

# Edinburgh Dragon Trust

## Artificial reality

Edinburgh Dragon Trust (EFM) is the largest and one of the most liquid investment companies in the AIC's Asia ex Japan sector. The fund manager aims to buy high-quality companies at attractive valuations – an investment 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 fundamentals. EFM's performance relative to market indices has suffered as a result. At some point, however, reality will prevail and then EFM's portfolio will stand on its own merits.

Over the past few months market volatility has picked up but so has government interference in financial markets. Japan has adopted a negative interest rate policy and China has been buying equities to shore up its stock market, but 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.

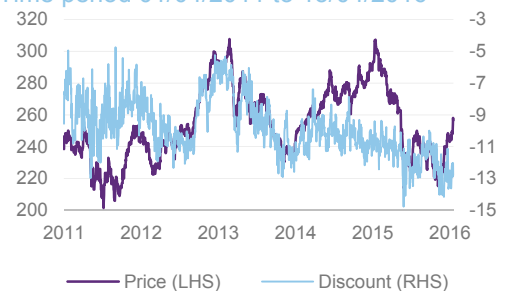
Year ended	Share price total return (%)	NAV total return (%)	MSCI AC Asia Ex Japan total return (%)	MSCI AC World total return (%)
31/03/12	5.1	2.0	(6.8)	(0.4)
31/03/13	19.5	19.0	12.7	16.3
31/03/14	(15.9)	(12.2)	(6.4)	6.2
31/03/15	20.6	19.9	24.4	18.4
31/03/16	(14.7)	(11.2)	(9.0)	(1.2)

Source: Morningstar, Marten & Co

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

## Share price and discount

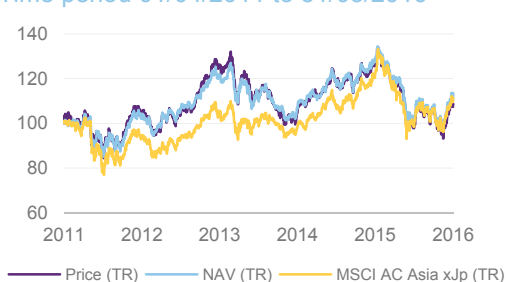
Time period 01/04/2011 to 15/04/2016



Source: Morningstar, Marten & Co

## Performance over five years

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



Source: Morningstar, Marten & Co

<b>Domicile</b>	UK
<b>Inception date</b>	7 September 1987
<b>Manager</b>	Team-managed
<b>Market cap (GBP)</b>	491.8m
<b>Shares outstanding</b>	191.7m
<b>Daily vol. (1-yr avg)</b>	222k shares
<b>Net gearing</b>	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](http://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 utilises gearing, with a view to maximising returns over the longer term. The shares that make up the portfolio are selected from companies that 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.

The manager comments that the main problem in Asia has been weakness in Chinese demand, coupled with a lacklustre recovery in the US. However, new potential problems keep cropping up, such as the recent decision by the Japanese to adopt a negative interest-rate policy, which led to increased volatility in Asian markets. These have postponed the hoped-for normalisation of the Asian economy, post the US interest-rate hike, for now. The collapse in the oil price has affected Asian countries in different ways, with Malaysia being a clear casualty and India a big beneficiary. 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.

The Chinese slowdown may not yet have bottomed out, but fiscal strength will provide some stability. There is the 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 Asian fiscal strength 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.

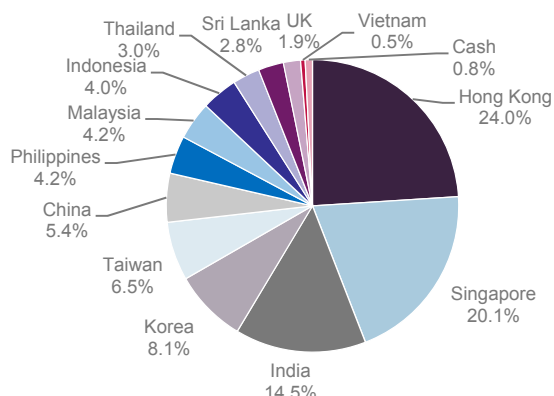
A significant underweight exposure to China is offset by significant overweight exposures to Hong Kong and Singapore.

## Asset allocation

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 you can see 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, which reflects a deliberate policy of the manager to diversify EFM'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

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



Source: Edinburgh Dragon Trust

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

The Indonesian weighting has been increasing in recent months, as the manager has picked up stocks such as Bank Central Asia and Astra International, on weakness. 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.

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

The day-to-day activity on the portfolio has stepped up, as the manager takes advantage 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 weaken, he would be happy to add to the position again. Oversea-Chinese Banking Corporation is another position that has been trimmed on valuation grounds. 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
<b>Total</b>			<b>38.8</b>	<b>38.2</b>	<b>0.6</b>

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, which benefits from defensive earnings and a large land bank, and AmorePacific Corporation, a cosmetics company that is 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 one-year returns disappointed. The governments in these territories have been taking action designed to tame property prices including raising taxes. In Singapore, banks are 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 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 unhelpful generally. 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 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 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.

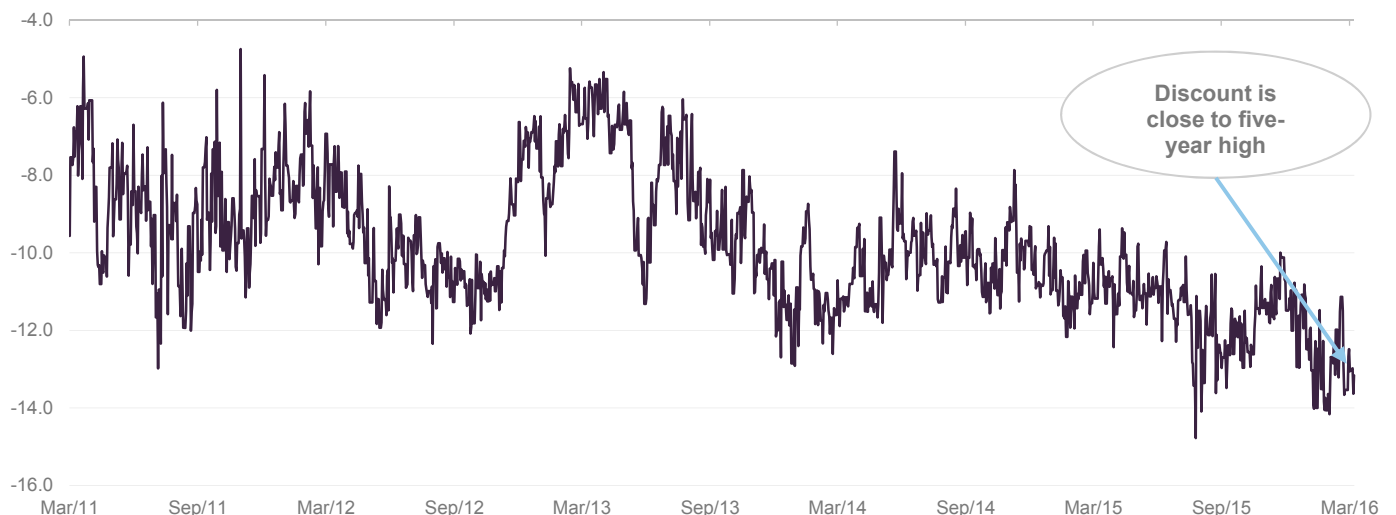
## Discount

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 underlying gearing of the fund, as the proportion of convertible unsecured loan stock (CULS) to ordinary shares rises. 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 *Keep the faith!* 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.

### Keep the faith! – 13 September 2015

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