Asia Dragon

DGN offers core exposure to a fast-growing region...

Update
06 April 2022

Overview

Asia Dragon (DGN) is intended to provide core long-term exposure to the exciting growth potential in Asia. Adrian Lim and Pruksa Iamthongthong of the abrdn Asian Equities Team aim to identify high-quality businesses which can grow faster than the market over the long run. Finding growth opportunities is key, but the managers are sensitive to the valuations they buy at. Adrian and Pruksa aim to be long-term in their thinking and have been using the recent volatility in Asia to add to their preferred stocks which have sold off and to secular growth areas which have hitherto been prohibitively expensive – like green energy, as we discuss under **Portfolio**.

DGN has outperformed the index considerably over the long run, as we outline in the **Performance section**. Absolute returns have been negative over the past year as Asia has sold off, led by China. DGN held up reasonably well until a crash in the shares of the Chinese internet-related stocks hurt some of its largest positions. However, Adrian and Pruksa believe they have the market leaders in these industries, and the valuations have become even more attractive. The **Discount** is in absolute terms wide at 11.4% at the time of writing.

DGN's portfolio is best characterized as balanced: the trust tends to have a quite neutral geographic spread and a mixture of growth and value characteristics with highly active single stock positions. This is intended to provide steady long-term outperformance rather than boom and bust cycles.

The trust tends to run with a modest level of gearing to enhance long-term returns and was 10.3% geared at the end of February.

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Analyst's View

DGN looks to be an interesting long-term Asia holding which provides exposure to the growth potential in the region without taking massive country, style or sector bets. That said, there is a bias to growth stocks rather than value versus the index, which could hurt in certain market environments and has held back relative returns in 2021 and 2022. We note investors buying now are getting a higher beta animal than they would have five years ago, with greater exposure to e-commerce, technology and to China leading to greater market sensitivity, but equally creating a portfolio with more exposure to growth in the digital space as well as traditional emerging market themes such as consumption growth and urbanisation.

We think the quality focus of the portfolio could prove attractive in the current market environment. The global economy is still recovering from the pandemic, and the war in Ukraine and the return of lockdowns in China have thrown further spanners into the works. In a tough economic environment, it should be market leaders and the companies with pricing power that can turn it to their advantage. While DGN's discount is not wide in historical terms, it is in absolute terms, and following the sell-off of the past year, the portfolio itself is arguably cheaper than it was.

BULL
Blend of growth and value characteristics plus geographical spread provides core exposure to Asian markets
The quality approach should ordinarily lead to outperformance in troubled markets
Asian equities are relatively cheap after a poor year for returns

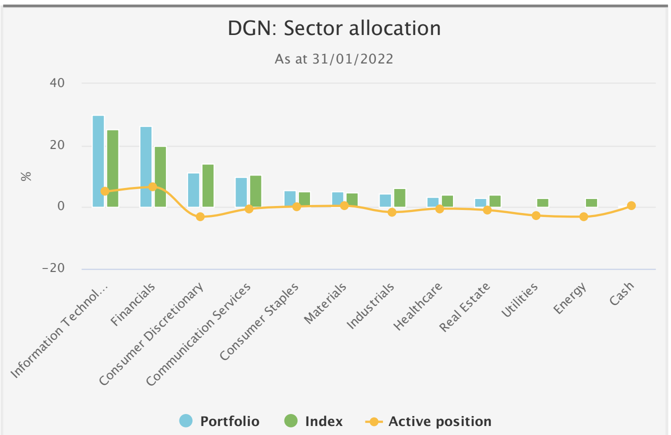
BEAR
Higher exposure to technology has brought with it higher beta than the trust had in the past
Structural gearing, although modest, can increase downside risks (while helping on the upside)
The portfolio has high exposure to China, with concomitant political risks

Portfolio

Asia Dragon (DGN) is managed for the long term by Adrian Lim and Pruksa Iamthongthong of the abrdn Asian Equities Team. Adrian and Pruksa set out to identify high-quality businesses in Asia which can grow their earnings faster than the market over the long run. This means they are ultimately looking to identify the winners in industries seeing structural growth. Typically, high-quality businesses would be expected to be able to grow their market share in tough economic times, and this is what the managers expect to see in the current troubled market environment. In fact, as the storm clouds have gathered over the past two quarters, they have been increasing the concentration of their portfolio and focussing on their highest conviction positions, which they believe to be of the highest quality.

These tend to be spread across different sectors and geographies. Adrian and Pruksa are active in their approach and aim to build a portfolio of best ideas rather than the best ideas in each sector or country. While this can lead to quite punchy positions – overweights to consumer sectors and technology and zero in energy and utilities have been fairly consistent positions – overall, the portfolio tends to be well-diversified, which could suit it for the role of a core Asian holding or one for long-term investors who don't want to chop and change tactically.

Fig.1: Sector Exposure



Source: abrdn, as at 31/01/2022

Another factor supporting this is the mixture of growth and value characteristics that the team look for. They search for companies with sustainable earnings growth potential but are alert to the valuations they buy on and sell at. Cutting the portfolio along Morningstar style lines on a holdings-based basis tends to lead to a fairly even split between growth, value and core companies. Since the start of 2020, the weight to core stocks has increased to around 40% of the portfolio – this may in part reflect the de-rating of some high-flying growth stocks since the reflationary rally that followed the emergence of vaccines. It should be noted that the weighting to growth is much higher than in the benchmark (where it is sub 20% according to Morningstar), and so on a relative basis, this factor is likely to drive performance at times.

Adrian and Pruksa's active approach comes through at a stock level. The top ten positions (below) make up almost half the portfolio, which compares to a weight of just 28% for the largest ten stocks in the MSCI AC Asia ex Japan benchmark. Top holding TSMC is almost 10% of the trust (as of the end of January) which compares to a weight of 8.1% in the index. Samsung and Tencent are held at about double the weight of the benchmark.

Top Ten Holdings

HOLDING	COUNTRY	(%)
TSMC	Taiwan	10.9
Tencent	China	7.6
Samsung	Korea	7.4
AIA	Hong Kong	5.2
Housing Development Finance	India	4.0
Alibaba	China	2.6
Bank Central Asia	Indonesia	2.6
Oversea-Chinese Banking	Singapore	2.4
Tata Consultancy Services	India	2.1
Kweichow Moutai	China	2.1
TOTAL		**46.9**

Source: ASI, as at 30/06/2021

TSMC, the world's leading semiconductor manufacturer, and Samsung, which has around half the market share of the global smartphone memory market, are good examples of the technology enabler theme in the portfolio. Increasingly, Asia is the home to world leaders in these industries, which are critical to the digital goods and services that are growing as a share of the world economy. Tencent and Alibaba are leaders in providing these goods and services in China, the largest economy in Asia. Both remain key positions for the trust despite the significant sell-off over the past year. Adrian and Pruksa tell us they believe they are the leaders in their industry and will emerge stronger from the volatility. They blame their poor performance over the past year on concerns about the impact of COVID-19 on consumption and, therefore, sales growth, as well as fears about regulation.

In fact, they note that the internet stocks look cheap after the sell-off – and certainly not priced as growth stocks. While investors worry about the impact of rising US rates on growth stocks versus value, Adrian and Pruksa think the impact won't be dramatic on their key picks in the e-commerce space as they are mature businesses rather than 'long-tail' growth stocks with the majority of the value in unproven future earnings. As well as Tencent and Alibaba, holdings in the e-commerce space include Kakao of South Korea, which operates in the messaging, gaming and e-commerce spaces - SEA ltd in ASEAN and Info Edge in India. The team have picked up some more speculative positions in early-stage companies to add to their more typical mature holding. This is in order to ensure the trust does not miss out on the fastest growth phase. However, they approach these companies in a cautious way, ensuring they take small positions in a basket of such stocks and being quick to cut their losses if the concept does not work.

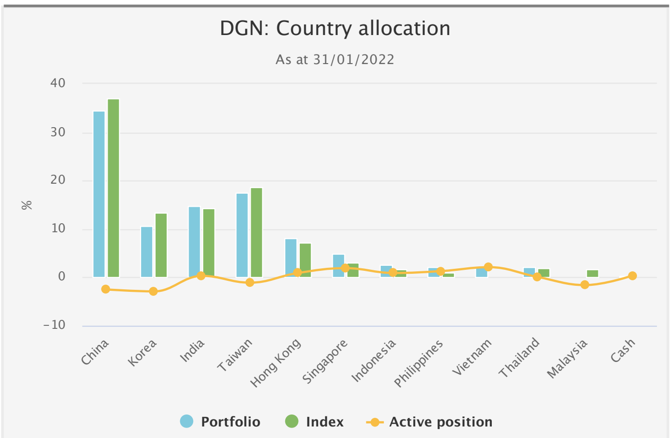
Other themes in the portfolio include some traditional emerging markets these such as increasing consumption by an aspirational middle class and increasing urbanisation. These themes offer investors access to the higher GDP growth in emerging markets via companies like Chinese spirits maker Kweichow Moutai and Bank Central of Indonesia which is geared to the fast growth of Indonesia's large and young population. The green energy theme in the portfolio is a more contemporary trend that is developing in parallel with developed markets in emerging markets such as China.

The CCCP's commitment to hitting 'net zero' by 2060 means an increasing amount of energy is going to be committed to a long-term drive that will transition the country away from fossil fuels. DGN's exposure includes positions in Yunnan New Energy Materials and electric vehicle battery maker CATL, both of which were among the portfolio's top contributors in 2021. Adrian and Pruksa think the war in Ukraine is only going to strengthen the impulse for decarbonisation as it has highlighted the importance of energy security to governments around the world and will also likely lead to higher fossil fuel prices for a sustained period of time. They have been adding to their positions in this theme in recent months after the sell-off in Chinese equities – previously, they had struggled to be comfortable with the valuations.

Overall, after such as poor year for Asian equities, in particular Chinese stocks, Adrian and Pruksa think the valuations are attractive in many structural growth themes. They are concerned about growth given the various risk factors in markets – although it is fair to say they are generally cautious in their approach to markets anyway. However, they believe that the current difficult environment should be good for market leaders as it should prove an opportunity to cement their positions, and as a result, they have been concentrating on increasing the quality in their portfolio, going through all of their smaller positions and being ruthless if they think they don't meet the highest quality requirements. While expectations of rising interest rates have led to a short term shift from growth to value in market leadership, DGN remains focussed on the long term and on remaining balanced, and so the managers have been looking to buy into growth themes as they sell off rather than shift the portfolio wholesale into value. However, they have added to some value themes, such as cement companies in India and financials in various countries.

The balanced approach comes through in the geographical allocation too. As the below chart shows, the over and underweights versus the index are relatively modest, with an underweight in mainland China offset by an overweight in Hong Kong. Historically, the portfolio tended to be significantly underweight in China, which had been dominated by state-owned giants in banking and energy, but this has changed as the Chinese market continues to evolve and now provides more exciting and diversified growth stories.

Fig.2: Country Exposure



Source: ASI

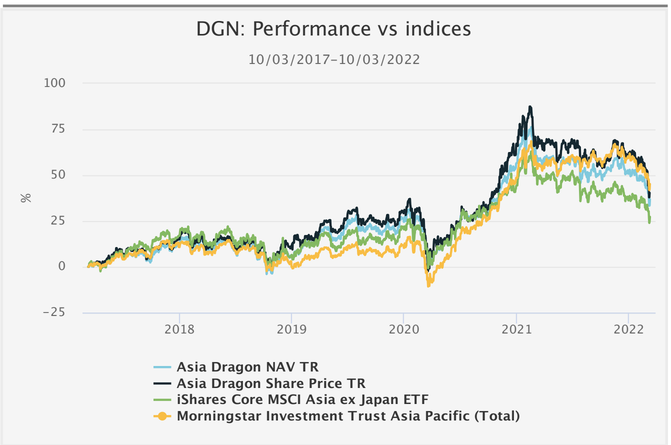
Gearing

DGN's board believes a modest level of gearing is an appropriate way to enhance returns over the longer term. The allowable range is 5% to 15%, and the managers have total facilities of £75m available. Of this, £25m is fixed and fully drawn down, equivalent to c. 4% of NAV, with the remainder available on a revolving basis. As of the end of February, net gearing was 10.3%. It is stock-specific opportunities that drive the level of borrowings rather than market level considerations.

Performance

Over the last five years, DGN has returned 36.9% on a NAV total-return basis, above the return of 27.3% for a passive investor in the benchmark but below the Morningstar Asia Pacific peer group's 41.8% weighted average. This good performance represents a return to form after a rough patch between 2013 and 2015, with amendments to the investment process and team organisation bearing fruit.

Fig.3: Five-Year Performance

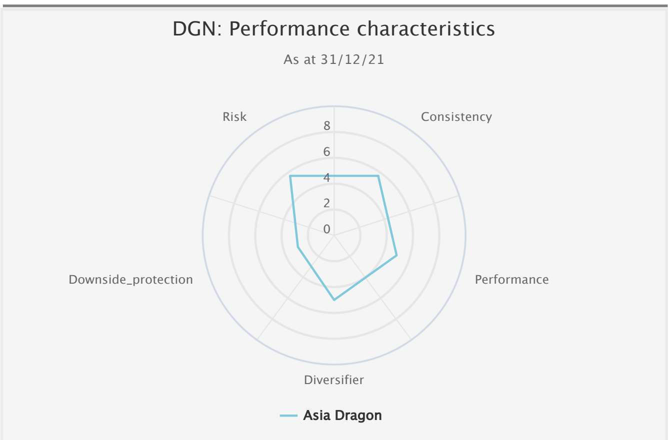


Source: Morningstar

Past performance is not a reliable indicator of future results.

During this five-year period, the trust has actually done better in rising than falling markets overall. This comes through in the KTI Spider Chart below, which shows how DGN has performed relative to an expanded peer group of all Asia Pacific trusts in some basic categories. Each category is scored out of ten, and scores are normalised to the peer group. DGN has been below average for downside protection. This is largely due to the 2020 coronavirus crash in which e-commerce and technology outperformed. DGN held less than its peer group and so lost more in the worst down-market during the past five years. The underweight to China versus the benchmark also hurt. However, DGN did outperform in the reflationary rally, as the greater sensitivity to valuations and more balanced portfolio proved helpful in the recovery. We would argue that the defensiveness of e-commerce and technology seen through the pandemic is not likely to be seen in the different economic environments of today in which inflation and geopolitics are the main risks haunting markets and Western economies are open.

Fig.4: KTI Spider Chart

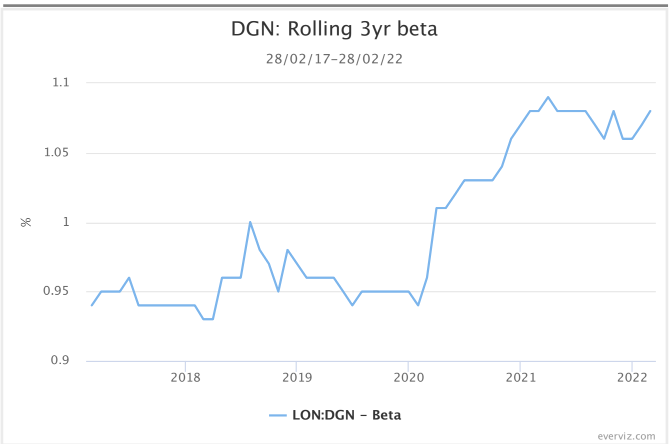


Source: Morningstar, Kepler calculations

Past performance is not a reliable indicator of future results.

In that light, DGN's balanced portfolio exposures could prove advantageous in future. However, we note that the trust has built up more exposure to technology and to China than it had in the past. This is a result of a rethink of valuation models after a tough period between 2013 and 2015. The team re-examined how they valued high growth, early-stage companies and, as a result, have been more willing to pay higher initial multiples. This has contributed to a higher allocation to China and a higher beta, as seen below.

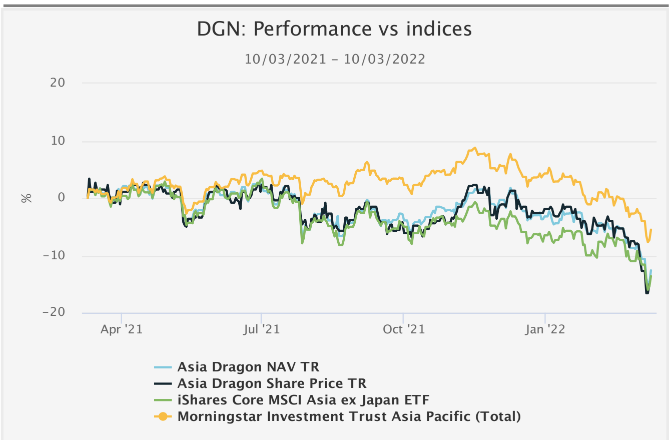
Fig.5: BETA



Source: Morningstar

Unfortunately, over the past year, China has underperformed, and technology has underperformed within China. However, DGN has held up reasonably well in a falling market. We attribute this to the balanced portfolio allocation leading to different behaviour than it did in the 2020 crash. Over the last year, DGN has lost 12.6% on a NAV total return basis whilst the benchmark is down 13.6% (as of 09/03/2022). In February and early March DGN has seen some underperformances come through as markets have sold off. Large Chinese tech firms have been amongst

Fig.6: One-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

the worst hit as China has seen a significant sell-off, which has hit DGN through its positions in Tencent and Alibaba. This may be due to fears of China being dragged into a US/Russia confrontation or just general risk aversion hitting growth stocks. Adrian and Pruksa have focused on increasing the quality of their portfolio over recent months, believing that higher-quality companies should be able to take advantage of a rough environment to strengthen their competitive positions (see **Portfolio**).

Discrete Performance (%)

	28/02/22	28/02/21	29/02/20	28/02/19	28/02/18
Share price	(8.4)	35.7	6.7	1.2	15.2
NAV	(10.2)	33.2	8.1	(2.9)	17.3
MSCI AC Asia ex Japan	(10.6)	30.1	4.6	(4.7)	19.5

Total return; NAV to NAV, net income reinvested, GCP. Share price total return is on a mid-to-mid basis.

Dividend calculations are to reinvest as at the ex-dividend date. NAV returns based on NAVs with debt valued at for value.

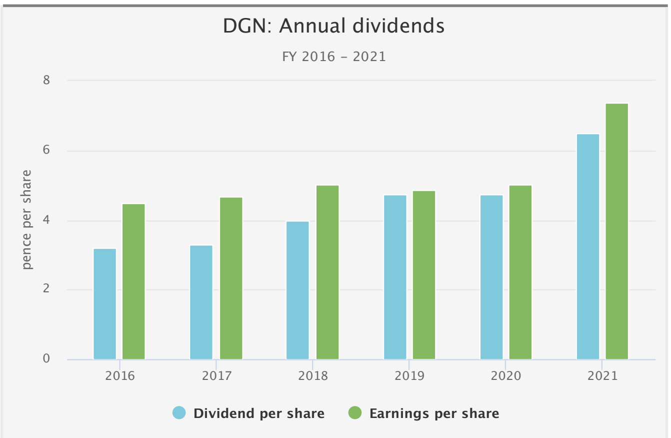
Source: Aberdeen Asset Managers Limited, Lipper and Morningstar.

Past performance is not a guide to future results.

Dividend

DGN aims to provide capital growth as opposed to income and the historic yield is just 1.3%. The board's policy is to pay out marginally more than the minimum 85% of net income required to maintain investment trust status, so dividends will vary from year to year. The yield is substantially higher than in the past as in the 2021 financial year the board decided to switch from charging all costs to the revenue account to splitting them 75%/25% between capital and revenue. However, it is unlikely to be enough for those seeking an income from their investments.

Fig.7: Dividends And Earnings Per Share



Source: abrdn
Past performance is not a reliable indicator of future results

For the 2021 financial year (which ended 31/08/2021), DGN's board declared a dividend of 6.50p per share, which was a c. 36.8% year-on-year dividend increase. DGN's revenue return per share increased c. 47.0% to 7.36p per share as underlying holdings began to increase pay-outs in the COVID-19 recovery, with the 2021 full-year dividend covered by revenue generation.

Management

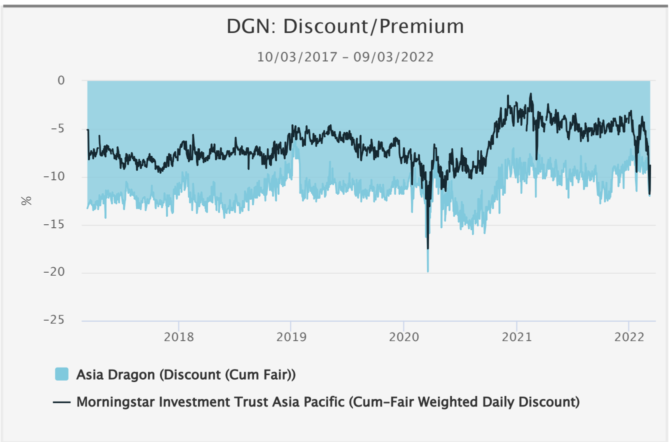
DGN has been managed by Adrian Lim for the best part of a decade, with Pruksa Iamthongthong having joined as co-manager in 2019 when abrdn chose to devote more resources to the trust. Adrian joined what is now known as abrdn in 2001, and resultingly is highly experienced in the quality-led strategy applied by the team. Adrian is part of the investment team managing Indian Equities and covers the South Asian region whilst also sitting on the Asia Pacific ex Japan Equities investment team, where he is tasked with company research and portfolio construction. Pruksa also sits on the investment team managing Chinese Equities and jointly covers greater China with help from her Singapore and Hong Kong-based colleagues. Despite the ultimate buy and sell decisions lying with Adrian and Pruksa, abrdn apply a team-based approach to their portfolios, with the Asia Pacific equities team collaborating collectively towards building agreeable views on stocks. abrdn's Asia Pacific equities team, which has more than 50 equity fund managers, is headed up by Flavia Cheong, who has been with abrdn since 1996. Including Adrian and Pruksa, 20 of the fund managers are based within the Singapore office.

The aim is to gain consensus on all stock buys and sells and take a long-term view with investments. Since conducting a review of their processes in 2017, the team have created sector specialist groups in the analyst team to aid international comparison, rather than specialising by country. They believe this creates more accountability for individual stock picks and is more appropriate for an increasingly globalised investment universe. They have also assigned certain significant holdings to analysts in 'Bull' and 'Bear' roles in order to focus discussion and help uncover problems with holdings sooner rather than later, having decided they were too slow to sell some companies when problems emerged in 2015 and 2016, during a period of poorer performance. These roles are implemented for companies where the team feel the need to test the investment hypotheses more vigorously.

Discount

DGN trades on an 11.4% discount at the time of writing, compared to a five-year average of 11.3% and the 7.9% average of the AIC Asia Pacific Trust sector. We think the current discount could be an interesting long-term entry point, although we note the discount is not wide relative to recent history.

Fig.8: Five-Year Discount



Source: Morningstar

One of the reasons the discount has not widened more is that the board have been conducting share buybacks. Since the beginning of the current financial year (which began 01/09/2021), they have repurchased c. 1.4m shares representing c. 1.1% of the original number of shares in issue (by 11/03/2022). DGN's board have previously stated that they "seek to manage the company's discount in line with its peer group" and conducted a tender offer in January 2019, where 30% of the shares were repurchased and cancelled.

Charges

DGN's latest ongoing charges figure (OCF) is 0.83%, lower than the AIC Asia Pacific peer group's weighted average of 0.88%. DGN's OCF is the second-lowest figure in the peer group, with shareholders benefitting from a tiered management fee that leads to a drop in the OCF as the trust grows. Management fees are charged at 0.85% of the first £350m of net assets, with 0.5% charged on the remaining net assets. Based on the current net assets of c. £592m, we calculate the blended management fee to be c. 0.71%. According to JPMorgan Cazenove, DGN's latest KID RIY is 1.09%, lower than the peer group's weighted average of 1.47%. However, we caution that calculation methodologies may vary.

ESG

The Asian Equities Team at abrdn (and previously at Aberdeen Asset Management, before it merged with Standard Life in 2017) were early adopters of what has become known as ESG investing, having long championed a focus on the ethical quality of management teams as well as their financial acuity. Originally, governance was the key focus, with the team always viewing good governance as an essential attribute of a quality company. Over time the commitment to ESG has grown and broadened, and abrdn employ over 50 dedicated ESG experts and ensure these issues are considered as a part of the analysis of every company under coverage.

Members of the Asian equity team carry out their own assessment of a holding's performance on an ESG basis rather than relying on ratings from third-party analysts. Adrian and Prukksa point out that rating providers are often working with outdated information or companies with poor disclosure. The team's own analysis often uncovers companies that should be rewarded with much higher ESG ratings once this is corrected for; this is a potential source of alpha for the trust should the market come to recognise practices are better than commonly recognised. It also means the portfolio's ESG strengths may be understated by external rating providers, although we note Morningstar Sustainalytics rates the portfolio as above average versus the peer group. In our opinion, DGN could prove attractive to investors who desire exposure to the Asian sector, where ESG considerations are fundamentally integrated across the investment process.

Adrian, Prukksa and the team aim to run a portfolio with an improved ESG profile and lower carbon footprint than the benchmark and highlight that as of February 2022, the trust's carbon intensity was 38% lower than the benchmark.

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