The Scottish Oriental Smaller Companies Trust plc

SCOTTISH ORIENTAL SMALLER COMPANIES TRUST PLC

Investor Note

July 2020

This is the tenth 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 FSSA 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$3 billion, or the equivalent thereof, at the time of first investment.

We are conviction-based, bottom-up stock selectors who place 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.

Covid-19

Covid-19 is becoming a global humanitarian disaster. The measures taken in an attempt to control the virus have created a global recession. The impact on economies of the various lockdown measures that have been put in place have in some cases been so far reaching there is a serious debate to be had that inaction could be a better outcome for the significant majority, particularly in countries with less developed healthcare infrastructure. Whilst fund managers and financial analysts can safely work from home and continue to be paid, many people cannot. A choice between not being able to afford to eat and potentially catching Covid-19 is at least a choice. But some people can no longer afford to feed their families without having even been offered this choice. This is an unmitigated tragedy.

There is much that is unknown about the medical consequences of Covid-19. We can offer no value-add on this. The short term economic impact is becoming apparent with some "winners" but more losers. The longer term economic impact will depend upon the efficacy of treatment, which is improving; whether successful vaccines are developed, made available to all, and taken by a large enough majority to work; and human psychology. Even with a 100% effective vaccine, cruise ships, gyms and cinemas might never be quite as popular as they were. Or all may be forgotten and by 2022 the world could be back to normal with the recession of 2020 just another blip in economic history.

Covid-19 and free money

The monetary and fiscal policy responses to the crisis is troubling. Traditionally, monetary and fiscal policy were separate with the former being overseen by central bankers and the latter by politicians. Many countries have independent central banks. Others are open to political pressure. And some central banks are heavily politicised. What this crisis has seen is an increasing politicisation of, even, independent central banks. This is a dangerous thing. Our ideal central banker would be a career bureaucrat and boring. Very boring. But fiercely independent. Politicians love being able to give handouts because it makes them popular. Central banks can create easy monetary conditions that allows growth in the short term but, invariably creates pain in the long term when capital gets misallocated. And central banks can even print money for "free". The danger is apparent if control is taken by someone who cares about an election cycle or their current popularity.

We are not economists and are well out of our depth when talking about such matters. But it strikes us that Modern Monetary Theory ("MMT"), also known colloquially as the "Magic Money Tree", is where much of global policymaking has inadvertently ended up as a result of the coronavirus crisis. This is ironic given that MMT came out of Marxist economic theories yet has been adopted by relatively conservative governments. We have been heading here since the aftermath of the financial crash that commenced in 2007. The level of money printing seen in the United States, Europe and Japan is staggering. It doesn't appear to matter to us whether the exact mechanism of money creation is quantitative easing where central banks purchase securities directly from the market, or the less direct MMT method whereby governments spend what they don't have resulting in large deficits funded by debt that will inevitably be monetised. The result is the same, being an increase in money supply.

When free money goes wrong

Historically debt is seen as being deflationary as repaying it acts as a brake on the economy taking money away from other purposes. But once government debt gets to a certain point it is just too much to repay as the consequent austerity is too politically unpalatable. The only option is to inflate the debt away. This is probably where we are now. We tend to think of inflation as meaning that consumer prices increase. This doesn't appear to be happening in many places other than the likes of Zimbabwe and Venezuela. This is partly because of excess capacity in many economies but also because inflation appears to be presenting itself differently of late as it is being reflected through asset prices. The impact of this depends on your personal circumstances. If you own your own home and you have lots of savings in the stock market, you are happy. If one day you aspire to own your own home and save for an appropriate income in retirement you are unhappy. The first category tends to reflect older people and the second category younger people. Inter-generational warfare is perhaps another thing we should worry about.

Money is fungible and flows to where it sees the highest returns. Governments have, in our opinion, been right in supporting their real economies as best as they can. However supporting financial markets makes less sense to us. Driving interest rates to either negligible or negative rates does not lead to sensible capital allocation. Why save when you can speculate? There appears to be a concern amongst some policymakers that the coronavirus crisis has led to too much saving by people who can still afford to save and choose to do so given the prevailing uncertainty. The response seems to be to print even more money and hope that these savers get the message. They should spend or speculate but saving is for fools. This is a very artificial situation. The bedrock of capital markets for generations has been the efficient allocation of pools of ordinary people's savings. When you cannot earn a return on cash deposits and government bonds pay derisory rates there is little option for normal people but to buy equities and hope they go up. And, in the main, they have gone up. Whether this can continue in the absence of economic growth remains to be seen but we are disturbed by what has become a huge disconnect between economic reality and stock markets.

A bird in the hand

The value of a company is the discounted sum of the cash flows it will generate over its life. When a company generates little or no cash but has the prospect of potentially large cash flows in the future, analysts often make ambitious estimates for these cash flows. In normal times, discounting these potential cash flows back to the present day typically brings these speculative companies' valuations back down to earth. But these are not normal times. There is a well-known proverb, "a bird in the hand is worth two in the bush". In finance terms this would be equivalent to "a dollar today is worth the discounted value of two dollars in the future." Very approximately we grew up with a discount rate of give-or-take 10% based upon a 5% risk premium for investing in equities and a 5% risk free rate. Discounting at 10% results in the conclusion that two dollars in 2027 is worth one dollar today. In a world where the risk free return is zero but still assuming a 5% risk premium we instead discount back at only 5%. Using the same hypothetical two dollars, we would conclude that two dollars in 2034 is worth one dollar today. This is a simplistic example but is reflective of the world we live in. A company where analysts are forecasting strong growth out into the future suddenly becomes much more highly valued even if there is no guarantee that the company will ever turn a profit.

The ten-year US Treasury note is the closest thing the world has to a consensus risk free investment. The ten-year US Treasury commenced 2020 yielding 1.9% but is now yielding less than 0.7%. This change alone means that we can wait two more years (from ten years to twelve years) to receive two dollars in the future that would be equivalent to one dollar today. Therefore as rates have fallen, more speculative stocks i.e. those generating the proverbial two dollars far out in the future, have outperformed. And the companies that are generating one dollar today have, in many cases, seen this dollar disappear as a result of the coronavirus-induced lockdown. They have been penalised for earnings declining in the short term, even if they have a franchise that will stand the test of time.

What could have been and what may well be (but probably won't)

If we had been nimble, we had a window in 2004, shortly after its initial public offering, when we could have bought Tencent, now one of China's largest companies with a market capitalisation of more than $600 billion. For the briefest period of time, its market capitalisation was small enough for Scottish Oriental to buy it. But in 2004 it had a short track record, and there were a lot of things that could go wrong. Instead things went very right for Tencent. There is now an entire industry focused on trying to identify China's next Tencent. The result of this is that start-up companies now tend to list on the stock market later than they used to as there is a surfeit of funds in the private markets willing to fund unlisted businesses. Often their backers encourage them to spend, spend, spend to gain scale in an all-or-nothing quest for glory. And often the companies that do list come at valuations that do not make sense to us. An example of this would be China's Pinduoduo. It has a business model of generating revenues from advertising. But the company subsidises third party merchants to sell goods cheaply on its online marketplace in an attempt to gain critical mass. It remains in business by raising equity and paying its merchants very slowly. Although Pinduoduo is lossmaking, by growing very rapidly, it is currently cash generative as it temporarily sits on cash before passing it over to its merchants. Rapid sales growth results in this temporary cash pile increasing. A little bit like a shark, it has to keep swimming to stay alive. If it stops growing rapidly it will suffer a large cash outflow. Pinduoduo has gained market share by offering the proverbial two dollars for sale at a price of one dollar. The bet is that by growing enough scale, at some point in the future it will be able to sell two dollars at a price of three dollars. We probably shouldn't be looking at this company as it has a market capitalisation of more than US$ 100 billion but it helps to understand the current market dynamic. It commenced operations in 2015, listed in the United States in the summer of 2018 and its share price has quadrupled since. Even if we could have bought Pinduoduo in 2018 we would not have done so. We find it less risky to identify companies with sustainable business models that earn one dollar today and we can see a pathway to earning two dollars in five to ten years.

Scottish Oriental's companies and where we are finding ideas

We have been very busy in the first half of 2020 catching up with the management teams of the significant majority of the companies in Scottish Oriental's portfolio as well as a number of candidates for the portfolio. Most of the portfolio has held its own but some companies have been put in a vulnerable position and where we have had concerns that Covid-19 will disproportionately impact a company we have sold. But out of crisis comes opportunity and we have added a large number of new holdings to the portfolio, many of which fell within our market capitalisation remit during March's market correction. Many of their share prices have since rebounded generating healthy returns for the Trust.

We perhaps should not say this but it seems that being small is becoming more difficult. Access to funding is simpler for larger companies. It is easier to build a brand if your advertising budget can come from billions of dollars of revenues rather than millions. As a result we have always tended to avoid companies that are small because they lag versus the competition. We want to buy leaders in their field that have small market capitalisations but large opportunities for growth. We also value a publicly listed track record. It helps us build conviction in the management team and franchise.

Despite, or perhaps because of, China's scale we are finding few ideas there. Chinese winners are very big. And smaller companies in China can quickly become vulnerable if their addressable market is big and a large company decides to target it. By comparison we have found that smaller companies in India, Indonesia and the Philippines very often are the winners in their respective markets with strong growth prospects in the long run. The largest manufacturers of air conditioners in China (Midea and Gree Electric) have market capitalisations of approximately US$ 60 billion and US$ 50 billion. These are not small companies. By comparison Scottish Oriental owns the largest and second largest manufacturers of air conditioners in India **(Voltas** and **Blue Star)** and the largest in the Philippines **(Concepcion Industrial)**. The market capitalisations of these companies are approximately US$ 2.4 billion, US$ 600 million and US$ 160 million respectively. We may be talking our own book but we believe that it is much more likely that the three companies the Trust owns will grow to a multiple of their current size in future years than their Chinese counterparts that are far too big for Scottish Oriental to own anyway.

Recent notable changes to the Scottish Oriental portfolio

The rapidly changing economic outlook and market dislocation over the past six months resulted in an unusually high level of activity within Scottish Oriental's portfolio. 13 new investments were made and ten holdings were sold. There are now 55 stocks in the portfolio.

Country weightings (%)	30-Jun-20	31-Dec-19
China	6.1	8.7
Hong Kong	7.9	7.1
Taiwan	3.4	6.8
Greater China	**17.4**	**22.7**
Bangladesh	1.8	1.6
India	38.0	32.6
Pakistan	1.3	1.6
Sri Lanka	0.6	1.2
Indian subcontinent	**41.7**	**37.0**
Indonesia	14.3	13.2
Malaysia	0.2	0.7
Philippines	13.0	11.4
Singapore	1.3	5.5
Thailand	0.0	0.0
Vietnam	2.4	2.3
South East Asia	**31.2**	**33.1**
South Korea	0.5	0.0
Cash	9.2	7.1
Total	**100.0**	**100.0**

Source: First State Investments as at 30 June 2020

Greater China

We reduced Scottish Oriental's overall exposure to Greater China over the period. Positions in mainland Chinese and Taiwanese companies fell over the period whereas Hong Kong companies increased modestly. Of note is that Scottish Oriental now only has only 3.4% invested in Taiwan whereas two years ago this was 12.2%. The reduction has predominantly been driven by valuations.

In Taiwan, we completely sold window blind manufacturer **Nien Made**. Its predominant economic exposure is to the United States where sales of its products have fallen in previous downturns. Given the largely discretionary nature of replacing window blinds we felt that it was prudent to sell. We also sold convenience store operator **Taiwan Familymart** on expensive valuations given limited growth prospects in Taiwan which remains the bulk of its business. We reduced Scottish Oriental's weighting in uninterruptible power supply maker **Voltronic Power**. The company continues to execute admirably but its share price performed well during the first half of the year and we have a nagging concern that a large portion of its sales are to emerging market countries whose economies are being badly hit by Covid-19. We initiated one "toehold" position in Taiwan. **Poya International** is among the leading retail chains in Taiwan, with a focus on categories such as cosmetics, ladies' accessories and fast moving consumer goods. Poya has successfully built a dominant franchise in the discount store format in Taiwan, by offering a large selection of products at low prices and with better service than the traditional wet markets and night markets it competes against. It is expensively valued hence the small position for now but continues to grow strongly.

In Hong Kong there were two transactions of note. We reduced the Trust's position in non-alcoholic beverage producer **Vitasoy**. Its share priced ended the period higher than it was at the start of the year despite a large portion of its business being driven by the sort of impulse purchases that have been happening much less of late. By contrast, we added to **Nissin Foods** which continues to grow its noodle brand in China and is benefiting from the move to more premium products in this segment.

In China, we sold traditional Chinese medicine company **Tong Ren Tang Technologies**. We have wavered somewhat on this company in the past with the strength of its brand not being matched by strength of execution by management. Now is not the time to own such stocks. We also reduced the Trust's positions in online recruitment platform **51job**; branded apparel retailer **JNBY Design**; and gas distributor **Towngas China**. The former two companies are likely to face much more difficult operating conditions given the restrictions in place in China and the latter continues to prioritise capital investment when we think it is time it focused on returns. One new position was purchased in China. **Zhejiang Weixing New Building Materials** is among the leading plastic pipe manufacturers in China. The plastic pipe industry in China is highly fragmented. Most companies in the industry focus on selling low-end products in large quantities to real estate developers. Since its inception, Zhejiang Weixing has instead focused on building a strong relationship with retailers and has consistently invested in brand building and upgrading its product portfolio. Due to this, its profitability is industry leading. Its brand has also led to consistent market share gains.

Indian Subcontinent

Scottish Oriental's exposure to the Indian subcontinent increased over the period. This was a result of the market tumult offering us numerous opportunities to buy companies that were on our shopping list. We also saw some larger companies temporarily fall within Scottish Oriental's market capitalisation remit. In total we purchased nine new Indian holdings but also sold five. Technically we bought ten and sold six as we purchased a toehold position in leading tractor manufacturer **Escorts Limited** but sold out a few months later after its share price almost doubled.

Starting with the new holdings, we purchased two cement companies, **Ambuja Cements** and its subsidiary **ACC Limited**. These are controlled by Lafarge-Holcim, one of the largest cement manufacturers globally. Ambuja's new CEO, Neeraj Akhoury has a strong track record of improving profitability at ACC and intends driving synergies between the two companies. Both companies are valued at approximately half the cost of replacing their plant and we believe both are well positioned to grow as India's economy normalises.

Bosch Limited is the only listed subsidiary of Robert Bosch GmbH. With a dominant position in supplying engine components to all major automotive original equipment manufacturers, including a monopoly in some segments such as tractors, Bosch has been badly impacted by the slowdown India's economy has seen over the last couple of years. However the upcoming shift towards more stringent environmental and safety norms across vehicle categories should lead to an increase in content per vehicle for Bosch. **Castrol India** is the leading automotive lubricant brand in India, majority owned by British Petroleum. The company has operated in the country for over a century. It has built a well-recognised consumer brand due to its superior product quality and consistent investments in advertising. Castrol should also benefit from the changes to emission regulations as customers switch to higher priced lubricants.

Eicher Motors is the leading premium two-wheeler manufacturer in India. It operates the iconic Royal Enfield motorcycle brand. Over the past two years, it suffered due to high regulatory price increases and weakening demand as the economy slowed. The company subsequently appointed a new CEO for Royal Enfield, Vinod Dasari, who has a strong track record at other automotive businesses. His focus is on improving distribution, building new revenue streams and strengthening the product portfolio. The company's commercial vehicle joint-venture with Volvo has also been hurt by a severe cyclical downturn in the commercial vehicle market. Its performance should improve when India's economy rebounds.

Metropolis Healthcare is among the leading diagnostics companies in India with industry-leading quality standards. The Indian diagnostics industry is highly fragmented, and dominated by 'mom and pop' laboratories where testing and safety practices are poor. As patients are becoming more aware of the need for higher quality testing services, these small laboratories are gradually losing market share. Metropolis has acquired a number of smaller laboratory chains, and improved their processes and systems. It is leading the industry's consolidation. The disruption due to Covid-19 is likely to put a significant strain on these small operators, as customer footfall has fallen substantially. This is likely to be an inflection point to accelerate the consolidation in favour of the organised sector.

United Breweries is India's largest beer company with over 55% market share. Heineken owns 46% of the company and controls its operations. Annual per capita beer consumption is only a fraction of other markets. Beer consumption should continue to grow given India's demographics. United Breweries has built a dominant portfolio across different segments. Its Kingfisher beer brand is the leader in India. It also has several regional brands and Heineken has introduced its own premium products into the company's portfolio. This should help the company grow strongly in the coming years. Complex tax regulations which require capacity creation in each state; government control over distribution of alcohol; and prohibition on advertising create large barriers to entry for new players.

Voltas is the leading air-conditioning brand in India. It is majority owned by the respected Tata group. The Indian air-conditioner industry has a penetration rate of only 5%, compared to that of over 70% in China. The industry has been growing rapidly in recent years, led by higher disposable income and better availability of electricity in semi-urban and rural areas. Voltas has consistently strengthened its market position. Its larger scale has led to the company having notably higher profitability than its peers. It has recently introduced a range of consumer durable products including washing machines, refrigerators and dishwashers through a joint venture with Arcelik Group of Turkey, which operates the well-known Beko brand. The company has significant long term potential to build a bigger presence in these categories.

For the five companies that we sold, only one has been a truly successful investment. Having benefited from a coal ban in ones of its key operating regions, city gas distributor **Gujarat Gas**'s valuation became expensive. Given the risk that the natural gas regulatory authority is likely to allow competitors to operate in Gujarat Gas's key markets, which were previously monopoly operations for the company, we chose to exit. A second, mechanical automotive cable manufacturer **Suprajit Engineering** had performed well for us. We sold the bulk of the Trust's position profitably in 2019 given its then expensive valuation. However, performance in 2020 has been poor meaning we sold out of the small remaining position at a loss. Whilst its core Indian business remains good, the risks associated with acquired business in Europe and the United States are now perilously high given that much work needs to be done to turn around these operations. Before we had every faith in Suprajit's management, but things look a lot tougher now.

The other three sales in India were unambiguously unsuccessful. Cancer specialist centre group **Healthcare Global Enterprise** has been a tremendous disappointment to us. Over-expansion and diversification away from its core specialism has led to poor returns. A lack of contrition from the founder means that the focused strategy we bought into seems to have fallen by the wayside so we exited for a painful loss. Children's garment manufacturer **SP Apparels** was equally poor. Its customer base was dominated by UK based retailers. Weak sterling and a weak UK economy has seen disappointing orders, numerous "one-offs" and shown a business that isn't as strong as we believed. Management have done a reasonable job diversifying its customer base but we have again been reminded that textiles is a difficult industry to make money from.

The final sale was finance company **Mahindra & Mahindra Financial Services**. This was a stock we had only purchased in the previous period following a sharp fall in its share price. We expected management to comfortably to ride out the Indian non-banking financial crisis. However, Covid-19 is much less controllable for the company. We are particularly concerned about a six month moratorium on loan repayments mandated by the Reserve bank of India which raises the risk of large credit losses given that many customers may use this moratorium period to divert their cash flows towards other uses leaving them unable to make loan repayments at the end of the loan moratorium.

South East Asia

Scottish Oriental's South East Asian weighting fell over the period. This was the result of a reduction of the Trust's holdings in Singapore. We added to a number of holdings in Indonesia and the Philippines although this was countered by share price weakness across our holdings in these markets.

Taking Singapore first, we completely sold hospital operator **Raffles Medical** which has been owned by Scottish Oriental for more than a decade. The company has operated its Singapore hospital well over the years. Recent expansion into China has promise but will likely take many years to bear fruit. The impact of Covid-19 will be significant for the company with a large portion of its Singapore revenues derived from international patients. These patients are currently unable to come to Singapore and this seems unlikely to change soon. In addition, the economics for its two new hospitals in China will become more difficult given the disruption that Covid-19 is having on healthcare. Earnings expectations have been revised down but we expect further downwards revisions. The company is expensively valued and we see little upside in the medium term. In Singapore we also halved the Trust's position in **Haw Par**. A key distribution channel for its Tiger Balm business is airports. Few people are travelling and travel is likely to be lower for some years. In addition the dividend income Haw Par receives from its large stake in United Overseas Bank is far from guaranteed given the potential for stress in the banking system.

In Indonesia we made notable additions to Scottish Oriental's positions in two companies. Having initiated a position in home improvement store operator **Ace Hardware** last period, we took advantage of share price weakness to add to the position. We also added to Pizza Hut franchisee **Sarimelati Kencana** on share price weakness. Although its restaurants have suffered in the last few months, its delivery operations have thrived. The company has renegotiated terms with its landlords and Yum! Brands, owner of Pizza Hut has accepted a reduction in royalty payments all of which has mitigated the impact of Covid-19 for the company.

In the Philippines we purchased one new holding. **Universal Robina Corporation** is one of the Philippines' leading consumer staples companies, with leading market positions in snacks, candies, chocolate, instant coffee and ready to drink tea. Two years ago the company appointed a new CEO, Irwin Lee. Irwin has led a number changes at Universal Robina, including higher brand investment, faster introduction of new products and increasing the direct distribution reach. This has led to an improvement in the company's market share across its categories over the last year. These market share gains should continue. It also has the opportunity to introduce new products in products such as instant noodles and beverages through its joint ventures with leading brands including Nissin Foods and Vitasoy.

We made notable additions to two holdings in the Philippines. Branded food company **Century Pacific Food** has benefited from increasing consumer demand for its canned food products given their affordability and long shelf lives. The company is also taking steps to introduce new products which should accelerate its growth further. Casual dining restaurant operator **Max's Group** has had a difficult few months but its relatively new CEO is using the disruption to accelerate his efficiency drive. Regrettably we bought casual restaurant operator **Jollibee Foods** and then promptly sold it. It is the largest restaurant operator in the Philippines but had burdened its balance sheet by acquiring businesses overseas. We were impressed at the plans to turnaround these operations and pay down debt but had not foreseen the extent of the coronavirus crisis. As its impact became apparent on casual dining we concluded that we could not sleep well at night with Jollibee's leveraged balance sheet and sold. Finally in the Philippines we sold out of **China Banking Corporation**. We have found management lacked urgency in the task of improving returns at this bank. Combined with the poorer economic outlook and the likelihood this will lead to higher non-performing loans we felt it no longer belonged in the portfolio.

South Korea

In Korea we initiated a new position meaning Scottish Oriental no longer has a zero weighting in this market. **NHN KCP** is the largest payment gateway company in South Korea. As the share of e-commerce and cashless transactions increase, its business is growing steadily. It has been much more focused than its competition and has been very proactive in acquiring good merchants domestically. It also collaborates with overseas payment gateway companies who refer their merchants to NHN KCP for their Korean operations. The result of this has been a steady gain in market share over the past few years which we expect to continue.

Scottish Oriental investment performance in GBP (%)

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	18.0	-11.4	-16.8	-16.2	8.2	89.4
NAV – total return	18.5	-11.0	-16.1	-13.3	14.5	113.1
Asia Index*	17.2	2.2	5.0	17.9	60.2	121.2
Small Cap Index**	26.7	0.3	-1.6	-0.9	18.7	58.0
Share Price	22.1	-17.7	-19.4	-21.0	1.7	82.4
Share Price – total return	22.1	-17.7	-18.4	-18.2	8.5	109.4

Source: First State Investments. As at 30 June 2020
* MSCI AC Asia (ex Japan) Index
** MSCI Asia (ex Japan) Small Cap Index

Annual Performance in GBP

Time Period	1 yr to Jun 20	1 yr to Jun 19	1 yr to Jun 18	1 yr to Jun 17	1 yr to Jun 16
NAV %*	-16.8	0.8	-0.1	19.3	8.3
Asia Index** %	5.0	3.6	8.4	30.8	3.9
Small Cap Index*** %	-1.6	-4.2	5.2	19.3	0.4
Share Price %	-19.4	1.0	-3.0	23.3	4.5

* Capital only return
** MSCI AC Asia (ex Japan) Index
*** MSCI AC Asia (ex Japan) Small Cap Index

These figures refer to the past. Past performance is not a reliable indicator of future results. All performance data is as at 30 June 2020. The performance comparative indices shown are the MSCI AC Asia (ex Japan) Index and MSCI AC Asia (ex Japan) Small Cap Index, on an income reinvested gross of tax basis. Sources: i) Trust Administrator for Trust performance; ii) Lipper for index performance.

Six month performance

To say that stock market performance so far in 2020 has perplexed us would be an understatement. With a backdrop of a global pandemic and the world entering its deepest peacetime recession in a century, stock markets have been rallying. Towards the end of January, as the threat of the new coronavirus built, the Chinese market started to lag as it entered its Chinese New Year holiday. After a week's break the Chinese market opened with a sharp fall but then proceeded to regain almost all its losses over the next several weeks. By March it had become very apparent that the coronavirus would not be contained and global markets fell sharply. However governments responded in spades with massive amounts of fiscal and monetary stimulus. The result was a rebound in global stock markets which have since continued to rise resulting in only modest losses for the period. As the pound weakened during the first six months of the year, sterling-denominated returns were mildly positive.

Within Asia, Bangladesh, India, Indonesia, Pakistan, the Philippines, Singapore, Sri Lanka and Thailand all fell by double digits. By contrast the Chinese and Taiwanese markets rose. South Korea and Malaysia only posted modest losses. Smaller companies in Indonesia and the Philippines performed particularly poorly. The result has been very weak performance from Scottish Oriental during the period. We are bottom up stock pickers - regrettably the resultant portfolio could not have been more poorly allocated geographically in the first half of 2020.

The Trust's holdings in Hong Kong and Taiwan produced strong returns. However these markets are relatively small weightings for Scottish Oriental. The Trust's holdings in China, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore and Sri Lanka all performed poorly. Whilst our holdings performed better than the overall stock markets in several of these countries they did not in China which further impacted performance as Scottish Oriental did not benefit from its holdings in the best performing market.

What helped

At a stock level, four of the top contributing stocks were those that we bought opportunistically during the period – **ACC Limited, Universal Robina Corporation, Eicher Motors Limited** and **Ambuja Cements**. Three were consumer staples companies that are listed in Hong Kong but with significant operations in China – **Vitasoy, Nissin Foods** and noodle and beverage manufacturer, **Uni-President China**. All three benefited from both their defensive characteristics and exposure to the Chinese market.

The top contributing stock was Taiwanese cable and connector manufacturer **Sinbon Electronics** which reported good results and has been benefiting from increased demand for its products used in ventilators and other medical equipment. A second Taiwanese holding, **Voltronic Power** also contributed positively as, although its sales fell as a result of various lockdowns, margins improved and it reported healthy order visibility. Finally, Indian food and beverage producer **Tata Consumer Products** (formerly Tata Beverages) performed strongly on a combination of good results, pantry stocking and expectations that its new CEO will be as successful here as he was at Whirlpool India.

What hurt

Scottish Oriental's holdings in India were the biggest detractor from performance with six Indian companies in the bottom ten contributors. The impact of Covid-19 on India has been severe with the country's poor healthcare infrastructure unable to cope and its economy hurt by the rapidly imposed lockdown. Nevertheless we believe the management teams of Scottish Oriental's Indian holdings will pass this test – India has seen worse in its history and we expect it will recover.

Looking at these six Indian holdings first, the single-biggest detractor from performance was the now sold **Mahindra and Mahindra Financial Services**. The economic slowdown, the impact of the loan forbearance imposed on the company by the regulator and the announcement of its intention to conduct a rights issue all weighed heavily on the share price. Air conditioning and refrigeration company **Blue Star** lost a large part of its key summer season as a result of India's lockdown. Real estate developers **Mahindra Lifespace** and **Oberoi Reality** both declined on expectations that Covid-19 will negatively affect property sales. The former also suffered after it reported a loss as the result of a write-down in the value of ones of its projects. We have engaged with the company's new CEO given the company's unsatisfactory performance. Bearings manufacturer **SKF India** reported weak operating performance on lower industrial demand although management have indicated that they believe this to be short term in nature. Auto components manufacturer **Mahindra CIE** was negatively impacted by the shutdown of its customers' plants but this should improve gradually.

Outside India, **Max's Group** was badly affected by the Philippines' lockdown with all its restaurants shut at one point. However operations are beginning to normalise. Indonesian filtration systems provider **Selamat Sempurna** saw falling sales on lower mobility in Indonesia. Management is focusing on improving its product mix and increasing automation in its plants and this downturn may well provide the company with opportunities to further consolidate the industry. **Raffles Medical** was impacted by concerns over the decline in international patients and that its Chinese operations will remain a drag for longer. **Haw Par** declined alongside United Overseas Bank from which it derives the bulk of its value.

Outlook and conclusion

We willingly admit that we don't know what is going to happen in stock markets. A key part of our investment process is entrusting the capital of Scottish Oriental with the management teams of companies which we believe are in a position to grow the Trust's capital in good times and preserve it in bad. It is no understatement to say that the outlook is cloudier than it has been at any point we can remember. Against the backdrop of a pandemic and a global recession, stock markets have been rallying even as earnings forecasts have been cut. Company valuations are towards the higher end of their historical range. Debt levels are too high and growing. We are both concerned for the future and perplexed about the present.

If we could pick one word to describe the recent behaviour of stock markets it would be 'artificial'. The tsunami of money that has been printed by developed markets central bankers has created easy monetary conditions nearly everywhere. And when this is the case, stock markets tend to go up. This may be rational as there are a limited supply of listed companies whereas the supply of money could be infinite. But it feels artificial and we do not wish to participate in chasing speculative stocks higher. We would rather stand by businesses we know well that have track records we can hang our hats on. We have struggled to generate ideas in China, instead finding the bulk of companies that meet our investment criteria in India, Indonesia and the Philippines. Capital in these three countries has historically been scarce which has taught company management teams capital discipline. In the current investment climate, capital discipline is almost a handicap.

We have no doubt that Scottish Oriental's companies will ride out the current crisis but our resolve is being sorely tested. Earlier in July, Chinese state media actively encouraged retail investors to buy stocks. That week, China's two main stock indices rose by over 7% and over 10% respectively. This is not normal. The president of the other superpower appears to measure his own success in terms of stock market performance rather than the wellbeing of his nations' economy and people. The governments of India, Indonesia and the Philippines have bigger things to worry about than their stock markets but the conditions remain for the companies Scottish Oriental owns in these markets to prosper over the long run. However, we fear the medium term may be bumpy.

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.