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South East Asia – Sector Update

How did Asian equity markets perform in the three months to the end of February 2008?

Despite the superior economic backdrop compared to the US, Asia shares fell as much as US stocks. Earnings growth forecasts have started to come down and Asia now trades on a much more sustainable 12x 2008 earnings.

The S&P/Citi BMI Asia Pacific (excluding Japan) index lost 10.5% while the S&P/Citi BMI Asia Pacific Index, which includes Japan, fell -9.1%. The S&P 500 index reported a return of -9.7% (in US$) in the same period. The worst affected markets were China with the S&P/IFCI China down by 17,1%, followed by Korea (-11.4%) and India (-10.7%). Smaller markets such as Singapore reported -8.6% (S&P/Citi BMI Singapore) and the Philippines -7.6%. The strongest markets were Indonesia (+7.2%), followed by Thailand (+6.8%), Malaysia (+3.6%) and Taiwan (+1.5%). Japan lost -13.3% (S&P Topix 500) (all figures are in US$).

Which S&P rated funds were least and worst affected by the recent global sell off?

In South East Asia (ex Japan), the AAA rated First State Investments - Asia Pacific Leaders Fund, managed by Angus Tulloch and Alistair Thompson only lost -0.9 over the three months to the end of February 2008. They report that performance was helped by the overweight position in gold miner Newcrest Mining (Australia) which performed very strongly as the gold price approached $1000 per ounce. The overweight position in Malaysia was also a significant positive, especially the holding in IOI Corp (consumer staples) which outperformed as the palm oil price continued to rally. Hong Kong & China Gas also performed strongly as investors anticipated robust growth from its businesses in Mainland China.

The worst performer was the AA (New) rated Martin Currie Global Funds - Asia Pacific Fund, run by Jason McCay and Richard Evans, which lost 15.4%.

In the Pacific sector (inc Japan), the AA rated Invesco Perpetual Far Eastern Investment Series - Pacific Fund, which is managed by Stuart Parks, lost (only) 6.6%. Parks reports that the underweight in China, Korea and Australia contributed positively as well as the overweight in consumer staples and the underweight in energy. Stock selection in Hong Kong, Taiwan, India, Australia and Japan was a positive along with holdings in financials and industrials. On the other hand, the overall overweight in financials detracted along with both stock selection in the consumer sector and in China.

Hardest hit was the A rated JF Pacific Smaller Companies Fund (Jeffrey Roskell), which lost 13.2%. (all figures are in US$)

What is the outlook for the Asia ex Japan region?

All managers interviewed expect volatility to continue, but most of them are optimistic for the region on a medium to long term basis, citing strong fundamentals with GDP growth exceeding 6%, sizable trade surpluses, growing domestic consumption and gradually appreciating currencies. These trends support continued strength in corporate earnings, underpinning Asian share prices. However, none of the managers interviewed believe in a complete decoupling effect from the US.

Stuart Parks at Invesco believes that the slowdown in the developed economies will affect Asia mainly through reduced export growth although economic growth will remain good relative to the rest of the world. He continues to be relatively sanguine about prospects for the region on a medium- to long-term view, but expects Asia to outperform if investors become more comfortable that a slowdown in global growth will not extend into a prolonged recession.

The team at Legg Mason believes that Asia ex-Japan continues to offer one of the world's most compelling investment opportunities for long-term investors. Asian economies are developing important internal sources of growth, gradually reducing their dependence on the US and Europe. The managers expect this trend to continue, although the US remains one of the largest markets for Asian exports, and exports still account for more than a third of GDP for China, Taiwan and Korea. In the short term, they are therefore wary of slowing growth in the US and the reduction in global risk appetite.

Suresh Sadasivan of Old Mutual believes that although Asia is more robust, it will still suffer from the US recession. He expects markets to remain volatile and points out that, given the difficult backdrop, good stock fundamentals are no defence in a sell-down.

Jonathan Schiessl at Ashburton notes, that Asia is suffering "collateral damage" from the US and thinks that markets are unlikely to rebound until there is greater clarification of the US situation.

How are fund managers currently positioned?

There was a clear statement from the fund managers, who describe their current approach as defensive with a focus on domestic quality companies. Alistair Thompson at First State Investments limits the exposure to cyclical manufacturing, resource and financial sectors. In addition Sun Hung Kai Properties was sold to reduce exposure to the Hong Kong property sector in light of turmoil in the global credit markets. The proceedings are invested in more domestic orientated companies as witnessed in the purchase of Mahindra & Mahindra, an Indian holding company with dominant market shares in domestic tractor and utility vehicles.

Stuart Parks at Invesco has a similar point of view, focusing on the consumer sector as demographics, high-savings rates and increasing wages are all powerful factors for consumer spending. Parks also has also increased financials' exposure except for banks where he remains heavily underweighted. By contrast, the manager is underweight in some cyclical areas, where global economic headwinds are likely to reduce earnings expectations further. He remains underweight in technology, but is looking for opportunities as the sector has de-rated sharply on global-growth concerns.

Greg Kuhnert at Investec reports that the fund took profits in late cyclical companies at the end of the year when the group's 4Factor process indicated an inflection point towards more domestic orientated plays. Since then, the manager has changed investments into defensive local companies with visible earnings growth and high

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cash flow generation. Preferred areas include local consumption stocks, financials, utilities and toll road companies. Export orientated companies such as technology stocks, and companies exposed to the global economy were trimmed. Examples include shipbuilders, where a large supply is expected in the second half of the year and order books are falling.

Has there been any large redemption in the funds interviewed for this review?

None of the managers we talked to has seen any sizeable redemption. More the opposite seems the case, although inflows are modest. Examples include the A (new) rated Old Mutual Asian Select Fund, the AA rated Investec Asia Ex Japan Fund and the AA rated Legg Mason Global Funds - Batterymarch Pacific Equity Fund.

South East Asia (excluding Japan)

First State Investments - Asia Pacific Leaders Fund, Angus Tulloch, Alistair Thompson, AAA

The fund significantly outperformed the S&P South East Asia sector over both the last three months to the end of February 2008 and 2007 as a whole. It also outpaced its MSCI AC Asia Pacific ex-Japan Index benchmark over both periods. Recent fund performance was helped by the overweight position in gold miner Newcrest Mining (Australia) which performed very strongly as the gold price approached $1000 per ounce. The overweight position in Malaysia was also a significant positive, especially the holding in IOI Corp (consumer staples) which outperformed as the palm oil price continued to rally. Hong Kong & China Gas also performed strongly as investors anticipated robust growth from its businesses in Mainland China. Changes to the portfolio are stock driven. Over the last three months the managers bought Taiwanese technology companies Acer and Mediatek. Acer is a leading IT franchise trading at attractive valuation, while Mediatek has a strong position in optical storage, handset chipsets and digital TV chipsets. They also purchased Mahindra & Mahindra, an Indian holding company with dominant market shares in domestic tractor and utility vehicles. We sold Australian stocks Wesfarmers (consumer staples) on valuation concerns, and AGL Energy (utilities) on worries about the earnings outlook following a management change. Sun Hung Kai Properties was sold to reduce exposure to the Hong Kong property sector in light of turmoil in the global credit markets. The fund remains defensively positioned with a limited exposure to cyclical manufacturing, resource and financial sectors. In China the managers do not expect monetary tightening to be too aggressive because of the weak international environment and the reluctance of the government to cause further weakness in the Mainland markets ahead of the Olympic Games in August. They remain very positive on the long-term outlook for South East Asia as economies are expected to grow at a faster pace than Western ones.

First State Investments - Asia Pacific Fund, Angus Tulloch, Martin Lau, AAA

The fund outperformed the S&P South East Asia sector over both the last three months to the end of February 2008 and 2007 as a whole. It outpaced its MSCI AC Asia Pacific ex-Japan Index benchmark in the first period, but slightly lagged it in the later. Recent fund performance was helped by the overweight position in gold miner Newcrest Mining (Australia) which performed very strongly as the gold price approached $1000 per ounce. The overweight position in Malaysia was also a significant positive, especially the holding in IOI Corp (consumer staples) which outperformed as the palm oil price continued to rally. Hong Kong & China Gas also performed strongly as investors anticipated robust growth from its businesses in Mainland China. Changes to the portfolio are bottom up. Over the last three months the managers bought Indian company Voltas, a Tata Group member focused on electrical contracting (air-conditioning systems installation) with substantial exposure to the Middle East and other international operations. They also bought Allgreen Properties (Singapore) as they are positive on the domestic residential mass property market and Dah Sing Financial, a well managed Hong Kong bank. Advantech (Taiwan, Information Technology) was sold on concerns that its high margins were unsustainable given the negative outlook for global demand. They also sold Australian stocks Wesfarmers (consumer staples) and AGL Energy (utilities).

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Legg Mason Funds - Legg Mason Asia Pacific Fund, team, AA

After a strong performance in 2007, the fund lagged the S&P South East Asia sector in the three months to the end of February 2008. The team at Boston based Legg Mason's Batterymarch subsidiary reports that in the later period the underweight to Malaysia and overweight to South Korea detracted from returns while the overweight in India and underweight in China and Taiwan were positive. Stock selection in India and South Korea was particularly positive.

Despite the recent sell off, the team believes that Asia ex-Japan continues to offer one of the world's most compelling investment opportunities for long-term investors. The fundamentals in Asia remain strong, with GDP growth exceeding 6%, sizable trade surpluses, growing domestic consumption and gradually appreciating currencies. These trends support continued strength in corporate earnings and optimism for Asian share prices. Asian economies are developing important internal sources of growth, gradually reducing their dependence on the US and Europe. The managers expect this trend to continue, as surpluses add to domestic investment and domestic consumption gathers steam. In the short term, however, they are wary of slowing growth in the US and the reduction in global risk appetite. The US remains one of the largest markets for Asian exports, and exports still account for more than a third of GDP for China, Taiwan and Korea. With 2008 an election year in the US, it would expect the Federal Reserve to take meaningful steps to try to lessen the effects of an economic slowdown, which should help the US economy muddle through rather than see a prolonged recession. Such a benign scenario is important for Asia, as it would allow the Asian economies to continue their impressive growth.

The fund size slightly increased to £70m at the end of January 2008.

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Legg Mason Global Funds - Batterymarch Pacific Equity Fund, team, AA

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The fund size increased from US$221m at the end of September 2007 to US$332m at the end of December 2007.

Invesco Asian Equity Fund, Stuart Parks, AA

The fund underperformed the S&P South East Asia sector in 2007 but recovered over the three months to February 2008, placing it in the first quartile. Manager Stuart Parks reports that in terms of asset allocation the underweight in China and Korea contributed positively as well as the overweight in consumer staples and the underweight in energy. Stock selection in Hong Kong, Taiwan and India was a positive along with holdings in financials and industrials. On the other hand, the overall overweight in financials detracted along with both stock selection in the consumer sector and in China. The fund maintains its defensive stance with a focus on the consumer sector as demographics, high-savings rates and increasing wages are all powerful factors for consumer spending. Parks also has also increased the financial exposure except for banks where he remains heavily underweighted. By contrast, the manager is underweight in some cyclical areas, where global economic headwinds are likely to reduce earnings expectations further. He remains underweight in technology, but is looking for opportunities as the sector has de-rated sharply on global-growth concerns. The sector, however, is only likely to perform better if sentiment for global growth improves. The stock markets of India and China still look expensive if earnings continue to disappoint, but Parks is willing to invest in China (currently heavily underweight) and India (neutral) as their markets de-rate. He has also increased exposure to Taiwan (neutral) in the belief that there is an end of interest rate tightening and the KMT party wins the March election. Companies are not perceived as expensive there. He expects to see high volatility in the Asian markets, but continues to be relatively sanguine about prospects for the region on a medium- to long-term view, expecting Asia to outperform if investors become more comfortable that the slowdown in global growth will not extend into a prolonged recession.

Investec Asia Ex Japan Fund, Greg Kuhnert, AA

The fund significantly outperformed the S&P South East Asia sector median in 2007, but underperformed it slightly over the three months to the end of February 2008. Manager Greg Kuhnert reports that the fund took profits in late cyclical companies at the end of the year when the group's 4Factor process indicated an inflection point towards more domestic orientated plays. Since then, the manager has changed investments into defensive local companies with visible earnings growth and high cash flow generation. Preferred areas include local consumption stocks, financials, utilities and toll road companies. Export orientated companies such as technology stocks, and companies exposed to the global economy were trimmed. Examples include shipbuilders, where a large supply is expected in the second half of the year and order books are falling while steel companies were sold on the back of higher input costs. Bottom up stock selection led to an overweight in off benchmark countries such as India (+9% relative to the MSCI AC Far East ex Japan Index benchmark), Malaysia (+5%) and Thailand (+2%) while the underweight in index components Taiwan (-9%) and Korea (-8%) mainly resulted from an underweight in export related technology companies. Hong Kong is overweight (+4%) while China is underweight (-2%).

The manager is cautiously optimistic for the region but shows two scenarios. One is that the global economy falls into worldwide recession, which is, however, not the view of the manager. In this case, Asia is not a favourable place to invest because Kuhnert does not believe in a complete de-coupling effect. The second scenario assumes a recession only in the US, affecting Asia less since rising consumption, boosted infrastructure spending, improving corporate governance and appreciating currencies will support the region. The fund experienced some inflows and assets under management grew to £91m at the end of February 2008.

Investec Global Strategy Fund - Asian Equity Fund, Greg Kuhnert, AA

The fund significantly outperformed the S&P South East Asia sector median in 2007 and was slightly ahead of it over the three months to the end of February 2008. Manager Greg Kuhnert reports that the fund took profits in late cyclical companies at the end of the year when the group's 4Factor process indicated an inflection point towards more domestic orientated plays. Since then, the manager has changed investments into defensive local companies with visible earnings growth and high cash flow generation. Preferred areas include local consumption stocks, financials, utilities and toll road companies. Export orientated companies such as technology stocks, and companies exposed to the global economy were trimmed. Examples include shipbuilders, where a large supply is expected in the second half of the year and order books are falling while steel companies were sold on the back of higher input costs. Bottom up stock selection led to an overweight in off benchmark countries such as India (+9% relative to the MSCI AC Far East ex Japan Index benchmark), Malaysia (+5%) and Thailand (+2%) while the underweight in index components Taiwan (-9%) and Korea (-8%) mainly resulted from an underweight in export related technology companies. Hong Kong is overweight (+4%) while China is underweight (-2%).

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Old Mutual Asian Select Fund, Suresh Sadasivan, A (New)

Manager Suresh Sadasivan reports that over the past few months he has adopted a more defensive strategy. He has reduced China and India in favour of increased exposure to Taiwan and Thailand. In Taiwan, he particularly likes property, given the expectation of further cuts in interest rates. Sadasivan has also added to gold stocks and to Hong Kong utilities. Cash has been raised to 10%.

This defensive strategy has led to continued strong performance relative to the peer group, placing the fund in the top quartile of the S&P South East Asia sector in the three months to the end of February 2008, Sadasivan notes that sector allocation, rather than stock selection, has driven performance. He highlights asset plays in Taiwan, utilities in Hong Kong and resources in Australia as positive contributors to returns.

Sadasivan is bearish on the outlook for equity markets, as the high cash position indicates. He has thought for some time that the US is in recession and this is now the consensus view. Sadasivan does not subscribe to the "de-coupling" theory, believing that although Asia is more robust, it will still suffer from the US recession. He expects markets to remain volatile and points out that, given the difficult backdrop, good stock fundamentals are no defence in a sell-down. The fund has experienced modest net cash inflows.

Waverton Asia Pacific Fund, Alan Gibbs, A (New)

Manager Alan Gibbs reports that in January 2008 for the first time he began to buy some Taiwanese stocks (12%). With the KMT party ruling, this would have a dramatic effect upon the relationship with Mainland China and should impact particularly upon domestic companies - banks, insurances and real estates - which have suffered from the country's isolationist stance. The largest position was bought in Taiwan Fertilizer which is benefiting from a strong agricultural market worldwide and also has a very significant undeveloped land bank in Taipei. The Vietnamese market suffered from a sharply higher declared inflation rate for February of 12% and concern that the government's privatisation programme might be delayed (the fund has a 4% investment there). In Singapore (18% of assets), indications of slower growth and a much quieter property market overshadowed continued good news on order books in the marine and offshore sector. The debate about whether growth in Asia will be affected by Western financial problems still rages and is currently being won by the more bearish elements. Whilst strong commodity prices and shipping rates would appear to indicate that the economy is still in rude health, there is no guarantee that things will not deteriorate as the year progresses.

The fund outperformed the S&P South East Asia sector in 2007 and over the three months to the end of February 2008. Assets under management decreased from US$171m at the end of June 2007 to US$157m at the end of February 2008.