

Pacific roller

By investing in a fluid combination of Asia's old and new economies, Martin Currie Pacific Trust can quickly seize opportunities across the region, says Fiona Hamilton

Martin Currie Pacific Trust could be viewed as a dinosaur in that it offers exposure to the whole of the Pacific Basin, including Japan and Australia, as well as to the wide array of well-established city states and hugely populous emerging markets scattered across Asia. This is out of tune with the demands of many private client managers, who prefer more focused vehicles that allow them to decide on their own asset allocation.

The trust's format, however, could be an attractive option for investors who recognise that Asia's old and new economies are increasingly integrated, and that whereas the stock markets of the emerging giants almost certainly offer the best long-term growth opportunities, the more mature ones can also be exciting at times.

Combining them in a single trust should make performance less volatile. It also means investors do not have to worry about the right time to raise their exposure to commodity producers in Australia, Japan's world-class exporters of cars and electronics, or even the high-technology manufacturers of South Korea and Taiwan. The trust's managers expect to make that decision for them.

Wide-ranging remit

An added consideration is that the trust's wide-ranging remit spares investors the expense and possible tax implications of having to take a stake in a Japanese trust if they think the world's third largest economy is embarking on one of its periodic strong rallies. The managers can and do move its assets around to exploit the most profitable investment opportunities, and if they are bursting with positive ideas they can gear up to accommodate them rather than having to pick and choose, as would be the case for most direct investors.

At the time of the trust's launch in 1985, Japan accounted for around 70 per cent of the Pacific Basin index. But the trust's board did not want a predominantly Japanese portfolio with a bit of Asia tacked on, so it limited the Japanese component in its benchmark to 40 per cent. This proved to be a wise move, as the Japanese market lost around 80 per cent of its value between 1989 and 2008, whereas the rest of Asia made ground. The net effect was that by summer 2008 Japan was down to 47 per cent of the index.

Lead manager John Millar says: 'This persuaded the board that the gap was not big enough to warrant continued customisation of the index, which made it harder to compare our performance with that of our peers.'

No benchmark constraints

However, he also says the change to an uncustomised version of the MSCI All Countries Asia Pacific index will not affect the way the trust is managed, as it has never been constrained by its benchmark. 'We had over 60 per cent in Japan in 2005, when Japan decoupled on the way up, and we got briefly below 15 per cent last year as we were more negative than we have ever been. We would not normally go below 15 per cent, because we are mindful that for many it is a one-stop exposure to Asia and Japan, so we need a respectable amount in Japan even if we are quite negative.'

Millar has been lead manager of the trust since 2002 and is responsible for selecting its Japanese holdings. He started to specialise in Japan soon after joining Stewart Ivory as a graduate trainee in 1992. He switched his attentions to Europe for a couple of years in 1998, but



reverted to Japan when he joined Edinburgh-based Martin Currie Investment Management in 2000.

Just over half the £9 billion in equity portfolios under management by Martin Currie Investment Management are invested in Asia and Japan, so the trust's remit plays to its strengths. Asia ex Japan accounts for the majority of that total, just as it generally accounts for the majority of the trust, so the skills of the Asia ex Japan team are clearly critical. Unusually, it is divided into two subgroups, headed by Jason McCay and Chris Ruffle.

Ruffle has been based in Shanghai for more than a decade and leads an 11-strong team specialising in China A shares. Around 5 per cent of Martin Currie Pacific Trust's portfolio is invested in a pooled vehicle managed by Ruffle, so it is of modest significance at the moment, but Millar expects it to be very rewarding in the long term.

'Ruffle was a pioneer investor in China and focuses mainly on small caps,' says Millar. 'He and his team travel extensively, looking for unidentified companies and building positions while they are still very illiquid. His returns have been fantastic, but they have also been very volatile, with huge gains in 2007 and big losses in 2008.'

Edinburgh-based team

McCay is of far greater immediate relevance, as he heads Martin Currie's nine-strong Edinburgh-based Asian team and is responsible for the majority of the trust's Asian and Australasian holdings.

'Although we talk through individual shares on an ad hoc basis at any time, McCay and I sit down together at least once a week to think about new ideas, and about buying and selling opportunities,' says Millar.

'Our asset allocation is largely dictated by the number of attractive ideas we come up with from each section of our coverage, but we then make sure the overall distribution is coherent and not too risky. While I may be the front man, the reality is that the trust is very much managed by the two of us.'

In looking for investment ideas, McCay and Millar can use Martin Currie Investment Management's proprietary screening system, the Dynamic Stock Matrix. This system whittles down their universe by focusing on four factors: quality (critically balance sheet strength), growth (mainly in earnings per share), value (as demonstrated by the price/earnings ratio) and change (which includes revisions to analysts' forecasts, share price momentum, and – in Japan – changes in corporate profit margins).

Extensive fundamental research is then undertaken to establish the most attractive investments, with the seven-strong Japanese team alone conducting some 450 company visits a year, as well as hosting around 350 companies in Edinburgh and making a similar number of one-on-one conference calls.

The emphasis, as in other parts of Martin Currie Investment Management, is on identifying unrecognised change. 'We look for companies that are demonstrating positive change, are trading at attractive valuations and where we think the consensus has got things wrong,' Millar says.

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Ready to use gearing

Gearing, like asset allocation, is driven primarily by bottom-up considerations and can be up to 20 per cent if the managers have enough great ideas. Until recently, the trust remained close to fully invested at all times, but after last year's stock market collapse the board widened the parameters so that it can go up to 15 per cent liquid.

The proof of the Miller/McCay combination is that the trust performed splendidly in the five years to the end of 2007, with a 130 per cent gain in net asset value per share total return. This was miles ahead of the two other trusts in the Asia including Japan sector, and competitive with all but a couple of the Asia ex Japan specialists. Sadly, it then suffered a 29 per cent fall in net asset value per share total return in 2008, which was much the worst fall in its small sector and 10 points worse than its benchmark index, although it was well ahead of almost all the Asia ex Japan trusts.

Part of the problem was that the trust was underweight in Japan throughout the year. This was justified by the huge fall in the Japanese index in local currency terms, but yen strength cancelled out the downturn for UK investors, making Japan one of the safest places to be invested, so in practice it was the wrong call. Millar takes comfort that at least his Japanese share selections were good, with the portfolio concentrated on companies that benefited from yen strength and little in the big exporters until the market had bottomed out.

Slow on the defensive

On the Asia ex Japan front, the trust remained too positive for too long, despite spotting the dangers building up in the financial system. It was slow to adjust to an ultra-defensive portfolio, with share selection in Hong Kong particularly poor. It was hurt by steep falls in its China A share portfolio, and it retained some of its gearing until May 2008, which further damaged its returns.

Having done so badly in 2008, the trust recovered ground over the first two months of 2009, but it dropped behind again in the spring rally when it felt the market was becoming too bullish too soon.

Looking ahead, the Martin Currie Pacific Trust team share the widespread belief that the Asian region should be an exceptionally rewarding place to invest over the medium to long term. However, it is still worried that the stock market has run ahead of events and will suffer at least a short-term setback as earnings forecasts prove overly optimistic. Demand from the West may be picking up, but it seems likely to stabilise at lower levels than before. In the meantime, Asian countries may be trying to stimulate their domestic demand by improving their social security and social infrastructure, but it will take time for them to pick up the slack.

Decoupling myth

Millar was among the first to warn that 'near-term decoupling is a myth', and he and his colleagues seem far from convinced that the global economic recovery is firmly under way. However, as Miller has learned in Japan, a difficult economic environment does not mean there are not good individual investments to be made.

In the Asia ex Japan context the emphasis has been on companies that can capitalise on the efforts to stimulate domestic consumption – but only if they have the balance sheet strength to survive the downturn and make whatever adjustments are needed to come out of it fighting fit.

'Those who can get through current hard times by investing in new products and flexing their cost base while weaker competitors shrink or go bust should do very well when the market recovers,' says Millar.

On a more positive front, the expectation that inflation is now more likely than deflation has encouraged the inclusion of some reflationary exposure, through investments in trading companies, financials and real estate companies across Greater China. China is seen as well placed to adjust to a new economic scenario, thanks to its command economy, and together with Hong Kong it accounts for a quarter of the portfolio. Millar has also turned more positive about specific opportunities in Japan, which is up to around a third of the portfolio. He says Japan's shrinking population will make it hard to grow its domestic economy, and its big exporters will have to work hard to protect their global franchises from mounting Asian competition.

However, he praises their ongoing commitment to research and development, and their proven ability to adjust to harder times. He expects the best of them 'to do well again once the world is doing well'. 'Japanese industry proved it could restructure meaningfully in 1999-2003, even though it was very painful, and we think it will again,' he adds.

Strong balance sheets

His confidence is boosted by the relatively strong balance sheets of many Japanese companies, which have been paying down their debt for decades, whereas many western companies have been gearing up. This will make it easier to restructure, which can be expensive in the short term. It could also allow some to buy in growth through overseas takeovers, as Japan Tobacco did when it took over Gallaher.

On this basis, near the start of the year Millar bought into exporters such as Nikon, Asahi Glass and some of the car component suppliers. This has boosted the trust's cyclical bias. It also illustrates Millar's

contention that including Japan gives the trust more options and flexibility than a straight Asia ex Japan trust.

'What we need to get past is the feeling of why have anything in Japan, due to confusion between the (unexciting) economy and the stock market,' he says. 'If we cherry-pick the best ideas in Japan and Australia, it can enhance the overall performance.'

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