Invesco Asia

IAT's cheap portfolio is positioned for a strong 2020 in Asian markets...

Update
22 January 2020

Summary

Kepler GROWTH RATING

This trust is rated by Kepler Trust Intelligence as an outstanding option for investors seeking capital growth...
Find out more

Invesco Asia Trust (IAT) is managed by Ian Hargreaves, who aims to generate double-digit returns over a three- to five-year period by investing in good-quality businesses which are worth more than the market believes. Generally, returns are expected to come from capital growth, but a secular shift to paying higher dividends in the region means that the yield on IAT's portfolio has risen to 2.8% (the shares currently yield 2.2%). Ian expects dividend growth to be a medium-term trend in the region, while IAT's board is committed to growing the dividend, and has the ability to pay out of capital.

The trust has generated returns close to target since Ian took over in March 2011, with annualised NAV total returns of 9.4%, despite the market trending sideways over the past two years. IAT has tended to perform well in both rising and falling markets, helped by the strategy of balancing risk exposures (**see the Portfolio section**). Overall, the trust has outperformed its peer group by an impressive 16% over five years, with Ian beating the benchmark in both good times and bad. In fact, he has outperformed in seven calendar years out of the last nine.

Ian observes that the valuation gap between IAT's portfolio and the index (MSCI AC Asia ex Japan) has widened in recent months as he has found a number of cheap opportunities after a weak period for Asian markets. These valuation opportunities and Ian's optimism for the region in 2020 explain why the gearing has reached new highs, **as we discuss in the Gearing section**.

Despite the strong long-term performance record, the discount stands at 9%, wider than the AIC Asia Pacific sector average of 7.5%.

Analyst's View

IAT's manager Ian Hargreaves employs a sophisticated strategy which we think should allow it to do well in different types of markets. The stock-selection strategy balances growth and valuation inputs while the risk-management work aims at ensuring the portfolio is not overexposed to any risk factors or style, and the benefits of this approach come through in the consistent record of returns. Here Ian benefits from the depth of resources at Invesco, which allows him to understand the risks in his portfolio while retaining full autonomy over investment decisions.

That said, there is a value tilt to the portfolio which we believe could be attractive after a period in which growth has outperformed considerably in Asia. This comes from the contrarian approach Ian takes to identifying undervalued Asian franchises.

Key Information:

As at	16/01/20
Price (p)	308
Discount (%)	-9.0
OCF (%)	0.98
Turnover Ratio	0.0
Yield (%)	2.2
Gearing (%)	0
Ticker	IAT
Shares (£)	66,853,287
Market cap (£)	205,908,124

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The value tilt is more pronounced than it has been in the past, thanks to the opportunities that have opened up in the weak markets of late 2018 and in 2019.

Ian is excited enough by these opportunities and the green shoots he sees in the economic data to have raised gearing to new highs. As such, we believe IAT is well positioned should 2020 see a rebound in markets. Although Ian is more bullish and more positioned in cyclicals than he has been in the recent past, having met with him and discussed his approach and outlook we are convinced he remains a cautious, risk-aware investor, and the portfolio will continue to reflect that.

We believe that if Ian is right that the data suggests an uptick in manufacturing, exports and cyclicals in 2020, this should drive shareholder returns in several ways. First of all, the portfolio's valuation discount to the wider market should close. Secondly, should the region perform as well as Ian expects next year, we would expect discounts across the sector to move in. At the same time, given the trust trades on a significant discount to more 'growthy' peers (perhaps due to its value tilt), the discount relative to its peers' should narrow. These possibilities should be considered against a backdrop where IAT's discount of 9% is wider than the sector average of 7.5%.

Analyst's View

BULL	BEAR
A highly experienced manager with an in-depth knowledge of the region	The portfolio's cyclical exposure and gearing could hurt if the market falters
A wider discount than peers despite strong relative performance	The US/China trade war means there is significant uncertainty about the prospects for Asian markets
A flexible approach which has led to a strong track record of outperformance in rising and falling markets	The discount has proven stubborn and so could remain wide relative to peers'

Portfolio

Invesco Asia Trust (IAT) invests in the equity of Asian companies. Although its objective is long-term capital growth, secular changes in the parts of the market that manager Ian Hargreaves invests in mean that dividends have become more significant in recent years. Ian believes this trend will continue and takes a total return mindset, aiming to increase the dividends paid over time.

Ian's approach is quite balanced stylistically, although there is a tilt to value. He believes that the most sustainable way to make money for shareholders is to buy companies that are worth more than the market believes. Ian aims to identify stocks which can generate a double-digit return over a three- to five-year holding period (Morningstar figures suggest an average holding period of approximately four years). To do this, he looks for companies whose shares are undervalued by the market, which leads him into contrarian positioning at times. The idea-generation process often starts by looking at what has underperformed and been out of favour and also by trying to identify if markets have undershot or missed something. The aim is to form different views than the market and patiently allow these theses to play out.

Ian views starting valuation as an important determinant of return potential, and therefore the valuations in the market are an important determinant of his risk appetite. However, an assessment of a business's earnings potential and whether it is properly recognised by the market is critical to the stock-selection process, so Ian characterises his approach as more of a growth-at-a-reasonable-price (GARP) strategy than a strict value discipline. The aim is to find good-quality businesses when they are cheap and out of favour. Ian draws on his own research, as well as that of the three other fund managers and two analysts who are focused on Asia in the Invesco Asia and Emerging Market Equities team he co-heads; he also draws on external research.

When we met Ian recently, he explained that the valuation gap between his portfolio and the market was at the widest he could remember, which helps explain why he has increased gearing to new highs (see the Gearing section). At the same time, he is very optimistic about sections of his portfolio in 2020 which have yet to play out given the narrow strength of the Asian market in 2019. The table below shows the portfolio is on a discount to the market on both a P/B and P/E basis, while it has much higher earnings potential (on consensus estimates gathered by Style Analytics). We think the considerably lower valuation

Fundamental Characteristics Of Portfolio

	CURRENT P/B, X	FORWARD P/E, X	FORWARD DIVIDEND YIELD, X	FREE CASH FLOW YIELD, %	FORWARD EPS GROWTH, %
IAT	1.2	12.7	2.8	10.5	20.2
MSCI Asia ex Japan	1.7	14.9	2.6	7.5	16.2
MSCI World	2.4	17.4	2.5	5.7	11.5
S&P 500	3.7	19.2	2.0	5.0	11.7

Source: Invesco

of the Asian market to global developed markets is also striking and suggests that should the global economy perform well in 2020, there is significant outperformance potential in Asian equities.

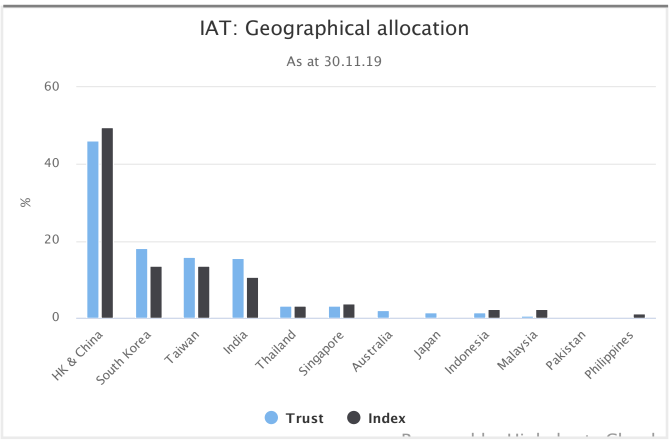
The portfolio's dividend yield reflects the value tilt, but also the strong dividend growth generated by portfolio companies in recent years. Ian and his analyst team forecast future returns from candidate stocks by building up their own estimates of future EPS growth, the stocks' expected P/E multiple re-rating or de-rating, and the dividends they expect to be paid, all in aid of identifying those stocks which can generate 10% or more a year in total shareholder return. Ian believes that the growth in dividends he expects from the Asian market (2% and growing) should ensure that total returns are at least in line with the 7% pa long-run average in the medium term, even if earnings growth is weaker than it has been in recent years.

Asian markets have been weak since Q1 of 2018 and this has opened up pockets of value in good-quality businesses which Ian has been taking advantage of, and which have contributed to the wide valuation discount between his portfolio and the market visible above. At the same time, Ian has become more optimistic about the outlook for the region's economy, which he believes is likely to benefit from a modest global recovery, which will be felt in some sectors and countries much more than in others. The recent easing of monetary policy by central banks is one contributor, while the pick-up in developed-world retail sales versus manufacturing output in recent months is bullish in Ian's view, as it is likely to be followed by a pick-up in production to meet improving demand. The ongoing trade dispute between the US and China is the major detractor, although Ian believes that the fact the markets have reacted less and less to each item of news in recent months indicates that they are looking through the rhetoric, and share prices already reflect most of the negative impacts.

One area of value Ian has been taking advantage of is the automotive industry. Autos have suffered from the slowdown in global exports amid trade disputes, but Ian believes the steady growth in GDP that has occurred while exports have been falling, along with the strong retail ex autos data mentioned above, indicates that demand remains healthy and that this gap is likely to close. IAT's recent purchases include Dongfeng Motor in China, which is still trading on a very cheap valuation (a P/E of 4.2 according to Bloomberg). Hyundai Motor in South Korea is also cheap in Ian's view, with a rising percentage of new products in its sales indicating the beginning of a positive product cycle. Mahindra and Mahindra is another recent auto purchase which is more of an India-specific story, operating in the tractor market rather than in the market for mainstream private vehicles.

South Korea is an area where Ian currently finds value because the market is trading on a cheaper P/B multiple than it did even after the 2008 financial crisis (0.85x compared to its 0.91 low in 2009). Samsung Electronics, the trust's largest position (6.7%), is trading on a low P/B relative to its recent history, while Ian believes we are starting to see the next generation of products which should drive the expansion of the business. The company has also increased buybacks and dividends, which Ian thinks are not fully appreciated by the market. This is an example of the strides being made in Korean corporate governance, which in Ian's view have the potential to erode Korea's valuation discount. This potential plus the low valuations mean that South Korea is one of the trust's key country overweights.

Fig.1: Country Exposure



Source: Invesco

India is another major overweight and the source of a large number of ideas, and Ian believes that the sell-offs over the past year or two have allowed more value to open up in this market, which is benefiting from structural reforms and a strong demographic tailwind. The country is early in

Top Ten Holdings, As At 30/11/19

INVESTMENT	COUNTRY	%
Samsung Electronics	South Korea	6.7
TSMC	Taiwan	5.3
Tencent	China	5.2
Alibaba	China	4.6
ICICI	India	3.7
NetEase	China	3.5
MediaTek	Taiwan	3.4
AIA	Hong Kong	3.3
United Overseas Bank	Singapore	3.1
Industrial & Commercial Bank of China	China	2.7
TOTAL		**41.5**

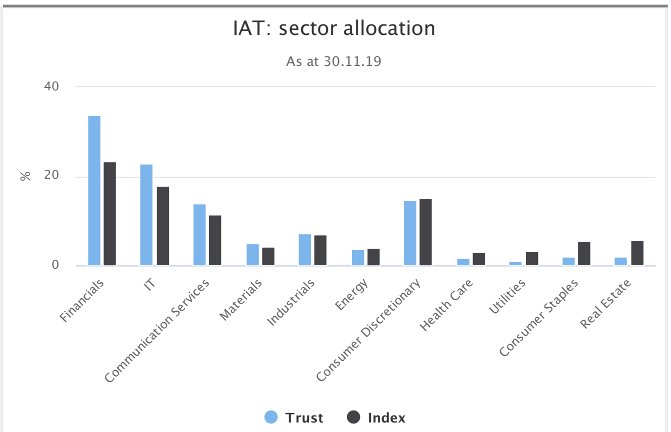
Source: Invesco

the credit cycle, with low levels of debt and the potential for a gearing effect to earnings growth as they pick up. Along with Mahindra and Mahindra, mentioned above, Ian continues to find the private-sector banks highly attractive, such as ICICI Bank, a key overweight and top-ten position. Shriram Transport is considered a good-quality Indian company which has become attractively valued after the weakness in the region's markets, trading on a single-digit P/E. It provides financing for second-hand vehicle purchases and is therefore exposed to a stronger consumer. Although a negative outlook for global growth would not help, India is more of a self-help story and is less exposed to global trends than the rest of Asia, whose markets tend to be correlated to export growth and therefore international trade. The Indian exposure therefore reduces IAT's beta to this risk factor.

Ian's value picks are balanced by positions which might be considered growth plays, but which growth Ian thinks is not fully reflected in current valuations. A good example is NetEase, the Chinese computer-game developer. This is a long-term holding for the trust, having first been purchased back in 2012. Valuations had become less attractive in 2017 and 2018, and Ian reduced his weighting somewhat, but after the high-growth tech and internet names led the Chinese market down in Q4 of 2018, Ian believes there is now value in the shares again, which has led him to increase the position. Internet retailer JD.com is another stock which fits this theme. The internet retailer is seeing rising margins and still looks cheap on a price to sales basis, in Ian's view, although the market has become more wary of paying up for non-profit metrics.

Ian does a great deal of work to ensure the portfolio's holdings are not overexposed to common risk factors. To this end he can draw on the work of Invesco's risk teams, who provide detailed statistical analysis of the exposures in the portfolio, highlighting the presence of hidden correlations. This is one of the benefits of operating within a large global asset manager such as Invesco, although the decisions on positioning are always left to the manager himself. One example of this work is the balance between growth and value exposures described above, which means IAT is not dependent on a recovery in value versus growth. This work also reveals that the high weighting to financials (visible in the chart below) does not indicate a particular common risk factor. Although IAT is over ten percentage points overweight to financials, the stocks it owns in that area are sensitive to different themes and are without, for example, an overarching exposure to US interest rates. In addition, the banks in India which are benefiting from secular changes in that economy and sector are not correlated to the banks in South Korea. Meanwhile, the Chinese insurers are more exposed to the growth in that sector in China than global interest-rate trends.

Fig.2: Sector Exposure



Source: Invesco

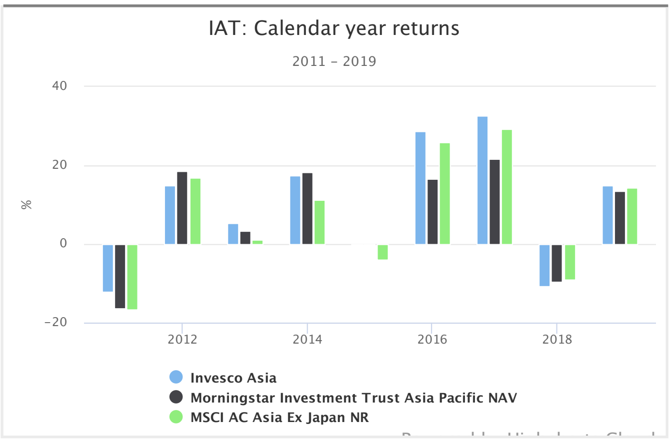
Gearing

Ian is excited enough by the opportunity in Asian markets to have increased gearing substantially in recent months. The trust is currently 9% geared, having been net cash as recently as August 2019. This increase has been driven by the valuation opportunities Ian sees in the market, and he has been flexible in adding or reducing gearing over the past year as valuations have shifted. Gearing is taken through a short-term revolving credit facility, which gives Ian complete flexibility. Going forward, we understand the intention is to take a disciplined approach to gearing that aims to enhance returns.
For most of 2017 and 2018 the trust had net cash in its portfolio, with Asian markets having seen a sharp rally and reflecting Ian's caution on the level of prices. After the sell-offs at the end of 2018, as well as in spring and summer 2019, more value has emerged and hence Ian has taken on debt to increase the trust's exposure. Gearing has not historically been much of a feature of the trust, but Ian tells us it is likely to play a greater role in the future, reflecting the board's stated desire. This clearly increases the return potential, and should the manager's optimism prove well founded, could lead to a strong relative performance if markets make progress in 2020. On the other hand, it is worth noting that gearing will exacerbate the downside in falling markets. The board has the permission to gear the trust up to 25%, but gearing levels are left to the manager on a day-to-day basis.

Performance

IAT has a track record of grinding out excess returns ahead of the benchmark year on year. Since Ian took over in 2011, the trust has outperformed the MSCI AC Asia ex Japan benchmark in seven out of nine calendar years on an NAV total return basis. Impressively, the trust outperformed in two of the down years for markets. In the other down market (2018) it underperformed very slightly, by just 1.6%. The average annual outperformance under Ian's tenure has been 2.4% per annum.

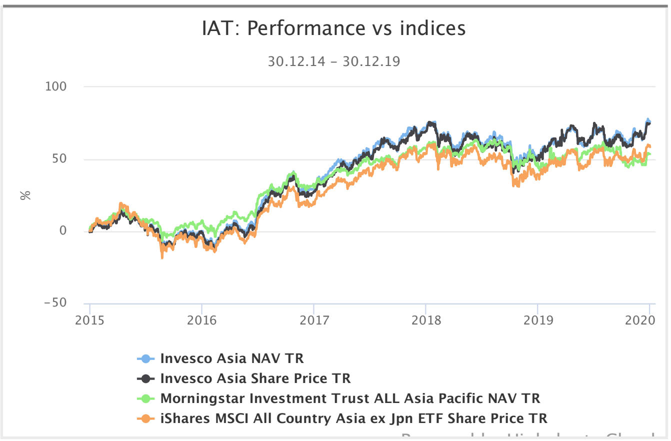
Fig.3: Nav Returns



Source: Morningstar, 2019 data to 30/12/19

The upshot has been strong long-term outperformance. Over five years, the trust has generated NAV total returns of 75.8%, with the share price up 74.8% over the same period. This compares to returns of just 58.4% for the iShares MSCI All Country Asia ex Japan ETF, representing a passive investment in the index. The average trust in the AIC Asia Pacific sector has returned just 55.3% on an NAV TR basis.

Fig.4: Five-Year Performance



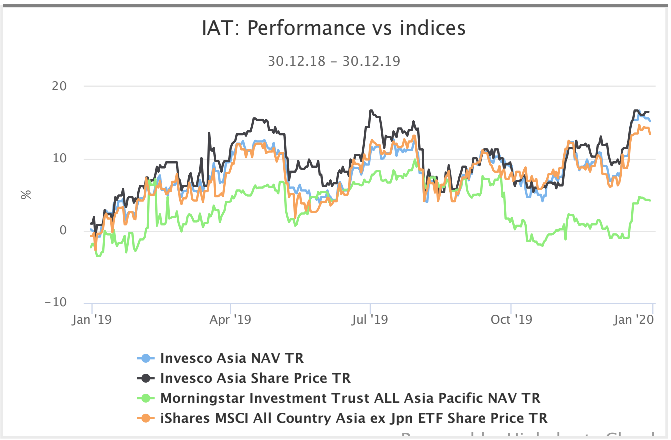
Source: Morningstar

The main reason for outperformance historically has been individual stock selection. In particular, Ian was an early investor in some Chinese technology names which have performed very strongly over the past five years, for example NetEase and JD.com. Despite the underweight to China, Ian's strong stock selection in the country means that it has contributed significantly to excess returns. Stock selection in India has also been a major contributor, with HDFC Bank and UPL (the latter held since 2005) being two highly successful picks.

In 2018, the first year of underperformance since 2015, some of 2017's winners in China retrenched and hurt relative performance, such as JD.com. However, in keeping with his long-term perspective, Ian has managed those positions cautiously, reducing the weight where he thinks valuations are toppy and increasing again when he thinks the prospects have improved – and in recent months, as of December 2019, he has been increasing the internet names again.

Over the past 12 months, the trust has outperformed the ETF again, returning 15.2% in NAV TR terms compared to 13.4%. The increased levels of gearing since the summer have played a role here, in our view illustrating the potential if the market has another good year in 2020.

Fig.5: One-Year Performance



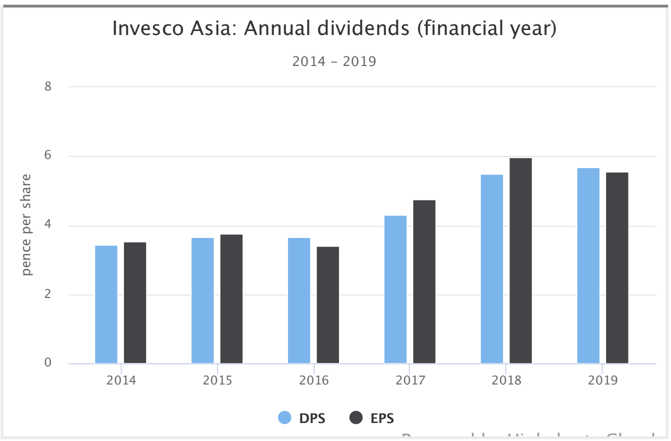
Source: Morningstar

Dividend

Invesco Asia has targeted a growing dividend since the start of the 2019 financial year, and the shares yield 2.2%. This policy reflects the board's desire to reduce the discount and the manager's assessment that Asia is going through a secular shift in dividend policy to a far more payout-friendly culture. This is driven by growing demand for savings products as the affluent middle class in the continent increases in size, as well as growing standards of corporate governance. We therefore believe that dividends should become a more significant part of the total return offered by the trust (even if the official objective remains to grow capital).

In 2019 IAT also paid its first interim dividend, having previously paid a single dividend, and the board stated it would use capital reserves to fund the payout when necessary, which it did in 2019 when the dividend was uncovered by current-year income. In fact, the total dividends paid rose just 4% in that year, the first year of the new regime; however, the interim this year (3.4p) is up 20% on 2019. Dividend growth was also considerable in the two years prior to the policy change, as a result of the shift to higher dividends in the region Ian highlights.

Fig.6: Dividend



Source: Invesco

Management

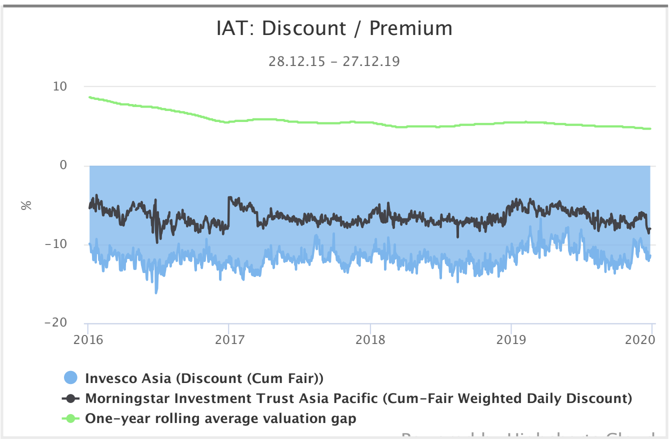
Manager Ian Hargreaves is highly experienced in Asian equities, having started his career in Hong Kong in 1994 with Invesco Asia Pacific, covering Indonesia, Korea and the Indian sub-continent. After ten years in Asia, Ian returned to the UK and has since worked on the Henley Asian Equities team at Invesco. He took over as lead manager of the Invesco Asia Trust in January 2015, having served as co-manager since January 2012 and worked on the investment team managing the company before that.

Ian was appointed joint head of Asian and Emerging Markets Equities in 2018 as a part of a merger of the two teams, which has expanded the resources involved in the management of the trust. The combined team now have ten members, and Ian is now co-manager of the open-ended SICAV Invesco Asian Equity Fund as well as the onshore and offshore open-ended emerging markets funds run by the desk. Ian draws on the other team members as well as external sources for ideas and analysis, but retains full responsibility for, and control over, IAT's portfolio. The team have extensive experience and tell us that they have learned to be patient, employ tried-and-tested fundamental analysis, and let their investment theses play out. The extensive risk resources available at Invesco are also of benefit to the manager, as discussed in the Portfolio section.

Discount

IAT has tended to trade on a wider discount than the sector, despite its strong performance (discussed in the Returns section). The discount of the current share price to NAV is 9%, compared to 7.5% for the AIC Asia Pacific sector weighted average. In December 2018, the board announced a series of improvements to the corporate proposition which are intended to increase demand for the shares and thereby close the discount. These improvements included a progressive dividend policy, fee reductions and marketing efforts. Although the discount has been volatile on a daily basis (not helped by the volatility in the underlying markets), there is some evidence that the new policies are having an effect. The graph below shows the one-year rolling average of the gap between IAT's discount and that of the sector: this has narrowed from around 5.5 at the end of 2018 to 4.7, its lowest for five years.

Fig.7: Discount



Source: Morningstar

In our view, the full benefits of the policy changes are yet to be felt. The share price yield is 2.2% on a historical basis and could rise further as the progressive dividend policy is implemented year on year. Meanwhile, management fee reductions will kick in once net assets pass £250m. It is therefore quite possible that this valuation gap between the trust and sector discount could narrow further.

The board targets an average discount of under 10% over the financial year. Since the end of the last financial year in April 2019, the trust has traded on an 11% average discount and the board has been active with buybacks, generally when the discount has been above 10%. There is also a three-year continuation vote (the last one was held in 2019, when the vote was passed).

Charges

The OCF is 0.98%, in line with the 0.95% market-cap weighted average for the AIC's new Asia Pacific sector. This includes a management fee of 0.75% on the first £250m of net assets and 0.65% on additional assets (with IAT at £227m at the time of writing, this has not kicked in yet). The board has stated it aims to reduce the ongoing charges steadily over time, and there is no performance fee. The KID RIY is 1.18%, which is below the sector weighted average of 1.38%, although we note that methodologies can vary.

ESG

Invesco is a signatory to the United Nations Principles for Responsible Investment. Funded by signatories and launched in 2006, these principles seek to encourage a sustainable financial system made up of responsible investors. Signing commits a manager to incorporating ESG issues within their investment decisions (the full list of principles is available on the unpri.org site). However, IAT is not an ESG product. Environmental, social and corporate governance issues are considered as among the risk factors of a candidate holding, but investments are not made solely on ESG grounds. Therefore the trust is, in our view, unlikely to appeal specifically on the basis of its ESG credentials.

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