First State Stewart Asia - Scottish Oriental Smaller Companies Trust plc

Investor note

January 2017

This is the third semi-annual update on the Scottish Oriental Smaller Companies Trust plc ("The Trust" or "Scottish Oriental"). Our aim is to provide a general update on some of our current thoughts and views, insights about existing holdings, and changes to the portfolio over the period.

How we invest

Scottish Oriental is managed by the First State Stewart Asia team, an independent investment management team within First State Investments. The team manages a range of Asia Pacific equity strategies on behalf of institutional and wholesale clients globally, with offices in Hong Kong, Singapore and Edinburgh.

The Trust aims to achieve long-term capital growth by investing mainly in smaller listed companies across the Asia region; that is companies with market capitalisations of below US$1.5 billion, or the equivalent thereof, at the time of first investment.

We are conviction-based, bottom-up stock selectors with a strong emphasis on high quality proprietary research. Our investment approach adopts an absolute return mind-set and is inherently conservative, focusing on capital preservation as well as capital growth. By focusing on the potential downside (not just the upside) when making any investment decision, the risk to long-term client returns is significantly reduced. We are long-term investors and prefer to invest in quality companies that we can hold on to for many years.

The most significant source of investment ideas for the portfolio comes through country and company visits. As a team, we conduct more than a thousand direct company meetings throughout the year, seeking to identify a small sub-set of quality companies that meet our investment criteria. We place a clear emphasis on frequent visits to countries in the Asia region and on meeting the management of those companies in which the Trust is invested, or might invest.

While cultural, political, economic and sectoral influences play an important part in the decision-making process, the availability of attractively-priced, good quality companies with solid long-term growth prospects is the major determinant of Scottish Oriental's investment policy. Our country weightings bear no relationship to regional stock market indices and we do not consider ourselves obliged to hold investments in any individual market, sector or company. As a result, our asset allocation on a country and industry level is a residual of our stock selection process.

Current portfolio positioning

Country weightings (%)	Scottish Oriental	Asia Index*	Small Cap Index**
China	13.4	31.5	24.5
Hong Kong	6.7	12.0	8.4
Taiwan	9.6	14.5	18.6
Greater China	**29.7**	**58.0**	**51.5**
Bangladesh	1.1	0.0	0.0
India	23.3	9.9	12.5
Sri Lanka	4.4	0.0	0.0
Indian subcontinent	**28.8**	**9.9**	**12.5**
Indonesia	7.9	3.1	2.8
Malaysia	1.1	3.0	3.4
Philippines	6.0	1.4	1.2
Singapore	8.9	4.6	6.1
Thailand	5.6	2.8	4.3
Vietnam	0.5	0.0	0.0
South East Asia	**30.0**	**14.9**	**17.8**
South Korea	3.5	17.2	18.2
Gearing	-6.2	0.0	0.0
Liquidity	14.2	0.0	0.0
Total	**100.0**	**100.0**	**100.0**

Source: First State Investments as at 31 December 2015. *MSCI AC Asia (ex Japan) ** MSCI Asia (ex Japan) Small Cap Index.

Having focused on country and sector positioning in our prior notes, we had a request to discuss valuations. This is an interesting topic given our oft-repeated stance that we do not find valuations of Asian companies particularly attractive.

Firstly we should explain how we think about company valuations. Our competitive advantage as investors is not that we build models, forecast earnings and value companies better than others. In fact, we would argue the opposite. We don't build models; are happy to take stockbroker forecasts – albeit with a pinch of salt and a dose of common sense – and our company valuations tend to be relatively simple. Our investment process has always focused and will always focus on identifying quality companies where we define quality as a strong, aligned management team (and controlling shareholder if there is one); a sustainable franchise; and attractive financials. And we spend a lot more time looking at a company's past than we do its future as, in our experience, the past is a much better guide than analyst forecasts. We feel it is more important to find the right companies to invest in long-term than to forecast earnings and value our holdings better than anyone else. An adage that we tell our graduate trainees, who always seem to be very enthusiastic about building discounted cash flow models with the output being a specific numerical stock value, is that it is much better to be approximately right than exactly wrong. What we mean by this is that, when we invest, we prefer to identify companies we expect to compound out steady returns for the foreseeable future as opposed to trying to find companies that are temporarily mis-priced. If we pay a bit too much for a good quality company it will likely grow into its valuation in time. And if we have faith in the management, franchise and financials then we can always add to our position on share price weakness. Whereas if we try to pinpoint moments where there is specific and defined upside on a company then we are doing what the majority of "market participants" are doing and it is impossible to outperform in the long-run by doing the same as everyone else.

However, this being said, we do value all holdings in our portfolios. We tend to use simple metrics, namely price to earnings and price to book. We will also look at capacity-based measures e.g. price to tonne of capacity for a cement company; price to sales – particularly where we believe margins and hence earnings to be depressed; and occasionally we will even use a discounted cash flow model. We are conscious about the impact that assumptions can have on a discounted cash flow valuation – as one of our senior, i.e. grey-haired, colleagues recently pointed out "DCFs are like sausages: if you knew what went in them, you would never ever eat one". What we try not to use is the "price to hope" method, that is the complicated scenarios required when a business model is not yet clear and therefore earnings and cash flows still remain somewhat abstract. We prefer simple metrics for simple yet proven companies.

10 Largest Holdings

	Net Assets (%)	Country	Sector	Current year Price to Earnings (PE)*	Current year Price to Book (PB)*	Current year dividend yield*
Tong Ren Tang Technologies	3.3	China	Healthcare	26x	3.0x	1.2%
Delta Electronics (Thailand)	3.1	Thailand	Industrials	18x	3.2x	3.7%
Minth Group	2.9	China	Consumer Discretionary	14x	2.3x	2.3%
Godrej Industries	2.7	India	Materials	43x	4.0x	0.8%
Towngas China	2.6	China	Utilities	9x	0.8x	2.5%
Mphasis	2.5	India	Information Technology	14x	1.7x	3.7%
Taiwan Familymart	2.5	Taiwan	Consumer Discretionary	31x	9.5x	2.2%
Raffles Medical	2.3	Singapore	Healthcare	35x	3.9x	1.4%
SKF India	2.3	India	Industrials	27x	4.2x	1.2%
Vitasoy International	2.3	Hong Kong	Consumer Staples	26x	6.2x	2.0%
	26.5					

*Current year is accounting year to 31 December 2016 / 31 March 2017

Source: First State Investments as at 31 December 2016.

As can be seen above our top ten holdings feature companies that would be considered to range from the inexpensively valued to the very expensive.

The inexpensively valued:

On 9x earnings the question could be asked why natural gas supplier **Towngas China** is so cheap. The answer lies in the regulatory uncertainty that prevails in this industry and also that a healthy proportion of revenues (and the majority of profits) arise from connection fees which are less sustainable than the ongoing business of supplying gas. Nevertheless gas will remain a core part of China's energy mix for a long time and given concerns on pollution we believe there should be a regulatory preference for its use. We expect slow but steady growth in the long-term here.

We believe automobile body part manufacturer **Minth** to be attractively valued given the growth prospects that still remain. It has grown impressively overseas during the last decade and there are now some concerns about the increased protectionism in the world, particularly in the United States. However the company is well diversified with a quality manufacturing culture and we see it continuing to win market share.

IT outsourcer **Mphasis** should continue to grow and we see a likely chance of increased dividends given the strength of its balance sheet. It is primarily exposed to technology spending in the United States which again leads to the protectionism question, but we believe the risk reward profile to be attractive at current valuations.

The expensively valued:

Delta Electronics (Thailand) produces switching power supplies, DC brushless fans, automotive electronics, industrial automation equipment and inverters for solar and wind power generation. All of these areas can be cyclical but the company has managed to grow by continuing to invest in new technologies. We believe it to be fairly valued and would hope for several percent earnings growth plus the attractive dividend which makes it a solid investment for us.

With a brand dating back to the 17th century when it supplied the Imperial Court in Beijing, traditional Chinese medicine company **Tong Ren Tang Technologies** has perhaps the best provenance of any of our companies. Whilst by no means cheaply valued it has been growing at approximately 15% per annum which looks set to continue.

Vitasoy International also has a very strong brand but the company only dates back to 1940 when the founder sought to help the people of Hong Kong by providing them with a nutritious and protein-rich soymilk drink at an affordable price. More than 75 years on, the company continues to do so. Recent growth has been incredibly strong as the brand took hold in China. Growth is slowing to more sustainable levels but we believe it is worth paying up for both the defensible characteristics of the franchise and the long-term opportunity.

SKF India is the leading provider of automotive and industrial bearings in India. This is an underpenetrated market and as India develops there is an increasing preference for the higher quality products that SKF India manufactures. Although it is expensively valued, strong growth could make the valuation appear very reasonable in time.

The very expensively valued:

Taiwan Familymart is the exclusive operator of the Familymart convenience store brand in Taiwan and also owns an 18% stake in the profitable China FamilyMart. Although the company is still growing it is arguably too expensively valued for what will probably be single digit growth. We have held the company for a long time but it is more likely to be a source of cash than a use for cash at current levels.

Raffles Medical operates medical clinics and a hospital in Singapore with a very successful track record. Unlike many companies it has been cautious about expansion, preferring to focus on maximising returns from its existing assets. However it is set to open a hospital in Shanghai in 2018 and the investment in this asset has depressed earnings in the short term as management has been bolstered in advance. The company is justifiably expensive but is not without risk.

Finally, the most expensive company in our top ten is **Godrej Industries** on 43x earnings. The company has significant stakes in Godrej Consumer Products (trading on 40x current year earnings) and Godrej Properties (trading 26x current year earnings) both of which have strong prospects as well as some other smaller and unlisted businesses. The reason that Godrej Industries trades on a more expensive valuation than its underlying holdings is that the company has a significant amount of debt at the parent company, the interest payments on which dilute its accounting earnings. We'd rather Godrej Industries didn't have this debt, but carrying out a sum-of-the parts valuation on the company sees it trade at a reasonable discount.

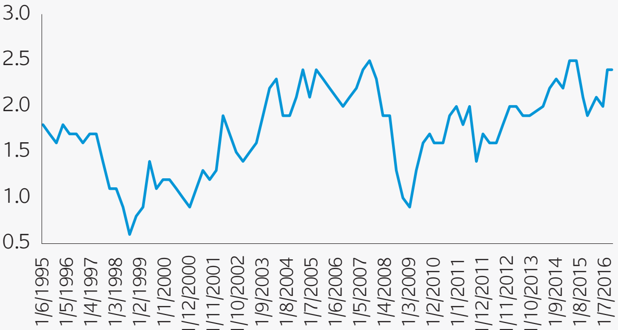
Scottish Oriental's history

We took advantage of the Friday before Christmas by delving into the dusty archives to retrieve twenty years' history of Scottish Oriental. Approximately every quarter we update results and forecasts for the portfolio and calculate the median price to book, price to earnings, dividend yield and earnings growth for the portfolio. Typically, we don't do our own forecasts for this exercise but choose to use those of consensus or a sensible stockbroker analyst. Occasionally, where a stock has little or no coverage we will produce our own forecasts, largely using history as our guide. The purpose of this exercise is to allow us to monitor progress of both individual holdings and the portfolio as a whole.

We present median valuations for the portfolio so it should be noted that position-size weighted average valuations will likely be higher as the smaller companies held tend to be cheaper and the Trust typically has smaller positions in smaller companies. But as a guide the results are quite instructive. It should also be noted that we last updated these valuations in October 2016, although little has changed since then.

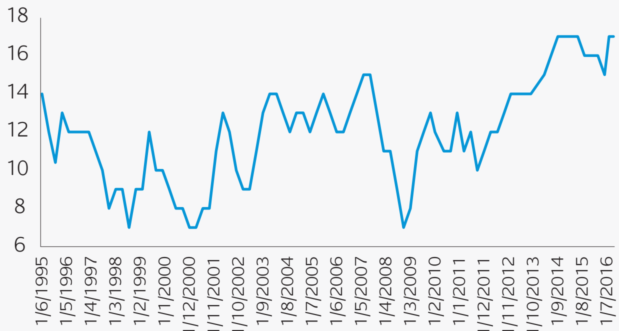
On a historic price to book basis the portfolio is towards the top end of its range at 2.4x book. The average over the Trust's history is 1.7x. For a relatively prolonged period during the Asian Financial Crisis it was trading below book value and also briefly during the more recent Global Financial Crisis. The peak price to book of the Trust's portfolio was 2.5x.

Median price to book (historic)



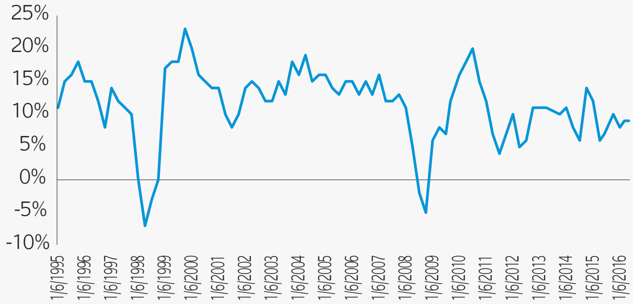
On current year earnings expectations the portfolio trades on 17x which is as expensive as it has ever been. The average over the Trust's history is 12x with it being possible to buy the portfolio on 7x earnings on a few occasions.

Median price to earnings (current)



Expected growth in earnings per share for the current year is 9%. The average over the Trust's history has been 11%.

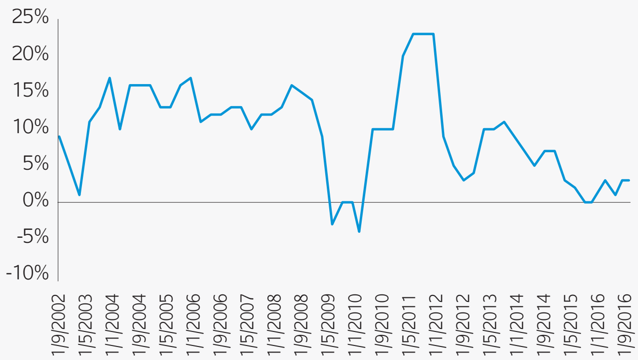
Median earnings per share growth (current)



We have only kept track of actual, i.e. historic, earnings growth on the Trust's portfolio since 2002. Historic growth is worth highlighting as recently earnings growth has disappointed. Actual earnings growth for the last several periods has been in the low single digits compared to expectations in the high single digits. Since we've tracked historic earnings growth, on average historic earnings have been lower than those expected one year earlier by 2%. We will call this 2% "the disappointment". During 2015 and 2016 the disappointment averaged 7%. This should be caveated as these expectations are for the median of the portfolio so not on a like-for-like stock basis, but you would hope in the long-run this would average out.

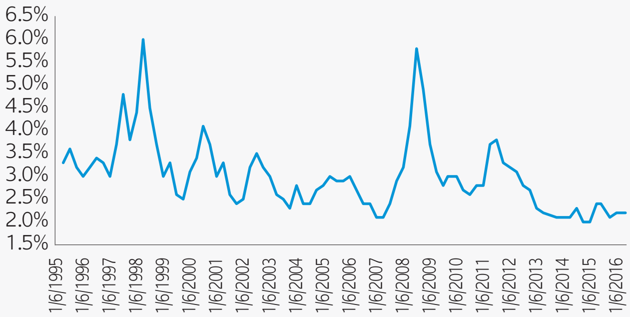
Carrying out the same exercise for data since 2002 but now comparing forward forecast earnings to those actually recorded two years later sees an average disappointment of 7%. During 2015 and 2016 this disappointment averaged 14%. Beware of Greeks bearing gifts and fund managers bearing optimistic earnings expectations. Forecasts have a tendency to be over-optimistic but of late have been particularly inaccurate.

Median earnings per share growth (historic)



Our expected dividend yield for the portfolio is 2.2% compared to an average of 3.0% over the Trust's history.

Median dividend yield (current)



We apologise if the above all seems somewhat gloomy. In Scottish Oriental's 2016 annual report we mentioned that valuations of the Trust's holdings are high compared to history but interest rates are as low as they have ever been. In our view it is these record low interest rates that have resulted in such high valuations. Paying 17x earnings for (some) earnings growth and a 2.2% dividend yield is relatively attractive when compared to the interest rate that, for example, HSBC offers someone willing to lock up HK$ 1,000,000 or £100,000 for a year with the former paying 0.2% and the latter 0.6%. It has been the intention of central bankers to stimulate economies with these low interest rates since the Global Financial Crisis. Whether economies have been duly stimulated is questionable but what is fairly clear to us is that asset prices have been bid up given the scant returns available on cash.

Recent notable changes to the Scottish Oriental portfolio

Country weightings (%)	31-Dec-16	30-Jun-16
China	13.4	16.6
Hong Kong	6.7	6.4
Taiwan	9.6	12.7
Greater China	**29.7**	**35.7**
Bangladesh	1.1	0.0
India	23.3	24.6
Sri Lanka	4.4	2.8
Indian subcontinent	**28.8**	**27.4**
Indonesia	7.9	4.8
Malaysia	1.1	2.6
Philippines	6.0	2.6
Singapore	8.9	14.6
Thailand	5.6	4.4
Vietnam	0.5	0.0
South East Asia	**30.0**	**29.0**
South Korea	3.5	3.9
Gearing	-6.2	-6.6
Cash	14.2	10.6
Total	**100.0**	**100.0**

Source: First State Investments as at 31 December 2016.

There has been an unusually high level of portfolio turnover in the last six months. 13 new holdings were purchased and 19 were sold. The number of companies in the portfolio continues to consolidate to a more focused list. The main driver behind the higher-than-usual level of activity was the sale of a relatively large number of companies where we have painfully concluded that there is little growth and little likelihood that the value remaining in these companies will be realised. These “value traps” did not start life in Scottish Oriental’s portfolio as value investments but sometimes it is easier to continue to hold an investment that has not worked on the basis of value than it is to sell such a company and reinvest the proceeds in a smaller company that has a good chance of becoming a large company in the long-term. Admitting mistakes remains one of the most difficult parts of investing.

Greater China

Our exposure to Greater China reduced during the period. A number of investments were sold that have not worked well for us. Handbag and leather goods manufacturer, **Sitoy** (China, Consumer Discretionary) was sold despite its cheap valuation as we do not like its increasing focus on selling its own brand goods when it should be working on diversifying its client base. Luxury retailer, **Trinity** (China, Consumer Discretionary) was sold as, having fallen so much, it was too small a position in the portfolio yet we did not have the conviction to add given its poor prospects. Garment manufacturer, **Makalot Industrial** (Taiwan, Consumer Discretionary) was sold after – for us – a very brief holding period when we realised we’d been beguiled by the company’s track record and the outlook for many of its customers was not good. Industrial barcode printer manufacturer **TSC Auto ID** (Taiwan, Information Technology) has been finding life difficult with Chinese competition and we do not see this relenting. We also significantly reduced our position in **Luthai Textile** (China, Consumer Discretionary) which remains cheaply valued. Our reappraisal of Makalot reminded us just how difficult the textile industry is. Finally we also significantly reduced our holding in industrial PC manufacturer **Axiomtek** (Taiwan, Information Technology) where a trip to Taiwan left us questioning the company’s ability to grow. There is perhaps value in all of these businesses but equally this perceived value may be a trap.

Not all of the stocks we sold were unsuccessful investments. Hong Kong property companies **Keck Seng Investments** and **Tai Cheung** were both sold for a respectable profit. Both companies still trade substantially below a conservative appraisal of their respective net asset values but are managed, to an extent, as private family offices and we see little likelihood that the share prices will converge on these net asset values. Perhaps both could be described as value traps. We exited testing equipment manufacturer **Chroma ATE** (Taiwan, Information Technology). This is a well-managed but cyclical company and we’ve learned to our expense that the cycle can change very quickly so best to sell while the market is assuming the best for it. We may well get an opportunity to buy it back in the future. We also significantly reduced the Trust’s position in **Sunny Optical** (China, Information Technology). It has continued to gain market share with its camera lenses and modules and the valuation has re-rated accordingly.

It was not all selling in Greater China with positions established in four companies. **Uni-President China** (China, Consumer Staples) appears to be navigating the difficult Chinese market better than most with its instant noodles and beverages and is gaining market share. The reward for success here could be significant. Bus operator, **Kwoon Chung Bus** (Hong Kong, Industrials) has been focusing on more profitable non-franchised routes and is attractively valued. We were impressed at the barriers to entry in **Sinbon Electronics’** (Taiwan, Information Technology) cable and connector manufacturing business. **Sitronix Technology** (Taiwan, Information Technology) designs driver integrated circuit chips and its focus on older technologies where there is considerably less competition allows them to be very profitable.

Indian Subcontinent

Our exposure to the Indian subcontinent was relatively stable. Most of note was the Trust’s first ever investment in Bangladesh. **Delta Brac Housing Finance** (Bangladesh, Financials) is the first private sector specialist housing finance institution in Bangladesh where the concept of home mortgages is in its infancy. Mortgage penetration is still low in the country and with a conservative lending culture resulting in very low non-performing-loans, Delta Brac should continue to grow for the foreseeable future.

We also initiated positions for Scottish Oriental in **Gujarat Gas** (India, Utilities), which is the country’s largest city gas distributor; **HeidelbergCement India** (Materials), which has evolved to become one of India’s lowest cost cement producers; and **John Keells Holdings** (Sri Lanka, Industrials). John Keells’ management became distracted by a significant investment in a resort project featuring a casino where the economics changed substantially following a government ban on casinos. Management are now suitably chastened but have responded positively with a renewed focus on their core businesses which we find encouraging.

We also continued to build up our positions in air-conditioning and commercial refrigeration company **Blue Star** (India, Industrials); **Godrej Industries** (India, Materials) where we like the exposure to the Godrej Group’s consumer product and property companies; and **Commercial Bank of Ceylon** (Sri Lanka, Financials), Sri Lanka’s best managed bank.

We completely sold our positions in courier company **Blue Dart Express** (India, Industrials); financial holding company **IDFC** (India, Financials) and branded tea producer **Tata Global Beverages** (India, Consumer Staples). Blue Dart was sold on expensive valuations. IDFC was probably a mistake – although we made a modest profit on this investment, we under-estimated the difficulty IDFC faces in building a bank and the attractiveness of buying its assets at a deep discount to book value perhaps distracted us from this. Tata Global Beverages was definitely a mistake. We had been trimming the position as our enthusiasm waned but a boardroom coup at parent Tata Sons (where the then chairman was ousted by the former, and now “interim”, chairman) catalysed us to completely exit as such distractions make the decisions necessary to turn this business around less likely to happen. Although there is much value in the brands it will not be easy to realise.

We also significantly reduced the Trust's holdings in logistics company **Container Corp of India (Industrials)**; Kansai Nerolac Paints (India, Materials); FMCG company **Marico** (India, Consumer Staples); and conglomerate **Tube Investments** (India, Industrials). All are trading on valuations where profit taking seemed prudent.

South East Asia

Our overall exposure to South East Asia was relatively unchanged but there was a notable reduction in Scottish Oriental's exposure to Singapore with the proceeds recycled into Indonesia and the Philippines where we can find growth prospects. We also made Scottish Oriental's first direct investment in Vietnam.

We initiated holdings for the Trust in several stocks. **Concepcion Industrial** (Philippines, Industrials) is the Philippines' leading manufacturer of air conditioners and refrigerators. With an extensive sales and servicing network Concepcion has an entrenched position that should enable healthy growth. **Integrated Microelectronics** (Philippines, Information Technology) designs, tests and assembles electronic equipment. It has built its automotive segment in a decade to represent half of revenues. Part of Hong Kong's Jardine Group, **Astra Otoparts** (Indonesia, Consumer Discretionary) manufactures and distributes automotive parts. Over the last several years the company has built out an after-market business which is more profitable and has more stable demand than selling to the auto manufacturers. In recent years the company struggled due to rising labour costs; a delayed ability to pass on rupiah depreciation; and – having upgraded its production plants – too much capacity. We now expect a return to growth and strong cash generation from the company. **Mitra Adiperkasa** (Indonesia, Consumer Discretionary) operates franchises in food and beverage, department stores, sportswear and fashion apparel. The company has top tier partners such as Starbucks, SOGO, Converse and Zara. Following poor performance caused by over-expansion, inventory build-up, a weak rupiah and poor consumer sentiment, Mitra Adiperkasa looks set to resume growth and improve its margins. **FPT** (Vietnam, Information Technology) focuses on IT outsourcing and fixed line telecommunications. Its formally domestic IT business is transitioning to become an international IT outsourcer dealing with multi-nationals. Its telecommunications business offers fixed line broadband where penetration is low and the competition is predominantly state-owned. It is also the #1 internet service provider in Cambodia and has recently entered Myanmar.

We added significantly to the Trust's existing holding in **Delta Electronics (Thailand)**. Results earlier in the year disappointed some as the company has been investing heavily in research and development for its various electronics products which it chooses to expense rather than capitalise. We were happy to take advantage of the subsequent share price weakness. We also added to the Trust's positions in **China Banking** (Philippines, Financials), **Manila Water** (Philippines, Utilities), **Haw Par** (Singapore, Consumer Staples) and **Hana Microelectronics** (Thailand, Information Technology) – all of these companies offer reasonable prospects for growth at reasonable valuations.

Property Developer **Bukit Sembawang** (Singapore, Real Estate) has been held by Scottish Oriental for a long time. Despite the significant upside to its net asset value the company has struggled to convert this upside to its results and we have concluded it is unlikely to perform. **Tan Chong International** (Singapore Consumer Discretionary) has also been held by the Trust for a long time. Management do not enjoy meeting investors and, in the several meetings we have managed to obtain with the company over the last fifteen years, enjoyed questions about the potential value in their real estate even less. Both these companies are also classic examples of value traps and we grudgingly decided to exit. We also sold **Ezion Holdings** (Singapore, Energy) and **Tat Hong** (Singapore, Industrials). Both are cyclical business. Both have too much debt. And both were small positions where we did not have conviction to add. **M1** (Singapore, Telecommunications) is Singapore's third largest mobile telephony operator. It is very profitable but likely to be less profitable in the future given the government seems keen to allow a new entrant to increase competition. It was sold but unfortunately after the likely effects of this competition had weighed on its share price. **Eu Yan Sang** (Singapore, Health Care) exited the portfolio when the privatisation offer we mentioned in our last note completed. These six sales explain the significant drop in the Trust's Singapore weighting.

Elsewhere in South East Asia we sold longstanding holding, hypermarket operator **Aeon Company** (Malaysia, Consumer Discretionary) as the prospects for the company in Malaysia's economy seem poor. We also sold clothing retailer **MC Group** (Thailand, Consumer Discretionary) and **Somboon Advance Technology** (Thailand, Consumer Discretionary). Neither investment has contributed positively to performance. Both have, perhaps, some value trap characteristics.

South Korea

Our only activity in South Korea during the period was topping up **Hana Tour Service** (Consumer Discretionary) on share price weakness caused by Chinese sabre-rattling at the South Korean deployment of the American THAAD (Terminal High Altitude Area Defense) system.

Scottish Oriental investment performance

We invest with a long-term, that is, a three-to-five year mind-set, if not longer; and we hope to be measured over a similar time period. However, we are aware that the long-term is made up of several short-and medium-terms and sometimes it can be helpful to look at what has driven recent performance.

	3mth	6 mth	1 year	3 years	5 years	10 years
NAV	-0.9	7.4	23.0	30.7	80.8	263.3
NAV – total return	-0.8	8.1	24.4	35.3	92.3	318.3
Benchmark*	-1.4	11.8	26.2	35.8	61.5	134.3
Small Cap Index**	-2.3	7.9	16.8	30.2	60.8	130.9
Share Price	0.3	8.7	23.7	16.7	72.9	244.4
Share Price – total return	1.6	10.1	25.3	21.7	85.8	304.4

Source: First State Investments. As at 31 December 2016.

* MSCI AC Asia (ex Japan) Index

** MSCI Asia (ex Japan) Small Cap Index

Six month performance

Scottish Oriental underperformed over the second half of 2016, which is disappointing. We had our usual winners and losers on a stock by stock basis but what stood out the most when looking at the attribution analysis was poor country and sector allocation. Hopefully our bottom-up investment approach is familiar – our country and sector allocations result entirely from stock selection as opposed to any form of top-down asset allocation. But it appears we picked stocks in the wrong countries and sectors this time around. Scottish Oriental owns much less in China and South Korea and much more in India and Singapore than these countries' respective weightings in the MSCI Index. China and South Korea were notable outperformers and India and Singapore were notable underperformers over the period. On a sector basis we have heavy weightings in Industrials and Consumer Staples with considerably less invested in Information Technology and Financials companies than the MSCI Index. Both Industrials and Consumer Staples underperformed, whereas Information Technology and Financials outperformed. Scottish Oriental's positioning in these countries and sectors has been relatively stable for a number of years and we are comfortable that the companies we own within them will have their day in due course.

Our worst performing holding over the period was **XL Axiata** (Indonesia, Telecommunications). We added to our position in the first half of the year via a rights issue, so this was disappointing. The company has lost market share and its results reflected this. However, unlike some of the competition they are being rational on pricing which we believe to be the sensible long-term strategy. Our two Korean Holdings, **Amorepacific Group** (Consumer Staples) and **Hana Tour Service** (Consumer Discretionary) were also very weak. Both were significantly impacted by the spat between China and South Korea over South Korea's deployment of the American THAAD system. China has identified its opposition to the THAAD deployment as one of its key foreign policies for 2017 and this has been negatively impacting South Korean companies' business interests in China and Chinese tourism to South Korea.

Indian holdings **Container Corp of India** (Industrials) and **Godrej Properties** (Real Estate) were negatively impacted by the government's surprise decision to withdraw larger denomination bank notes from circulation in an attempt to crack down on "black money". This has impacted economic activity in India and will likely see fewer goods moved by freight and fewer properties bought – in the short-term. Funds/investment platform **iFast Corporation** (Singapore, Information Technology) was weak as its revenues depend to a significant extent on investment sentiment in Singapore which is not good just now. Auto components manufacturers **Selamat Sempurna** (Indonesia, Consumer Discretionary) and **APM Automotive** (Malaysia, Consumer Discretionary) were both weak on light results but these results did not concern us unduly. Finally, Singapore companies **Ezion Holdings** (Energy) and **M1** (Telecommunications) performed poorly before being sold. Having featured in both of our previous notes as detracting from performance, we are particularly disappointed by Ezion. We held onto this stock for too long after it became apparent the investment case was deteriorating as it had taken on far too much debt in pursuit of growth.

Less disappointing was **Pacific Basin Shipping** (Hong Kong, Industrials), which also featured in both of our previous notes as detracting from performance. It was the Trust's best performing holding in the second half of the year and Scottish Oriental is now showing a modest gain on this investment. Little has changed here – it continues to ship dry bulk commodities in an efficient manner but the market has re-rated the stock as it was just too cheap. Nitrogenous fertiliser producer **China Bluechemical** (China, Materials) was our second-best performer, rebounding as product prices rose. Having remained profitable when much of its competition was not, improved pricing in this industry may just see a return to capacity addition so the company's days in Scottish Oriental are perhaps numbered.

The Trust had strong performance from a number of its Information Technology holdings: electronics assembler **Hana Microelectronics, Sunny Optical**, point-of-sale terminal manufacturer **Posiflex** (Taiwan); and industrial control system distributor **Lumax International** (Taiwan) all saw improving results. **Tube Investments** and **Tong Ren Tang Technologies** also reported strong results and both helped performance.

Finally, we benefited from rebounds in the share prices of both **Delta Electronics** (Thailand) and **Commercial Bank of Ceylon**, recovering from oversold levels.

2016 performance

For the calendar year, Scottish Oriental produced a healthy return and just about managed to keep up with its benchmark despite smaller companies being out of fashion. It should again be reminded that most of these apparently strong absolute returns resulted from sterling's 16% fall against the US dollar over the year.

Broadly the same effects discussed under six month performance above impacted the Trust where our stock selection was much better than our country and sector allocation. One point worth noting is that by far the biggest reason for smaller companies' underperformance relative to the larger peers over the year was a near 30% difference in performance between larger companies in South Korea and their smaller counterparts. This, at least, makes us more comfortable that we did not overlook South Korea in our quest to generate ideas.

On a contribution basis, the five stocks that helped performance most were **Minth Group**, **Sunny Optical**, **Tong Ren Tang Technologies**, **Tube Investments** and **Kansai Nerolac Paints** (India, Materials). All reported strong earnings during the year.

Of the five stocks that hurt performance most during 2016, only one, **Hana Tour Service** remains in the portfolio. We believe the impact of its duty free store start-up losses and China's response to the THAAD deployment to be temporary. Three of the others, **Trinity Limited**, **Ezion Holdings** and **Dickson Concepts** (Hong Kong, Consumer Discretionary) were mistakes which we have discussed previously. The final stock that hurt us during 2016, **Blue Dart Express** (India, Industrials), was not a mistake. Scottish Oriental did well out of this investment but it took us much longer to sell than we would have liked and the share price fell as we sold.

Outlook and conclusion

Global growth remains muted. This lack of growth has resulted in challenging export conditions for Asian corporates. Rising populism is creating a more hostile trade environment and it is possible that this will further add to the export sector's woes. Further export weakness could impact domestic sentiment slowing consumption and hindering growth in Asia's economies.

Valuations of Scottish Oriental's holdings are high compared to its history but interest rates are near their all-time lows. It is possible to make a case for the rationality of such valuations when using these low interest rates in a discounted cash flow model or indeed comparing the dividend yields of many of our favoured companies to what can be earned on cash deposited in a savings account. Our concern remains that interest rates may return to their long term historic average. When this happens, in the absence of anything other than strong growth, equities will look less attractive than they do now. The difficulty is that we have little ability to forecast what central bankers might do and when.

Therefore, our focus remains the preservation of capital in both absolute and real terms, that is, we wish to avoid losing money but also want to preserve purchasing power. To this end, Scottish Oriental remains heavily invested in Asian focused businesses with defensible franchises that should be long-term winners no matter what the economic and monetary backdrop. We continue to place a significant emphasis on Indian companies where we find both growth and some of the best management teams in Asia. We have generated some new ideas in the Philippines and Indonesia recently and continue to find ideas in India. All three countries have comparatively strong domestic growth. The Trust has relatively high cash levels and we would like an opportunity to deploy these funds in some of our favourite names but would prefer to make such investments at more reasonable valuations. Therefore we are being cautious with the price we are willing to pay for stocks when investing these funds.

We wish we could be positive as we commence 2017 but the same issues that have been weighing on us for the past few years remain. To add to this we have some new issues to worry about with the more hostile rhetoric coming from the United States and the increasing possibility of rising interest rates.

We trust this update has given you a better understanding of the companies that Scottish Oriental invests in. We would welcome feedback on whether it has been helpful as well as what you would be interested in reading about in the future.