LIONTRUST

ASIA INCOME PROCESS

An investment process for the Liontrust Asia Income Fund managed by Mark Williams, Carolyn Chan and Shashank Savla

Fund name	Sector	Fund type
Liontrust Asia Income Fund	IA Asia Pacific ex-Japan	UK Unit Trust (UCITS)
Liontrust GF Asia Income Fund	N/A	Dublin OEIC (UCITS)

Investment philosophy

The investment process is based on the belief that the dominant influences on Asian equities will vary as cycles and environments change. Our approach is also shaped by our view that the region will generate long-term growth and companies are increasingly paying dividends back to shareholders.

While expectations will alter as events unfold across Asia, the end aim of the investment process remains constant. We seek to identify companies that will benefit from the growth in the region, have an attractive yield and give us a greater chance of expectations being beaten. We aim to avoid those stocks that are likelier to miss expectations. The process is also designed to enable us to compare companies on a like-for-like basis across countries and sectors.

By targeting at least 1.1 times the dividend yield of the region across our portfolio, we believe this will ensure the equities we invest in are amongst the more conservative, better managed companies. We do not see the additional yield criteria as leading to low relative returns, as long as it is combined with growth and attractive valuations.

To filter our potential universe of stocks and to enable us to focus our resources and time on the areas of the Asia Pacific ex-Japan markets that we believe will generate the greatest returns, we identify what are likely to be the key drivers of equities in the region over the following six to 12 months. We then determine the impact and the winners and losers of these drivers before selecting companies based on yield, earnings growth and cheap valuations.

The investment style and valuation metrics adopted are determined by the key drivers, the stage of the cycle and the stock opportunities available rather than being a predetermined feature of the process. Taking such a flexible and pragmatic investment approach is intended to provide us with sufficient freedom to seek to maximise returns from Asian equity markets rather than having our success determined by the business cycle.

Investment process

1. Identify the key drivers
2. Create a framework to capture the impact of the drivers
3. Analyse companies that will benefit from these drivers
4. Construct the portfolio

There are four main stages to our process:

1. Identify the key drivers for Asia Pacific (ex-Japan) equities.
2. Create a framework that captures the likely effects of these drivers, both positive and negative.
3. Analyse individual companies that will benefit from these drivers, looking for those stocks which have relatively high dividend yields backed by strong free cash flows, earnings growth and cheap valuations on an appropriate metric (beyond yield alone).
4. Construct the portfolio, diversifying across drivers, countries, sectors and stocks.

The investment process is iterative in that the information gleaned from company management and analysis is as important in helping to determine the drivers as it is in stock selection.

Identify the key drivers

The first stage of the investment process is to identify the key drivers of equity markets. We define drivers as developments, secular trends, anomalies in market and economic data and structural changes that influence equity markets in Asia.

Drivers, for example, may develop and be formed out of the current stage of the macroeconomic cycle (globally and regionally); demographic trends; geopolitical developments; structural, regulatory, country and industry changes; innovation; movements in relative valuations; or changes in supply and demand dynamics.

We use a combination of proprietary and external sources of information, data, research and analysis, both top down and bottom up, to identify the key drivers. These include political, macroeconomic and data analysis along with fundamental sector and company research.

Our timeframe for each driver is six to 12 months and they are continually reviewed to evaluate whether the drivers are likely to have an ongoing and strong impact on equity markets.

Knowledge gained from company analysis can be as much an input into this part of the process as it is a core part of portfolio stock selection. Companies give valuable information, not only about the organisation concerned but also its competitors, suppliers, industry and the countries where it does business, which can feed into our process of identifying and selecting the key drivers.

For example, we may identify ongoing increases in Asian wages as a driver, formed by a combination of a fast pace of economic growth and government policies raising minimum wage levels. This could be a high conviction, long-term view and would then feed into the next stage of the process.

Create a framework to capture the impact of the drivers

The second stage of our investment process is to determine what the impact of these drivers will be. This helps to identify which sectors, countries and types of companies will be the potential beneficiaries and losers from each driver. Similarly determined by the drivers will be an evaluation of the most appropriate valuation methodology, size bias, investment style, macroeconomic outlook and cross-sectoral trends in the current environment.

For example, in 2008, we looked only at historical price/book because there was no earnings clarity, but as the environment improved in 2009 we moved to forward price/earnings. We also eschewed small caps in the defensive environment of 2008 but embraced them again in 2009 as government stimulus gained traction. We were significantly underweight India at the start of 2011 due to macro-economic concerns and high valuations.

In continuing the example we used in the previous section, we might believe that rising wages will lead to rising consumption, especially at the low end of the market. At the same time, it should lead to increased wage bills for companies dependent on larger numbers of workers. This analysis would lead us to areas where we should focus our research for positive impacts of the driver across numerous industries and countries – those where the main revenue stream will be supported by rises in ongoing discretionary consumption – and negative impacts – all companies will see an increase in labour costs, especially harming those with high levels of unskilled labour.

Analyse companies that will benefit from these drivers

The third stage is to take our framework and analyse companies within it. One of the strengths of this approach is that it acts as a screening tool, enabling us to focus our time and resources efficiently on those countries, sectors and companies operating in a relatively benign environment, while avoiding impeding headwinds. We do not automatically invest in stocks that will profit from one of the key drivers we have identified, as the drivers merely aid us with our fundamental research on individual companies.

The framework also ensures that similar inputs are included when different analysts look at companies in different industries and countries. This removes the personal biases that are often present in research.

The core factors that we seek in our holdings are an attractive dividend yield (the portfolio target is at least 1.1 times that of the Asia Pacific ex Japan region); growth in earnings, which we believe should lead to capital appreciation over time; strong free cash flow to ensure the yield is sustainable; and attractive valuations on an appropriate metric other than yield. For the latter, the methodologies we use vary from driver to driver and include P/E, PEG, P/CF, P/BV, SOTP, EV/EBITDA and P/NAV*. While these are our primary criteria for investing in companies, we favour stocks that also have low pay-out ratios and low debt ratios.

The dividend bias will automatically push us towards more conservative, well managed companies that generate strong cash flows. By identifying companies that we believe will benefit from the more positive drivers while eschewing the negative, conservative earnings assumptions are more likely to be beaten. This is part of our aim to deliver more consistent performance than most of our peers over the long term with a lower level of volatility than the average fund in the sector.

Construct the portfolio

With our framework ensuring similar inputs in all analysis, the process leads us to a number of companies that we can compare a like-for-like basis. The aim is then to create a diversified portfolio (we hold between 50 and 70 stocks in our portfolio across 12 countries). The portfolio targets a yield of at least 1.1 times that of the Asia Pacific (ex-Japan) market's average and aims to deliver long-term capital growth (driven by companies' expected earnings growth). Once stocks are identified for inclusion, sizes are determined by our outlook for stock markets and our confidence in each of the key drivers and individual stocks. A target price is established for each stock.

While the geographical and sector exposures and portfolio construction reflect our key ideas, we also have to ensure there is sufficient diversification at country, sector, driver and stock level, which combine to seek to provide outperformance while mitigating risk. The prerequisite for yield means that our portfolio's asset allocation is likely to vary significantly from those of any Asia Pacific indices.

Changes in country and sector allocations result from changes in overall confidence in the drivers and the identification of attractive investment ideas within those areas, again requiring significant yields to be available for the portfolio.

Liquidity also represents a key component of each position's (and the overall portfolio's) risk/reward assessment. We invest in sufficiently liquid companies and manage holding sizes so that a significant majority of the portfolio can be traded in one day, within 1/3 of daily average volumes.

The aggregate portfolio should reflect our drivers, targeting a combination of yield and growth, all at reasonable valuations. This in turn should deliver long-term outperformance when compared to the major indices of the region.

We are not trying to identify catalysts that will prompt subsequent share price rises, as we believe markets are efficient enough to price in known events likely to impact share prices significantly. Instead, we rely on valuations to determine when appropriate entry points exist for individual companies.

Sell discipline

If a target price is exceeded, this will trigger a comprehensive review of assumptions, potentially leading to a sale. We will sell a holding or increase or reduce a position for the following reasons:

- An adverse stock movement will lead us to:
  - Increase a position if the investment case remains robust
  - Sell a position if the market is reflecting new information
- Identification of an alternative investment with better risk reward will lead to a switch.
- Ongoing alteration of individual position sizes is made to adjust portfolio risk.

*price/earnings; price/earnings to growth; price/cashflow; price/book value, sum of the parts, enterprise value/EBITDA (a measure of earnings); price/net asset value

For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

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