VT HALO Global Asian Consumer Fund

3rd Quarter 2015

Given the increased market volatility and general lurch down in markets over the last 3 months, a lot of it blamed on China and its slowing growth, it is hard to avoid talking about the macro. So we will discuss below the macro environment and hopefully provide you with a more balanced view than some of the headlines that have appeared on the TV and in newspapers recently.

As to the performance of the fund, this has suffered over the last 3 months given our focus on Asia and the consumer, with investors around the world starting to write off China and its ability to transition to consumption. The fund's PE multiple has fallen from 17x at the beginning of the year to 14x at the end of September. So the fall in the value of units has been driven by a derating rather than material downgrade to earnings. The combined expected earnings growth of the stocks in the fund today over the next 12 months is 15%, so the outlook remains robust.

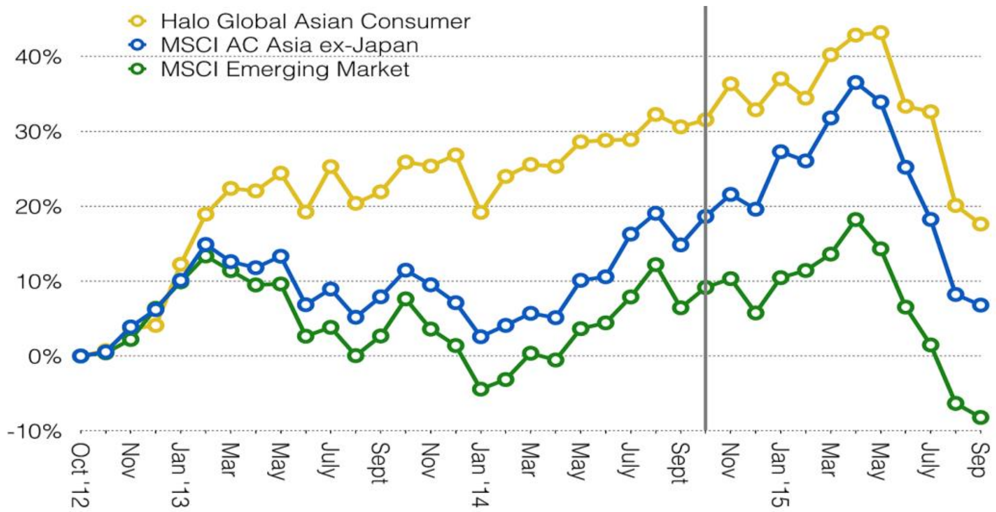


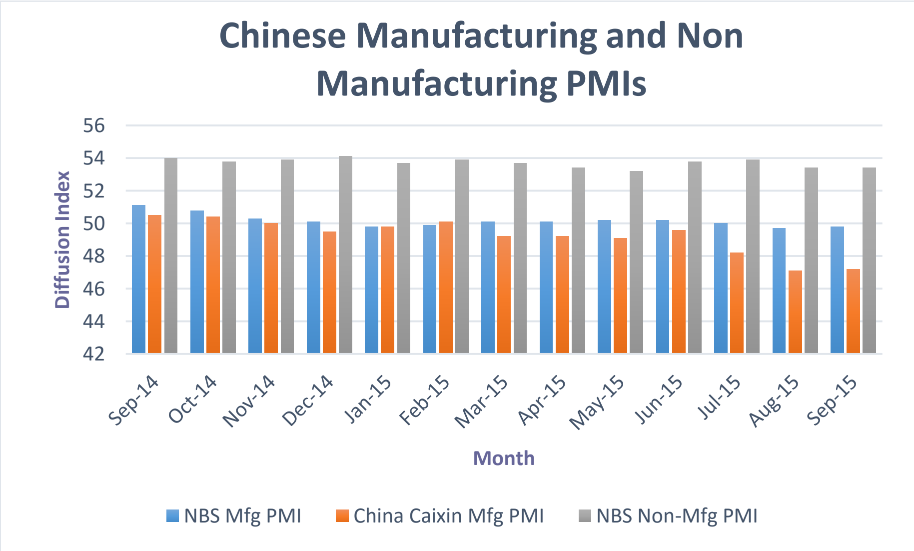
Chart to the right of the grey bar is of the model portfolio with full audit trail net of costs, the right of the bar is of the VT Halo Global Asian Consumer fund £B Acc. Units.

China's Economic Situation

The key points over the last 3 months, which have upset markets, are the "devaluation" of the Renminbi and the decline in the Manufacturing Purchasing Managers Index (PMI) and how these amongst other headline grabbing numbers have been interpreted to mean China is heading for a hard larding or recession. Something we still believe is unlikely to happen.

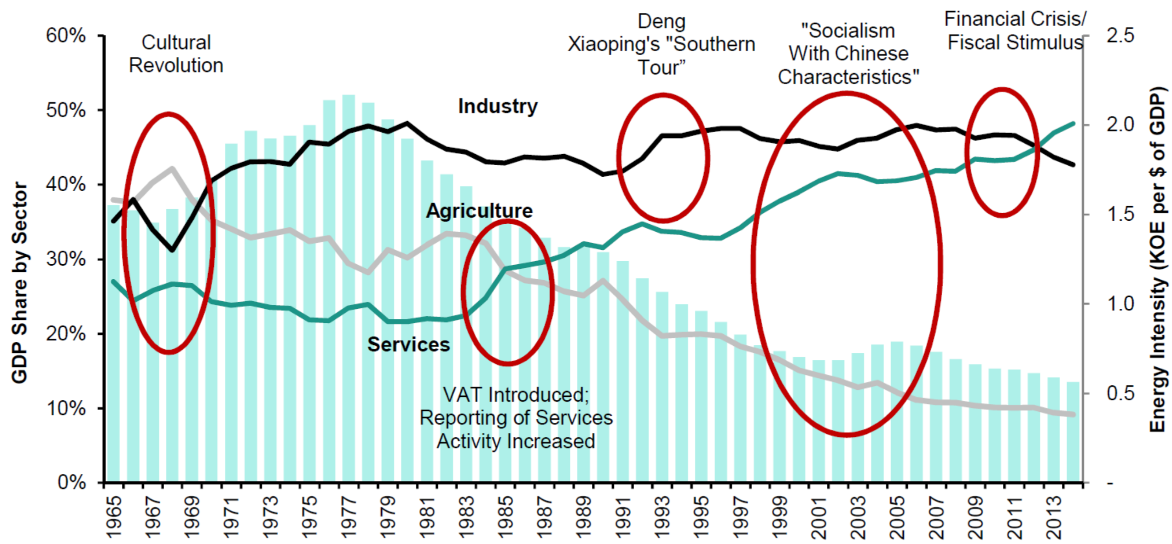
Firstly with regards to the devaluation, let's put this in context, there was a move of 4% against the US Dollar (the strongest major world currency by far this year). Against all other currencies the Rmb is still strengthening and a 4% devaluation does not really alter the dynamics of the economy. It will not help the export sector in China, as some people surmise, firstly it's really too small a move to be relevant coupled with the fact other currencies in the region have fallen by a similar amount against the USD since the move happened. Secondly China imports a lot of raw materials and parts which are then processed to finished goods and then exported. The fall in the currency just increases the cost of goods for these products, therefore delivering only a marginal benefit to them. My belief is this was a badly communicated adjustment of the value of the currency to make it more market orientated with the aim of it becoming part of the IMF's SDR basket. It is *not*, as the market has interpreted it, a signal that the economy is in serious trouble.

Secondly, the Caixin Manufacturing PMI survey does not tell the whole story. This survey is focused on 400 or so small and medium sized manufacturers who are geared towards the export sector and not consumption at home. So it can be argued that they are a better guide to *global* demand rather than domestic Chinese demand. Interestingly, exports to the US and Europe are holding up well and are positive year on year, the real issue is a fall in demand from other emerging economies (especially those who have been reliant on the export of commodities to China to drive their own economic expansion). One should also note that a reading below 50 does not indicate a contraction as would be the case in surveys conducted in the West, since historically a reading of 50 has been associated with an economic growth rate of 8% or so.



If we look at two other surveys (which journalists and other commentators with a bearish tack fail to mention), China does not look that bad. Firstly there is the National Bureau of Statistics Manufacturing PMI (blue columns in chart above), which predominantly surveys the large state owned enterprises (SOEs), by their nature more domestically focused, which has been hovering around 50 for the last year. Also if one looks at the Non-manufacturing PMI survey (services) grey columns, you will notice that it has remained resolutely in the 53-54 range, indicating strong growth in this segment of the economy. Further to make a point, the chart below from Bernstein shows that the service sector is now larger than manufacturing for the Chinese economy and therefore more important. Another area that commentators regularly highlightas a guide to underlying Chinese GDP growth data namely power consumption data, has become less relevant. This is because the energy *intensity* of Chinese GDP growth has declined as they move away from manufacturing, to a service and consumption orientated economy. Power consumption is up this year but only by 2% or so, with the latest reading in August up 2.5% year on year.

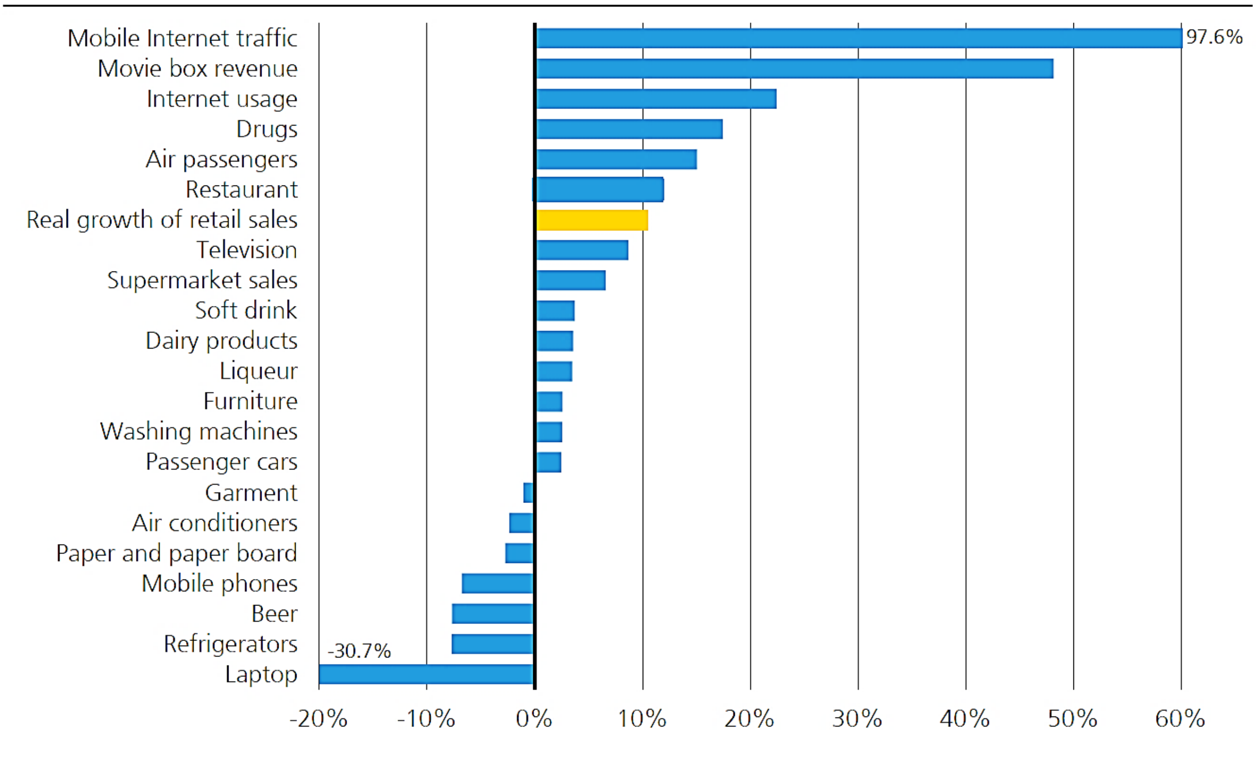
Chinese economy by sector and Chinese energy intensity, 1965-2013



Source: Haver, World Bank, and Bernstein Analysis

Other incidental data points that we have come across over the last few months also point to an economy that is not in recession or heading for a hard landing. For instance, cinema ticket sales are up 47% year on year, **Ctrip**, the online travel company, have said that October Golden Week bookings for long haul travel are up 150% year on year, and retail sales are still growing at over 10% pa at the end of August. The graph below highlights some of the spending growth, with laptops down, as people move to tablets, and smart phones are down due to overstocking last year as penetration reaches saturation. However, what this chart does not show is the *value* of phones bought is up, as consumers trade up to smart phones. Yes, China is slowing from the 8% growth rates the world had become used to and perhaps will "only grow at 6.5%" in 2015, but this is still considerably faster than any other major economy. We have to understand that this slowdown in China is structural, and that the growth in the future will be of a better quality, as consumption moves to become the dominant contributor to growth.

Volume growth of consumption sectors



Source: Wind

Within this dynamic, as we have stressed in the past,we remain focused on investing in companies that serve the consumer in many different ways, be it through direct consumption of brands, or internet companies that serve to fulfil consumption, to wealth management, healthcare and companies enhancing the environment for consumers. We do *not* invest in manufacturing companies. Having just returned from China it is hard to detect any material slowdown in demand from comments from the companies I met. Competition remains fierce with, in some cases profits being sacrificed today for top line growth (something the stock market hates because it depresses profits in the short term), as they aim to grab further market share, this being particularly true in the newly emerging internet services, an area which I will delve into a bit further later on.

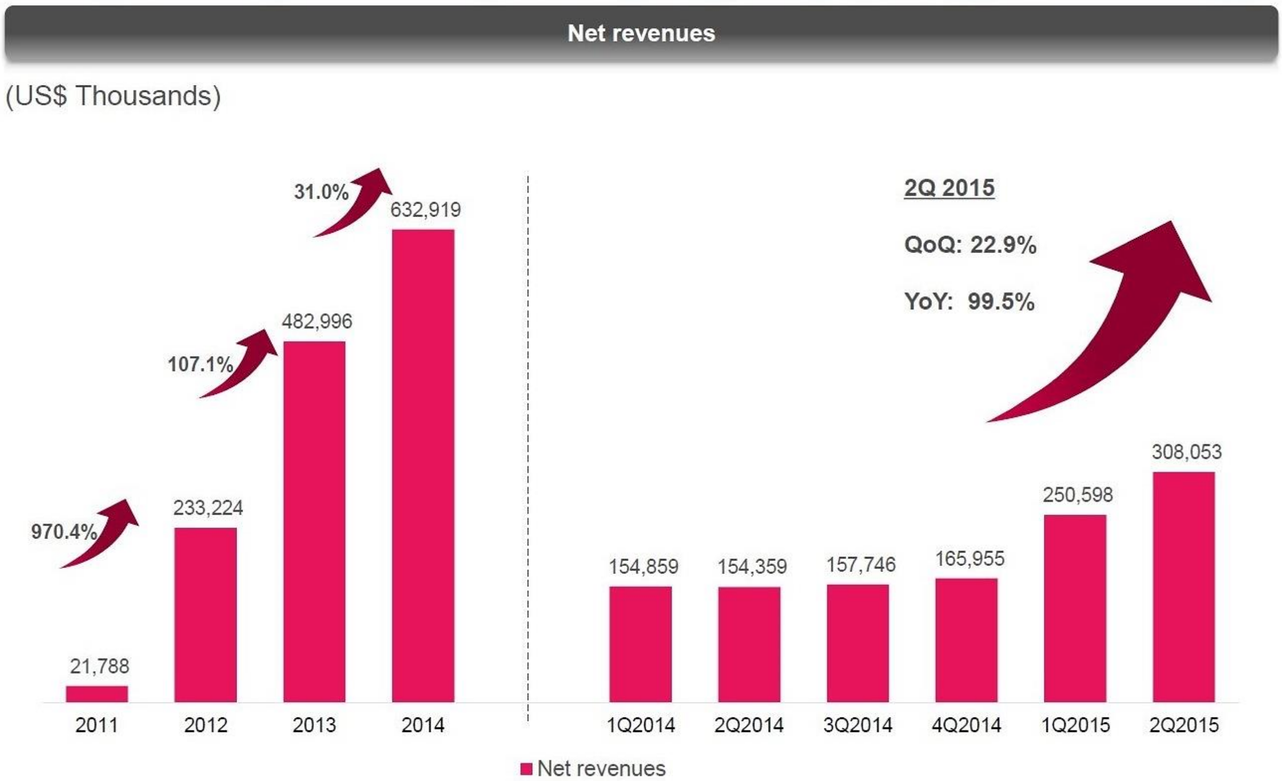
The Internet, cross border and O2O services

We currently own **Jumei**, an internet cosmetics retailer. The cosmetics market is estimated to be growing at 9-10% pa, with demand driven by urbanisation and rising incomes, with internet sales growing at a multiple of this. Currently China is estimated to spend $75 per female capita on beauty and personal care and this is about 15% of peers' spending in Asia with Hong Kong at $504 and Japan at $608, according to CLSA. Online spending has been capturing a disproportionate amount of the growth, with on line spending as a total of the overall cosmetics market rising 10.2% from 5.3% in 2011, to 15.5% in 2014, and is expected to climb to 25% over the next few years as share is taken from the supermarkets and department stores.

Jumei, up until just over a year ago, was an Ebay equivalent, acting as a market place specialising in selling cosmetics and related products. The issue with this business model was the prevalence of fake cosmetics, which they had little control over. They decided in 2014 to move to a model where they could control what is sold on their site and became a cross border cosmetics internet retailer. What do I mean by this? They moved away from being a market place for others to sell products, to a business where they sell their own private label cosmetics aimed at the mass market as well as exclusive products from international brands, which can be mass or prestige products. At the same time they have been moving into other related categories that a typical 20-35 year old female would buy on the internet, with goods such as baby & maternity products and vitamins. These products will make strategic losses in the early timeframe as they are used to generate traffic and acquire new users.

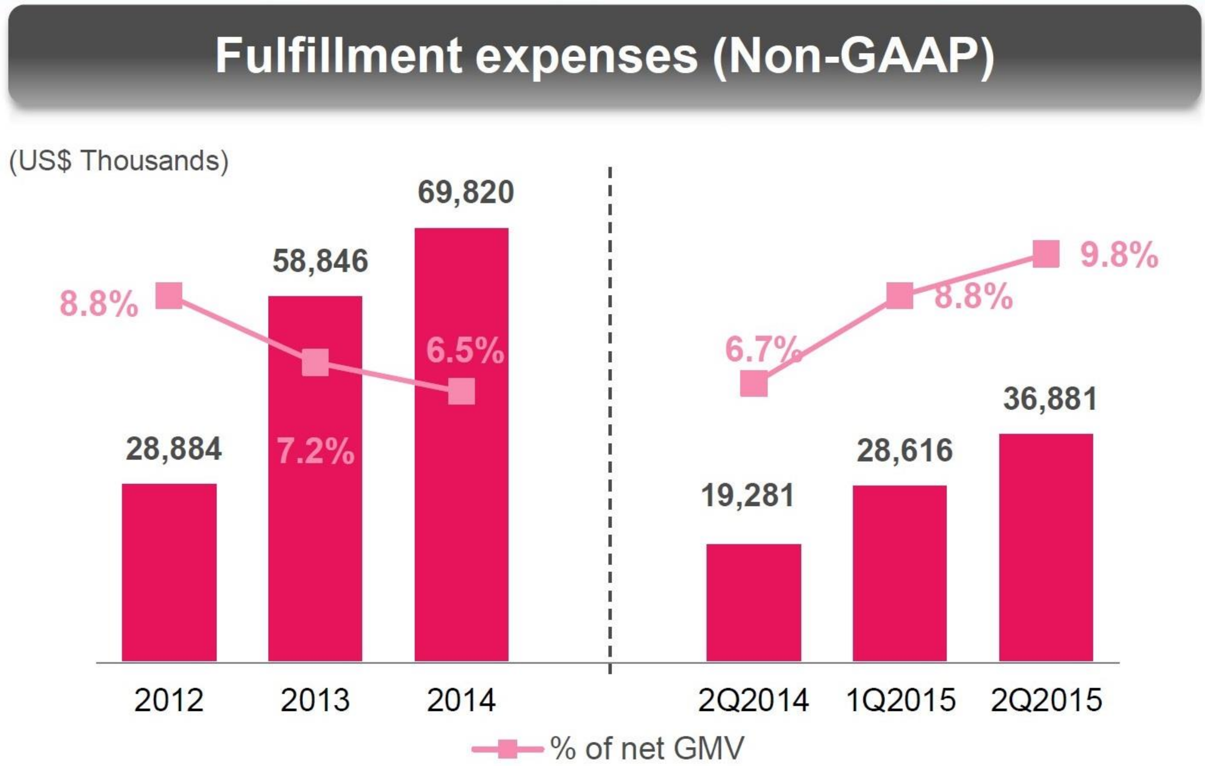
Revenue growth year over year in the second quarter of 2015 was 100%, which admittedly will slow from here but I would expect it still to be up over 30% in 2016. The number of customers continues to expand and is up 28% in the last 12 months, while customers who are repeat purchasers made up 89% in the last quarter.

Chart below shows revenue acceleration in 2015 as Jumei ramp up its Global business



Cosmetics and other related goods are a lot more expensive in China than elsewhere, which is due to a consumption tax, import taxes and VAT in China. This encourages a lot of grey imports which are sold over the internet on consumer to consumer websites such as Tao Bao, owned by Alibaba. The government has been encouraging the internet retailers to import these goods through free trade zones in China, as this will reduce the prevalence of grey market goods sold where the government receives no tax, and it legitimises this cross border trade business.

All this sounds great with 100% revenue growth, but there is currently zero profit growth projected for 2015. The costs of fulfilment of the new Jumei Global model are higher, as shown in the graph below from their last quarterly results. Importing goods direct from manufacturers and offering free postage (to the majority of customers), has resulted in margins falling in 2015, with fulfilment expenses having risen from 6.7% to 9.8% of sales from 2Q 14 to 2Q 15, leading to group operating margins down from 8% to 4.5%.



We like to invest in companies for the long term, by which we mean a minimum of 3 years and ideally over, and we believe Jumei has a unique internet vertical, with a strengthening brand. Margins are going to recover in 2016 as they will start to charge customers for products delivered by post, thus reducing the cost of fulfilment for their Jumei Global business. In addition they are gaining traction in cross-selling own label and exclusive beauty products to customers, which have significantly higher margins. The company's margins should start to rebound next year, as management have indicated that in the medium to long term they want to move margins to over 10%. Sell-side analysts do not factor in much margin recovery in 2016, as the market is very much in "show me" mode, given what is happening this year. The valuation today at 13x 2016 earnings in my view does not factor in any of this, and assumes revenue growth of 40% and margins of 6.4%. If they actually deliver a margin increase in 2016, as they say they will, the stock is extremely undervalued, with earnings growth of 50% in 2016 and 40% in 2017. This implies the market is deeply sceptical this growth can be achieved, but our view is (if you have patience and can stomach some short term volatility) the returns that we should experience over the next few years, will be exceptional.

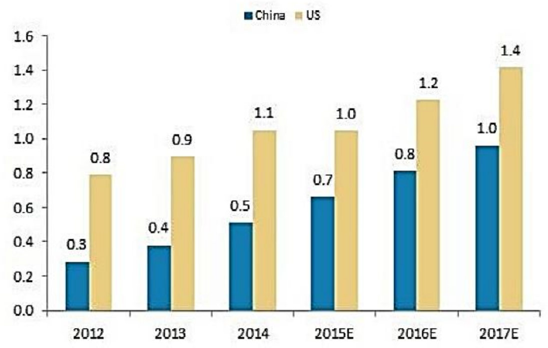
Another area of debate full of commentator scepticism regards the development of a new area in ecommerce namely O2O services, which is having a big impact on the share price of Baidu.

What is O2O?

This stands for online to offline and what this jargon really means is internet companies connecting consumers to bricks and mortar businesses through the use of the internet, typically via a mobile device. This is geared to services rather than actual material goods, and consumers can order such things as takeaway food, book a restaurant, purchase cinema tickets, book domestic travel and home services such as cleaning or a manicure/massage services or even consulting a doctor and arranging an appointment. The key is it allows internet companies to become a distribution channel for traditional, local offline services, thereby expanding their monetisation opportunities beyond advertising to commissions based on the gross revenue they help generate. **Baidu**, is currently spending a large sum of money (billions of US Dollars) to invest in this area as it sees it as "the next big thing" of the internet.

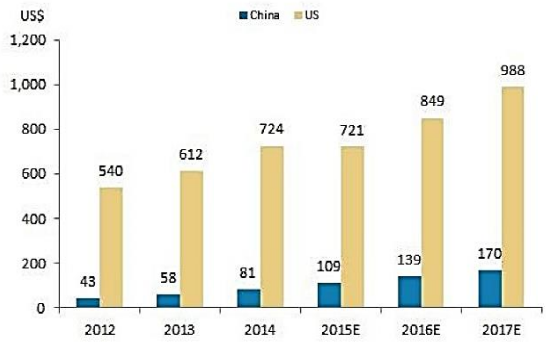
As shown below, the monetisation of the internet in China is some way behind the US, but as China shifts to a more consumer driven economy, internet services companies will be large beneficiaries of this. At some point China will overtake the US in internet revenue as a percentage of GDP and in the distant future also on a revenue per user basis. Why do we believe this? Well, China is more suited to the internet because of its lack of developed national retail stores and the population density in cities being far greater, something the urban sprawl of the US less favours. This provides the cluster effect for the economies of scale of the internet to work.

China is somewhat lower than the US in Internet revenue as a % of GDP...*



Source: Company data, Bloomberg, CEIC, Morgan Stanley Research. *Revenue estimate from Bloomberg, GDP estimate from Morgan Stanley Research.

...and substantially lower than the US in revenue per user*



Source: Company data, Bloomberg, CEIC, eMarketer, Morgan Stanley Research. *Revenue estimate from Bloomberg, US Internet user estimate from eMarketer, China Internet user/GDP estimate from Morgan Stanley Research.

In certain business lines of O2O commerce, China are ahead of the US in their adoption. I think because of this some investors are struggling to understand why companies are willing to spend so much on a service technology that is unproven with little visibility of when it will ever make a profit.

Baidu in particular have a number of subsidiaries which operate in this space. They have Qunar, an online travel agent, which although currently losing money is growing even faster than the online travel industry as a whole (which is growing at 30% pa), whilst travel more broadly is growing at 10%. They also own Nuomi, a group buying company, that is the umbrella for numerous services, such as restaurants and takeaways, household services and cinema tickets. This also fits neatly with *Baidu Maps* as a location based service that can offer the user relevant coupons to encourage that person to step into a physical store that is close by.

How it currently works is the O2O provider will take a commission of 15% for a hotel booking, or 10% of revenue from a restaurant or takeaway. But in order to grab market share they are offering a large subsidy to the user by giving them money-back (discounts) on any transaction they complete. This rebate is greater than the commission earned, so creates a loss. But right now this spending, by all the participants in the space who subsidise these local services, leads to low user loyalty and significant losses for all participants. The fear is that these losses continue to mount as the battle amongst O2O service providers runs for some time. Ultimately consolidation *will* happen to establish the winner in this space. So Baidu by signalling they will spend some $3bn on this market over the rest of 2015 and 2016, hopes to discourage new entrants and achieve the coveted slot of being the No.1 market player, so benefiting enormously as the market consolidates and becomes profitable.

Given the lack of clarity as to when this might happen, investors have assumed the worst and expect this battle for market share to continue beyond 2016 so depressing profits at Baidu. Given the losses incurred the market is attributing a negative value to these new business lines, which strikes me as odd. Firstly Qunar, the on line travel agent is actually quoted, with a market value of $4bn and Baidu owns 54% of it today having just taken part in another round of financing in August. With regards to Nuomi, it is hard to establish a value of this business but if we put the core Baidu search business on 15x earnings, and exclude all the other businesses we get a value of $210 per share for the search business alone. The share price today is $138, which implies that, even if you value Qunar at zero and not $2bn (for Baidu's share), the other businesses including O2O are valued at a negative $25bn. The bears would argue this is fair since margins for Baidu will fall from 27% in 2014 to 17% in 2015 due to these O2O losses and then only start to recover from these levels in the second half of 2016. Given other companies in the sector who are also making losses are valued by Private Equity in the billions, this appears too negative. Again our view is you have to have patience and a longer time horizon than the next 3-6 months to value a company like this correctly. We certainly see value, and have been adding to our holding at the current valuation.

Conclusion

In general we do not believe the macro situation in China is anything like as bad as the headlines suggest. It's true that fixed asset investment is slowing, principally driven by the property sector, which currently is showing zero growth, and hence dragging down the overall headline number. This slowdown in property does have a knock on effect in goods such as furniture, air conditioners etc. But as we have stated, this is not an area we invest in. We are more focused on the service sector in China (avoiding infrastructure and other heavy industries), which continues to exhibit robust growth.

We are also happy to own stocks that are unloved in the short term, which provide good entry points for investors with a longer term view, in the belief we can achieve significant returns in a 3-5 year time frame, and can stomach a bit of volatility in the short term. We are able to do this as we also own large cap quality Western companies that sell to emerging Asia, which typically have a low beta keeping our overall portfolio risk and volatility below a comparable Asian index.
