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Aberdeen Standard Asia Focus

AAS offers exposure to exciting growth companies in Asia, and has traditionally done very well after global crises...

Update
03 February 2022

Overview

Aberdeen Standard Asia Focus (AAS) has generated excellent long-term returns by investing in smaller companies listed in Asia. The trust has been managed to the same basic strategy by the same team for over two decades, but the board has been active in seeking to revivify and revamp the approach in recent years, which has helped deliver strong recent **Performance**.

Shareholders have just approved another series of tweaks aimed at improving performance potential and increasing demand for the shares. These include a new performance-linked five-year tender offer to address the **Discount**, a share split to increase the fungibility of the shares, and a fee cut.

One significant change is to remove the strict market cap limit on new investments. As Asian markets have developed, the limit has been raised multiple times and having a strict region-wide limit has made it hard to invest in China. The managers will have much more freedom to invest in that country in future, and they tell us they expect the weighting to increase in recent months, with the recent sell-off in the country generating opportunities (see **Portfolio**).

AAS will also pay a more significant **Dividend** in future, with the board committing to double the 2021 payout in the current 2022 financial year. On the current share price the proposed dividend would amount to a 2.2% yield.

Hugh Young has managed this portfolio since it launched in 1995, although he was named lead manager only in 2017, as there is a strong team-based approach taken by the abrdn Asian Equities team to their portfolios. Considering the expected increase to North Asia and succession planning, Flavia Cheong is being named co-lead manager.

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Analyst's View

AAS has been through a process of change in recent years which we think has left it in a good place to continue its long-term track record of success. The recent changes follow a series of adjustments in 2018 which have led to a more concentrated portfolio with greater exposure to high quality technology stocks. These changes have already borne fruit, with AAS performing very well in 2021. The key changes for us are to the investment remit, in particular lifting the $1.5bn limit on market capitalisation at the time of initial investment. This opens up the Chinese market to the trust, at a time when China has suffered a significant sell-off and therefore could be at an attractive entry point.

Good recent performance has seen the discount come in from a five-year average of 13.2% to 12%. Some of the changes adopted in January could help that close or at least remain narrower in future: the five-yearly conditional tender offer, the stock split which makes it easier to trade shares and the enhanced dividend, with the ability to pay out of capital to support it. If successful, these moves could boost shareholder returns offering another potential source of performance alongside stock-picking and structurally high gearing. The material reduction in the management fee (see **Charges**) only adds to the attractions of this trust which is one of few to focus on the huge growth potential in small cap Asian companies.

BULL
Focus on strong balance sheets and operational resilience should serve well in troubled environment
Strong secular growth potential in many of the region's economies
Extensive experience and resources in the Asian Equities Team

BEAR
Structural gearing increases the downside risks
Highly active country allocations, such as the low weight to China, can lead to large under or overperformance at times
Portfolio is expensive relative to the market, which means earnings growth will need to meet expectations

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Portfolio

Aberdeen Standard Asia Focus (AAS) invests in Asian smaller companies. Historically there has been a limit on the market cap at the time of investment, most recently $1.5bn, but that has been dispensed with to give the managers greater freedom to invest in China. The trust will remain focussed on small caps, with the managers interpreting that in the light of the market structure of individual countries – necessary given the divergence in development paths in Asia over the past three decades. Another tweak to the mandate is to eliminate Australasia from the opportunity set for future investments, although the three stocks currently in the position will be maintained until the investment thesis is played out (these make up c. 3.5% of the portfolio). This arguably brings the strategy in line with what investors are typically looking for in an Asian fund, and the board highlights the greater GDP growth rates available elsewhere in the region. The key change from a portfolio perspective will be to see the weighting to China rise from its structurally very underweight position closer to if not above the index weight of c. 7.5%. The precise amount will reflect conviction in stocks rather than the country.

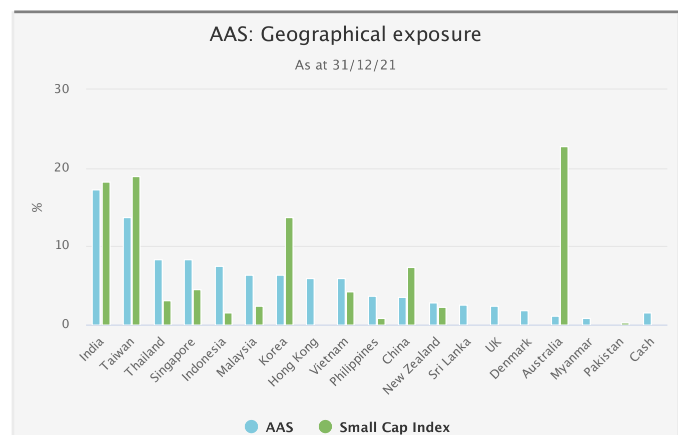
A number of other changes have been made, to the dividend policy, the charges and the introduction of a performance-related tender offer. However, none of these alter the philosophy, strategy and approach to stock-picking which have remained consistent in their essentials over more than two decades. Lead manager Hugh Young and Gabriel Sacks work within the framework used by the abrdn Asian Equities Team, aiming to identify market-leading businesses with significant long-term growth potential. Hugh and Gabriel look for companies which have the potential to dominate their niche, and which demonstrate the typical characteristics of a quality company such as high and sustainable earnings growth, strong balance sheets and good quality management. The team, which has a highly collaborative approach, maintains a list of companies which meet their quality screens, and watches for opportunities to buy at attractive entry valuations. The approach is cautious and measured, involving meeting company management and generating a consensus in the team on the company. They then typically build a position incrementally. This slow-but-steady approach can at times prove difficult: the volatility in markets during 2020 meant that it was difficult for Hugh and Gabriel to build up the position sizes they wanted, before the sharp rally towards the end of the year took share prices and valuations up.

The emphasis on quality tends to lead to the trust's portfolio trading on higher valuations than the market but generating superior earnings growth. Portfolio companies typically have cash on the balance sheet which more than offsets any debt, providing operational resilience. This is a particularly helpful characteristic in troubled economic environments such as that being currently experienced in the aftermath of the pandemic.

The managers have historically found it hard to find companies of sufficient quality in China in their market cap domain. China is such a large market that industry-leading companies are rarely found with a market cap below $1.5bn. As a result, the trust has historically been significantly underweight China versus the MSCI AC Asia ex Japan Small Cap Index, which isn't a formal benchmark but is a reasonable approximation of the opportunity set. (Although the active share is typically extremely high to any index given the managers don't take them into consideration when building a portfolio.)

The most recent factsheet, as of the end of December, shows AAS to have had 3.5% in China compared to 7.4% for the MSCI AC Asia ex Japan Small Cap Index. When we met with the managers to discuss the changes to the strategy, they said they thought it likely the weighting to China would rise close to or above the index weight in the short to medium term, although there would be no overnight shift. Give the team covers the whole market cap spectrum in China for their various portfolios, there are a number of companies in the country that are regarded highly by the team and are potential candidates when the valuation is right. Hugh and Gabriel tell us they view the recent sell-off as an opportunity, and that it may be they look to the consumer sectors for new additions to the portfolio as these are less likely to be the subject of political interference. They add that the politicians are mainly interested in the large caps given their influence and importance for employment and growth, and this favours small caps given the political atmosphere in China ahead of Xi's re-election campaign. They also see some possible consolidation in some industries which offers the potential for stock-specific growth. Any delay in the weight to China rising is likely to be as much about the high conviction the managers have in their current portfolio, which they think still looks good value after the current pullback.

Fig.1: Country Allocation



Source: Aberdeen Standard Investments

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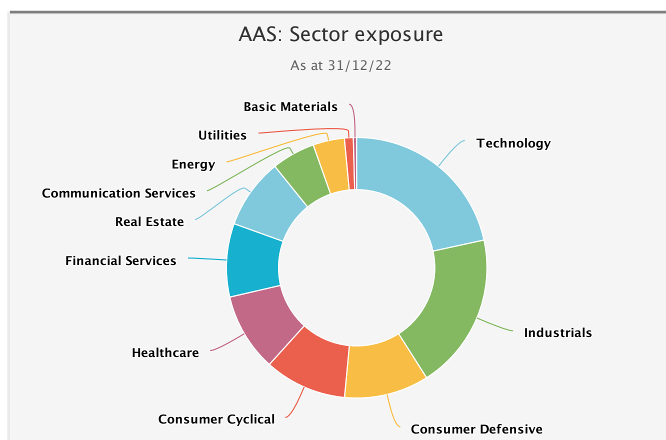
Hugh and Gabriel don't take positions based on macroecoomic views about countries, and so their positioning reflects their views on the companies themselves. The same is true of sectors too. However, in 2018 the board did ask Hugh to overhaul the portfolio, increase the concentration and remove lower-conviction positions. He and the team also devoted time and resources to looking for technology and ecommerce companies which might fit their quality and value demands. As a result, the portfolio has become fairly diversified across old and new economy sectors. The quality tilt means there is a bias to more defensive sectors, but there are cyclical companies too, selected on a case-by-case basis. The top ten illustrates the diversity in the portfolio: Momo.com is Taiwan's leader in ecommerce, and it sits alongside Pacific Basin Shipping, an old and venerable company in an industry that has been around for centuries. Both were strong performers in 2021 and contributed to AAS's excellent **Performance**.

Top Ten Holdings

HOLDING	COUNTRY	% OF PORTFOLIO
Momo.com	Taiwan	4.4
Park Systems	Korea	4.3
Affle India	India	4.1
Nam Long	Vietnam	3.7
AEM Holdings	Singapore	3.3
Cyient	India	3.0
Pacific Basin Shipping	Hong Kong	2.9
Hana Microelectronics	Thailand	3.8
John Keells Holdings	Sri Lanka	2.6
Mega Lifesciences	Thailand	2.5
TOTAL		**33.6**

Source: abrdn, as at 31/12/2021

Fig.2: Sector Allocation



Source: Morningstar

Technology has risen from under 4% of the portfolio in May 2018 to 22% at the end of December 2021. Industrials have significantly increased while there have been significant reductions in the weights of financials and the consumer sectors. Within technology the managers insist on high quality companies and haven't been chasing the market into zero-growth or blue-sky companies. For example, Affle India, a digital marketing business, generates net margins of 20% while it is growing earnings at 50% a year.

Gearing

AAS operates with significant structural gearing with a view to benefitting from the tendency of stock markets to rise over the long run. This can obviously increase its losses in periods of falling markets too. AAS's structural debt includes convertible unsecured loan stock (CULS), which matures in 2025. Between now and then holders can convert units into shares every May and November. £37m of CULS paying 2.25% was issued in May 2018, of which £36.5m remains, amounting to roughly 7% of net assets (c. £524m as of the end of December 2021). AAS has also issued a £30m loan note with 15 years to maturity and a coupon of 3.05%. Net gearing as of the end of December was c. 12.6%. The loan facility allows for the company to borrow an additional £35m over a five-year period, which the board has indicated it would only do in order to redeem the CULS early. Given the structure of the debt, we expect the trust to remain significantly geared on a structural level rather than the managers trying to time the market.

Performance

AAS has had an outstanding year, outperforming the region's small and large cap indices as well as being the top-performing of the three trusts in the AIC Asia Pacific Smaller Companies sector. The strategic changes made by the board are therefore being made from a position of strength, to 'future-proof' the trust, rather than turn around the ship. Over the past 12 months the NAV is up 19.7% in total return terms, according to Morningstar, compared to 14.5% for the MSCI AC Asia Pacific ex Japan Small Cap Index and 17% for the sector.

AAS has clearly been boosted by a renewed appetite for small caps, after a long period of large cap outperformance, but the outperformance reflects the positioning and stock picks of the management team. Performance has come from a variety of sectors, with its stylistic balance being beneficial. Taiwanese-listed ecommerce stock Momo has been a strong performer from the new economy stocks while Pacific Basin, an old economy shipping company, has done exceptionally well as freight rates have risen to unlock supply chains. Names in the real estate sector, another 'old economy' and cyclical industry have done well too, in particular Nam Long

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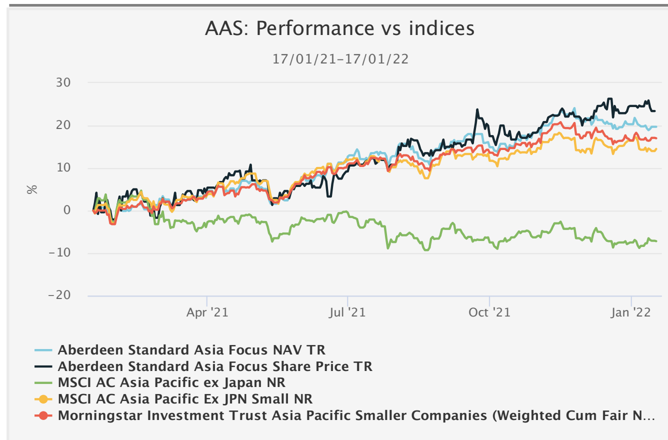
Vietnam, which constructs township developments, and Prestige, an Indian developer. The underweight position in China was helpful, and the trust benefitted from having a large position in India in absolute terms, although it was slightly underweight the index.

Fig.3: One-Year Performance

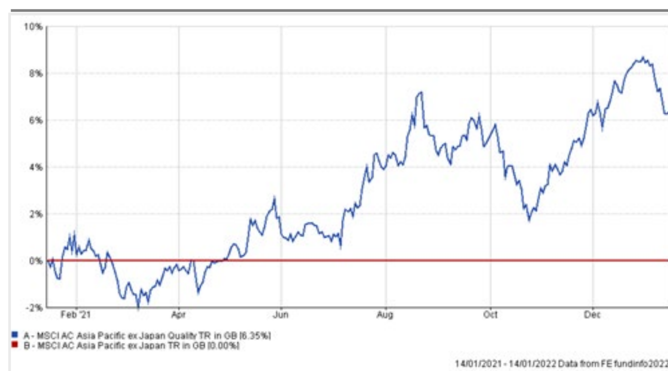


Source: Morningstar

Past performance is not a reliable indicator of future results.

Hugh and Gabriel's focus on finding quality companies has been helpful, with that style outperforming in the Asia Pacific ex Japan region by over six percentage points in the year to 14 January. We have highlighted **in recent notes** that AAS has done well after the past two major global crises thanks to the quality tilt, and it may well be that proves to be the case again as the world recovers from the pandemic. That said the managers do not position the portfolio around macro trends, and stock-picking will continue to drive their decisions.

Fig.4: Outperformance Of Quality Over One Year

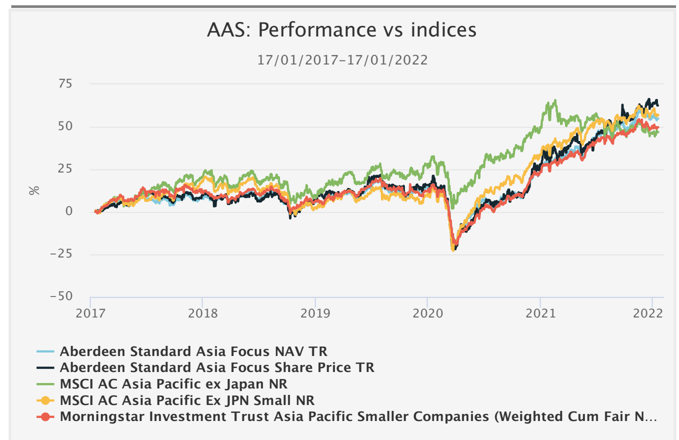


Source: FE Analytics

Past performance is not a reliable indicator of future results.

This strong year has helped pull up the five year returns versus the sector. The NAV total return has been 54.8% compared to a 49.7% weighted sector average. The small cap index is up slightly more over the time, at 57.1%.

Fig.5: Five-Year Performance

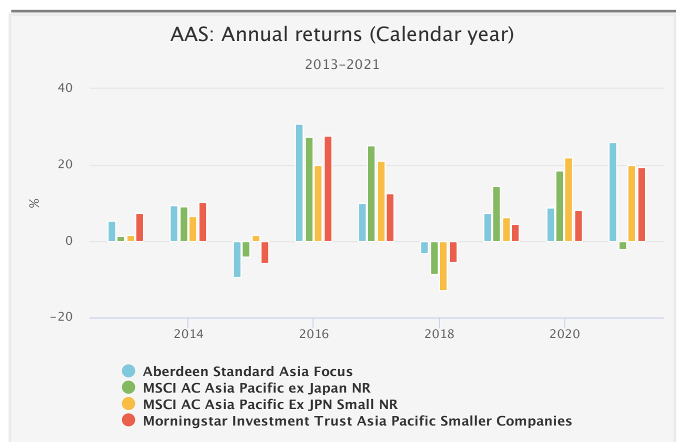


Source: Morningstar

Past performance is not a reliable indicator of future results.

This is despite relatively disappointing calendar years in 2017, 2018 and 2020. During these years large caps outperformed, as did China. AAS had relatively little in technology at the start of the period which was also a detractor. However, over that period Hugh and Gabriel have bolstered their position in this sector, where they have found stocks that fit their quality screens, leading to a more balanced portfolio that has borne fruit over the past 12 months. In 2020 the extreme preferences for tech and China at the start of the year and for low quality cyclicals at the end of the year (the 'dash for trash') led to AAS underperforming. It certainly seems like the environment is more conducive to the managers' style post-pandemic, while Hugh's revamping of the portfolio since a 2017 strategic review has led to a more balanced and concentrated portfolio which has proven to be a success.

Fig.6: Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

We note AAS has generated excellent returns over the very long term and has had some periods of exceptional outperformance, most notably after the bursting of the tech

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bubble and after the 2007/2008 financial crisis. Over the past 20 years, during which period it has been managed by the same team with the same basic strategy, the trust has generated 16.1% a year compared to 11% for the MSCI AC Asia Pacific ex Japan Small Cap Index.

Discrete Performance (%)

	31/12/21	31/12/20	31/12/19	31/12/18	31/12/17
Share Price	28.1	10.6	8.1	(2.5)	13.2
Diluted NAV[A]	27.4	8.3	7.5	(2.8)	9.7
MSCI AC Asia Pacific ex Japan	(1.8)	19.0	14.9	(8.3)	25.4
MSCI AC Asia Pacific ex Japan Small Cap	20.3	22.5	6.6	(12.5)	21.4

Total return; NAV to NAV, net income reinvested, GBP. 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 fair value.

Source: Aberdeen Asset Managers Limited and Morningstar

Past performance is not a reliable indicator of future results

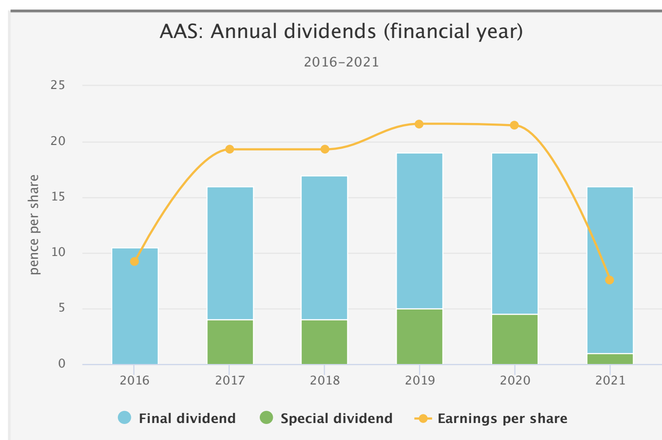
Dividend

As part of a strategic review of AAS, the board has decided to significantly enhance the dividend, targeting a full-year payout of 32p per share for the 2022 financial year, twice the 2021 dividend, and to grow it progressively in future. The board will be able to make contributions from capital reserves to the enhanced payout which should vastly reduce the chances of a cut in tough times. However, it does not expect to do this until after 2025 when the existing CULS will mature (see **Gearing**). The dividend will also be paid quarterly in equal instalments.

The 32p payout compares to the full year dividend of 16.0p per share declared for 2021 which consists of a final year dividend of 15.0p per share, up from 14p a year earlier, and a special dividend of 1.0p per share, down from 4.5p. Over the longer term, the trusts dividend growth has been strong, increasing by more than 13 times since AAS's inception in 1995, and the board clearly remains committed to growing the payout. The new dividend would amount to a yield of 2.17% on the current share price, making it the highest-yielding of the three Asia smaller companies trusts.

During the 2021 financial year, AAS's revenue per share fell c. 65% to 7.52p per share, due to the delayed effects of the COVID pandemic. A contribution was made from reserves, with the 2021 full-year dividend c. 47% covered by revenue. The board highlights that revenue reserves continue to remain strong after this contribution, with c. 24.0p per share of revenue reserves remaining for subsequent financial years, and clearly they retain confidence portfolio earnings will recover given they intend to pay the rebased higher dividend from revenue and revenue reserves util 2025.

Fig.7: Dividends



Source: abrdn

Management

Hugh Young is one of the most experienced Asian equity fund managers, having run Asian equity funds since 1985. He is chairman of Asia Pacific at Aberdeen Standard Investments and has been based in Singapore since 1992. Hugh has been involved with the management of the trust since it was launched in 1995 and is also a shareholder. In 2018 the board requested Hugh take greater personal control over the trust, and he was named lead manager; previously, AAS had reported itself as "team managed". Shortly after, Gabriel Sacks moved to working more closely with Hugh on AAS, being particularly tasked with generating new ideas for the portfolio. In their roles for AAS, Hugh and Gabriel continue to work within the Asian equities team with a process that is highly collaborative. This team is made up of over 40 investment professionals, and the team aims to reach a consensus on favoured companies and the valuations on which they should be bought.

As a part of the changes proposed by the board this year, Flavia Cheong, abrdn's Head of Equities, Asia Pacific, has been appointed as joint lead manager, and Neil Sun has joined the team as an investment manager directly responsible for managing the potential increased weighting in North Asia. The intention is they will work alongside Hugh and Gabriel to bolster their work on China, expected to become a larger part of the portfolio with the change of policy in regards to market capitalisation. In reality, there is a strong team element to how abrdn's Asian equity team run all their portfolios, and ideas will be discussed amongst the whole analyst team outside the four named on the portfolio as they were before.

Discount

As of the time of publication, AAS' discount stands at 12%, below the five-year average of 13.2%. In our last note

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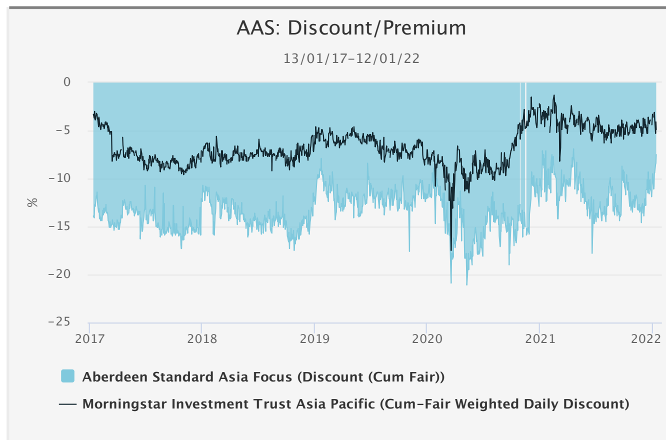
published in July we highlighted AAS' discount was wider than those of its two peers despite it being the strongest performer in 2021, and the discount did narrow prior to the January market wobble. The board proposals which have been adopted may well help keep the discount range narrower than it has been in the past now they have been voted through by shareholders.

Fig.8: Discount



Source: Morningstar

Most notable is the five-year tender offer which will see the board offer to repurchase up to 25% of the shares at NAV less costs if the trust does not outperform the MSCI AC Asia ex-Japan Small Cap Index in the five years to 31 July 2026 and every five years thereafter. We think this should have a material influence on the discount as that time draws near, if performance is lagging. A five-for-one stock split could also increase the liquidity of the shares, with a potential impact on the discount. Meanwhile the higher yield may see income-seekers take more of an interest in the shares, although we note the yield will still be low compared to income-focussed trusts in the AIC Asia Pacific Equity Income sector.

Charges

Management charges have been cut as a part of the proposals accepted by shareholders in January 2022. This means the historic ongoing charges (OCF) of 1.1%, compared to a weighted average of 1.03% for the three-strong AIC Asia Pacific Smaller Companies sector, are likely to fall. The management fee has been slashed from 0.96% of market cap per annum to a tiered fee of 0.85% for the first £250m of, 0.6% for the next £500m, and 0.5% for market capitalisation above £750m. This will bring the management charge down substantially to 0.73% by our calculations, using the market cap as of 12/01/2022 (although this will of course change as the company grows or shrinks). In fact, it looks like AAS will become the cheapest in the peer group once this reduction is factored into the OCF.

We note the management fee is charged on market cap rather than net assets, which incentivises the manager to close the discount. There is no performance fee. The KID RIY is 1.61%, compared to a 1.44% sector average, according to JPM Cazenove, although methodologies can 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 Hugh and the team he leads 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.

Asian equity team members conduct their own assessment of the performance of candidate companies on ESG grounds, but also consider the ratings of external analysts at MSCI and try to understand the reasons for any differences. Another modern trend the team anticipated was a focus on active engagement to improve governance issues. The team work to encourage better ESG policies in portfolio companies and view themselves as being in partnership with the management of their portfolio companies. They believe this should lead to better long-term returns to shareholders, as they believe ESG issues are frequently material to long-term company performance. One recent example of engagement was with Affle India. The team discussed with the company the reputation of their external auditor, which was under disciplinary action by the RBI. They also discussed the independence of its audit committee and some of the company's accounting policies, and came away encouraged by its responses.

Given the importance they place on governance, the team will often not invest if they think governance practices are particularly poor and there is no or limited scope for them to improve this as management are unlikely to be receptive to their input. This means they have been happy to sit out the gains on a fashionable stock if they think its standards of behaviour are not acceptable and management have not indicated any willingness to change. As such we think AAS should appeal to investors who want a moral dimension to their investments. The trust has not been awarded a rating by Morningstar Sustainalytics. However, as a house, Aberdeen Standard Investments has been awarded A+ on the UN Principles for Responsible Investing framework for equities.

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