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Schroder Asian Total Return Investment Company

Schroder Asian Total Return seeks to limit the volatility of Asian stock markets while capturing the best stocks...

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Management

The strength of the management team is one of the key advantages of the trust, from the two managers to the extensive research team based on the ground in Asia. Robin Parbrook (now based in London) and King Fuei Lee (based in Singapore) took over this trust in March 2013, but have run the same strategy for an open-ended vehicle, Schroder ISF Total Return, since November 2007. They have worked together since 1999, and both came through the Schroders graduate scheme in the 1990s. Both have a background in economics. King Fuei's area of specialism was econometrics, or the use of statistics to describe and predict economic systems, and he takes the lead on developing the macro models the pair use on their funds. Robin's area of specialism was development economics, and he focuses more on the face-to-face meetings with company management. The pair collaborate on the final stock-picking decisions.

The managers are lucky to be able to call on the expertise of a team of 39 Asia-Pacific analysts at Schroders with an average of 15 years' experience and 7 years with Schroders. The analysts' responsibilities are divided up primarily on a country basis, although there are some analysts devoted to sectors across the region. They cover and rate 900 stocks between them, and their models of fair value and their ratings form part of the screens used by the managers to narrow down their focus.

Summary

Schroder Asian Total Return (ATR) aims to benefit from the impressive growth potential in Asian stock markets. At the same time, the managers seek to limit the equally impressive volatility that stock markets in the region have exhibited historically.

Managers Robin Parbrook and King Fuei Lee have built an investment process on a foundation of highly active, valuation-sensitive stock selection. They overlay this with the use of quantitative economic models to warn them of impending market corrections in the underlying countries, which allows them to apply hedges to the portfolio to limit the exposure to the downside.

The managers take a highly active, benchmark-agnostic approach, which they view as crucial in Asian markets. The valuation element to the stock-picking and the hedging strategy have helped the trust produce one of the highest upside/downside capture ratios in the sector over the past five years.

At the same time, the trust has handsomely outperformed the index and peer group under the strategy implemented by Robin and King Fuei since March 2013. Over the past five years, the trust's NAV total return has been 110%, while the average trust in the AIC Asia Pacific ex Japan sector has returned just 76% and the index even less – 71.1%. The trust has also displayed NAV volatility significantly below the sector average over the period.

Although the trust has a total return objective, the managers view dividends as a sign of a well-run company and have been increasing their exposure to yielding companies as their view on the marker becomes more bearish. As a result, the trust's dividend growth has been substantial in recent years, and the shares now yield 1.7%.

Schroder Asian Total Return has traded on a premium since July 2017, currently 1.3%, and has been regularly issuing shares. The trust has a performance fee charged on absolute rather than relative returns.

Portfolio

Schroder Asian Total Return (ATR) aims to benefit from the growth potential in Asian stock markets, while limiting the particularly high volatility. Managers Robin Parbrook and King Fuei Lee have built an investment process on a foundation of highly active, valuation-sensitive stock selection. They overlay this with the use of quantitative economic models to warn them of impending market corrections in the underlying countries, which allows them to apply hedges to the portfolio to limit the exposure to the downside. The valuation element to the stock-picking and the hedging strategy have helped the trust produce one of the highest upside/downside capture ratios in the sector over the past five years, as we discuss in more detail in the performance section.

At the core of the strategy is stock selection. Robin and King Fuei draw on the research of a team of 39 company analysts based across the region who do in depth quantitative and qualitative research on their areas of coverage, and rate all their stocks from 1 to 5. The managers use this to lead them to the most attractive stocks, backing up the analysts' research with their own company visits and analysis. They seek to push out the analysts' forecasts and analysis into the longer term, as they believe that most investors are too short term in their thinking, and this creates opportunities. The turnover on the portfolio averages 34% over the past three years, according to Morningstar data, consistent with a holding period of three years.

Robin and King Fuei look at those stocks with the most upside to the analysts' fair value. Analysis focuses on companies with high and sustainable returns on invested capital, plus various valuation metrics. They thereby filter a universe of around 900 stocks down to a portfolio of their 50 highest conviction names. The mixture of growth and value elements mean this could be considered a "GARP" approach, although the aim is to maximise long-term returns rather than to implement such a strategy per se.

In selecting stocks and building the portfolio, the focus is on absolute rather than relative returns and the index is not used as a reference point. Rather, the analysts' scores and estimates of fair value form the "map" that the managers use to guide them to their stocks. In fact, Robin and King Fuei believe that the indices in their region are particularly unsuited to use as a yardstick or for passive investment.

ATR's portfolio is dominated by a number of key themes: tech leadership and innovation and Chinese development are the principal ones while the trust has significant exposure to the rapidly expanding Indian private sector banks and also looks for opportunities in high quality stocks on a discount or financials with a defensible niche.

The trust owns a number of 'world class exporters', many of which are in the tech sector. Within this bucket, Robin and King Fuei own both 'new economy' stocks like Alibaba and Tencent, and hardware manufacturers like Techtronics and Venture Corp. There are long-standing positions in tech super-cycle stocks Samsung and TSMC, although the managers are more cautious on this area in the short term.

They also have heavy exposure to stocks benefitting from the development of Chinese consumption and the growing sophistication of the services sector. White goods manufacturer Midea is a long-standing favourite here, while the portfolio includes online recruiter 51job, insurer Ping An and Huazhu hotels.

Greater China dominates the portfolio, with 61% allocated to China, Hong Kong or Taiwan. However, the exposure is highly selective, with the trust having limited exposure to state-owned companies, which make up a major part of the China market. While Robin and King Fuei have made good money from a few specific onshore-listed A-Shares (Midea, for example), they are also highly sceptical about the majority of that index thanks to the results of their stock-specific analysis and company meetings. They also warn that the influx of money following the first step in their inclusion in the MSCI indices has left them overvalued as a sector.

GEOGRAPHIC EXPOSURE

Source: Schroders

On the other hand, the trust has limited exposure to ASEAN countries at the current time. On a bottom-up basis, the managers find few listed stocks within secular growth areas, and indices which are heavily weighted to financials, real estate and energy. On a top-down basis, they doubt the ability of the governments in Thailand, Indonesia and the Philippines to effectively implement reforms. The relatively young populations could also find it harder to prosper in an increasingly automated world, they believe, while China, with its shrinking population, should have less need for labour in future.

Given the foregoing discussion of themes, it should be no surprise that the trust is concentrated in consumer discretionary, IT and selected financials, with little exposure to utilities and to communications stocks (which are being disrupted by the shift to mobile and online). The concern for valuation means the exposure to consumer staples remains low. The exposure to "old economy" sectors such as materials and energy is low, although the trust will take positions when the managers view valuations as attractive. Rio Tinto has been a long-term holding, for example, while BHP is a top-ten position currently.

SECTOR EXPOSURE

Source: Schroders

The hedging strategies offer another dimension to this trust and make it unique in the AIC Asia Pacific ex Japan sector. Predominantly developed by King Fuei, who is an econometrist by training, both long-term and short-term models are run to guide the managers' thinking regarding market risk. Once the managers have selected their preferred stocks, they can therefore decide whether or not to hedge out the beta of the underlying market if they think it has poor prospects and capture the alpha from the stock selection. The models are based on mean reversion, and look at a series of valuation metrics plus some inputs designed to give information about the stage of the business cycle. Their impact is that the managers can adjust their market exposure as their view of the attractiveness of the market changes, but continue to generate alpha from their stock selection even when their outlook is pessimistic.

It is important to note that this isn't a market neutral approach, but the aim is to limit the volatility of the extreme swings of sentiment the Asian market is prone to. Robin and King-Fuei often use cross-market hedges to limit their exposure when the cost of hedging the underlying market is prohibitive (China is expensive to hedge directly for example). The results are always cross-checked with the bottom-up valuations produced by the analysts on a stock by stock basis. If they still find value in specific stocks while the market looks expensive, they can hedge out the market, while if they find both over-valued, they will take no exposure at all.

The managers also run shorter-term models looking out six months which are designed to limit their exposure to short-term market corrections. Indicators here are PMI momentums, sentiment indicators, inflation markets and commodity prices amongst others. These short-term models are being slightly deemphasised as Robin and King Fuei think the current tendency for activist central bank policy is making it harder to read the consequences of negative short-term indicators (banks are so quick to slash rates or print money that formerly negative indicators could be a "buy" signal). The managers only use shorting to hedge out market risks and don't short individual stocks. Over the last five years the net exposure has varied between 70% and 100%.

Gearing

The company has an official gearing limit of 30% of NAV, but on a practical basis gearing limits are discussed between the board and the managers on a quarterly basis and has been much lower than that. Within the agreed limits, Robin and King Fuei adjust their gearing levels in line with what their strategic macro models are telling them about the outlook for returns. Since they took over the trust in 2013, the model has not indicated they should gear up, as the market has not been cheap enough on the metrics it tracks even once. A full description of these models is given in the portfolio section.

Since taking over the trust, therefore, the managers have only used moderate levels of gearing, up to around 5%. In fact, in line with the more cautious output of their models, the managers have been reducing the gearing slightly over the year and it now stands at 2.3%, down from 4.5% at the start of 2018. The trust currently has a borrowing facility worth around 5% of NAV at current levels.

Returns

The trust has outperformed the index and peer group since the strategy was implemented by Robin and King Fuei in March 2013. Over the past five years, the trust's NAV total return has been 110%, while the average trust in the AIC Asia Pacific ex Japan sector has returned just 76% and the index even less – 71.1%. The trust has also displayed volatility significantly below the sector average over the period: 11.86% annualised compared to 15.15%.

FIVE-YEAR PERFORMANCE

Source: Morningstar

This has been partly thanks to superior performance in down markets. The downside capture ratio for the trust has been just 62% over this time. In itself, this 62% isn't exceptionally low – the peer group average is 66% over the period. However, the trust stands out when we look at the ratio between the upside and the downside capture. The trust's score of 1.45 is second only to Fidelity Asian Values in the 16-strong sector. In 2015, the trust managed to generate a positive return when the sector and market both fell. This was almost entirely due to stock-picking rather than the macro hedges, which contributed only 0.1% to absolute returns. Stock selection in China, India and Hong Kong were the major successes.

RETURNS

Source: Morningstar

The trust also performed strongly in the 2016 / 2017 bull market. During this period, it was the exposure to large-cap tech names which particularly helped, such as Samsung, TSMC and Tencent. In 2017, the trust's picks in China were particularly helpful, notably Tencent, Alibaba and Sina. A-Share picks Hanzhou Hikvision and Midea were also among the big winners as the domestically listed A-Shares received strong inflows ahead of their inclusion in the MSCI indices. Having made good profits ahead of this move, Robin and King Fuei have become much more cautious on the A-Share market, believing that lots of bad companies are being bid up to extreme prices as investors come late to the trend.

In 2018, the end result was a slight outperformance of the index in line with the trend of outperformance in a falling market well established on the open-ended fund since 2007 – Schroder ISF Total Return, managed to the same strategy, outperformed in 2008 and 2011, the two previous down years. However, the trust's hedges didn't work, and so the trust underperformed slightly in the March and October falls.

The key detractors were the Chinese stock picks, including the tech and A-Shares. Robin and King Fuei's models led them to correctly sell down these positions ahead of the early 2018 falls, but led them to buy back in too early, only for the Q4 market correction to catch them unawares. When we met Robin, he explained that the tactical macro overlay correctly identified that China was a market to hedge, but that they tried to implement it with short positions in the Australian and Taiwanese indices. These are cheaper to short and have historically been correlated highly to China, but this failed to come off. King Fuei is making adjustments to his models as he always does (they are constantly being refined and developed) and the managers have also decided to include more of a qualitative element in their short-term positioning. The rationale for this is that in an era of activist central banks and QE, short-term fundamentals are less likely to be predictive of returns – if the economic news darkens, the most likely thing to happen is that the central banks cut rates aggressively and print money, which paradoxically makes a "buy" decision more appropriate.

2019 has seen the trust rebound further than the market, and it is ahead of the index and sector year to date, meaning that over a 12-month period the trust has also outperformed, with NAV total return up 6.5% compared to returns of 4.1% for the index and 4.8% for the sector.

ONE-YEAR PERFORMANCE

Source: Morningstar

Dividend

The trust has a total return objective, but Robin and King Fuei view a stock's dividend as an important consideration. Stock selection focuses on capital growth and yield potential. The managers believe that a healthy and growing dividend signals good corporate governance and good earnings growth. Over the last five years ATR's fully-covered dividend has grown by 17.5% a year, and the trust currently yields 1.7%. Given their view of where we are in the business cycle, the managers have been investing more in companies with a yield over recent months for their defensive properties. The trust has 1.7 times the 2018 dividend in reserve, by our calculations.

DIVIDENDS

Source: Schroders

Discount

Schroder Asian Total Return trades on a premium to NAV, and has done so since July 2017. At the time of writing, the current premium is 1.3% compared to a sector average discount of 5.8%. The board has authority to issue shares which it has done over the past two years to attempt to limit the premium. In 2018, the board issued 8.4 million shares at an average premium of 2.6%, equivalent to 7.7% of the number of shares in issue at the start of the year. ATR has continued to issue shares in 2019.

The board targets a maximum discount of 5%. The last time the discount widened beyond 5% was in 2016, when the board repurchased shares as a result.

DISCOUNT

Source: Morningstar

Charges

The OCF (ex performance fee) is 0.9%, which compares favourably to a sector average of 1%. The management fee is 0.65% of gross assets less cash and equivalents. There is also a performance fee paid of 10% of the outperformance of the NAV over a 7% hurdle rate with a high-water mark. This fee is capped at 1.5% of net assets. Charging the performance fee on absolute performance is welcome in our view and likely to be more in line with investors' intuitions – many might object to paying a performance fee on outperformance of an index when both index and fund have fallen. Given the market and trust fell over the course of 2018, no performance fee was payable. The KID RIY is 1.75% compared to a sector average of 1.45%, although we would caution that calculation methodologies vary.

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