



Stewart Investors Sustainable Funds Group

COVID-19 and Investment returns in Asia

March 2020

This document is a financial promotion for Stewart Investors Asia Pacific Leaders Fund and Stewart Investors Asia Pacific Sustainability Fund for retail and professional clients in the UK and professional investors elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** The Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund.
- **Emerging market risk:** Emerging markets may not provide the same level of investor protection as a developed market; they may involve a higher risk than investing in developed markets.

Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell. Reference to the names of any company is merely to explain the investment strategy and should not be construed as investment advice or a recommendation to invest in any of those companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document Stewart Investors Asia Pacific Leaders Fund and Stewart Investors Asia Pacific Sustainability Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Latest in a long line of market shocks

COVID-19 is the latest in a long line of shocks to hit Asian markets and economies.

Given how benign Asian markets have been over recent years, it's easy to forget just how frequently Asian markets have dropped precipitously over the longer sweep of time.

For example, since 1980 Hong Kong has suffered a steady series of market crashes, many of which have long faded from memory. A few of us were around for the 1983 handover crash in Hong Kong, and the October 1987 collapse when the Hang Seng Index fell over 40%¹ after

¹ See appendix

a combination of debt concerns, financial engineering and imperfect electronic trading systems took the US market down. Less than half of Asia ex Japan's population today had been born by the time Hong Kong collapsed again by over 20% in a single day in 1989 following Tiananmen Square.² Hong Kong went on to have further serious market crashes in 1997, 2000, 2003 and 2008, when it fell by over 50%. Despite these falls, the Hang Seng Index in Hong Kong has managed to return a respectable 11% a year since 1980 for long-term investors.³

Other Asian markets have seen similar, frequent collapses over time. Some have been the result of mistimed or poorly designed government policies. In December 2006, the Thai market fell 16% in a single day following a failed attempt to introduce capital controls to arrest a strengthening currency. Some are the result of a single unanticipated incident, be it a terrorist attack, a sudden escalation in conflict across one of Asia's many contested borders or a market scandal. For example, the Indian stock exchange fell 13% in a day in 1992 following the Harshad Mehta stock exchange scam. These shocks tend to fade from market memories quickly and asset prices often bounce back quickly.

In other cases, Asian market crashes have been the result of a sudden shock that delivers an immediate economic hit as well as exposing more fundamental underlying problems, such as during the Asian Crisis of 1997, the "TMT" (technology, media and telecoms) bubble of 2000 and the 2008 "GFC" (Global Financial Crisis). The same appears to be true with COVID-19. While the immediate origin of the shock is a healthcare crisis that has transferred to an immediate economic crisis following the global "lockdown" response, the crisis has also exposed some of the more serious underlying structural challenges facing Asia today. Or to put it another way, the impact of COVID-19 in Asia is likely to be both short and long-term.

Short-term impacts

Indiscriminate selling

The sharp rise in markets over 2019, the lack of any visibility over the magnitude and duration of the immediate economic shock as governments implement containment strategies and the role of system-wide capital allocation via passive funnels such as ETFs (Exchange traded funds) have all combined to result in a sell-off that has been largely indiscriminate to date. Companies with strong net cash balance sheets have fallen as quickly as those which are heavily indebted. Companies trading on very cheap multiples have fallen as quickly as their eye-wateringly expensive counterparts. To date there has been little differentiation.

With the exception of China

The one major exception to this indiscriminate selling has been in China. Despite being the epicentre of the pandemic, the Chinese market has fallen very little so far. From 1 January to 16 March, the MSCI AC Asia Pacific ex Japan Index fell 22.1%, compared with only 14.9% for

² Source: Stewart Investors

³ Source: © Bloomberg L.P. as at March 2020.

MSCI China⁴ (USD total returns).⁵ On the days that China has fallen, it's been in a surprisingly mild and controlled manner. While it's hard to explain fully this anomaly, it seems likely to be due, in part at least, to China's policy of government intervention in stock markets during times of stress. This intervention has historically included indirect messaging around short-selling and selling as well as the direct buying of equities by the "National Team", a group of financial institutions earmarked by authorities to help support asset prices. Previously the National Team has been made up of local securities companies and banks, who were credited with preventing the 2015 sell-off turn into a full-blown crash. More recently, the Chinese Government has signalled that a group of state-owned insurance companies are ready to play the role of buyer of last resort in the event of a market crash. Given the relative stability of Chinese share prices, it is possible that the National Team has been active over recent weeks. Even if not yet active, the clear presence of the National Team provides markets with an expectation of downside protection, for now at least. Whether direct stock market intervention can be successful for a long period of time is far from clear. The history of currency market interventions is littered with failures as well as the odd success.

Immediate portfolio impact

The immediate portfolio impact of the indiscriminate sell-off and China's relative stability is that our own Asian portfolios have fallen almost as much as the market to date. This is unusual for us, given our focus on investing in good quality companies with strong balance sheets and strong cashflows. Our Asia Pacific Leaders sustainability strategy currently has less than 2% invested directly in Chinese companies, compared with over 35% in Indian-listed companies (by economic exposure it is a different story, with 11% of revenues coming from China and 19% from India).⁶

In addition to our low direct China exposure, our large positions in Indian IT companies Tata Consultancy Services (TCS) and Tech Mahindra have not held up to the extent we would have hoped. These are highly cash generative, net cash companies whose business models are designed to be resilient during times of stress. Indeed, they are usually well placed to benefit during economic slowdowns as companies look to outsource their IT requirements.

Unfortunately, they are also people-orientated businesses. TCS has over 400,000 employees while Tech Mahindra has over 100,000 employees. While both companies have a long history of managing restricted travel movements for their staff – particularly around US visas - the market has for now attached little value to their resilience and both have been sold off in-line with the broader Indian market.

Elsewhere, although the sell-off has been largely indiscriminate as noted above, our large cash positions and consumer exposure in India and Taiwan have helped stem the extent of falls. We also own two leading healthcare companies which are well positioned to contribute directly to tackling COVID-19. Fisher and Paykel Healthcare is a significant manufacturer of intensive care unit ventilators and consumables, while CSL is a global leader in vaccines, including the flu vaccine. Fortunately, both companies have a wonderful, long-term, patient-orientated culture that will not see them exploit the obvious opportunity to put short-term profits ahead of patient and society welfare. Our Indian pharmaceutical companies have also held up reasonably well so far, as have our Japanese holdings.

4 See appendix

5 Source: FactSet

6 Source: Stewart Investors

Until results start to appear

Once companies start to produce their results, we are hopeful that the market will become more discerning. The immediate economic shock to companies as economies shut down will be severe and rapid. The difference between resilient Asian companies with strong cashflows and even stronger balance sheets and those with thin profit margins, unreliable cashflows and onerous debt commitments is likely to become increasingly apparent. Companies which have experienced previous crises have a significant advantage.

It is notable that the rise of debt has left traditionally defensive areas of the market such as telecoms much less safe than usual. For example, Singapore Telecom had a market capitalisation of around US\$30bn in 1997, and a net cash war chest of US\$3bn on its balance sheet. Today, it has a similar market capitalisation, but is carrying over US\$9bn of debt. It is a much less resilient company than it was in 1997⁷. It's a similar story across countries and sectors. Very few telecoms companies or utilities in Asia (or globally) are net cash. The financial engineers squeezed out the telecommunications, water and electricity engineers many years ago.

Debt mindset still prevails

The debt mindset is far from broken across the corporate sector. Debt-financed share buybacks are still happening. Softbank has just announced it will buy back \$5bn of its own shares, despite already sitting on a debt pile of over \$150bn. AT&T announced a \$4bn buyback despite net debt of US\$170bn. The two largest cruise companies were both laden with debt long before COVID-19 first appeared. Carnival Cruises ended 2019 with net debt of US\$11bn and only US\$46m of free cashflows, while Royal Caribbean had US\$11.5bn of net debt with only US\$700m of free cashflows⁸. These are not balance sheets well suited to a cyclical industry vulnerable to significant economic shocks.

While low and falling interest rates may reduce the size of many companies' debt obligations in the short term, for many of these companies disappearing cashflows will far outstrip any benefit from falling rates. Servicing even shrinking interest payments may become too challenging for many.

Currently just over 75% of the non-bank exposure in our Asia Pacific Leaders strategy is in net cash companies and we are hopeful they will be well placed to survive the downturn and thrive on the other side. Historically, many of these companies have taken the opportunity to consolidate their market positions during times of stress.

It's possible that the most vulnerable part of our Asian strategies is our bank holdings, where gearing is by its very nature very high. For our Asia Pacific Leaders strategy, we currently own seven banks – some of them quite small positions. While all of them have survived multiple financial crises and come out stronger the other side, very low interest rates and shrinking net interest margins pose an additional challenge this time as they navigate the financial stress of their borrowers. As a result, we have been trimming our bank exposure over recent weeks.

It is also hard to know whether there is systemic risk still sitting in the financial system. After the Global Financial Crisis fallout and clean-up it would be reasonable to expect not.

⁷ Source: Stewart Investors

⁸ Source: Stewart Investors

However, there are several areas that require close scrutiny over coming months, from the role of synthetic ETFs and over-engineered algorithmic trading to off-balance sheet borrowing and the conventions around the pricing of unlisted assets on corporate and private equity balance sheets.

Country resilience varies

Just like companies, Asian countries vary in their resilience and their choice of responses. China's economy was already slowing fast before COVID-19 hit. Despite a raft of fiscal and monetary stimulus measures, it is likely to experience its worst economic contraction in over 50 years. Chinese share prices do not yet reflect this, for reasons already alluded to.

Elsewhere, the picture is more mixed. India's economy was also struggling pre-COVID-19, yet India, Thailand and the Philippines all spend more than 3% of their GDP (Gross Domestic Profit) importing oil and gas. A falling oil price provides some breathing space for fiscal stimulus for these countries. It is quite possible that economic contractions in Asia will be similar to those felt in 1997/8. Worth noting is the historic resilience of Taiwan which was the only Asian economy not to contract during the Asian crisis. It still remains Asia's most resilient economy today, despite being the only Asian country not to be a member of the World Health Organisation. As a geopolitically isolated country it has learnt the hard way the importance of planning for stormy weather, for example 57% of the largest 100 ex-financial companies in Taiwan are net cash, compared with only 18% in USA.

Where does this leave our Asia Pacific Leaders strategy? We continue to sit tight and wait for buying opportunities although there are now several interesting companies which are approaching levels of extreme undervaluation. Korean banks are a good example. They are priced for bankruptcy and yet the strongest of them is more than capable of making it through this crisis relatively unscathed. Some of the more cyclical companies we own such as Mahindra and Mahindra and Kasikornbank have also reached very attractive valuation levels after significant share price falls. Unfortunately, the long list of Chinese companies sitting on our wish list have yet to fall. As a result, they are all without exception trading on over 40x next year's market forecast earnings. With earnings forecasts likely to be cut for all of them without exception, we are hopeful we will be able to build meaningful long-term positions at prices much lower than those they trade at today. Meanwhile, we must sit and wait.

Longer term

It is impossible to know how long the economic impact of COVID-19 will last. What is clear is that huge adjustments will be required before the underlying economic excesses and imbalances work themselves out. The over-reliance on debt to fund cosmetic growth will take many years to resolve itself.

Localise or diversify supply chains?

COVID-19 has already raised many questions about the design of global supply chains. An overemphasis on efficiency at the expense of resilience has proved unwise. What is not clear is whether the response will be to localise or to diversify across geographies to ensure no overdependence on any one country. The latter is probably an easier option for most companies and certainly the better one for Asia as countries such as Cambodia, Vietnam and Thailand all benefit from a "China plus" approach.

Market intervention or invisible hand?

It's likely that much ink will also be spilt on the topic of market intervention when economic historians look back on recent events. To what extent did the "Greenspan Put"⁹ and "Bernanke Put"¹⁰ and global money printing create more economic pain in the long-run? To what extent is it possible or desirable to underwrite a whole stock market, as China's National Team has sought to do? Or close stock markets altogether in times of stress as the Philippines and Sri Lanka have recently done. Should airlines, aeroplane manufacturers or cruise operators be rescued? Should banks be bailed out again? Should borrowers be bailed out again? How damaging is high frequency trading and does it require more regulation? To what extent should the world continue to tolerate cartels in key markets such as oil? Does the collapse of OPEC (Organization of the Petroleum Exporting Countries) have implications for how societies should choose to limit the market power of internet companies?

Governance

COVID-19 is also posing many questions around governance. Across Asia it is hard to argue that good governance has progressed over recent years, be that at a corporate or a country level. COVID-19 poses significant questions around democracy, transparency and accountability in Asia and beyond. What is the right intersection between public rights and individual rights? The enforced lock-downs get straight to the heart of this particular democratic question. Many parts of Asia have always felt uncomfortable adopting wholesale the perceived "Western" answer to this question. COVID-19 may well help to evolve the Asian democratic model in ways that are hard to envisage right now. It is likely to be a significant moment in the evolution of Asian democracy one way or another. The running battle between "fake news" and "science" is also impacted. For now, it appears as though "science" may get a much-needed renaissance in the role it plays in guiding policy, although it is too early to be sure.

COVID-19 and Sustainable Investment

Finally, much has been made of the climate benefits of the global "lockdown" as flights are cancelled and economic activity curtailed. While carbon emissions may temporarily dip and localisation may reduce embedded carbon in the supply chain, the COVID-19 crisis has arguably made progress on many sustainability issues harder, for now at least. It will be hard to get the attention of management teams to discuss single-use plastic or harmful chemicals for many months. Many good initiatives are likely to lose much-needed momentum. The forthcoming Climate Change Bill being championed by Zali Steggall in Australia has been withdrawn this week. Elsewhere, environmental protections are being identified as obstacles to recovery. China recently relaxed environmental permits for new projects in a bid to kick-start investment again. Hopefully these are temporary set-backs but it is too early to tell. Economic recession is not the solution to Asia's sustainability challenges.

In short, we are still at the beginning of the beginning. These are extraordinary times, but we have been here before. Who would have thought that three million South Koreans would queue up in 1997 to hand over USD2bn worth of their own gold to the Government to help

9 Greenspan Put: A term coined in the late 1990s describing US Federal Reserve chairman Alan Greenspan's loose monetary policy. Throughout this period, Greenspan and the Federal Reserve kept interest rates rather low to encourage growth in the stock markets.

10 Bernanke Put: Similar to "Greenspan Put" however in 2007 and early 2008 the new Federal Reserve Board chairman, Ben Bernanke continued the practice of reducing interest rates to fight market falls.

pay the national debt. The history of Asian markets is full of such extraordinary times. Fortunately, the resilience of good quality Asian companies, and in particular their emphasis on net cash balance sheets, should leave them well placed to weather this storm, just as they have done many times before.

Appendix

Discrete annual index performance	12 months to 29-Feb-16	12 months to 28-Feb-17	12 months to 28-Feb-18	12 months to 28-Feb-19	12 months to 29-Feb-20
MSCI AC Asia Pacific ex-Japan Index (USD)	-20.7	28.3	27.6	-6.8	0.4
MSCI China Index (USD)	-25.5	31.4	47.0	-11.3	3.4
Hang Seng Index (HKD)	-20.3	29.5	34.8	-3.8	-5.4

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than those shown above, the return may increase or decrease as a result of currency fluctuations.

Source: Lipper IM/Stewart Investors, income reinvested gross of tax.

Glossary

ETF (Exchange Traded Fund): a type of investment fund that is traded on a stock exchange and tracks an index.

Net cash: a company's total cash minus total liabilities when discussing financial statements.

Multiple: A multiple measures an aspect of a company's financial well-being, determined by dividing one metric by another metric.

Buybacks: A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market.

Gearing: Gearing shows the extent to which a firm's operations are funded by lenders versus shareholders, or debt versus equity.

Systematic Risk: Risk which affects the overall market, not just a particular stock or industry.

GDP (Gross Domestic Product): the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Synthetic ETFs: A synthetic ETF is an asset designed to replicate the performance of an underlying index using derivatives and swaps rather than physical securities.

Short-selling: The short trader borrows shares from an existing owner through their brokerage account. They will then sell those borrowed shares at the current market price.

Important information

This document has been prepared for informational purposes only and is only intended to provide a summary of the subject matter covered and does not purport to be comprehensive. The views expressed are the views of the writer at the time of issue and may change over time. It does not constitute investment advice and/or a recommendation and should not be used as the basis of any investment decision. This document is not an offer document and does not constitute an offer or invitation or investment recommendation to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any material contained in this document.

This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy, or completeness of the information. We do not accept any liability whatsoever for any loss arising directly or indirectly from any use of this information.

References to “we” or “us” are references to Stewart Investors. Stewart Investors is a trading name of First State Investments (UK) Limited and First State Investments International Limited.

In the UK, issued by First State Investments (UK) Limited which is authorised and regulated by the Financial Conduct Authority (registration number 143359). Registered office Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB number 2294743. Outside the UK within the EEA, this document is issued by First State Investments International Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registered number 122512). Registered office: 23 St. Andrew Square, Edinburgh, EH2 1BB number SCO79063.

Certain funds referred to in this document are identified as sub-funds of First State Investments ICVC, an open ended investment company registered in England and Wales (“OEIC”) or of First State Global Umbrella Fund, an umbrella investment company registered in Ireland (“VCC”). Further information is contained in the Prospectus and Key Investor Information Documents of the OEIC and VCC which are available free of charge by writing to: Client Services, Stewart Investors, 23 St Andrew Square Edinburgh, EH2 1BB or by telephoning 0800 587 4141 between 9am and 5pm Monday to Friday or by visiting www.stewartinvestors.com. Telephone calls with Stewart Investors may be recorded. The distribution or purchase of shares in the funds, or entering into an investment agreement with Stewart Investors may be restricted in certain jurisdictions.

Representative and Paying Agent in Switzerland: The representative and paying agent in Switzerland is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. Place where the relevant documentation may be obtained: The prospectus, key investor information documents (KIIDs), the instrument of incorporation as well as the annual and semi-annual reports may be obtained free of charge from the representative in Switzerland.

First State Investments entities referred to in this document are part of First Sentier Investors a member of MUFG, a global financial group. First Sentier Investors includes a number of entities in different jurisdictions, operating in Australia as First Sentier Investors and as First State Investments elsewhere. MUFG and its subsidiaries do not guarantee the performance of any investment or entity referred to in this document or the repayment of capital. Any investments referred to are not deposits or other liabilities of MUFG or its subsidiaries, and are subject to investment risk including loss of income and capital invested.

The First State Investments logo is a trademark of the Commonwealth Bank of Australia or an affiliate thereof and is used by FSI under licence.

Copyright © (2020) Stewart Investors

All rights reserved.

Contact details

Edinburgh

Stewart Investors

23 St Andrew Square
Edinburgh EH2 1BB
United Kingdom
e. info@stewartinvestors.com
t. +44 (0) 131 473 2900
stewartinvestors.com

London

Stewart Investors

Finsbury Circus House
15 Finsbury Circus
London EC2M 7EB
United Kingdom
e. info@stewartinvestors.com
t. +44 (0) 207 332 6500
stewartinvestors.com

Singapore

Stewart Investors

58 Duxton Road
2nd & 3rd Floor
Singapore 089522
e. info@stewartinvestors.com
t. +65 680 59670
stewartinvestors.com

Sydney

Stewart Investors

Suite 10, Level 3
13 Hickson Road
Dawes Point
Sydney NSW 2000
e. info@stewartinvestors.com
t. +61 2 8274 8000
stewartinvestors.com