

Edinburgh Dragon Trust

An artificial reality?

Edinburgh Dragon Trust (EFM) is the largest and one of the most easily tradeable investment companies in the AIC's Asia ex Japan sector. The fund manager aims to buy high-quality companies at attractive valuations – an approach that has been applied consistently for many years. The manager believes that the policies of central banks and governments have created an artificial environment where market valuations are no longer based on reality and that EFM's performance, relative to market indices, has suffered as a result. They believe however that this situation is transient and, as things return to normal, EFM's portfolio will benefit and its performance will see a return to form.

Over the past few months market volatility has picked up but so has government intervention in financial markets. For example, Japan has adopted a negative interest rate policy and China has been buying equities to shore up its stock market. Many commentators are questioning the long-term effectiveness of these measures. EFM suggests the best hope for benefiting from a normalisation of markets is investing in companies that will prosper in such a situation.

Year ended	Share price total return (%)	NAV total return (%)	MSCI AC Asia Ex Japan total return (%)	MSCI AC World total return (%)
31/03/12	5.1	2.0	(6.8)	(0.4)
31/03/13	19.5	19.0	12.7	16.3
31/03/14	(15.9)	(12.2)	(6.4)	6.2
31/03/15	20.6	19.9	24.4	18.4
31/03/16	(14.7)	(11.2)	(9.0)	(1.2)

Source: Morningstar, Marten & Co

Sector	Asia ex Japan
Ticker	EFM LN
Base currency	GBP
Price	256.50
NAV	294.01
Premium/(discount)	(12.8)
Yield (%)	1.2

Share price and discount

Time period 01/04/2011 to 15/04/2016



Source: Morningstar, Marten & Co

Performance over five years

Time period 01/04/2011 to 31/03/2016



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	7 September 1987
Manager	Team-managed
Market cap (GBP)	491.8m
Shares outstanding	191.7m
Daily vol. (1-yr avg)	222k shares
Net gearing	11%

[Click here for our initiation note](#)

Capital growth from larger Far Eastern companies

Additional information is available at the Trust's website: www.edinburghdragon.co.uk

Edinburgh Dragon aims to generate long-term capital growth through investment in the Far East. Investments are made mainly in stock markets in the region, with the exception of Japan and Australasia, principally in large companies. The company may borrow money, with a view to maximising returns over the longer term. The shares that make up the portfolio are selected from companies that EFM's manager considers have proven management and whose shares are attractively priced.

Manager's view

Weak Chinese demand and slow US recovery are the key problems for Asia, whilst a spate of new potential problems has served to delay normalisation in Asia.

Edinburgh Dragon's manager considers that the main problem in Asia has been weakness in Chinese demand, coupled with a lacklustre recovery in the US (muting demand for Asian exports). However, he says that new potential problems keep cropping up, such as the recent decision by the Japanese to adopt a negative interest-rate policy, which has led to increased volatility in Asian markets. These have, in his view, postponed the hoped-for normalisation of the Asian economy, following the US interest-rate hike. The collapse in the oil price has affected Asian countries in different ways, with Malaysia being a clear casualty (a net exporter of oil and gas) and India a big beneficiary (a net importer of oil and fossil fuels in general). At the moment oil prices appear to be stabilising, but the manager considers that, with many factors at work, there is no clear visibility on how the oil price will develop from here.

Chinese slowdown may not yet have bottomed out, but the strength of Asian government's finances helps. Potential for interest-rate cuts across the region.

The manager thinks that it could be a few quarters yet before China's slowdown bottoms out but, generally, he believes that the strength of Asian government's finances provides the region with some stability in the face of a cyclical downturn. The manager also thinks there could be interest-rate cuts across the region, as other central banks respond to Japan's move in a bid to keep their exporters competitive.

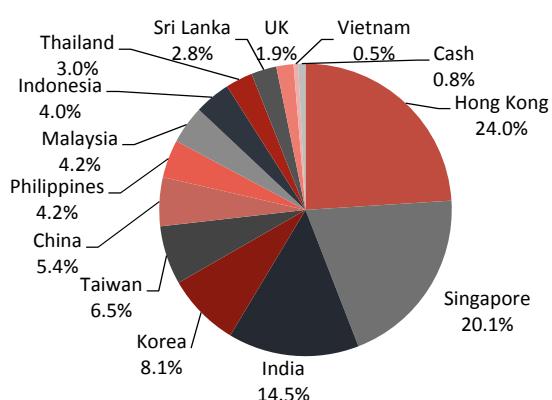
Asset allocation

A significant underweight exposure to China is offset by significant overweight exposures to Hong Kong and Singapore.

Figure 2 shows the largest geographic over and underweights of EFM's portfolio relative to the MSCI AC Asia ex Japan Index as at 29 February 2016. The portfolio has a significant overweight exposure to Hong Kong and Singapore, which is offset by a large underweight exposure to Chinese stocks. The portfolio is also overweight India and underweight Korea and Taiwan. The allocations to Sri Lanka, the UK and Vietnam, which you can see in Figure 1, are all exposures that are not represented in the benchmark index.

At the end of February 2016, EFM held 61 stocks and, as illustrated in Figure 3, the top 10 holdings accounted for 38.8% of the portfolio on that date. The overall number of stocks in the portfolio has been rising over the past 18 months. The manager says that this is a reflection of a deliberate policy to diversify the trust's portfolio. A dozen or so names have been added around the core portfolio (which has remained relatively stable) and these account for just shy of 10% of the fund.

Figure 1: Geographical allocation as at 29 February 2016

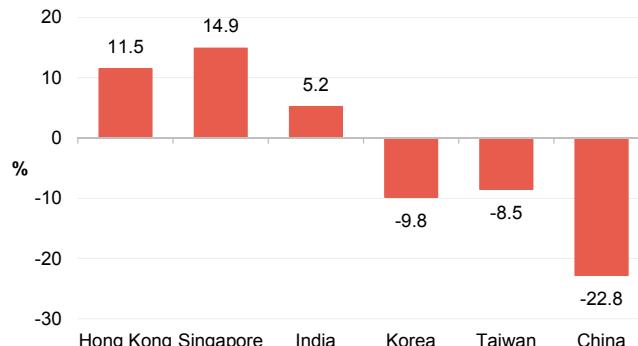


Source: Edinburgh Dragon Trust

The weighting to Indonesia has increased as the manager has added to positions on weakness.

Portfolio activity has increased as the manager has sought to take advantage of volatility.

Figure 2: Geographical weights relative to MSCI AC Asia ex Japan Index as at 29 February 2016



Source: Edinburgh Dragon Trust

The Indonesian weighting has been increasing in recent months, as the manager has picked up stocks such as Bank Central Asia and Astra International, during a period when the Indonesian market was weak. The manager says that both of these companies have been reporting decent quarterly numbers despite a slowdown of the Indonesian economy and both represented opportunities to add quality companies at good valuations following the market set-back.

The day-to-day trading activity on the portfolio has stepped up. The manager says that this because he is using periods of market volatility to add to stocks he likes and trim stocks that are looking expensive. An example is AIA Group. The manager has trimmed the position but continues to like the company. He thinks it has good fundamentals, is in a structural growth area and has resilient earnings. Should the stock price weaken, he would be happy to add to the position again. Oversea-Chinese Banking Corporation is another position that has been trimmed as it has become more expensive. However, the manager continues to like its strong franchise, believes it has good asset quality and will benefit from structural growth. Vinamilk is a position that has been added. The manager sees this as a very well-managed quality business with strong fundamentals, which offers the opportunity to gain some frontier market exposure within the portfolio.

Figure 3: Top 10 holdings as at 29 February 2016

Holding	Sector	Geography	Allocation 29/02/16 (%)	Allocation 31/08/15 (%)	Percentage point change
Samsung Electronics Preferred	Technology	Korea	5.1	4.6	0.5
Jardine Strategic Holdings	Conglomerate	Hong Kong	4.8	4.3	0.5
Oversea-Chinese Banking Corporation	Financials	Singapore	4.7	4.8	(0.1)
Taiwan Semiconductor	Technology	Taiwan	4.0	3.9	0.1
AIA Group	Financials	Hong Kong	3.6	3.6	0.0
Housing Development Finance Corp.	Financials	India	3.6	4.0	(0.4)
Singtel	Telecoms	Singapore	3.4	3.1	0.3
HSBC	Financials	UK / Hong Kong	3.3	3.6	(0.3)
United Overseas Bank	Financials	Singapore	3.2	3.2	0.0
Swire Pacific Bank	Conglomerate	Hong Kong	3.1	3.1	0.0
Total			38.8	38.2	0.6

Source: Edinburgh Dragon Trust, Marten & Co.

In addition to the stocks mentioned above, the manager has added positions in MTR, the Hong Kong transportation stock (the manager believes it benefits from defensive earnings and a large land bank), and AmorePacific Corporation, a cosmetics company that the manager sees as a play on the growth of consumer spending.

Performance

Weakness in the Hong Kong and Singapore property has adversely affected performance.

The manager says that one of the factors that has adversely affected EFM's recent performance have been weakness in the Hong Kong and Singapore property markets. These are areas that EFM is exposed to through stocks such as City Developments in Singapore and Hang Lung Group in Hong Kong. Whilst the Singapore property market performed well in Q1 2016, the manager says that the one-year returns were disappointing. The governments in these territories have been taking action designed to restrict property price rises including raising taxes. In Singapore, banks have been increasingly constrained as to how much mortgage lending they can take on and are being discouraged from lending against second and third homes. Both property markets are also quite open to foreign investors and the manager says that these have seen reduced interest from Chinese and Indonesian investors as those economies slow.

Exposure to banks has detracted from relative performance as has the decision not to hold Tencent, over concerns regarding its legal structure.

In addition, EFM's exposure to banks has been generally hindered performance. For example, Standard Chartered Bank, formerly a top 10 holding, has fallen by 58% over the past year – it recently reported its first annual loss since 1989. Elsewhere, the decision not to hold Tencent, which is both one of the largest stocks in the MSCI AC Asia ex Japan Index, and a strong performer over the past six months (up 27% since we last wrote about EFM), has detracted from EFM's relative performance. The manager says they are uncomfortable with Tencent's legal structure, which involves variable interest entities (VIEs). These are used as a way of trying to get round China's restrictions on foreigners controlling companies in "sensitive" industries. The government appears to be turning a blind eye to this practice for now, but the manager is wary that this position could change, leaving foreign holders potentially exposed.

An underweight exposure to China has contributed positively to performance.

Elsewhere, an underweight allocation to China has helped performance, but the managers say that, increased market volatility, with investors not discerning between lower and higher-quality stocks, has meant that they have not been able to generate the stock selection benefits they would have expected to be able to.

EFM's manager is not yet certain that the recent bounce in performance will persist.

In March, Asian markets and EFM both had a bit of a bounce, but the manager is not sure what has been driving this and is not yet convinced that this will persist. During this period though, EFM has been outperforming its benchmark (see Figure 4).

Figure 4: EFM NAV/MSCI All Countries Asia Ex Japan Index, rebased to 100, since 31 March 2011



Source: Morningstar, Marten & Co.

Figure 5: Cumulative total return performance to 31 March 2016

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
Edinburgh Dragon NAV	8.7	4.7	11.0	(11.2)	(6.5)	13.5	125.2
Peer Group Median NAV	6.3	4.6	12.8	(6.0)	4.9	32.5	140.3
Edinburgh Dragon Price	8.4	1.9	10.0	(14.7)	(13.5)	8.6	104.5
Peer Group Median Price	5.2	3.2	11.2	(9.0)	3.4	26.2	135.6
MSCI AC Asia ex Japan	7.8	4.4	11.4	(9.0)	6.0	11.4	104.4
MSCI AC World	4.1	2.8	10.9	(1.20)	24.2	43.9	79.9

Source: Morningstar, Marten & Co

Please click here to visit QuotedData.com for a live comparison of EFM versus its Asia Pacific Ex-Japan peer group.

As illustrated in Figures 4 and 5, EFM's performance relative to its peer group and its benchmark has perked up over the past few months. This is a period when the MSCI AC Asia ex Japan Index has been outperforming the wider MSCI AC World Index.

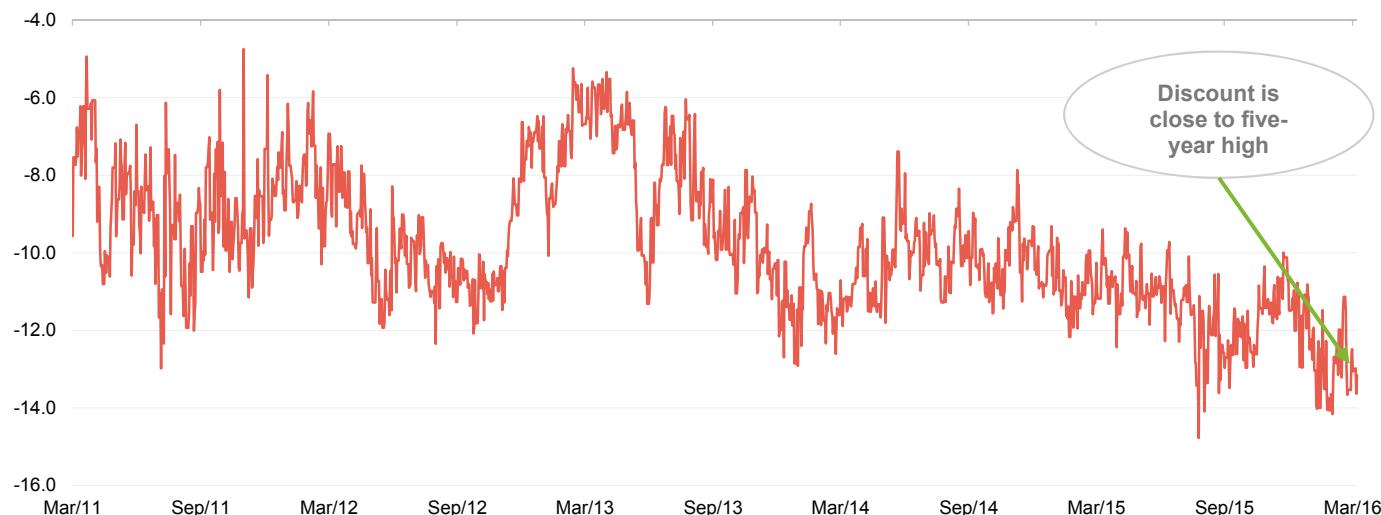
Discount

Edinburgh Dragon has been buying back shares actively over the past few months in an effort to reduce the volatility and absolute level of its discount. All the repurchase activity has been focused on the Trust's ordinary shares. This has had a marginal effect of increasing the proportion of borrowing in the fund's capital structure, as the ratio of convertible unsecured loan stock (CULS) to ordinary shares rises has risen. The repurchased shares have been held in treasury.

The discount has widened recently in common with its peers and the wider investment trust sector.

Figure 6 shows how the discount has moved over the past five years. The discount has widened a little in recent months, in line with discounts across the AIC's Asia ex Japan sector and the broader investment trust sector. EFM's current discount of 12.8% is the fifth-widest in its peer group. Over the past year, EFM's discount has moved in a range of 14.8% to 9.4%.

Figure 6: Premium/(discount) over 5 years (%)



Source: Morningstar, Marten & Co.

Previous research publications

Readers interested in further information about EFM may wish to read our initiation note *Focused on Quality* published on 13 September 2015. We have reproduced the contents page here. You can read the note [by clicking here](#) or by visiting our website.

Focused on quality – 13 September 2015

3 Market outlook – moving back to normality?

3 Figure 1: MSCI AC Asia Ex Japan/MSCI China over 10 years

3 Figure 2: Asia and global index F12m PE ratios over five years

4 EFM: Modestly geared exposure to large-cap Far Eastern equities

4 Managers' views (as represented by Aberdeen's Adrian Lim)

5 Investment strategy

6 Portfolio

6 Figure 3: Geographical allocation as at 31 July 2015

6 Figure 4: Sectoral allocation as at 31 July 2015

7 Figure 5: Top 10 holdings as at 31 July 2015

8 Performance

9 Figure 6: EFM NAV/MSCI AC Asia Ex Japan rebased to 100 since 31 Aug 2010

9 Figure 7: Cumulative total return performance to 31 August 2015

9 Dividends

10 Discount

10 Figure 8: Premium/(Discount) over five years

10 Fees and costs

11 Capital structure and trust life

11 Board

11 Figure 9: Board member - length of service and shareholdings

QuotedData

QuotedData is a trading name of Marten & Co, which is authorised and regulated by the Financial Conduct Authority
123a Kings Road, London SW3 4PL
0203 691 9430

Edward Marten
(em@martenandco.com)

James Carthew
(jc@martenandco.com)

Matthew Read
(mr@martenandco.com)

www.quoteddata.com

Registered in England & Wales number 07981621,
135a Munster Road, London SW6 6DD

IMPORTANT INFORMATION

This note was prepared for Edinburgh Dragon Trust Plc by Marten & Co (which is authorised and regulated by the Financial Conduct Authority).

This note is for information purposes only and is not intended to encourage the reader to deal in the security or securities mentioned within it.

Marten & Co is not authorised to give advice to retail clients. The research does not have regard to the specific investment objectives, financial situation and needs of any specific person who may receive it.

This note has been compiled from publicly available information. This note is not directed

at any person in any jurisdiction where (by reason of that person's nationality, residence or otherwise) the publication or availability of this note is prohibited.

Accuracy of Content: Whilst Marten & Co uses reasonable efforts to obtain information from sources which we believe to be reliable and to ensure that the information in this note is up to date and accurate, we make no representation or warranty that the information contained in this note is accurate, reliable or complete. The information contained in this note is provided by Marten & Co for personal use and information purposes generally. You are solely liable for any use you may make of this information. The information is inherently subject to change without notice and may become outdated. You, therefore, should verify any information obtained from this note before you use it.

Investment Performance Information: Please remember that past performance is not necessarily a guide to the future and that the value of shares and the income from them can go down as well as up. Exchange rates may also cause the value of underlying overseas investments to go down as well as up. Marten & Co may write on companies that use gearing in a number of forms that can increase volatility and, in some cases, to a complete loss of an investment.

No Advice: Nothing contained in this note constitutes or should be construed to constitute investment, legal, tax or other advice.

No Representation or Warranty: No representation, warranty or guarantee of any kind, express or implied is given by Marten & Co in respect of any information contained on this note.

Exclusion of Liability: To the fullest extent allowed by law, Marten & Co shall not be liable for any direct or indirect losses, damages, costs or expenses incurred or suffered by you arising out or in connection with the access to, use of or reliance on any information contained on this note. In no circumstance shall Marten & Co and its employees have any liability for consequential or special damages.

Governing Law and Jurisdiction: These terms and conditions and all matters connected with them, are governed by the laws of England and Wales and shall be subject to the exclusive jurisdiction of the English courts. If you access this note from outside the UK, you are responsible for ensuring compliance with any local laws relating to access.

No information contained in this note shall form the basis of, or be relied upon in connection with, any offer or commitment whatsoever in any jurisdiction.