategy is it prevents us from owning popular companies as these often trade at premiums to intrinsic value as investors are willing to overpay to own stocks in fashionable sectors (e.g. technology, healthcare, consumer staples). We also have a different approach to many other "quality" focused investors in that we pay a lot of attention to value. Although it seems that valuation appears to have become irrelevant to many investors, we still believe that, strange as it may sound, it *is* possible to overpay for investments – regardless of how confident one is in the future. As Warren Buffett puts it:

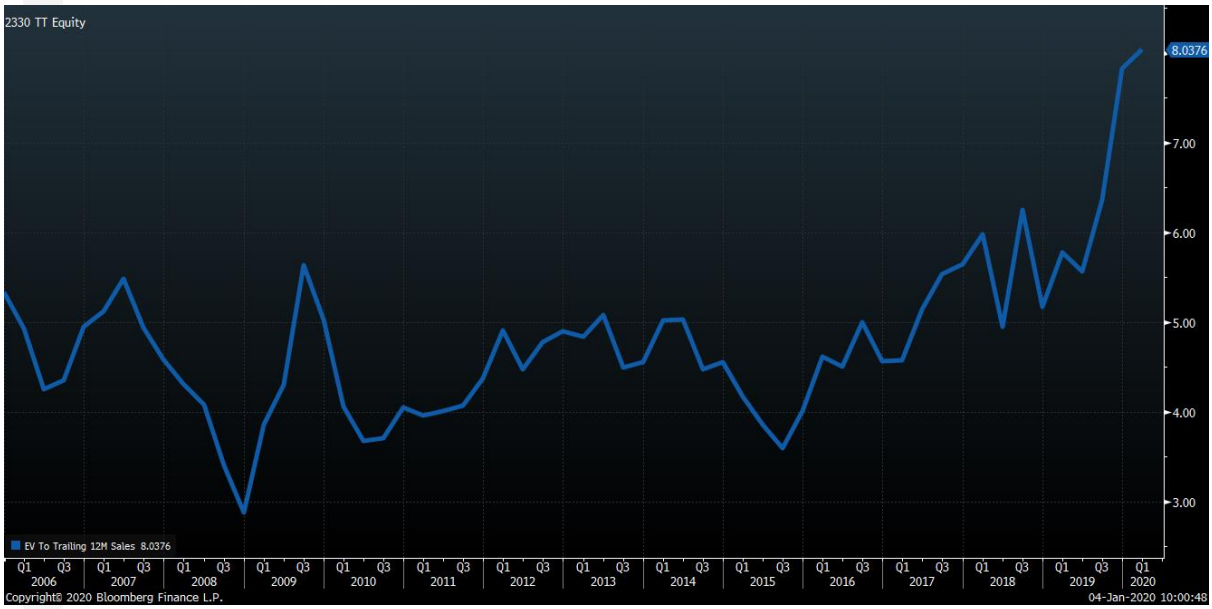
"For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favourable business developments."

Because of our focus on valuation, this means that there are many great businesses which we believe are not attractive investments because they are trading at large premiums to intrinsic valuation which means the upside potential (if we are right) is limited and the downside risk (if we are wrong) is substantial.

For example, below we have included the valuation histories for two popular stocks – TSMC and CSL. Both are very high-quality companies with high returns and excellent growth potential. The only issue is that investors are now willing to pay very high valuations for both companies. In the case of TSMC – 8x sales and in the case of CSL – 10x sales. Although it is not possible to say that valuations cannot go higher, it is perhaps instructive that the last time CSL traded on a similar multiple was during the 1999/2000 bubble.

[2] Each year we look at what the performance of the fund would have been if we'd made no changes to the fund and compare that to the actual performance. On average, we have added 300bps annually by our changes to the portfolio.
[3] Of course, we can't guarantee either but we can improve our odds by focusing on sustainability of companies' earnings, balance sheet risk, valuation risk, diversification of risk and so on.

TSMC EV/Sales



Source: Bloomberg

CSL EV/Sales

Source: Bloomberg

Re-Rating

One of the key reasons for our underperformance in 2019 which isn't covered in the attribution analysis above was that the market saw a dramatic re-rating during 2019**. Even though forward earnings estimates fell by 5%, the market P/E increased by 22%. In contrast, our portfolio saw the median P/E fall by 8% even though the average earnings estimate increased by 2%[4].** There is no one reason that we can find for this de-rating, as the reasons are generally specific to the company, for

[4] We use the portfolio at the end of the year so we did not necessarily own every stock for the entire period.

example **Swire Pacific** (Hong Kong protests), **Metro Pacific** (concerns over the regulatory environment), **Scentre Group** (fears over e-commerce).

Interestingly, the stocks that de-rated most significantly during 2019 were also those that saw the best growth in fundamentals (earnings estimates[5]).

	P/E Dec 18	P/E Jan 20	Change in P/E	Change in forward EPS
Average PAEIF holding	**11.3**	**10.4**	**-8%**	**+2%**
MXAPJ	**11.6**	**14.2**	**+22%**	**-5%**
Positions >2% of NAV which de-rated in 2019				
CK Hutchison	6.9	6.9	0%	-2%
Travelsky	17.6x	17.6x	0%	-2%
Zhejiang Expressway	7.4	7.3	-2%	+9%
Scentre Group	15.7	15.3	-3%	-1%
Jasmine Broadband	10.1	9.2	-9%	+10%
Swire Pacific	11.1	9.2	-18%	+6%
Power Grid	10.6	8.5	-20%	+22%
Metro Pacific	9.3	6.7	-28%	+2%
ITC Ltd	25.4	17.8	-30%	+20%
Average			**-12%**	**+7%**

Source: Bloomberg/Prusik

The current PAEIF portfolio is also trading at a substantial discount to its 10-year average. On a P/E basis it is trading 15% below its historic average and this increases to a 24% discount on a book value basis.

	DY	Avg DY	Vs avg	PE	Avg P/E	Vs avg	PB	Avg P/B	Vs avg
PAEIF	5.3%	4.2%	+26%	10.5x	12.3x	-15%	1.07x	1.42x	-24%
MXAPJ	2.9%	3.3%	-12%	14.3x	12.4x	+15%	1.58x	1.52x	+4%

Source: Bloomberg/Prusik

This suggests that there is a 30% relative valuation gap between PAEIF and the MXAPJ which is interesting and potentially lucrative (if mean reversion still exists!).

[5] We use forward earnings as a proxy for fundamentals. Although not perfect, it is a reasonable estimate to assume that if earnings estimates increase by 10% over the year that the fundamental valuation has also increased by 10%. It is by no means always the case but it is a relatively good rule of thumb to use.

Hong Kong

The political environment in Hong Kong remains volatile and it is not clear what it will take to resolve the current conflict. I have already written about why I believe Hong Kong is still an attractive investment but, in this quarterly, we will address the subject of how much exposure the fund has to Hong Kong (on an underlying basis) and one of our more exposed stocks, (**Swire Pacific**), in more detail.

PAEIF has approximately 30% of NAV exposed to Hong Kong which can be broken down into 3 broad categories:

- Global/regional companies with minimal exposure to domestic economy (10% of NAV). **CK Hutchison**, **First Pacific** and **CK Infrastructure** have <5% of their earnings derived from Hong Kong. We would not expect these businesses to be affected by the protests.

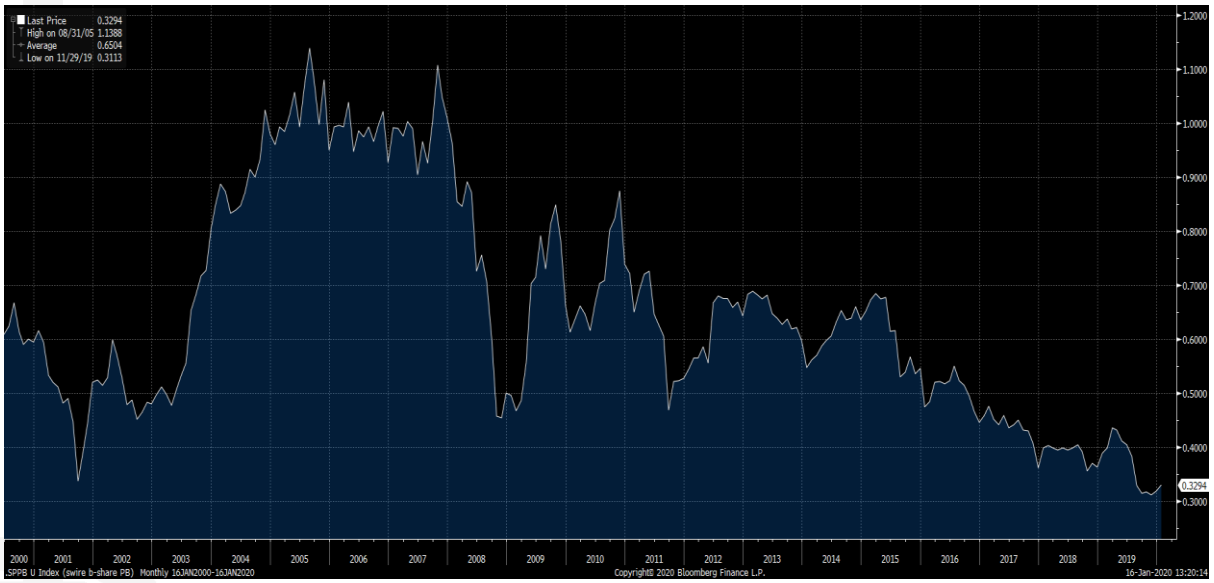
- Non-cyclical Telecom stocks (6% of NAV). **PCCW** and **Hong Kong Broadband Networks** have 100% of their earnings from Hong Kong but are not substantially affected by economic slowdown due to their non-cyclical earnings.

- Insurance and real estate stocks (14% of NAV). **AIA** (25% exposure), **CK Assets** (50%) and **Swire Pacific** (70%) are exposed to the Hong Kong economy. They will benefit if Hong Kong recovers and will suffer if political conditions worsen.

Swire Pacific

Swire Pacific is the one position we own which is substantially exposed to the Hong Kong economy. Although **CK Assets** also has a significant exposure, the management of that company have been diversifying away from Hong Kong (and China) for a decade and will continue to do so for the foreseeable future, meaning that their dependence on Hong Kong will decline over time. **Swire Pacific**, on the other hand, is expanding in both Hong Kong and China and so does not have a "plan B" in case Hong Kong does not recover.

Swire Pacific B-share Price to Book Value



Source: Bloomberg

The first point to make is that the market has already taken a very dim view of **Swire Pacific's** prospects. The chart above shows the Price to Book ratio for the B-shares over the past 2 decades. In contrast to the charts of TSMC and CSL, it is clear that the market is somewhat pessimistic about the outlook. It trades on a similar Price to Book as Deutsche Bank despite having virtually no debt and owning a number of tier 1, fully let properties in Hong Kong and China[6]. But, of course, investors would be right to

[6] Recall that as recently as 18 months ago they were able to sell some non-core assets at *premiums* to book value.

question these valuations as much has changed in Hong Kong over the past year. So below we show a valuation analysis which considers that valuation if things go back to where they were 6 months ago vs. a more pessimistic scenario.

For the base case we use book values to calculate the value of their real estate and airline business. Analyst valuations are above book value but we use the lower value to be conservative[7]. For the other businesses we use a sector P/E multiple of 20x for Beverages and the privatisation price for HAECO. The beverage business is a Coca Cola bottling business that operates in Hong Kong, Taiwan, US and China. HAECO is an aircraft maintenance business which the company took private last year. We deduct debt to arrive at a valuation of HK$36.44/share. **Assuming that the stock trades at a 25% discount to NAV (the long-term average), this would imply upside potential of 134%.** For the pessimistic scenario we assume that the Hong Kong real estate and Cathay Pacific valuations are reduced by 2/3. This is an extremely negative scenario, which I think is very unlikely, but if Hong Kong loses its special status (for whatever reason) and becomes just another province of China then I think it is possible. In that case, the upside potential is still 19%. **Even if we write off the Hong Kong real estate assets completely then the NAV is above the current share price.**

Swire Pacific Valuation

	Base case	*Reduction*	Stressed
	HK$ (bn)		HK$ (bn)
Real Estate (Hong Kong)	173	*-67%*	57
Real Estate (China/other)	61		61
Cathay Pacific	28	*-67%*	9
HAECO	12		12
Beverages	15		15
Other	7		7
Net Debt	- 22		- 22
NAV	274		139
Number of shares	1,502		1,502
NAV/B-share	36.44		18.53
Share Price (31 Dec 19)	11.66		11.66
Discount to NAV	**-68%**		**-37%**
Upside (assuming 25% discount to NAV)	**134%**		**19%**

Source: Bloomberg/Prusik

This demonstrates why we believe that selling **Swire Pacific** at these levels would not be a good idea. Even though it may well take time for the stock to reach our target valuation, in the meantime, we receive a 5.7% dividend yield (covered by an underlying free cash flow yield of 11%).

Current Portfolio

In order to give investors an idea of how the portfolio is currently constructed, we have split it up into 3 new categories. The table below shows the current breakdown.

[7] Our base case assumes that valuations do not fall – this is perhaps optimistic but important to note that the majority of Swire Pacific's assets are located in Island East which is not as economically sensitive as Central.

	% of NAV	Economic Cyclicality	Valuation	Growth rate	Examples
Cheap Infrastructure assets with limited economic cyclicality	50%	Low	Cheap	Medium	CK Hutch, Power Grid, Link Net, Metro Pacific, IRB Invit, PCCW
High quality compounders	30%	Medium	Not-insane	Medium-High	AIA, Samsung Electronics, Wynn Macau, Sands China
High quality stocks with limited growth but trading at distressed valuations	20%	Medium	Distressed	Low	CK Assets, Swire Pacific, OCBC, First Pacific, Cromwell European REIT

Source: Prusik

The largest category is infrastructure. These are owners of infrastructure assets, typically toll roads, ports, power plants and so on. Their operating margins are high (typically 50%) and they have long duration, annuity like earnings which are not overly cyclical. The growth rate tends to be around nominal GDP (5-10%) and valuations are attractive. The key risk that we have to manage and mitigate is a regulatory one. Because the legal and regulatory systems in many Asian markets are not well developed, we have to make a judgement as to how likely it is that the company will not be able to achieve the assumed returns. Expected returns for these stocks are often a roughly equal combination of dividend yield, growth and valuation upside.

The second biggest category we have called high quality compounders. These are companies that have high growth potential (>10%), high return on capital and management that are able to reinvest that capital at an attractive rate. They often have moderate cyclicality although their growth isn't dependent on strong GDP growth. From a valuation perspective they do not look conventionally cheap (on average 15x P/E) however, they do trade below intrinsic value. The dividend yield for this group averages 3.5% and so we expect to make the bulk of our returns from the compounding of growth over the long-term.

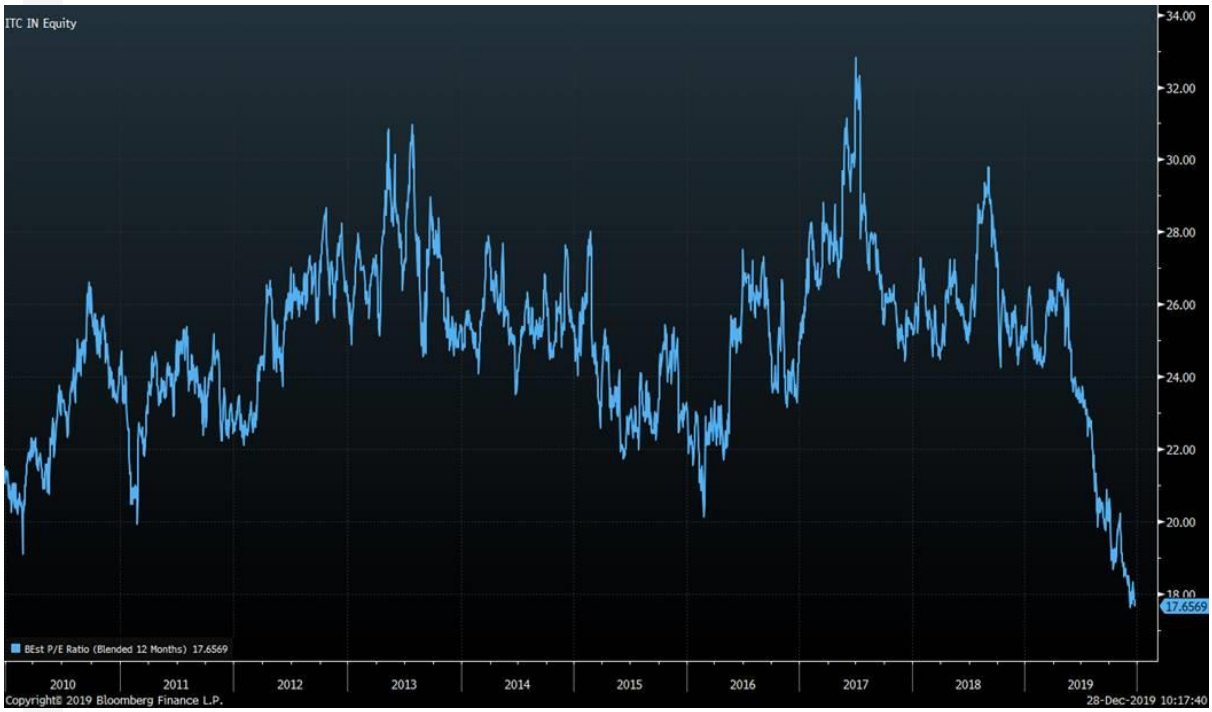
The final group consists of high-quality stocks that are trading at distressed valuations. Although the growth potential for this group is often limited (5%), the upside potential is very significant (e.g. **Swire Pacific**). We would expect to make the bulk of our returns by a valuation re-rating although the combination of dividend yield (5%) and growth (5%) means that even without that they should cover their cost of capital.

New Positions

ITC, 30% owned by British American Tobacco, is India's dominant tobacco company with a 70% market share. It has been investing the free cash flow from this business into other businesses including consumer products and hotels. These businesses have not been significant contributors to profitability up until now because the company has been investing heavily. However, that is likely to change over the next several years as that phase comes to and end and free cash flows increase.

The stock has been de-rated due to the poor growth in cigarette volumes and expectations that tax rates on tobacco will rise sharply. It is now trading 3 standard deviations below its 10-year average P/E ratio and generates a dividend yield of 3.5% which is growing at 10-15% (dividends have grown by 16% a year over the past decade). If margins on its consumer business approach industry levels then this could add 200-300bps annually to growth.

The company has excellent corporate governance (thanks in part due to the BAT shareholding) and has a high ROE and a rock-solid balance sheet. Risks include government tax policy as well as long-term demand for tobacco products.



Source: Bloomberg

Exited Positions

We sold our holding in **Embassy Office Parks REIT** as the valuation had become very expensive post the 50% rally since the April IPO. We also exited **Bangkok Bank** after the company announced it was to acquire an Indonesian bank – an acquisition which we believe has zero strategic value and changes our view on management's ability to allocate capital.

Final Thought

Although we have not changed our investment approach, we can't help but notice that the stocks we like are also stocks that are found in the bottom quintile when ranked by valuation and so our current portfolio has a "value" tilt to it. This is not deliberate however and we take no view on whether value will outperform growth or vice versa – our investment approach is not dependent on either happening**. However, the advantage of having a portfolio that trades at a 30% discount to the market means that If, for whatever reason, "this time isn't different" and markets return to normal then the odds are very much in our favour**.

PORTFOLIO PERFORMANCE

Performance Summary (%)
Period ending 31.12.2019

Class 1*	B-USD	Benchmark**
1 Month	3.19	5.84
3 Months	5.41	10.59
2019	11.26	19.48
2018	-9.52	-13.68
2017	32.79	37.32
2016	10.36	7.06
Since Launch+	182.29	52.79
Annualised Since Inception	12.22	4.82

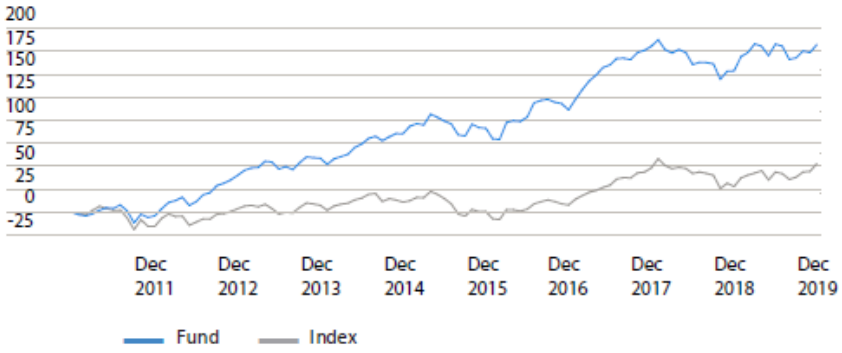
Source: Morningstar

* 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.

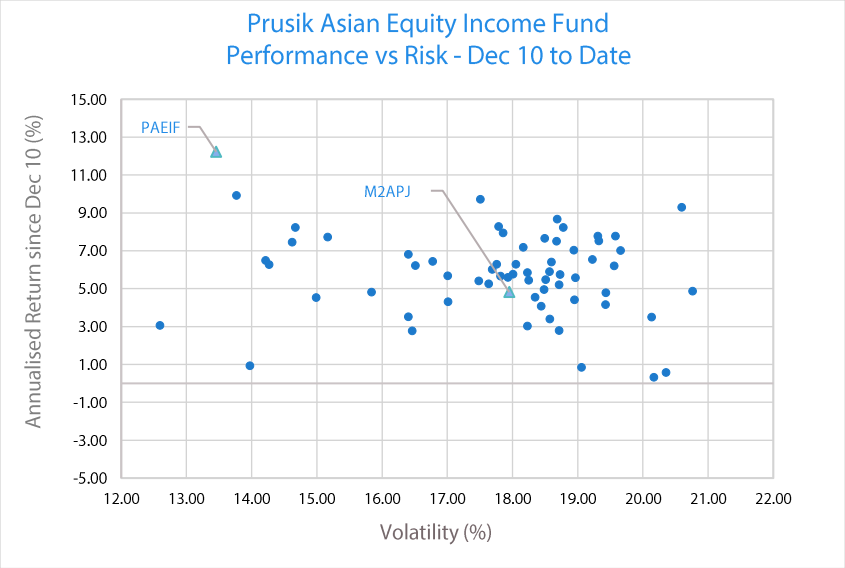
Monthly Performance Summary (%)

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
2019	6.09	1.66	3.47	-0.99	-3.59	4.65	-0.84	-5.11	0.62	2.79	-0.62	3.19	11.26
2018	2.51	-3.76	-1.26	1.34	-1.18	-4.76	0.96	-0.13	-0.52	-6.38	3.49	0.21	-9.52
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 (%)
Beta	0.76
Alpha (%)	7.94
Sharpe Ratio	1.24
Volatility (%)	13.46

Source: Morningstar
Since inception: B 31.12.2010



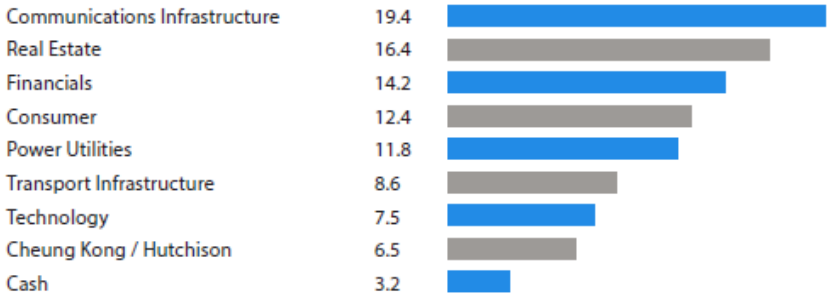
Source: Morningstar

THEMATIC & GEOGRAPHICAL BREAKDOWN

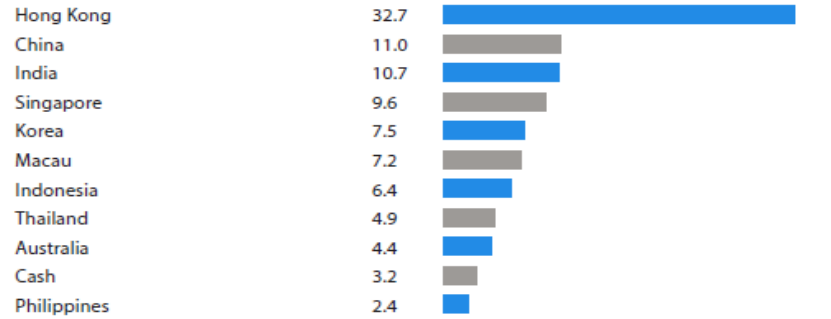
Top 5 Holdings (%)

Samsung Electronics-Pref	7.52
CK Hutchison Holdings Ltd	6.51
Power Grid Corporation of India Ltd	6.18
Zhejiang Expressway Co	5.18
CK Asset Holdings Ltd	5.13
Total Number of Holdings	29

Thematic Breakdown (%)



Geographical Breakdown (%)



Portfolio Financial Ratios*

Predicted Price/Earnings Ratio	10.5x
Predicted Dividend Yield (%)	5.5

All data as at 31.12.2019. Source Prusik Investment Management LLP, unless otherwise stated

FUND PARTICULARS

Fund Facts

Fund Size (USD)	879.53m
Launch Date	31st December 2010
Fund Structure	UCITS III
Domicile	Dublin
Currencies	USD (base), GBP, 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	290.39
B USD	Unhedged	Distributing	B4QVD94	IE00B4QVD949	198.13
C GBP	Hedged	Distributing	B4Q6DB1	IE00B4Q6DB12	187.94
D SGD	Hedged	Distributing	B4NFJT1	IE00B4NFJT16	187.02

*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	177.00
Y GBP	Hedged	Distributing	B4TRL17	IE00B4TRL175	168.36
Z SGD	Hedged	Distributing	B6WDYZ1	IE00B6WDYZ18	173.51

*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	169.30

*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)7891 767 386
Email: mark.dwerryhouse@prusikim.com

Lizzy Irvine
Tel: +44 (0)20 7493 1331
Fax: +44 (0)20 7493 1770
Email: lizzy.irvine@prusikim.com

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

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