First State Stewart Asia
– Scottish Oriental Smaller Companies Trust plc
Investor note
July 2018

FIRST STATE STEWART ASIA – SCOTTISH ORIENTAL SMALLER COMPANIES TRUST PLC

RISK FACTORS

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If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

This is the sixth 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.

Fund Managers' travels

The most significant source of investment ideas for the portfolio comes through country and company visits. Over the past six months members of the First State Stewart Asia team have travelled to most of the major Asian markets. In total we met with well over 400 Asian companies during the period. These meetings have informed our views about the companies owned by the Trust, as well as the economies they operate in.

For this note we thought it might be of interest to discuss some of our recent trips, the conclusions we reached and the impact this had on Scottish Oriental's portfolio.

Indonesia:

First up was a visit to Indonesia in January by Vinay, Richard and Rizi. The economy has not recovered since the Indonesian Rupiah depreciated significantly against the US Dollar in 2013. Due to Indonesia's high import dependence, increased costs were passed on to consumers in the form of higher prices. Consumers have been trading down to cheaper products and growth has thus been slow. Nevertheless we were encouraged to see signs of change in the country. Infrastructure investment funded by the government has picked up sharply. The introduction of universal healthcare has also been a success. The corporate management teams we met told us that corruption and red-tape have reduced. They also expect the Asian Games and elections in the country next year to boost consumer demand.

The last decade witnessed a land-grab in the mini-mart industry in Indonesia. **Sumber Alfaria (Alfamart)** expanded aggressively, particularly in distant islands where purchasing power is low and distribution cost is high. Weak consumer demand led to their net margins collapsing from 2% in 2011 to 0.6% last year. Net debt increased from US$50 million to US$600 million over the same period. Management spoke to us about cutting their annual store expansion by half, reducing the number of employees per store and getting better terms of trade with suppliers. These initiatives should lead to higher profitability and free cash flow. Valuations had fallen significantly. If management deliver, valuations should re-rate upwards. We initiated a small position in **Alfamart** following our meeting although we will need to satisfy ourselves regarding a number of related party transactions before we could make this a large position in Scottish Oriental.

Selamat Sempurna is currently a small business with sales of US$250 million, operating in the filtration systems market which is worth US$50 billion globally. In our meeting, its Chairman explained his plans to grow the business by entering large new markets such as water filtration and air-conditioners. The company's sales mix has also shifted towards higher margin products, with help from its joint-venture partner Donaldson, a world leader in this segment. The family has injected all their automotive businesses into the listed company over the years and is thus aligned with us as minority shareholders. The Chairman now aspires to replicate Donaldson's track record of decades of uninterrupted dividend growth. We gained conviction about **Selamat Sempurna**'s growth opportunity, as well as our alignment with its promoter family. Therefore, we added to the Trust's position.

The Philippines:

During a visit to the Philippines in April, Vinay, Rizi and Andrew observed that several family owned businesses were undergoing generational change. This includes **Century Pacific Foods** and **Max's Group**. Our meeting with the founding family of **Max's Group** gave us insight into the family's intention to professionalise the business. A follow-up discussion with the recently hired Group COO, Ariel Fermin, served to increase our conviction about the new management's plans to improve profitability. Therefore, we initiated a position.

We also noted that most companies in the Philippines have increased their financial leverage over the last five years. This has been the case with **Manila Water**. Its net debt increased by over 40% in the last five years but its operating profits have increased by less than 10% over the same period. Therefore, its return on invested capital has almost halved from 10% to 6%, which is now lower than its cost of capital. The company historically benefited from a lucrative concession in Manila, which contributes the majority of its profits. As its network expands outside Manila, the new projects deliver lower returns and have higher risk as many of them are funded by US Dollar denominated debt. We concluded that these risks merit a smaller position in the portfolio.

Our meeting with the CEO of **Cemex Holdings Philippines** was more encouraging. The outlook for the cement industry has improved after a period of high discounting led by imports. Volumes are growing steadily and imports have fallen sharply. The company increased prices recently and expects to make a further increase later in the year. This should improve its profitability. The CEO was also receptive towards our suggestions to improve alignment with minority shareholders by reducing royalty rates and owning its limestone reserves through the listed entity. We added to the Trust's position after the meeting.

India:

We met most of the Trust's holdings during our visits to India in March, April and June with Scottish Oriental's board of directors accompanying Vinay, Naren, Sree, Shivika, Alistair and Wee-Li on the first of these visits. The introduction of the Goods and Services Tax (GST) is helping tax compliant businesses gain market share from their competitors operating in the informal sector. **Gujarat Gas** told us that they were seeing their industrial clients operating in the unorganised sector struggle after GST as it is increasingly difficult for them to sell directly to end consumers. Many of these companies are seeking to become contract manufacturers for larger businesses. **Jyothy Laboratories**' management also spoke of the changes they made to their distribution network after GST was introduced. The company has used its cash flows from the fabric care business where it has dominant market share to build stronger positions in underpenetrated segments such as dishwashing, household insecticides and personal care. Management is also exploring opportunities for partnerships with global companies. Such a partnership could have a significant impact on the long-term evolution of the business. We added to Scottish Oriental's holding in **Jyothy Laboratories** given its attractive valuations.

We also met several members of the Godrej group, which has been undergoing a generational change. Each of their businesses benefit from attractive growth opportunities. Godrej Consumer Products has leading market shares in highly underpenetrated markets including India, Indonesia and Africa. Its recently appointed Chairperson, Nisa Godrej, is singularly focused on building a successful franchise in Africa. Godrej Properties is India's largest listed residential property developer but its market share is below 1%. It is rapidly gaining market share as local developers are struggling after tougher regulations were introduced. The group holding company, **Godrej Industries** was valued at an attractive discount of 50% to the value of its stakes in its listed subsidiaries. Therefore, we added to the Trust's position. **Mphasis** and **Mahindra CIE** have witnessed a change in management over the past two years. **Mphasis**' revenues were declining under Hewlett-Packard's ownership. In 2016 Blackstone Private Equity acquired majority ownership and subsequently appointed Nitin Rakesh as CEO. New technologies have cannibalised legacy revenue streams across the industry but under Mr. Rakesh, **Mphasis** has adapted to these changes faster than many of its larger peers. This has led to the company's net profit growing by 30% over the past two years, after declining in each of the previous five years. Similarly, the Mahindra group's auto-component business had witnessed several years of poor performance before it merged with CIE of Spain. Ander Alvarez of CIE was appointed CEO in 2016. Since then, the company's operating margins have almost doubled. He expects to continue improving efficiency of their plants, while also consolidating smaller auto-component businesses through acquisitions. We added to the Trust's holdings in both **Mphasis** and **Mahindra CIE**.

We were disappointed by our recent interactions with **Blue Dart Express**. New competitors funded by venture capital have been burning cash to gain market share in the express logistics sector. The company has been forced to cut prices and stay out of certain markets which has hurt growth and profitability. Worryingly, these start-ups have poached members of the **Blue Dart Express**' senior management. We are also concerned by the company's recent partnership with Vakrangee, a provider of retail access points to consumers in rural areas. Vakrangee has a poor reputation for corporate governance. We engaged with management about our concerns, who are re-assessing the merits of this partnership. Given our concerns related to increasing competition and governance, we have reduced the Trust's position.

In contrast, **Shoppers Stop**'s recent partnership with Amazon has the potential to transform its business. Amazon acquired a 5% stake in **Shoppers Stop** and 400 brands of **Shoppers Stop** are now available on Amazon's website. The CEO was excited when he told us that even if only 1% of Amazon India's annual website traffic starts visiting their stores, their footfall would double. Over the last decade, **Shoppers Stop**'s profitable department store business was funding the losses of its hypermarket operation. It sold its hypermarket business last year and also exited two smaller, loss-making businesses. Following this, the company's profitability and cash flow have improved, while its balance sheet has now become net-cash. The divestment of poor businesses and the partnership with Amazon gives them the opportunity to be much larger and more profitable in future. We added to the Scottish Oriental's holding.

Bangladesh and Sri Lanka:

Martin and Andrew went to Bangladesh and Sri Lanka in April. The two countries have seen a divergence in economic conditions. Bangladesh's GDP has been growing at more than 7% per year. Over half its population is below 25 years old, which creates a large labour force. This has driven strong export growth and led to the Bangladeshi Taka being amongst the strongest Asian currencies over the past decade. In contrast, Sri Lanka's economic growth has been slow due to an increase in taxes, a weak currency, which has led to high inflation and political instability. Weak economic growth has driven consolidation across sectors. **Hemas Holdings** has used the weak economic environment to acquire Atlas Products, the leading stationery brand in Sri Lanka, at attractive valuations. Two small telecom operators, Hutch and Etisalat, have also merged their Sri Lankan operations. **Dialog Axiata** expects this consolidation to reduce price competition and lead to higher returns on capital across the industry.

Taiwan:

Martin, Winston and Helen visited Taiwan in March. Many Taiwanese companies have built export businesses as contract manufacturers for large companies like Apple. These contract manufacturers did well when demand for technology products was strong and raw material costs were low. But the structural strength of their underlying business is weak. They have little bargaining power against much larger customers. This makes it difficult for them to pass on price increases when costs rise. They also have to adjust their production capacity to respond to short demand cycles. These companies were adding capacity aggressively last year. Their utilisations are now falling as consumer demand has moderated. Our meeting with **Sitronix Technology** highlighted these challenges. It witnessed a decline in its revenue and profits as its customers have de-stocked inventory. As a supplier to manufacturers of low priced phones, it is also not able to pass on the cost inflation from higher raw material prices and currency depreciation to its customers. We took advantage of an increase in the company's share price to sell out of Scottish Oriental's position. The valuations of other exporters such as Macauto and Taiwan Paiho, which we also met, have corrected due to similar reasons. But our conviction in their ability to grow earnings across cycles has reduced. The Trust has not initiated positions in these companies.

Malaysia:

Richard and Rizi visited Malaysia in May. The recent change in the federal government has provided hope that the endemic corruption of the last few years will gradually reduce. However, we noted that there is no improvement in business sentiment on the ground. GDP growth of 5% is being driven by the infrastructure and construction sectors. The new government has announced a review of all major infrastructure projects. Some of these projects will be delayed or cancelled, which will suppress growth further. This announcement affected cement producer **Lafarge Malaysia**, which had secured orders for some of these projects. Cancellations would lead to lower sale volumes, while the cement price also remains weak.

China:

Members of the team made several trips to China during the first half of 2018 but we learnt most from a trip made to China by Vinay, Naren, Tianyi and Quanqiang in May. We observed that consumer preferences are changing. Foreign brands were historically preferred due to the perception that local brands were of lower quality. Over the past few years, local brands owned by companies like non-alcoholic beverage producers **Uni-President China** and **Vitasoy** have focused on improving their product quality. A new generation of consumers who grew up in an economically strong China has also emerged. They are not averse to buying these local brands. A follow-up meeting with Roberto Guidetti, CEO of **Vitasoy** back in Hong Kong helped us build further conviction on the company. Operational details such as measures being taken to reduce water consumption as well as strategic issues such as the measures being taken to continue building the brand in China and competitive dynamics were impeccably explained. It is clear to us that **Vitasoy** has a leader who we believe can continue to grow the company for the foreseeable future.

Another such company is **JNBY Design**, one of the leading branded apparel retailers in China. Management came across as focused on building a strong design capability by attracting good designers and creating customer engagement across online and offline platforms. The company also has a long runway for growth, as it aims to replicate the success of its JNBY brand across its portfolio of five other brands. We initiated a position after meeting the company. But as valuations re-rated too quickly (the share price rose by 70% in only three months), we decided to sell the Trust's holding.

We also met the Chairman of **Silergy** when in China. In its analogue integrated circuit design business, the Chairman's focus is on building a broader portfolio of clients and products to gain market share. We were impressed by his vision of becoming a technological leader in the industry, rather than chasing scale. **Silergy**'s business is still significantly smaller than that of industry leaders like Texas Instruments. Given the large market size and its initiatives to build a more diversified product and customer portfolio, we believe it could become a much bigger business over time. It is also benefiting from the trade related tensions between China and the US. Its' Chinese customers want to reduce their dependence on their US based suppliers and are turning to **Silergy** instead. We added to Scottish Oriental's position after our meeting.

Our meeting with traditional Chinese medicine company **Tong Ren Tang Technologies** was less encouraging. The company continues to face challenges in one of its key products, Ejiao. While competition has stabilised, price hikes have led to weak consumer demand. The introduction of new regulations for the sale of products to hospitals is also likely to hurt sales made through this distribution channel. We continue to engage with the company on the simplification of its corporate structure. The government's majority ownership in the company has led to slow progress on this issue. As valuations re-rated positively during 2018, we reduced the Trust's position.

We were excited to meet a number of well-regarded smaller Chinese companies which are not owned by Scottish Oriental. These included Hand Enterprises, whose sales have tripled over the last five years. But the growth has been driven by a significant increase in customer receivables. This increase in working capital led to negative cash flows and the company has consistently needed to issue new shares. We feel that such growth is likely to be short lived. Shanghai Pret, a plastics manufacturer, has also witnessed rapid sales growth. But we found its corporate governance standards a concern. The founder sold one of his privately owned businesses to the listed company, which later had to be shut down because it was loss-making. He has now pledged his stake in the company to privately acquire a bullet-proof vest manufacturer. We also met the ambitious Chairman of Shanghai Liangxin Electricals, a manufacturer of electrical equipment. His only strategy to gain market share against global players appears to be to under-cut them on pricing. This has helped the company gain scale. But the lower profitability of these orders has meant that its returns on capital have declined consistently as it has grown. The quality of these businesses left us disappointed.

Recent notable changes to the Scottish Oriental portfolio

Portfolio turnover has reduced during this period with a total of four new holdings purchased and nine completely sold. There are now 58 stocks in the portfolio down from 77 two years ago when Vinay Agarwal took on the lead manager role.

Country weightings (%)	30-Jun-18	31-Dec-17
China	8.7	10.0
Hong Kong	5.8	5.5
Taiwan	12.2	11.8
Greater China	**26.7**	**27.3**
Bangladesh	1.6	1.4
India	28.1	26.1
Pakistan	1.7	1.3
Sri Lanka	4.7	4.7
Indian subcontinent	**36.1**	**33.5**
Indonesia	8.0	6.8
Malaysia	2.0	2.8
Philippines	9.4	10.3
Singapore	5.2	4.8
Thailand	2.1	2.8
Vietnam	1.7	1.9
South East Asia	**28.4**	**29.3**
South Korea	1.9	2.9
Cash	7.0	7.0
Total	**100.0**	**100.0**

Source: First State Investments as at 30 June 2018.

Greater China:

Scottish Oriental's exposure to Greater China was relatively unchanged over the period. We did reduce exposure to China somewhat, taking profits on **Uni-President China** and gas distributor **Towngas China** as their valuations became more expensive. As mentioned above we also reduced **Tong Ren Tang Technologies**. We did, however, add to automobile body part manufacturer **Minth** which was weak over the period.

Within Hong Kong we exited finance company **Public Financial** on its dull growth outlook. We topped up the Trust's positions in quick service restaurant operator **Fairwood Holdings** and **Vitasoy** taking advantage of share price weakness.

In Taiwan, in addition to the earlier mentioned sale of **Sitronix Technology**, we also completed the sale of **Lumax International** and **Posiflex Technologies** both of which were discussed in our last note. As well as increasing the Trust's weighting in **Silergy**, we topped up window blind manufacturer **Nien Made** and networking equipment manufacturer **Wistron NeWeb** on share price weakness.

Indian Subcontinent:

Scottish Oriental's exposure to the Indian subcontinent increased over the period predominantly as a result of the additions following management meetings that we have already discussed. We also topped up a couple of holdings on weakness which we will mention later. One new position was initiated in India. **Federal Bank** is one of India's oldest private sector banks. Its management team was reinvigorated in 2010 with the appointment of a new CEO and he has brought further new blood to the bank. This management team has focused on expanding the bank's branch network outside its home state of Kerala and has exited higher-risk lending segments as well as building stronger deposit and fee-income franchises. We feel it is very attractively valued given this pragmatic management and the opportunity ahead. We also completed the sale of **Indoco Remedies** and **Jubilant Foodworks** that we started during the last period.

In Sri Lanka we swapped one bank for another. As a team we had a long-held belief that **Commercial Bank of Ceylon** was the best bank in the country. Our view has evolved and after a detailed examination of the two banks' track records and four meetings with **Hatton National Bank** in the last year we have concluded that the latter offers better prospects. The portfolio now reflects this.

South East Asia:

The Trust's South East Asian weighting was relatively unchanged over the period. Exposure to Indonesia increased, predominantly through the new position in **Alfamart**. On the other hand exposure to the Philippines decreased, primarily through the reduced weighting in **Manila Water**.

The only other activity of note in South East Asia was the sale of **Aeon Thana Sinsap** in Thailand. It is a very well managed finance company with a strong franchise in credit cards and personal loans. However once its share price rose above twice the value of its net assets we felt it was prudent to exit.

South Korea:

South Korea has become an even smaller part of the portfolio with the sale of testing pin/socket manufacturer **Leeno Industrial**. The Trust had a relatively small weighting in this company as we would have preferred for the stock to be cheaper when we bought it. The share price has performed well, however, so we decided to take profits given it operates in a relatively cyclical sector. Members of the team are visiting South Korea in the second half of 2018 and, as always, we are hopeful they will come back with some buy ideas.

Scottish Oriental's top ten holdings at 30 June 2018

	Net Assets (%) 30/06/18	Net Assets (%) 31/12/17	Country	Sector
Sinbon Electronics	3.3	3.1	Taiwan	Information Technology
SKF India	3.2	3.7	India	Industrials
Vitasoy International	3.1	2.2	Hong Kong	Consumer Staples
Jyothy Laboratories	3.1	0.8	India	Consumer Staples
Towngas China	2.9	3.2	China	Utilities
Haw Par	2.9	2.3	Singapore	Health Care
Concepcion Industrial	2.9	2.9	Philippines	Industrials
Uni-President China	2.6	2.7	China	Consumer Staples
Blue Star	2.5	2.8	India	Industrials
China Banking	2.5	2.5	Philippines	Financials
Total	**29.1**			

Source: First State Investments as at 30 June 2018.

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.

Cumulative Performance (% in GBP) to end-June	3mth	6 mth	1 year	3 years	5 years	10 years
NAV	4.0	-2.5	-0.1	29.1	40.8	271.0
NAV – total return	4.4	-2.2	1.1	33.5	48.6	322.5
Asia Index*	0.6	-2.3	8.4	47.3	72.5	172.4
Small Cap Index**	-0.9	-4.9	5.2	25.9	48.0	151.4
Share Price	4.0	-4.7	-3.0	25.0	19.6	263.8
Share Price – total return	4.0	-4.7	-1.9	30.1	28.0	325.0

Annual Performance (% in GBP) to end-June	1YR to 30/6/2018	1YR to 30/06/2017	1YR to 30/06/2016	1YR to 30/06/2015	1YR to 30/06/2014
NAV	-0.1	19.3	8.3	6.3	2.7
NAV – total return***	1.1	20.4	9.7	7.5	3.5
Asia Index*	8.4	30.8	3.9	13.2	3.5
Small Cap Index**	5.2	19.3	0.4	14.4	2.7
Share Price	-3.0	23.3	4.5	-2.2	-2.2
Share Price – total return	-1.9	24.9	6.1	-0.8	-0.8

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than the share class currency, the return may increase or decrease as a result of currency fluctuations.

Performance data is calculated on a net basis by deducting fees incurred at fund level (e.g. the management and administration fee) and other costs charged to the fund (e.g. transaction and custody costs), save that it does not take account of initial charges or switching fees (if any). Income reinvested is included on a net of tax basis

Source: First State Investments. As at 30 June 2018.

* MSCI AC Asia (ex Japan) Index

** MSCI Asia (ex Japan) Small Cap Index

*** Cum Income Total NAV Return

Six month performance:

It could be argued that Asian markets have been surprisingly robust so far in 2018 given the external environment that has seen the US Federal Reserve raise interest rates whilst shrinking its balance sheet and the US President seeming intent on launching a global trade war. It was only in the latter half of June that Asian markets went into the red for the year to date. Also surprising is that for the first half of 2018, China, Hong Kong and Taiwan were the best performing major markets. This surprised us given the "macro", but top-down investing has never been one of our strengths. One further point of note is that China's domestic stock markets were weak whereas Chinese companies listed outside China were generally not. The poorest markets this period were Indonesia and the Philippines – both suffering from weakening currencies as a result of their current account deficits. They have been caught short to an extent as interest rates rise and liquidity reduces. An additional wrinkle is that smaller companies in India performed particularly poorly whereas in Indonesia, smaller companies performed considerably better than their larger counterparts.

Over the last six months Scottish Oriental performed in line with the main Asian index and outperformed the smaller companies index. We might not have expected this to be the case given the Trust's relatively low weighting in China, high weighting in India and relatively large weighting in Indonesia and the Philippines. However stock selection was a significant contributor to performance in China and Indonesia and although the Trust's holdings in the Philippines fell in aggregate they did so by less than the market.

What helped:

At a stock level, three of the ten best contributing stocks were Chinese. **Uni-President China** contributed the most to performance of any stock in the portfolio as it reported an improvement in the profitability in both its beverage and instant noodle businesses. **Towngas China** occupied second place. During the period it reported its highest annual volume growth in five years. The company is benefiting from a recovery in industrial activity and conversion from coal to gas among its customers as environmental regulations become more stringent in China. The third Chinese stock in the top ten contributors was **Tong Ren Tang Technologies**. Its share price recovered much of the losses it had made in prior periods on firmer pricing for its products.

Three of the best contributing stocks were Indian although it should be noted that the portfolio's Indian holdings detracted from performance this period overall. **Mphasis**' industry-leading profit growth and improved profitability saw its valuation re-rated. **Jyothy Laboratories** also reported strong sales and profit growth as it grew market share across its businesses. And property developer **Mahindra Lifespace** rose as it ramped up its project launches.

We were fortunate with **Vitasoy** as, having added to the Trust's holding early on in 2018 when the share price was weak, the stock then performed strongly on accelerating growth in China. **Mitra Adiperkasa**, an operator of franchises in food & beverage, department stores, sportswear and fashion apparel, continued to see its revenues and profitability grow and the share price performed accordingly.

In Singapore, **Haw Par** benefited from a modest increase in the value of its stake in United Overseas Bank and also continued growth in its Tiger Balm business. And to round up the top ten contributors, the market decided that **Sitronix** was worth significantly more in June than it was in May. We are still unsure why this was the case but were happy to disagree with the market and move on.

What hurt:

India negatively impacted performance this period. Its stock market underperformed and the Trust's holdings were not shielded from this although they did perform considerably better than the Indian smaller companies average. However, four of the Trust's worst contributing stocks were Indian. The worst performing of these was air-conditioning and commercial refrigeration company **Blue Star**. A cooler and wetter than usual start to the summer saw the company's share price fall sharply in May and June on the expectation this would negatively impact results. Whilst we don't doubt this is the case we do not believe it fundamentally changes the investment case or the overall value of the franchise so we added to Scottish Oriental's position. We also added to **Gujarat Gas**. A number of analysts slightly lowered their margin assumptions for the company as a result of short-term price gas price fluctuations. The result was a weakening share price but, from our perspective, the long-term investment case is unchanged. **Blue Dart Express** was weak on the increased competition we discussed earlier. There is nothing untoward with bearings manufacturer **SKF India** but its share price eased back having reached an all-time high at the end of 2017.

The two worst performing stocks over the period were both cement companies – **Lafarge Malaysia** and **Cemex Holdings Philippines**. This is a lesson for us on the dangers of "trying to catch a falling knife". The share prices of both companies had already fallen substantially when we initiated positions in them. However in commoditised industries, it can quickly turn from feast to famine and both companies are very much famished right now. In the same way when the cycle turns the other way outsized gains can be made quickly and we will now need to be patient and wait for this to happen.

Two more of the worst performing stocks produce auto parts/components although these fell for different reasons. **Minth** has a successful business exporting body parts from Asia and Mexico to the United States and its share price has not responded well to the growing trade war fears. However the bulk of its business remains in domestic China and it already has capacity in the United States so any setback will likely be temporary. Indonesia's **Astra Otoparts** was again weak over the period with its weakness again caused by the company's results which showed improvement but not as much as the market was hoping for. It is taking us a long time to build up the position in Scottish Oriental so we do not mind this weakness.

Korean image solution provider **Vieworks** has not been a successful investment so far and it was weak again in the first half of 2018. Having suffered from increased competition it added to its woes with a product recall. We caught up with the CEO in June and concluded that the worst was over and will give the company the benefit of the doubt for now. Finally, **Delta Electronics Thailand**, a producer of power supplies and associated components remained weak. It has suffered from raw material shortages and foreign exchange headwinds of late. We have mentioned before how the market tends to overreact to short-term results on this company which we try to look through. We therefore added modestly to the position.

Outlook and conclusion

Over the last six months, little has changed yet much has changed. Although global growth remains strong there is now more of an acceptance that the unique economic conditions of recent years may be coming to an end. Economic commentary is not our speciality but it appears likely that the US Federal Reserve will continue raising interest rates given the labour constraints on the US economy and current inflation levels. So far this has led to a strengthening of the US dollar. Additionally the Federal Reserve will likely continue to shrink its balance sheet. This environment of tightening monetary conditions will make life tougher in Asia. In addition the risk of an escalation of Donald Trump's trade war and the potential dislocation it might bring is unnerving although in all likelihood such dislocation will be temporary given the ability of supply chains to adjust and that trade wars tend to have no winners. The combination of tightening monetary conditions and a trade war is unlikely to be conducive to strong stock market returns in Asia. There is, of course, a chance that the Federal Reserve does not raise interest rates further and stops shrinking its balance sheet. However, this scenario would likely be caused by a significant slowing of growth or indeed a financial crisis which would be equally unlikely to be conducive to strong stock market returns in Asia.

However we do not buy stock markets, instead we invest in companies that happen to trade on them. Based upon our recent meetings, most of the companies held within Scottish Oriental continue to perform acceptably and – importantly for us – have a healthy attitude to risk. With significant investments in India, Indonesia and the Philippines as well as holdings in companies based in several other countries with large domestic markets and attractive demographics we feel the portfolio is well-positioned to flourish over the long-run and withstand any headwinds, whatever the cause.

Although the outlook is cloudier than it was six months ago, counterintuitively we are perhaps slightly more optimistic. With uncertainty comes opportunity. And as bottom-up stock pickers we like being provided with opportunity. We believe that the companies in Scottish Oriental's portfolio have the potential for multi-year growth and such companies are, in turn, often provided with opportunities in tougher times that aren't available otherwise. The typical company in the Trust's portfolio now trades on 18x current year earnings. Whilst this is expensive relative to the Scottish Oriental's history, it is at least marginally cheaper than we have seen in recent periods. Should markets weaken further we will hopefully be able to fully invest the assets of the Trust.

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.