Overseas Asset Management

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OAM Asian Recovery Fund

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Dear Fellow Shareholder,

The Fund's NAV/share increased by 11.3% last year. By comparison, the Fund's benchmark, the MSCI Asia ex Japan (US$) index, rose by 15.4% last year. In strong years such as last year, we expect to underperform the benchmark, but decline less during downturns, with the expectation that the Fund can handsomely beat the benchmark over a full market cycle.

During the 21 years since inception, the Fund's NAV compounded at 12.8% per annum, rising more than twelve-fold, while the MSCI Asia ex Japan (US$) index rose less than fourfold or 5.9% per annum. The benchmark figures used for comparison do not include dividends. We estimate that if dividends, net of withholding taxes, are included in the benchmark returns, the benchmark returns would increase by around 2 ½ percentage points per annum.

Our market views remain roughly unchanged from a year ago, other than in a few specific respects. We still think that Asia ex Japan equities are cheaper than average, while US equities are close to all-time high valuations. We also believe that the US dollar is overvalued and likely to weaken against most major currencies over the next 5-10 years. It is emphatically overvalued on a purchasing power parity basis. As I commented last year, US dollar strength has historically tended to coincide with periods of US equities outperforming non-US equities, even in local currency terms, and vice versa. The reason for this is that investors tend to flock in one direction or the other and money flows inflate or deflate a country's or region's currency and equity market at the same time. Dollar weakness would give us a welcome tailwind going forward instead of the headwind that we experienced for most of the past decade.

What changed in the past year?

The major change taking place last year was the political unrest in Hong Kong. This decimated Hong Kong tourist arrivals and retail sales. The Fund had little direct exposure to Hong Kong's economy, but many Hong Kong listed equities saw their share prices impacted by the troubles there.

We added to the Fund's investment in COSCO Shipping International and now own 10 million shares worth US$2.5 million. This company has been consistently profitable and paid a dividend every year since 2004. In spite of having an asset-light business, the company holds nearly US$1 billion in excess cash on its balance sheet, most of which is held in US Dollars. Net cash per share is HK$4.15 and its operating business is worth more than

HK$1.00 per share, so at the current share price of HK$2.00, COSCO Shipping International is an incredible bargain, trading at a more than 60% discount to intrinsic value. The downside risk is low in our view given the cash backing, but there is a danger that intrinsic value may never be realised. This is a Chinese state-controlled company and most such companies do not count capital allocation as one of their strengths. I met with the company on my last trip to Hong Kong, and have written to the Board, as have other investment managers we know, urging them to repurchase shares, make a tender offer for a large block of shares, and increase the annual dividend. In the meantime, we collect a 8% dividend yield, free of withholding tax, while we sit and wait for a catalyst for the shares to close the gap with intrinsic value.

A new holding in the portfolio, added in the last five weeks of the year, is Swire Pacific Class B shares. We have long admired the Swire group. Everything they do, they do well. Pacific Place in Hong Kong which is owned by Swire Properties, in which they have a 82% stake, is one of the premier commercial property developments in the world, as are their Taikoo developments in Quarry Bay, Beijing, Shanghai, Guangzhou and Chengdu, and Brickell City Centre in Miami. Cathay Pacific, in which they have a 45% stake, is one of the world's best airlines. They also own 100% of the exclusive Coca Cola bottling franchises in Hong Kong, Taiwan, eleven of the most prosperous provinces of China, and much of the west coast of the US. Roughly a year ago, they bought the rest of Hong Kong Aircraft Engineering Company (HAECO) which they did not already own so that they now own 100%. HAECO provides aircraft maintenance and repairs in Hong Kong, Xiamen and the US. Swire also own a number of other businesses, in many cases representing other brands in Asia.

There are a number of ways to estimate the intrinsic value of Swire Pacific. One is to value the listed businesses at their current share prices and apply typical industry valuation multiples to the unlisted businesses. The problem with that approach is that Swire Properties which accounts for around 60% of the group's value when calculated on this basis is selling at a more than 50% discount to net asset value. The other problem is that the B shares, which are the super-voting class of shares which we own, are trading at a more than 20% discount to the A shares in terms of their rights to dividends. Swire Pacific publishes on a semi-annual basis a figure for equity attributable to shareholders on a per share basis for the A and B shares, and has done so for a few decades. Over the past 30 years, its B shares traded at between a 76% discount and a 60% premium to equity attributable to shareholders, averaging a 30% discount. The record discount was achieved in the depths of the Asian financial crisis in 1998. If we look at the 20-year history which excludes the early/mid '90's Asian boom and 1997/8 bust, the range has been a 69% discount achieved in Q4 2019 to a 25% premium achieved in Q4 2007, just prior to the Global Financial Crisis. The only other times within the past 20 years when Swire Pacific's B shares reached a mid- to high-60's discount to equity value was in late 2001, following which the share price doubled over the next two years, and late 2008/early 2009, following which the share price more than doubled over the next two years. Just getting back to the 20-year average of a 35% discount to equity value would result in the value of our Swire Pacific investment doubling. It could be argued that equity value is overstated, particularly at Swire Properties, but we are reassured by nearly US$4 billion in property sales in Hong Kong which they closed during 2018 and 2019 that resulted in gains over their recorded equity value, leading to the group having the lowest leverage since 2007. While we wait for "this time too shall pass", we earn a 5.5% yield free of withholding tax.

Some shareholders may be nervous about us entering the teeth of the storm in Hong Kong. It is never comfortable investing when current news is bad, but the results once the situation normalises is usually enticing. Those who were brave enough to invest in OAM Asian Recovery Fund 21 years ago when it was launched reaped

a bonanza. An indication of “the Hong Kong discount” is that for dual-listed businesses, the discount for the exact same companies listed in both Hong Kong and China now averages 30%. This is a high conviction investment for us and we sized it accordingly so the Fund now holds 4 million Swire Pacific B shares worth US$6 million.

Other changes to the portfolio

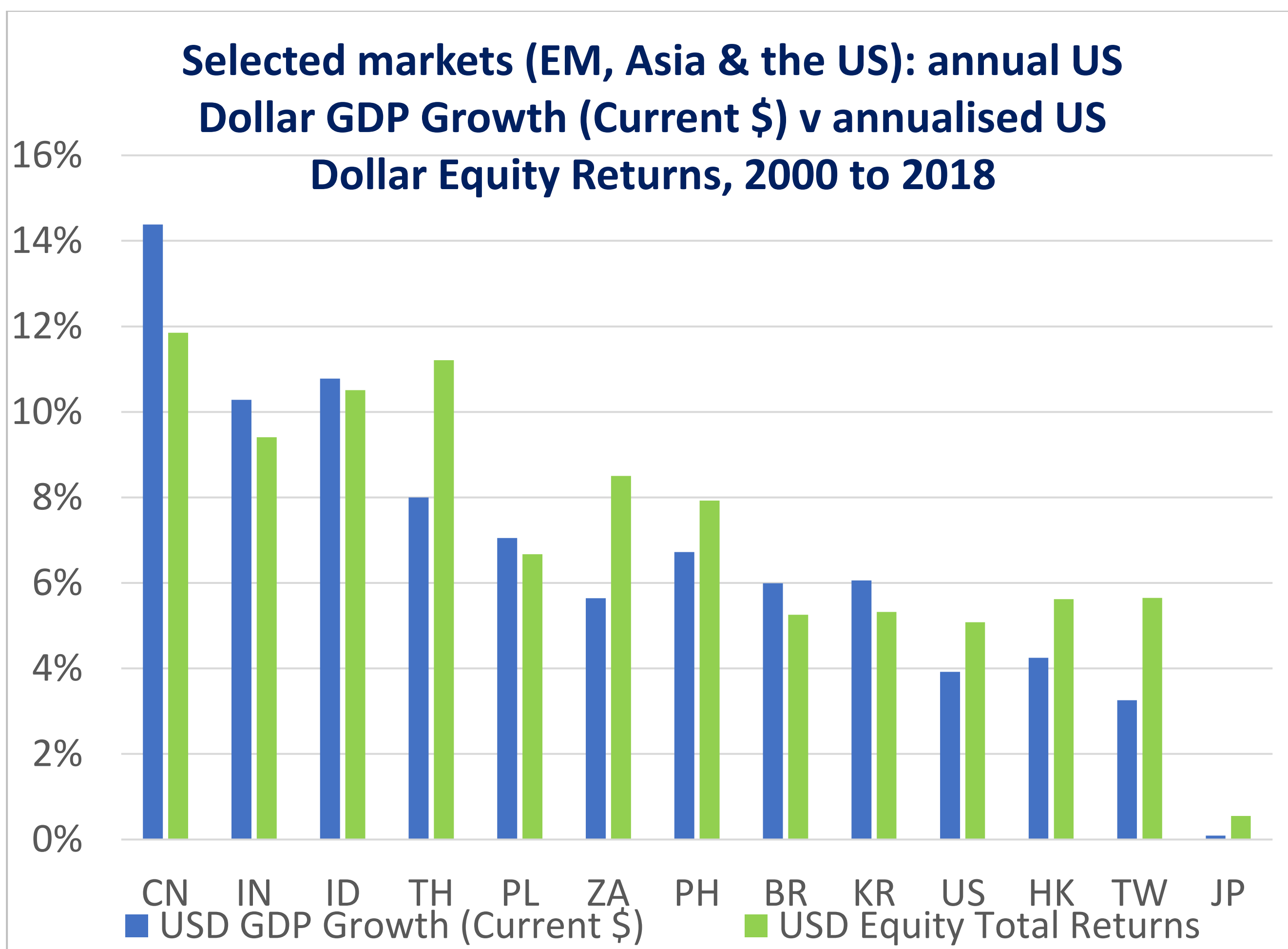
One of the other main changes to the Fund’s portfolio was the purchase of US$10 million shares in a new Indian equity fund that was launched by a manager in India who I have known for more than 10 years and for whom I have the highest regard. We invested in the fund on what we think are attractive terms and we very much like and can identify with their stock selection process. We anticipate having an investment in this fund for many years.

During the year, we received about US$9 million in distributions from four closed-end funds that are selling their remaining assets and returning capital to shareholders. Two have been very successful investments for the Fund, Pacific Alliance China Land and Vietnam Phoenix Fund; one has been a mediocre investment, ASM Asia Recovery Fund; and one has been a disappointment, Kubera Cross-Border Fund, though to give the manager and its directors credit, they stuck with it and pursued the release of value for shareholders and they appear set on finishing the job they set out to do.

A link between economic growth and stock market returns

In the short to medium-term, there is no link between economic growth and stock market returns. Arguments have been made over the years that there is no link between the two over the long-term, and in some cases, it has been argued that the two are negatively correlated. That makes no sense intuitively. I was therefore intrigued earlier this year when a fund manager in Asia for whom I have great respect put together data which suggests that over the long-term, there is a high positive correlation between nominal economic growth and stock market returns. I communicated with him and made a few suggestions as to how this might be refined.

The end result is shown at the top of the following page. The blue bars show the nominal GDP growth rate in US Dollar terms for various countries over the 19 years from 2000-2018, and the green bars show the total return in US Dollars, inclusive of reinvested dividends, in those markets. For China, we use the Hang Seng China Enterprises (HCEI) index. For other markets, we use the most commonly recognised benchmark indices for those markets, e.g. SENSEX index for India, Jakarta Composite index for Indonesia, S&P 500 for the US, Hang Seng index for Hong Kong, etc. The resulting bar chart shows a high correlation between the two factors over the long-term. Stock markets in high growth economies like China, India and Indonesia generated high returns over the period, while stock markets in low growth, mature economies like the US, Hong Kong, Taiwan and Japan generated low returns. This is too short a period to be statistically significant, but it bears watching over a series of rolling 20-year periods.



The next decade

There are many reasons to be positive about the Fund's prospects during the next decade. It would be very surprising to us if Asia does not remain one of the fastest growing regions in the world during this decade. The starting point for equity valuations is reasonable, and in the case of many smaller and medium-sized companies in Hong Kong and the ASEAN region, low. Dividend yields are attractive and the rate of withholding tax low or zero. Unexpected political disruptions, economic slowdowns, and corporate scandals are sure to arise in the region during the next decade. But a number of longer lasting factors hurt returns during most of the past decade, namely US dollar strength, the polarisation of stock markets in favour of a small number of growth stocks while ignoring a large segment of value stocks, and a general shunning of emerging markets by portfolio managers. There is a very decent chance that these negative factors will reverse this decade and help the Fund generate a return that is better than its 7.6% compound annual return during the past decade.

During the prior decade most of these factors were in our favour. It could be argued that the starting point for the measurement period (2000-2009) was highly favourable, but this was not the case. The Fund generated a 69.7% return in 1999, immediately before the decade started, so the starting point was not a major cyclical low. Furthermore, March 2000 was a major cyclical peak for equity markets globally. The MSCI Asia ex Japan (US$) index suffering a decline of nearly 60% in 2000/01 and a nearly 70% decline in 2007/08. In spite of these big drawdowns, the Fund returned 13.5% per annum during that decade.

The past five years have been disappointing for Asia ex Japan equities, particularly relative to US equities. Over that period, the S&P 500 index of large cap US equities rose more than 9.4%/annum and the NASDAQ index which has heavy exposure to US technology sector, the hottest area of the US stock market, rose 13.6%/annum. Compared to US equities, our Fund's return of 5.4%/annum over the period was pedestrian. The rise in US equities during the past five years was driven primarily by money flows rather than growth in corporate profits. That is a dangerous foundation on which to build investment returns. In the meantime, Asian equities valuations declined. Furthermore, the US dollar strengthened during the past 5 years - by 12% versus the RMB, 13% versus the Indian rupee, 12% versus the Indonesian rupiah – depressing returns in US Dollars. When compared the MSCI Asia free ex Japan (US$) increase of 4.1% per annum during the past 5 years, the performance of our funds was respectable. Over 10, 15, and 20 years, the Fund's outperformance looks a lot better. Part of the reason for the 5-year picture being less flattering than the longer-term picture is due to the underperformance of value stocks, combined with small cap stocks being ignored or sold as money flows were concentrated in the large cap indices. The Fund has little exposure to components of the MSCI Asia free ex Japan index, favoring instead smaller and medium sized Asian companies with limited or no research coverage that are often mispriced.

The natural instinct after enduring five years of pedestrian returns from an asset class is to sell and move into what has been performing well. We think that is the worst thing an investor could do. Just as the right thing to do during the dot com boom was to sell technology stocks and buy value stocks, today the right thing to do is to sell most US equities which have done stunningly well, and buy non-US equities, particularly the orphaned value stocks and the shares of small and medium sized companies where valuations are cheap and the prospects for future returns are favorable. Doing so is difficult because it means selling what has done well during the past few years and buying what has done poorly.

Liquidity risk

The travails of Woodford Investment Management are a wake-up call for the fund management industry. In a parliamentary hearing in June, the Bank of England governor Mark Carney said that funds which invest in illiquid assets but allow investors instant access to their money are "built on a lie, which is you can have daily liquidity" and called for changes to regulations. Carney added that for assets that "fundamentally aren't liquid or might become illiquid in a market downturn", he said the damage of that "lie" for financial stability is that it "leads to an expectation for individuals that it's not that different from having money in a bank". He concluded that fund investors should expect redemption terms that are in line with liquidity of the underlying assets.

One of the responsibilities taken by the Fund's Board is to review the liquidity of its investments to make sure that they are in line with the Fund's redemption terms. Shareholders in the Fund can redeem all or part of their holding by providing signed redemption instructions to the Fund 14 days prior to the Redemption Day which is the last business day of each month. The Fund also has the power to pro-rate all redemption requests on any Redemption Day to limit total redemptions to 20% of the Fund's shares. I therefore review the Fund's portfolio on a regular basis and report to the Board to ensure that at least 20% of the Fund's portfolio is likely to be liquid within 14 days and at least 50% within 3 months. To make this determination, we use the redemption terms of the underlying funds and a third of average daily trading volume during the past six months for listed equities as assumptions of likely liquidity. On this basis, the Fund's portfolio easily matches its liquidity terms and these parameters. Since it usually takes about two weeks to finalise the Fund's monthly NAV, in practice we have that additional time to raise liquidity if needed.

This is a risk to which we believe that many investors, fund managers, and fund directors are paying insufficient attention. It has long been a risk on our radar and we think this is part of the reason why neither of our funds needed to be "gated" during the Global Financial Crisis. It would be impossible for us to generate the returns we have historically without taking on some illiquidity risk. The key point is to ensure that the liquidity of a fund's investments is aligned with its redemption terms.

Geopolitical risk

The globalisation trend, anchored by generally declining import tariffs globally, started to reverse two years ago when the Trump Administration imposed tariffs on Chinese solar panels and washing machines. The Fund's NAV per share peaked in January 2018. Additional tariffs and skirmishes between the US and China followed such as the arrest of Cathy Meng, the CFO of Huawei, at Vancouver airport on the basis that the company breached US sanctions against Iran, and the sanctioning of several Chinese companies that are leaders in the development of Artificial Intelligence (AI) on the basis of human rights violations. We have no way of anticipating Trump's next tweet or how this economic war will play out. We made no attempts to anticipate or trade around these unpredictable geopolitical actions as evidence by the Fund's low turnover. Our edge is in identifying superb managers and undervalued businesses.

However, we are concerned by the overreach of the US Treasury Department and their penchant to impose enormous fines and in some cases expropriate assets that they say are derived from foreign regimes that they don't deem friends of the US. US financial institutions are terrified of the powers of the Treasury and effectively do their bidding in some cases. There have been noises about forcing a delisting of Chinese companies from U.S. exchanges, imposing limits on investments in Chinese markets by U.S. government pension funds, and putting caps on the value of Chinese companies included in indexes managed by U.S. firms.

The Fund's custodian is Bank of Butterfield (Jersey) Ltd. (BBJ). We have always shied away from using US custodians, other than to hold US assets. We recently instructed BBJ to move the Fund's Hong Kong listed securities from BNY Mellon who is their sub-custodian to ABN AMRO as the sub-custodian of Bank of Butterfield (Guernsey) Ltd. We also reviewed the custody and sub-custody arrangements of all the Asian managers with whom the Fund has investments. Only 7% of the Fund's assets are held in custody or sub-custody by US financial institutions. In the past, we have not needed to pay much attention to plumbing of the global financial architecture, but the world is changing and we need to monitor this risk carefully. This is yet another reason for those with future spending needs to outside the US to diversify globally.

A stable base of investors

The Fund had $310 million in net assets at year end. During the year, there were $4 million in subscriptions and $21 million in redemptions. This is the sixth consecutive year that the Fund has had net redemptions. This is a function of us not marketing, instead relying entirely on word of mouth referrals from happy clients, and our clients getting older. As our clients get older, some of them draw down capital for living expenses, to give to children, or because they become more risk averse.

The manager, the Fund's directors and their wives in aggregate now own 16% of the Fund's shares and entities which they manage or of which they are a director own an additional 4% of the Fund. A very high proportion of our financial assets is invested in the OAM funds. We think that our funds are likely to provide investors with higher returns than most other financial assets over the next 5-10 years. On a 1-5 year view we are agnostic. A

long overdue tumble in US equities from very high valuation levels would be damaging in the short-term, but we think could be a longer-term trigger for allocation away from US equities. In the meantime, we feel very comfortable with the valuation and growth prospects of what we own. Whilst in the past we have increased the minimum investment requirement to prevent assets growing too rapidly, we recently reduced the minimum required to open an account to $500,000 to new clients to invest in our two funds at a time when we believe they both look attractive.

Desmond Kinch, CFA
Chairman