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MARKET COMMENTARY

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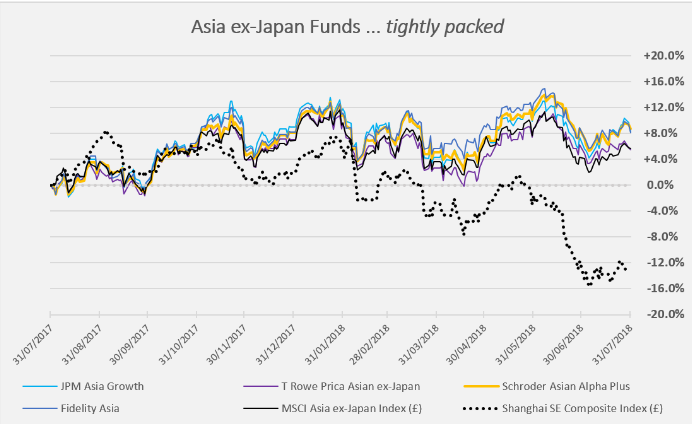
Is It OK To Hug?

July was another good month for equites across the board. The US led the way, with a broad-based move higher, following solid corporate earnings results and positive economic data. Several one-off factors boosted GDP for Q2 to hit an annualised rate of 4.1%, and although this will moderate to 2.9% for the year, according to The Economist it still compares very favourably to the Eurozone on 2.1% and the UK and Japan closer to 1.3%. Indeed GDP numbers for the Eurozone softened slightly in Q2, but with industrial activity still well into expansion territory and trade war fears easing, share prices across the region firmed. Emerging markets bounced back as political worries in South American regions eased and India rallied sharply as fiscal reforms were seen to have a positive effect. Fixed income was uneventful for the most part, although Japanese bond prices went through a tumultuous few days as the BoJ made a hash of explaining the outlook for its quantitative easing policy.

At the time of writing, most of the key stock market indexes across the world are close to hitting new all-time highs, with one major exception – China. It is now in negative territory over one and two years, in stark contrast to most other markets (see back page). There are several reasons for this including a slowdown in the country's growth rate, the rise of the dollar and, more recently, worries over a trade war with the US. This has certainly been a headwind for specialist Asian funds of late and it is creditable that many are in positive territory over the last 12 months. As the chart below shows, China has been a real burden, but what really jumps out is how closely a lot of the funds have performed.



Source: Bloomberg ®, Albert E Sharp

On closer inspection, it comes as little surprise that the dispersion of returns has been so narrow, because they all own so many of the same stocks, as Table 2 overleaf shows. In fact there is significant overlap with the benchmark MSCI Asia ex-Japan Index and Table 1 above shows the top ten constituents.

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Table 1: *MSCI Asia –ex Japan Index Constituents*

Rank	Company	Country	Sector	Weight
1	Tencent	China	IT	5.56%
2	Alibaba	China	IT	4.66%
3	Samsung Electronics	Korea	IT	4.29%
4	Taiwan Semiconductor	Taiwan	IT	4.26%
5	AIA Group	Hong Kong	Financials	2.27%
6	China Construction Bank	China	Financials	1.88%
7	Baidu	China	IT	1.47%
8	China Mobile	China	Telecoms	1.19%
9	ICBC	China	Financials	1.11%
10	Reliance Industries	India	Energy	1.06%
	Total			27.74%

Source: MSCI

Owning very similar holdings to the benchmark, yet claiming to be active, AKA index or benchmark hugging, is anathema to right-minded investment managers. As Mike Turner from Aberdeen Standard Life put it in this very readable note "Benchmark hugging is a cardinal sin of the 'active' investor. This deviant behaviour, especially among professional investors, is driven largely by fear. After all, if you follow your benchmark index at least you can't be sacked for underperforming it.

The sin with this approach is partly that it's lazy and unthinking. It means you are constantly investing only in assets that have done well in the past, rather than those that might do well in the future (stocks only enter indices following good performance and leave after poor)."

The ability to spot expensive trackers and avoid them is one of our key tasks in the fund selection process and an analysis of our portfolios should bear this out. So given that we favour the **Schroder Asian Alpha Plus** and **JPM Asia Growth** funds, is there not an inconsistency here?

The answer is that it might just be - on occasion - that bigger *is* better. The investment cases for all ten of the companies in the MSCI list above are very persuasive in our view. One might argue the point even more strongly now that the tech names have pulled back so much in recent months. (Tencent is 25% below its January peak, Samsung, Alibaba and Baidu 20% below theirs.) If buying the largest companies is the best strategy, then so be it.

The fact that they are the most liquid also matters. If, say, there is a sudden swing in investor optimism towards the region, one can be sure that these top names will be amongst the leading risers, because 'hot money' investors will want confidence that they can get out as easily as they got in.

However, the main reason that we prefer to have active management is the level of market inefficiency prevalent in emerging markets. Going down in size through the index, the amount of information flowing from companies starts to dry up. The value of having a team on the ground, conducting their own research with local knowledge starts to become apparent and the numbers speak for themselves. Over the last 10 years the **Schroders Asian Alpha Plus** fund is up 280%, compared to the index up 185%.

We accept that Schroders is not alone with an impressive team and a good case could be put forward for several others in the area. Investment trusts that are trading on what we see as unjustified discounts to their underlying NAV such as **JPM Asia** and **Schroder Asia Pacific** also look attractive at present.

The main point of this article though is to highlight the importance of how an these vehicles sit alongside emerging markets funds, because the scope for overlap is huge, as shown by the Table 2. Many investors will happily own an Asian fund and an emerging markets fund and rest comfortable in the knowledge that they have prudently diversified their portfolio, yet unwittingly doubled up on some holdings that they have never even heard of.

To be fair this only stems from the fact that there is definitional overlap and Asia comprises about two thirds of the emerging markets, according to MSCI. Very simply, we suspect that many investors may not be aware of this fact and its importance for portfolio construction.

For this reason we highlight the **Guinness Emerging Markets Equity Income** fund as a potential solution. Their approach is distinctly different from its peers, focusing on companies that have a demonstrable track record of delivering consistently high returns on capital. Most tech upstarts cannot demonstrate this and as a result the overlap is minimal. Although the fund is yet to notch up a three year track record, the performance over the last 12 months has been impressive, up 10.0% which compares to **Baillie Gifford Emerging Markets Growth** (+4.9%), **JPM Emerging Markets Equity** (+4.3%) and **Templeton Emerging Markets IT** (+2.7%).

Over the years, we have been big fans of the **Templeton Emerging Markets Investment Trust**, enjoying some excellent returns along the way - the trust more than doubled in the two years to January 2018. More recently, the performance has lagged somewhat, mostly due to a widening discount to its net asset value, following the departure of several key individuals, including legendary investor Mark Mobius. News recently broke that he has set up his own firm and will be launching a new flagship emerging markets fund. We have a meeting planned with his new team early next month and are keen to see if their story offers something new.

Ultimately this discussion is all about unsystematic risk: the amount of risk brought about by having too much money in too few stocks and the solution is diversification. Portfolio managers are paid to identify and deal with it. There is nothing wrong with having a lot of it periodically, so long as it is measured and understood. We just think that a lot of people do not, that's all.

Table 2: *Lots of common holdings across Asian funds*

Rank	Fidelity Asia	Weight	Schroder Asian Alpha Plus	Weight	JPM Asia Growth	Weight	T Rowe Price Asian Opps	Weight
1	Tencent	6.52%	Taiwan Semiconductor	6.75%	Tencent	7.10%	Tencent	5.70%
2	Taiwan Semiconductor	5.91%	Tencent	5.10%	Samsung Electronics	6.90%	Yum China	5.53%
3	Alibaba	5.38%	AIA Group	4.17%	Taiwan Semiconductor	5.90%	Samsung Electronics	5.49%
4	AIA Group	4.87%	Alibaba	3.74%	AIA Group	5.70%	HKT Trust	4.31%
5	Samsung Electronics	4.36%	China Pacific Insurance	3.01%	Alibaba	4.00%	Alibaba	4.13%
6	HDFC Bank	2.92%	HDFC Bank	2.76%	China Construction Bank H	3.90%	Taiwan Semiconductor	3.95%
7	Ind & Comm Bank China	2.25%	Swire Pacific	2.67%	HDFC Bank	3.60%	China Vanke	3.19%
8	Housing Development Finance	2.07%	Swire Properties	2.37%	Shinhan Financial Group	2.40%	Kotak Mahindra Bank	3.08%
9	United Overseas Bank	2.05%	Bangkok Bank	2.36%	Astra International	2.30%	Sun Art Retail Group limited	2.94%
10	Kweichow Moutai	2.02%	Samsung Electronics	2.36%	IndusInd Bank	2.30%	AIA Group	2.79%
Total		0.00%		35.29%	Total	44.10%	Total	41.11%

Table 3: Asia and EM funds overlap … but not Guinness'

Rank	Baillie Gifford Emerging Markets Gr	Weight	JPM Emerging Markets	Weight	Templeton EM IT	Weight	Guinness Emg Mkt Equity Inc	Weight
1	Tencent	6.80%	Tencent	6.20%	Samsung Electronics co ltd	7.93%	B3 SA - Brasil Bolsa Balcao	3.20%
2	Alibaba	5.80%	Alibaba	5.70%	Naspers ltd	6.97%	Porto Seguro	3.20%
3	Samsung Electronics	5.40%	AIA Group	5.10%	Taiwan Semiconductor	5.63%	TATA Consultancy Services	3.10%
4	Taiwan Semiconductor	5.00%	Housing Dev Finance	4.90%	Alibaba	5.04%	British American Tobacco	3.10%
5	CNOOC	4.70%	HDFC Bank	4.50%	Brilliance China Automotive	3.65%	Qualcomm	3.10%
6	Reliance Industries	3.90%	Samsung Electronics	4.30%	Tencent	3.19%	Infosys	3.10%
7	Ping An Insurance	3.90%	Taiwan Semiconductor	4.20%	Compania de Minas Buenaventura	3.09%	Credicorp	3.10%
8	Sberbank	3.80%	Ping An Insurance	4.00%	Unilever	3.03%	Indiabulls Housing Finance	3.00%
9	Norilsk Nickel	2.90%	Sberbank	3.10%	ICICI Bank	2.65%	Coca-Cola Femsa SAB	3.00%
10	Banco Bradesco	2.80%	BID	2.20%	Lukoil	2.49%	Taiwan Semiconductor	3.00%
Total		45.00%		44.20%		43.67%		30.9%

Source: Trustnet; data as of 31st July 2018.

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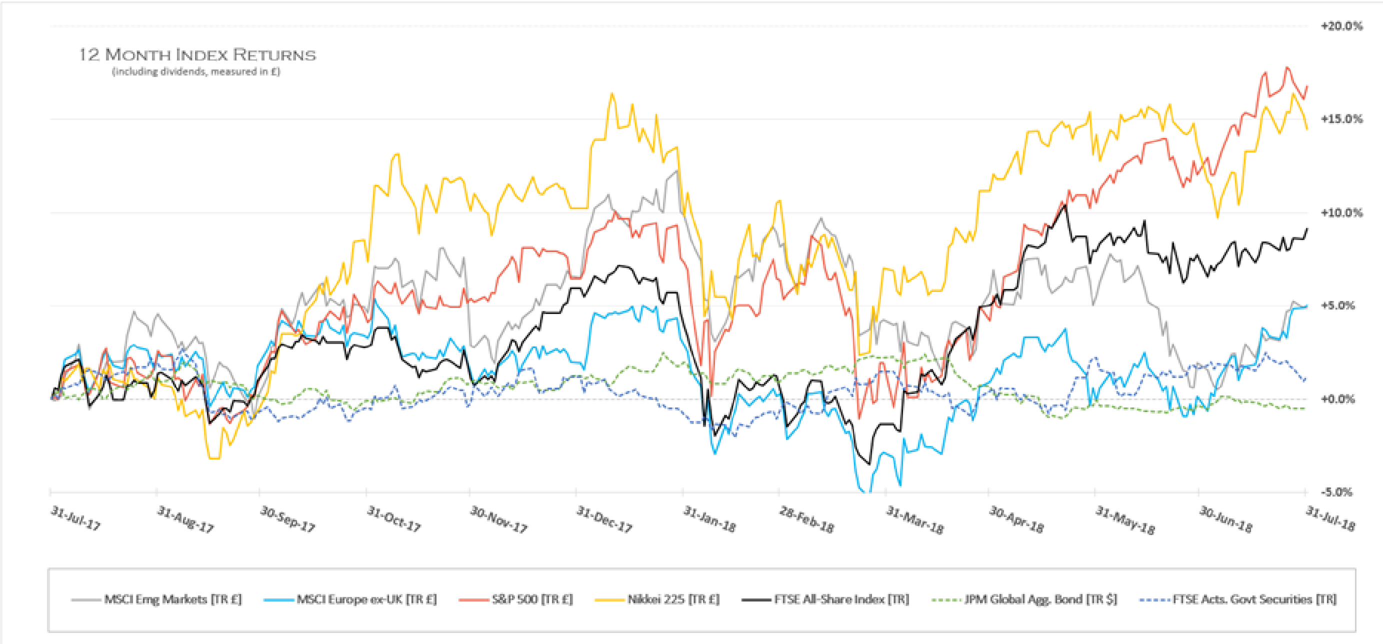
Index Returns

Index	Region/Asset Class	31 Jul 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,748.8	+1.5%	+5.1%	+15.2%
UK Mid Cap	UK	576.9	+0.1%	+4.2%	+12.2%
UK Small Cap	UK	5,880.9	+0.1%	+3.2%	+23.2%
Dow Jones Ind Avg	USA	25,415.2	+4.7%	+16.1%	+37.9%
S&P 500 Index	USA	2,816.3	+3.6%	+14.0%	+29.6%
NASDAQ Comp.	USA	7,671.8	+2.2%	+20.9%	+48.6%
Nikkei 225	Japan	22,553.7	+1.1%	+13.2%	+36.1%
Euro Stoxx 50	Europe	3,525.5	+3.8%	+2.2%	+17.9%
CAC 40 Index	France	5,511.3	+3.5%	+8.2%	+24.1%
DAX Index	Germany	12,805.5	+4.1%	+5.7%	+23.9%
Milan Index	Italy	22,215.7	+2.7%	+3.4%	+31.9%
MSCI Emg Mkts (£)	Emg Mkts	566.5	+2.9%	+4.9%	+31.9%
IBOVESPA Index	Brazil	79,220.4	+8.9%	+20.2%	+38.2%
IMOEX Index	Russia	2,321.1	+1.1%	+20.9%	+19.4%
S&P BSE SENSEX	India	37,606.6	+6.2%	+15.7%	+34.1%
Shanghai SE Comp.	China	2,876.4	+1.0%	-12.1%	-3.5%
Hang Seng	Hong Kong	28,583.0	-1.3%	+4.6%	+30.6%
UK All Property	UK Property	134.1	+0.3%	+6.4%	+15.1%
UK Conv Gilts	UK Gilts	3,591.3	-0.4%	+1.3%	-1.3%
UK Index linked Gilts	UK IL Gilts	4,887.5	+0.5%	+3.6%	+7.7%
JPM Glob Agg. Bond ($)	Global Bonds	560.4	-0.1%	-0.5%	-1.7%
iBoxx Non-Gilt	UK Corp Bonds	336.5	+0.1%	+0.1%	+1.8%
WTI Crude ($/barrel)	Oil	68.8	-7.3%	+37.1%	+65.3%
LMEX	Base Metals	3,044.0	-5.0%	+2.2%	+25.4%
Gold Spot ($/oz)	Commodities	1,224.09	-2.3%	-3.6%	-9.4%
S&P Agri & Livestock	Agriculture	736.63	+1.5%	-8.5%	-10.1%
£1 = US$	Currencies	1.31	-0.6%	-0.7%	-0.8%
£1 = €	Currencies	1.12	-0.7%	+0.6%	-5.2%
£1 = Yen	Currencies	146.78	+0.4%	+0.7%	+8.7%



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