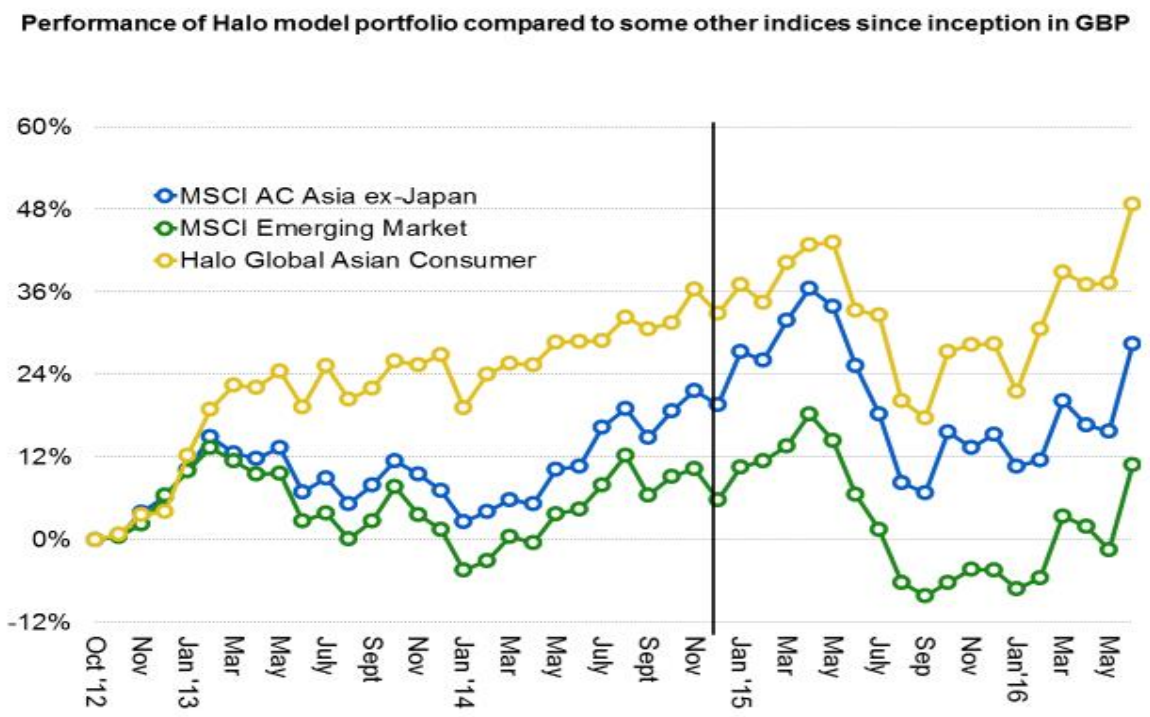
VT HALO Global Asian Consumer Fund

1st Quarter 2016

Markets over the last quarter have effectively been trading in a 10% range in local currency terms, as the mood swings move from brighter prospects in one month to feeling more depressed the following month. It proves that in the short term, macro sentiment drives markets. We continue to focus more on the fundamentals of individual companies and not let market noise detract us from this view.

Although one topic of conversation for British investors that has been unavoidable is the impact of the Brexit vote. What though does it mean for Asia and in particular for consumers? Firstly, I would say that markets always try to anticipate and second guess what the effects might be, hence the volatility we have witnessed especially in the last 10 days. We can all have an educated guess, but that is all it is, as to be honest no-one really knows. For Asia though, I think in the short term we can conclude that monetary policy in the West is going to remain looser for longer. With the US unlikely to tighten anytime soon and the market now saying December at the earliest, it means policy in emerging Asia can remain loose, with further interest rate cuts expected in 2017 from Indonesia, China, India and possibly Thailand. Also with the USD unlikely to strengthen further the pressure on their currencies will be less, which means higher real interest rates are not required to defend their currencies. We should thus expect the stock markets of the region to remain relatively robust. The only negative effect for Asia is if Brexit causes the EU to disintegrate, which will be a global negative event and Asia would not be immune, as Europe is its largest trading partner.

Obviously the fund has benefited from Sterling's depreciation and hence the NAV in June is up by 8.3%, even as markets were broadly unchanged in local currency terms with Hong Kong for instance off 0.1% for the month of June.



Performance shown to the left of the grey bar is of the model portfolio gross of fees and trading costs, to the right is the performance of the VT Halo Global Asian Consumer Fund £B Accumulation units inclusive of all costs. Past performance is not a guide to the future performance.

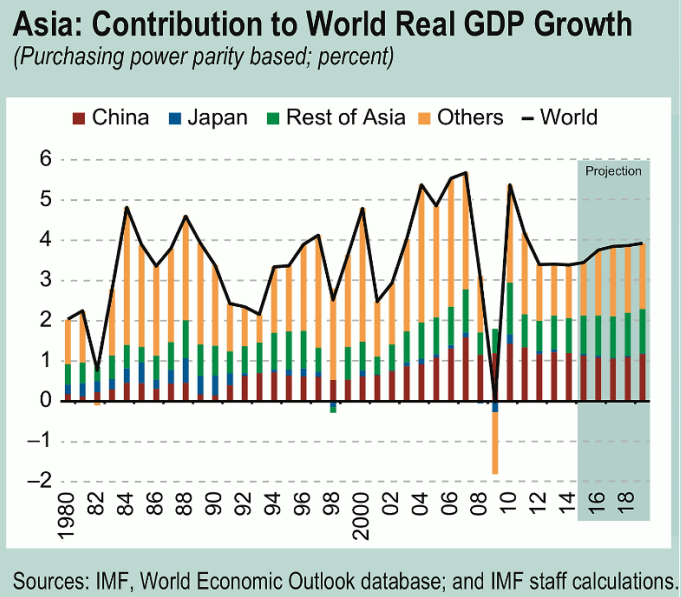
How important is consumption to Asian and Global GDP growth?

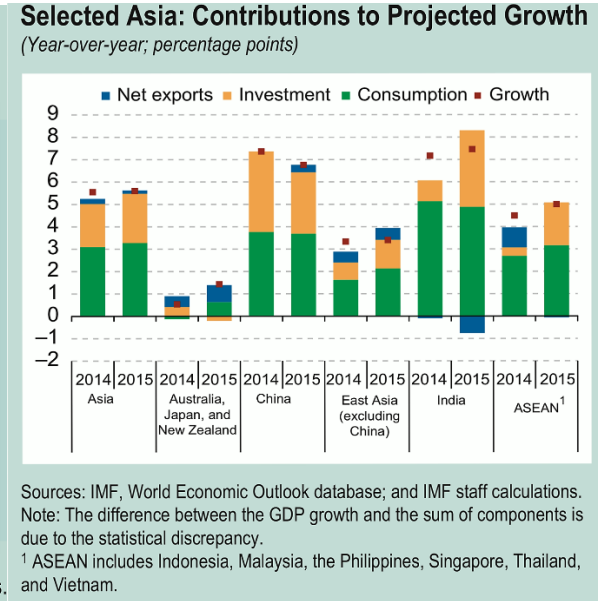
As discussed in previous quarterly letters, consumption accounts for the largest share of GDP across all the countries in which we invest and also is the biggest contributor to GDP growth. Below is a table of the percentage of GDP that comes from consumption in 5 key populous emerging Asian countries.

Country	Consumption as a % of GDP - 2014
China	50.1
India	70.7
Indonesia	66.1
Philippines	82.8
Thailand	69.3

Source World Bank

In addition, as well as being the largest part of GDP, for China it is only just, with it at 50.1%, but it was down to as low as 40% of GDP a few years ago, consumption is the biggest factor driving GDP growth in the region. The graph below shows global GDP growth for the world to be around 3.3% today, and rather optimistically by the IMF, expecting to accelerate towards 4% in the next few years on the back of improved growth in the US and Europe. The point to highlight here is growth from Asia is contributing just over 2% of the 3.3% of global GDP growth and consumption is the biggest driver of that as illustrated in the graph below right. For instance, ASEAN, which has seen GDP growth accelerate from 4% to 5% in 2015, has seen consumption (the green bar) contribute little over 60% of this growth. I would also note that Investment being the other large contributor to GDP growth but it has not been as consistent. Consumption growth has been pretty much tracking the same growth rate for the last 5 years or so and that is because consumption is a generational theme. An economic slowdown is unlikely to compromise consumption growth, as long as we continue to see nominal wage growth as urbanisation rises and people continue to upgrade their consumption.





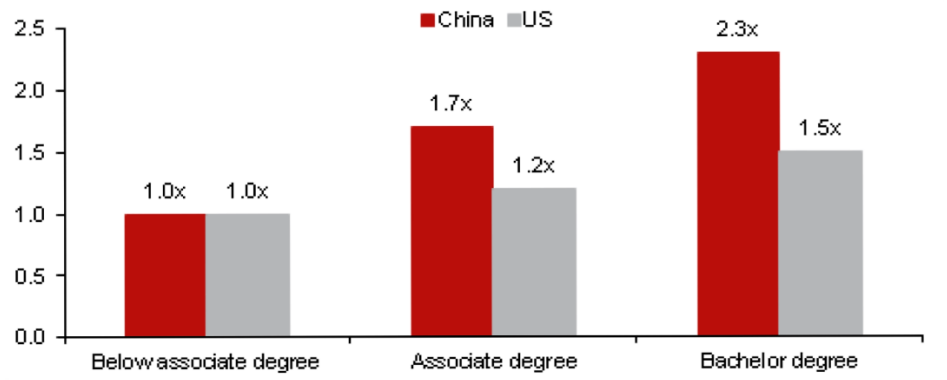
The reason for commenting on this, especially on a macro front, is to highlight how much world growth is dependent on Asia right now, but equity investors allocate a very small amount to it as emerging markets in general are around 10% of global benchmarks and Asia is a subset of this. Given the importance of Asia and its growing percentage of total world GDP, are investors missing something here?

Coming back to Brexit and its impact on consumption in Asia. Consumption growth is a long term structural development and at the moment Brexit is more a political event than an economic one. The UK itself does not really impact Asia given its global economic importance is small. The way to think about it is: will a consumer be put off going to the cinema, or ordering a take-away or not pay for their children's education just because the UK is leaving Europe? Assuming not, and also assuming that the rest of Europe continues to muddle through, then shares in Asian consumer companies have just become a little bit cheaper than they were a month ago.

Which leads me on to a sector that is currently seeing rapid growth in China and India and is unlikely to be derailed by Brexit and that is education. Indeed, with Sterling now 10% cheaper, I would expect a greater influx of overseas students to our shores.

Private Education in China

For Chinese families, academic qualifications are extremely important in life, which implies a demand for educational services that is likely to be relatively inelastic. As incomes rise, we expect demand for education to be increasingly filled by the private sector. In China, education, especially of higher qualified individuals, allows them to command a greater salary premium to those lacking qualifications as shown below in a chart from Nomura. In comparison this is less pronounced for US graduates.



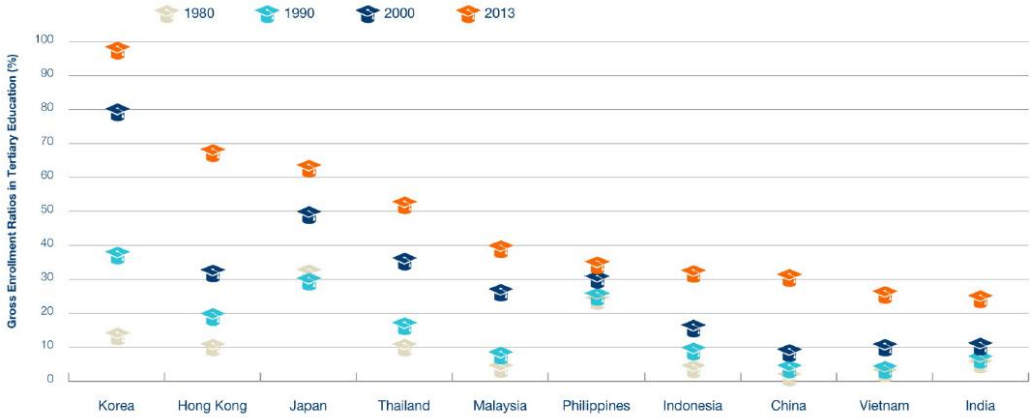
Source: Xueda, US Department of Labor, ChinaHR.com, US Census Bureau, EIU, IDC

Asia's increasing enthusiasm for higher education is shown below, with South Korea at the extreme, but Hong Kong and Japan also showing a very high enrolment ratio for tertiary education, compared to the West being closer to 50%. One can assume that as the wealth of China and other emerging Asian countries increases, the proportion entering tertiary education is going to climb to levels closer to the more advanced Asian economies. In the long run, this bodes well for increased demand for private education to ensure your child attains the best start in life and to enhance his/her job prospects.

Historical Strides in Tertiary Education

- The proportion of students in Asia earning their bachelor's degree has taken off over the last 30 years, with extraordinary numbers of students on a relative and absolute basis embarking on higher education throughout Asia.

Gross Enrollment Ratios in Asia Over Time

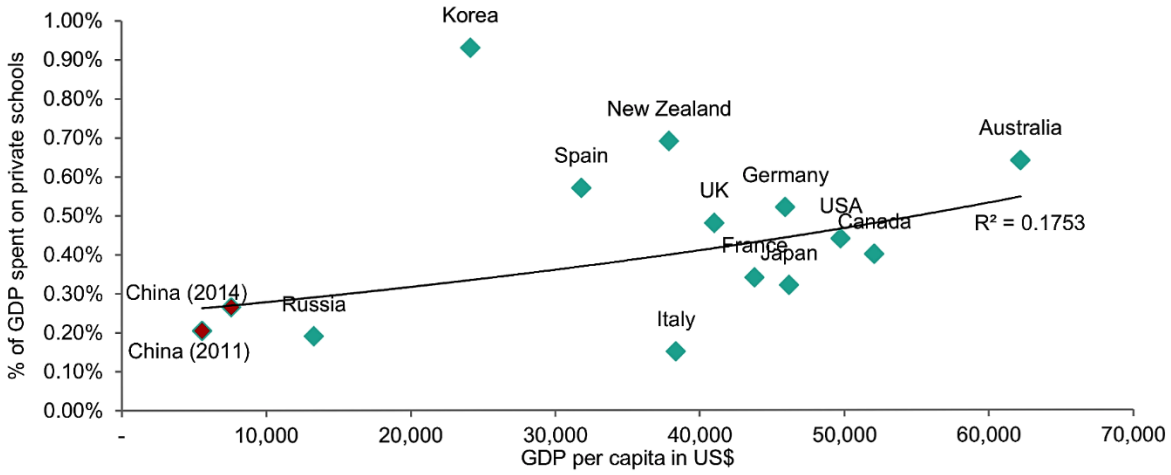


Source: World Bank (2016)

The result of all this is we are likely to witness increased demand for K-12 tutoring (in and out of school classes for those aged 6-18, to ensure they pass the university entrance exams) as urbanisation and the middle classes increase, even though the total student population itself remains flat due to the one child policy.

A couple of useful graphs from Bernstein illustrate the fact that China still has a long way to go to match the spending in the West, with spending as a proportion of GDP only at a level to be expected at the current GDP per capita and still way below Korea, which one could argue is obsessed by it, to the detriment of children not having much of a life outside school. One would expect China to move above the line perhaps closer to New Zealand, given the cultural priority of education.

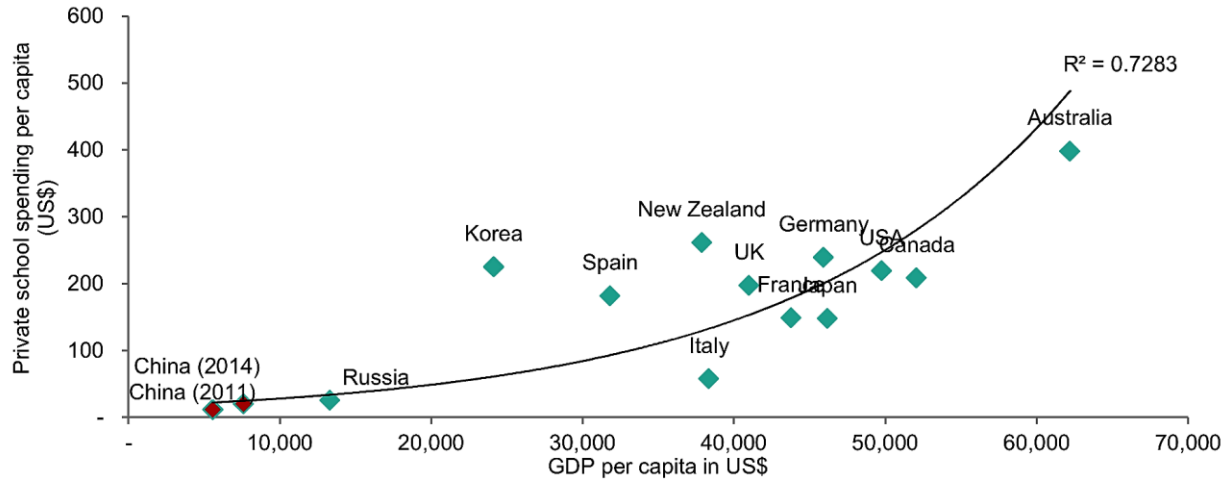
% of GDP spent on private schools (pre-school, K-12) vs. GDP per capita



Note: Education spending data from 2014 OECD report on education, based on 2011 figures for private expenditure on educational institutions unless otherwise stated. Education spending on China based on company filings and industry consultants

Source: OECD, World Bank, company filings, Frost & Sullivan, Bernstein analysis

Spending on private schools (pre-school, K-12) per capita vs. GDP per capita

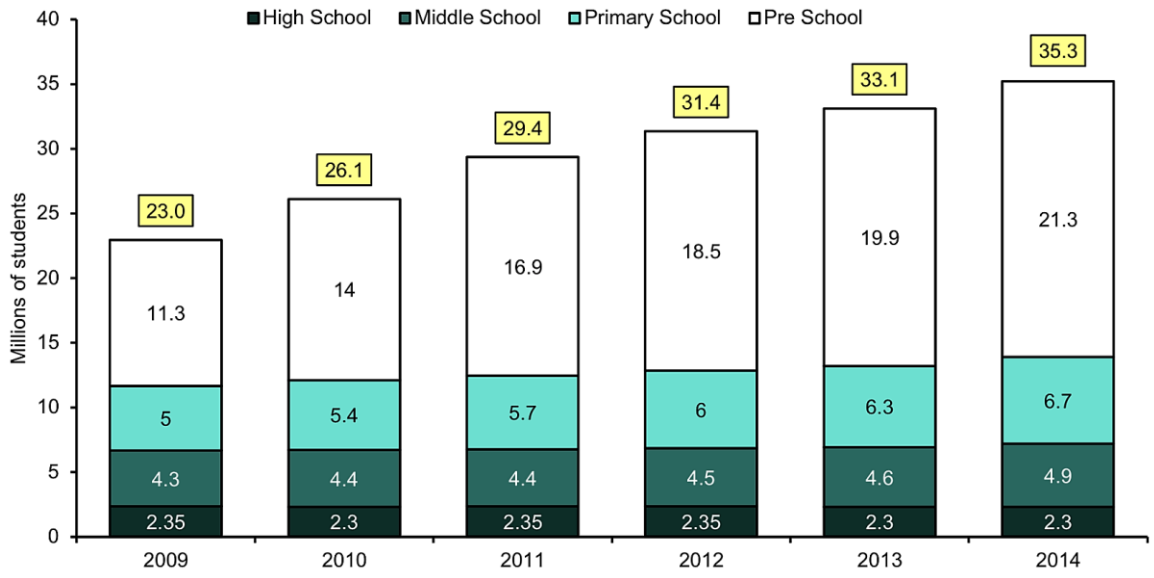


Note: Education spending data from 2014 OECD report on education, based on 2011 figures for private expenditure on educational institutions unless otherwise stated. Education spending on China based on company filings and industry consultants

Source: OECD, World Bank, company filings, Frost & Sullivan, Bernstein analysis

As shown below enrolments continue to grow, especially in pre-school, but more importantly in primary school. Once enrolled in a private primary school you are more likely to continue your education in the private system. Thus the growth we have witnessed over the last 5 years should continue for a while longer.

Private fundamental education enrollments in China (pre-school, K-12)



Source: Company filings, Bernstein analysis

Bernstein did their own survey of spending on education by urban households with disposable income of more than Rmb10, 000 a month, (estimated to be 67m households). The allocation to education was 9%, the second highest expenditure for a household after daily expenses. There are 35m students today using some form of private education out of a possible 200m students. Enrolment has grown on average by 9%pa for

the last 5 years, and one should expect the growth to continue albeit it might slowdown to mid-single digits. CLSA have also done their own surveys and point to this sector being a very defensive sector in terms of spending priorities and in their study of middle class China, they highlight that families spend 13% of their household budget on education, with 43% saying they will increase their outlay in this area when the family income grows, while only 2% would cut spending during tougher times.

With overall market growth for education likely to slow from current levels in the medium term, it is likely that existing schools with strong brands will continue to take share and maintain strong growth over the medium term. The market is characterised by local players who typically will have just one school or a few schools in only one city. Those companies which have a strong brand and have already branched out from the city where they were founded are likely to expand at a faster rate, as they play on parents' paranoia to pay for the best education they can afford and the willingness to pay up for well-regarded brands.

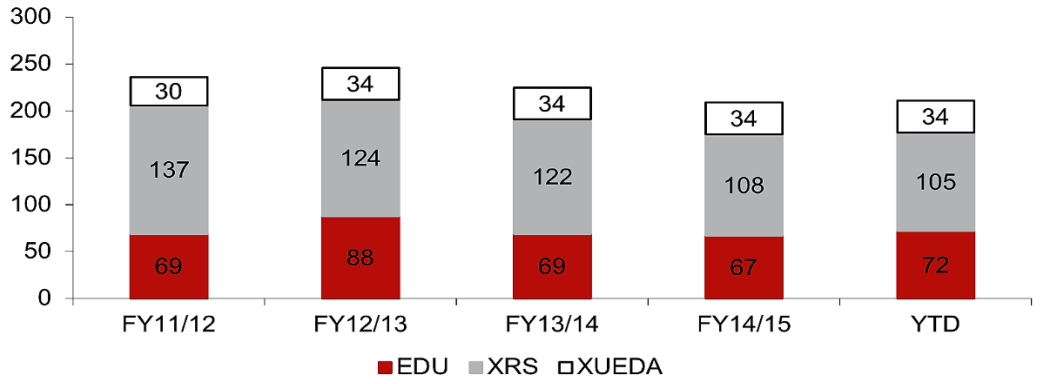
What are the risks for private education companies?

One obvious risk is cost inflation, especially with regards to teachers and their salaries. In order to enhance your brand, you need good quality teachers and the pay in the private sector relative to those in the public sector is significantly higher. Including bonuses, they can typically earn 2-3x what they might earn at a state school. So if they are seeing wage inflation from teachers in the high single digits and the cost of teachers' salaries can account for 25-35% of the companies' revenues, then the ability to increase prices is key for these educational establishments.

Another factor that could alter the landscape, especially for after school education is the penetration of online-only learning centres. Business models are changing, with established players with large physical presence trying out online-only and omni-channel learning, where they might attend a class at a centre but all homework and monitoring of their progress is completed online. It is harder to motivate children sitting in front of a computer in their own home, than an adult who is paying for his course out of his own pocket and is highly motivated to improve his job prospects and career. But again branding and reputation will be key. So for children of school age, I believe the omni-channel is more likely to work, so the presence of learning centres will still be required and the ability to communicate with a tutor face to face is always better than distance learning solely online.

The risk though, is that online education is a lot cheaper given its economies of scale, with class sizes that can be hundreds or thousands of people rather than 30-100. So people may opt to have their after school education at home as it is significantly cheaper than physically going to a class room. On the positive note, learning centres have the ability to reach students through online courses in towns and cities where no physical learning centre exists, so enhancing the utilisation of existing teachers and course work.

Lastly, when will markets reach saturation? As mentioned above the actual penetration rate appears to be around 17% of students nationally when you include primary schools as well. But in places such as Beijing, saturation point may be close, as shown in the chart below, which shows the number of learning centres for the largest 3 players and we can see it has been fairly flat over the last few years. However, this chart does not show the expansion of the number of classrooms in some centres to compensate for the closure of other centres in Beijing. The number of centres has been broadly flat over the last few years and one can assume that revenue growth has been driven by increased utilisation of existing centres as well as raising the cost of the courses. So if Tier 1 cities represent a large proportion of their current students and revenue, then we might become more nervous for the projected growth rates. But as wealth grows in other cities, these companies with strong brands can establish new centres to drive their expansion and also take share from existing local learning centres and this is what we are currently witnessing.



Source: Company data

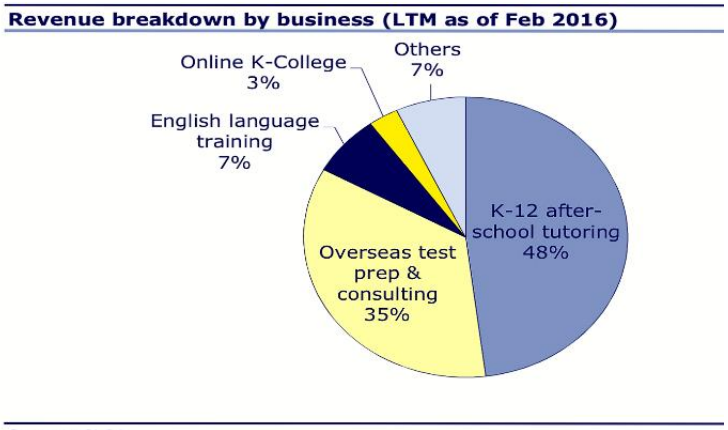
New Oriental Education, a new holding in the fund for this quarter

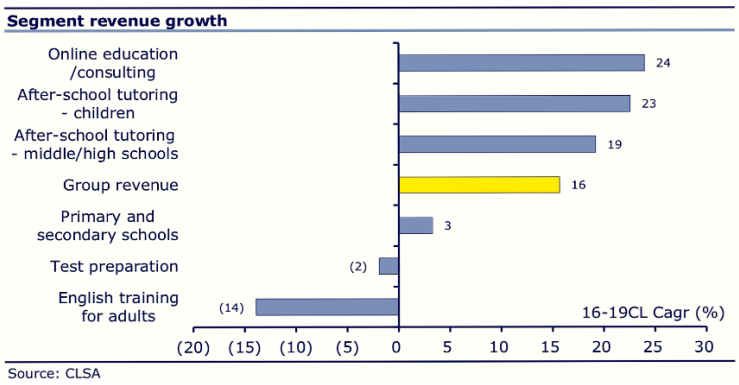
Given the trends discussed above we have increased our exposure to the sector. In our December 2015 quarterly letter, we discussed the purchase of China Maple Leaf, a Chinese private school operator, which has performed extremely well for us in 2016. They have increased profit guidance substantially since their half year results in April and the number of students enrolling at their schools is running well ahead of market forecasts and their new school expansion plans are also ahead of expectations. The shares are trading at new highs as I write.

I would like to highlight another stock we have recently bought, New Oriental Education (stock symbol EDU). They operate in a different area to China Maple Leaf. Whilst China Maple operates traditional private schools, EDU business is the after school market and test preparation for overseas study. Their revenue breakdown is shown in the pie chart below, together with the expected growth rates of each segment as estimated by CLSA.

K-12 is the largest contributor followed by overseas test prep. With the K-12 business currently growing in the low 20% range it will soon form over 50% of its business and if it can maintain this growth rate for the next 2-3 years, then we will see the company's revenue growth actually accelerate from today's levels. In addition, the company are focusing on taking their utilisation levels from 20% to 30%, which is effectively full utilisation of the classrooms as during certain times of day the classrooms will always be empty. As they increase the utilisation we should see the group profit margins and returns on capital expand and hence profits are likely to grow faster than revenues over the next 5 years.

With its strong brand we expect the company to grow faster than the market in the K-12 segment, both on and offline, which is itself as shown below, illustrating strong underlying fundamental growth, as they take share from the small one city operators. In addition the Test Preparation division might actually start to grow again as more Chinese students seek to further their education abroad. With a combination of strong revenue growth driven by increased student numbers, as well as increasing prices for their courses, we believe earnings growth can remain above 20% per annum for the next three years. Its current 2017 price/earnings ratio is 20x, which for a defensive consumer company is not a rich valuation in our view.





Tax amnesty law passed in Indonesia

One other event I wish to highlight that occurred right at the end of the quarter and to much relief for investors, the Indonesian Parliament passed a tax amnesty law last week, which is aimed at encouraging the billions of US Dollars parked overseas to come back to Indonesia. This should provide a one off fillip to tax revenues in the next 12 months, which will allow the current government expenditure on infrastructure to continue without breaching their self-imposed fiscal deficit rules, which is key to helping drive prosperity for Indonesia. The flow back of the money will also improve the balance of payments and help with the exchange rate. This will allow interest rates to be cut again, without harming the currency and allowing further capital investment by the private sector, which will again lift investor sentiment.

The funds will likely be used to buy government bonds, as well as further property investment and other large ticket items. There are big discrepancies as to how large the flow of money back to Indonesia will be, with estimates ranging from $10bn to $40bn, depending if you are speaking to the central bank, sell side research or the over-optimistic government. For the medium term, rather than a short term one-off fiscal revenue boost, it is key for further reforms to take place, increasing productivity and allowing for inflation to remain subdued.

Conclusion

The forward 12 month PE multiple of the fund today is 15.5x having crept up from 14x at the end of March. Part of this is down to some of our European stocks, whose share prices have reached new 2016 highs on the back of currency weakness but consensus earnings have not reflected the positive translational impact to their profits. Also of note is that the expected earnings growth for the fund over the next 12 months is now up to 16.5%, compared to Asia as a whole expecting 5%. So the increased NAV has mostly been down to an increase in the multiple expansion and we now wait for the half year results season to start in mid-July, to see if the companies we own deliver the results we expect from them. With little impact expected on the Asian consumer from Brexit, we continue to remain confident in the outlook and I would expect some positive price reactions from a number of earnings announcements in due course.