QuotedData

Update | Investment trusts

10 October 2016

Pacific Horizon

Brave new world

Pacific Horizon's (PHI)'s performance has started to improve over the past few months, yet the manager thinks that there is still considerable potential for the portfolio. He believes that some of the themes that he is focusing on could radically alter all our lives and that many Asian companies will be at the forefront of this change.

The portfolio's substantial exposure to the technology sector is only one strand of PHI's approach to investing in fast-growing companies. This update examines the manager's growing interest in Vietnam, for example. It also looks at the revisions that PHI is making to its discount control mechanism.

In a world of low growth and considerable uncertainty, investors have been favouring defensive and higher yielding but low-growth companies. The manager thinks that, sooner or later, investors may conclude that growth stocks offer a more logical path to long-term prosperity.

Asia ex Japan growth stocks

Investment objective: PHI invests in the Asia-Pacific region (excluding Japan) and in the Indian subcontinent, in order to achieve capital growth. The company is prepared to move freely between the markets of the region as opportunities for growth vary. The portfolio will normally consist entirely of quoted securities.

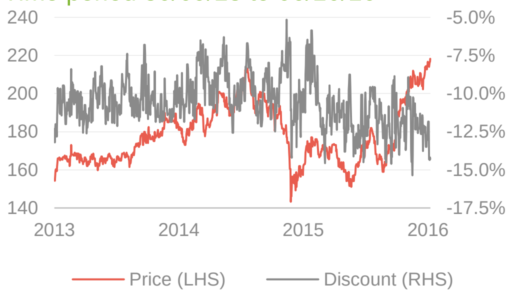
Year ended	Share price total return (%)	NAV total return (%)	MSCI AC Asia ex Japan TR. (%)	MSCI AC World total return (%)
30/09/12	23.9	16.3	15.4	16.7
30/09/13	8.4	1.8	5.0	17.4
30/09/14	20.4	15.1	8.1	11.2
30/09/15	(0.3)	(10.7)	(6.2)	(0.1)
30/09/16	30.3	37.0	36.2	30.6

Source: Morningstar, Marten & Co

Sector	Asia ex Japan
Ticker	PHI LN
Base currency	GBP
Price	218.25p
NAV	254.66p
Premium/(discount)	(14.3%)
Yield	0.2%

Share price and discount

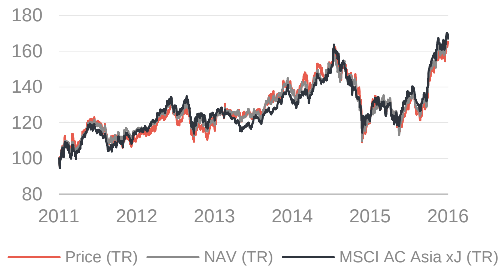
Time period 30/09/13 to 06/10/16



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/09/11 to 30/09/16



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	September 1989
Manager	Ewan Markson-Brown
Market cap (GBP)	125m
Shares outstanding	57.118m
Daily vol. (1-yr. avg.)	56,126 shares
Net gearing	3%

Click here for our initiation note

Focus on Asian growth

A unique approach focused on growth companies

Pacific Horizon is an Asia ex Japan fund that specialises in investing in growth companies. Baillie Gifford & Co Ltd, the manager of the fund, is a long-term growth investor and, as explained below, it believes there is a significant long-term opportunity to outperform markets over the long-term using this approach. Baillie Gifford believe PHI and its open-ended sister fund, Baillie Gifford Pacific, are unique; there are no other funds taking the same approach, listed or otherwise.

Ewan Markson-Brown (Ewan or the manager) has day-to-day responsibility for the management of PHI. He took over the management of the portfolio on 18 March 2014.

QuotedData's initiation note, published on 21 March 2016, describes the investment process and the structure of the fund. Click here to read it.

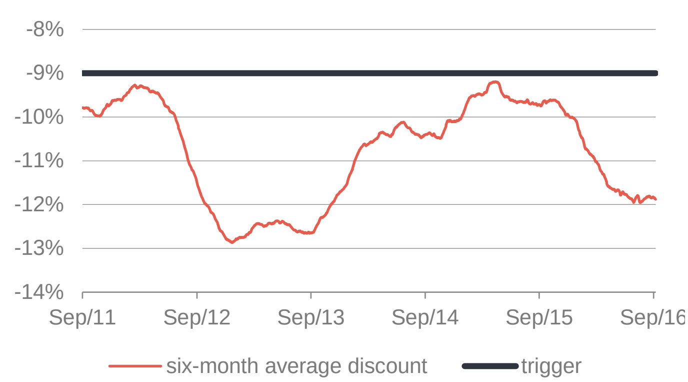
Discount control

PHI swapping six-monthly tenders for a larger three-yearly tender, triggered by poor performance

At the AGM in 2014, shareholders approved a discount control policy in the form of a semi-annual tender (31 January and 31 July) for 5% of the issued share capital. This was at the directors' discretion, provided that the average discount had exceeded 9% for the previous six months. As Figure 1 shows, this did not have the desired effect, in that the six-month average discount was never lower than 9% and, as Figure 2 shows, the fund shrank considerably through share buy backs.

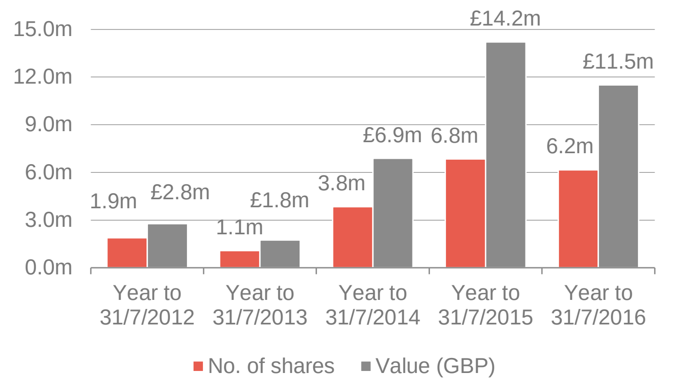
The directors have reviewed the policy and have decided it makes sense to discontinue this approach. They propose adopting a policy of holding a 25% tender in the event that the company's total return performance (capital + income) fails to exceed the total return of the comparative index (MSCI AC Asia ex Japan Index) by at least 1% per annum (cumulatively) over the three years to 31 July 2019.

Figure 1: PHI six-month average discount since 30/09/11



Source: Morningstar, Marten & Co

Figure 2: PHI share repurchases over the past five years



Source: Morningstar, Marten & Co

The announcement of the change in approach to tackling the discount, on 9 September 2016, had no immediate impact on PHI's discount. A number of commentators have observed that there comes a point where shrinking a fund through buy-backs in an effort to control the discount is counterproductive, as potential new investors start to be put off by diminishing liquidity. The directors believe PHI's new approach, where a tender would be triggered by underperformance of the benchmark over a three-year period, is appropriate given PHI's long-term investment philosophy. They also believe that, if PHI's performance improves, it may attract new investors, thereby narrowing the discount.

Market backdrop and manager's view

Defensive and high yielding stocks holding investors' attention, growth stocks relatively lowly valued

In an effort to stimulate economic growth, central banks are keeping interest rates low. Growth has been elusive however and investors appear to be nervous. They are seeking sanctuary in large, defensive and high yielding stocks and consequently they have been neglecting growth stocks and small-to-mid cap stocks. Ewan believes that, for many of the stocks in his portfolio, current valuations imply relatively low future returns. He strongly believes that any sign of rising interest rates or normalising markets could have dramatic effects on markets, as investors recycle money towards the areas favoured by PHI. He is encouraged that there are signs that China's growth is no longer slowing rapidly and that India's economy continues to expand, but says that we need to see a change in sentiment for PHI to achieve its potential.

Technology a bigger part of Asian indices

Ewan also points out that something that might help prompt a change in investors' thinking is that the technology sector has become a much more important part of the comparative index (the MSCI All Countries Asia ex Japan Index) and, within that, of MSCI China in particular. US-listed Chinese companies (including stocks such as Alibaba, Baidu and JD.com) have, since 31 May, been added to these indices. The technology weighting in the MSCI China index now exceeds 30%, changing the dynamic of this index. It had previously been dominated by somewhat more staid ex state owned enterprises.

Two of the themes that Ewan is focusing on currently are artificial intelligence (particularly as it applies to autonomous cars) and Vietnam.

Artificial Intelligence

Emerging technology will transform our lives and many Asian companies driving this change

There is an article "It's the end of the world as we know it…", written by Ewan, on PHI's website. Within the article, he identifies the falling cost of cloud-based neural networks, the progress in networks' ability to "learn" and advances in virtual reality as developments that will transform the way we live over coming decades. Ewan believes that many Asian companies will be at the forefront of these developments.

Ewan thinks that Asian countries may be more open to new technologies and faster to adopt them than western nations. He cites the example of Uber, which seems to have achieved far faster growth rates in Chinese cities than in the US and Europe. What makes that story more interesting is that, even with these growth rates, Uber could not match its more successful and profitable local competitor, DiDi Chuxing (DiDi), and in August it sold its Chinese operations to its rival. DiDi now has a 90% market share in China. It has made investments in Uber's competitors such as Lyft in the US, Grab in Malaysia and Ola Cabs in India and is expanding into areas such as bike sharing. DiDi's taxi services in China are four times the size of Uber's in the US.

DiDi is backed by Tencent and Alibaba (PHI's largest and third-largest investments – see Figure 9). Apple made a $1bn investment in the company, which was seen as a sign that Apple was seeking a tie-up with DiDi in the area of self-driving cars.

The advent of self-driving cars could have far reaching consequences

The shift to autonomous cars has the potential to transform our lives in many ways but raises many questions. Do you really need to own a car at all if you can hail one anywhere? Do we need as many cars? (reportedly, cars are parked, on average, 95% of the time) and, if we don't need as many, do we need car parks? At what point might you not be allowed to drive your own car? (if all the accidents are caused by human drivers) Why would you need car insurance if your car doesn't crash? What are taxi and lorry drivers going to do for a living? These are big questions, but we are going to need to know the answers soon because the age of self-driving cars is already upon us.

Grab has launched a fleet of self-driving taxis in Singapore. The software controlling these is supplied by NuTonomy, one of a number of companies aiming to capture a slice of this market. Google is well known for its efforts in the area but Baidu (PHI's fourth-largest holding), often referred to as the Chinese Google, is also putting great efforts into the technology needed for self-driven vehicles. Ewan expects that, by 2018, self-driven buses, operating on Baidu's software, will be deployed in a Chinese city – possibly Beijing.

China to fast-track the adoption of autonomous and electric vehicles

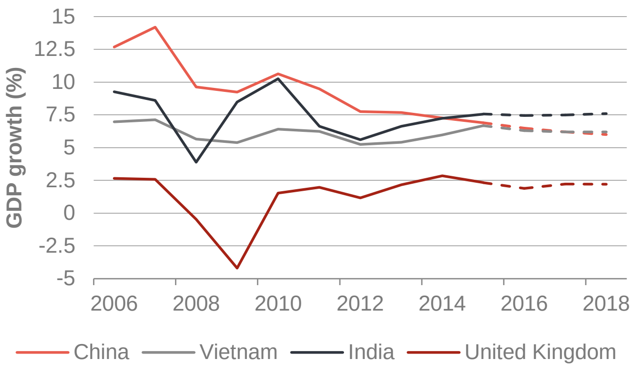
Ewan thinks that the Chinese authorities are going to fast-track the development of the sector. For this we will need to see the continued development of the enabling technology, improvements in security and an expansion of wireless network capacity, but Ewan says that China's need to control pollution, traffic accidents and congestion makes autonomous electric vehicles appealing. Ewan believes that, by 2030, 80% of vehicles on Chinese roads will be autonomous and electric.

Baidu is working on many other cutting-edge technologies. For example, it is a world leader in voice and image recognition and is using this technology to improve its search function. Baidu is also researching natural language processing, robotics and, in its Silicon Valley AI Lab, deep learning (teaching a machine to teach itself).

Baidu is just one example of a stock that PHI holds that Ewan believes will benefit from these trends. More are discussed on pages 6 and 7.

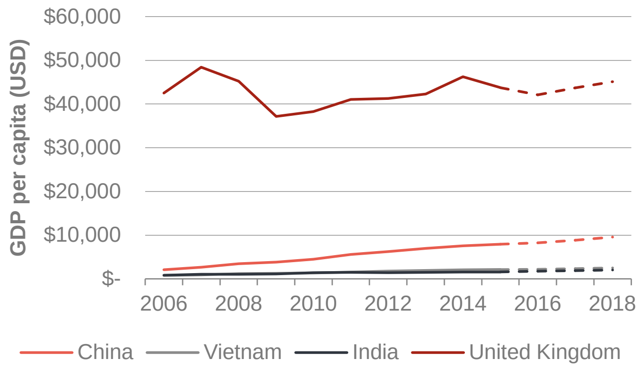
Vietnam

Figure 3: GDP Growth for selected countries



Source: World Bank (historic), IMF (forecast)

Figure 4: GDP per capita for selected countries



Source: World Bank (historic), IMF (forecast)

Vietnam's GDP growth could accelerate as it catches up with China

Vietnam is, alongside India, one of very few countries that is growing at a significant pace in spite of sluggish growth in the developed world. China's GDP growth has been slowing, as is evident in Figure 3, while Vietnam and India have been accelerating. However, as shown in Figure 4, there is a long way to go before Vietnam and India catch up with China in terms of GDP per capita and to reach western standards. The graph uses the UK as an example of a developed western nation. Based on IMF forecasts for GDP growth and GDP per capita in 2018, assuming population growth in each country is the same and GDP growth rates remain constant, it would take 43 years for China to catch up with the UK, 61 years for India and 76 years for Vietnam. That may be how things play out or it could be that, at some point, Indian and Vietnamese growth will accelerate, possibly matching the growth rates that China was achieving a decade ago.

Stable currency, lower inflation and growing population all work in Vietnam's favour

Vietnam has many attractions. It is resource-rich with reserves of oil and coal amongst other commodities. Chinese and other Asian businesses have been drawn to the country by its relatively cheap and educated labour force and have opened many factories in the country. The rapid growth of the manufacturing sector and foreign investment have transformed Vietnam's balance of payments, strengthening the currency and helping to rein in inflation. While China's population is ageing, thanks to its one-child policy, Vietnam's demographics are much more favourable to growth.

Vietnam has already been through a boom and bust phase. For many years its banking system and property sector were plagued by problems with non-performing loans, but this is being addressed. The government has been gradually liberalising the economy though it can still exert considerable control.

Relaxation of foreign investment limits and IPO programme attracting new investors

The stock market recently received a boost when foreign ownership limits for listed Vietnamese companies were relaxed. The stock market is still dominated by a handful of companies, but new privatisations are broadening and deepening the market, meaning that it is attracting a wider range of investors.

Ewan believes that the valuations of many Vietnamese companies look attractive. PHI has held the Vietnam Enterprise Investments fund, managed by Dragon Capital, for a number of years and recently took its first direct holdings, buying Vinagroup and Military Commercial Joint Bank. Ewan is keen to identify further potential direct investments. He is visiting the country in October and may increase the allocation to Vietnam further.

Market valuations

Figure 5: Price/earnings ratio relative – MSCI AC Asia ex Japan versus MSCI AC World

Source: Bloomberg, Marten & Co

Figure 6: Price/book ratio relative – MSCI AC Asia ex Japan versus MSCI AC World

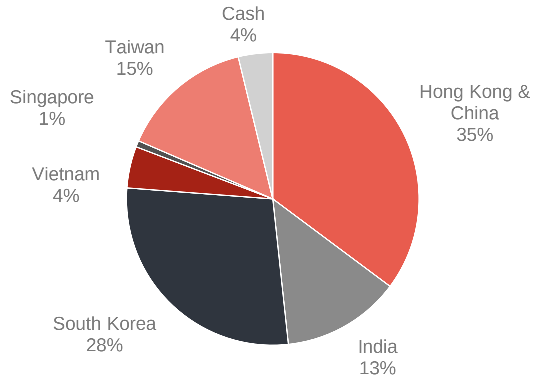
Source: Bloomberg, Marten & Co

Asian stocks are attractively valued relative to western peers

Ewan points out that, until recently, average valuations for stocks in the MSCI All Countries Asia ex Japan Index have been getting cheaper relative to stocks in the MSCI All Countries World Index. This is illustrated in Figures 5 and 6 which show how the relative price to earnings and price to book ratios have moved over the past 10 years. Part of the reason for the recent uptick may be the inclusion of the US- listed Chinese companies within the MSCI Asia indices that we referred to above. This had the double effect of introducing a number of more highly rated securities and encouraging index trackers to buy them, pushing their ratings up. Ewan feels however, that markets are not factoring Asia's higher long-term growth prospects into valuations and, at some point, he expects this to correct.

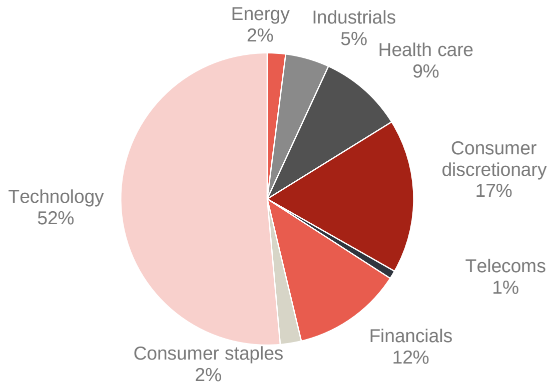
Asset allocation

Figure 7: Geographic allocation as at 31 August 2016



Source: Baillie Gifford

Figure 8: Industry sector allocation as at 31 July 2016



Source: Baillie Gifford

The major change to geographic weightings over the six-month period to the end of August 2016 has been the increase in allocations to Vietnam (discussed on pages 4 and 5) and Hong Kong and China. This has been funded from cash.

The already large allocation to technology has increased over the past few months. Part of this is down to performance.

Top 10 holdings

Figure 9: 10 largest holdings as at 31/08/2016

Stock	% of total assets 31/08/16	% of total assets 29/02/16	% Change	Sector	Business focus	Country
Tencent	10.2	7.9	+2.3	Technology	Internet	China
Naver	4.5	3.0	+1.5	Technology	Internet	India
Alibaba	4.4	3.1	+1.3	Technology	E-commerce	China
Baidu	3.6	4.1	-0.5	Technology	Internet search	China
Sunny Optical	3.2	1.8	+1.4	Technology	Optical products	China
JD.com	3.1	2.3	+0.8	Technology	Online sales	China
Hon Hai Precision	2.7	2.7	0.0	Technology	Manufacturing	Taiwan
Vietnam Enterprise	2.7	1.6	+1.1	Financials	Investment trust	Vietnam
Geely Automobile	2.6	1.4	+1.2	Consumer Discretionary	Automobiles	China
China Life Insurance	2.1	1.8	+0.3	Financials	Life insurance	Taiwan
Total	39.1	29.7	9.4			

Source: Baillie Gifford and Marten & Co

Most of the top 10 holdings shown in Figure 9 were covered in QuotedData's initiation note of March 2016 (see page 10 of this note for details). The new entrants to this list are Sunny Optical, Vietnam Enterprise and Geely Automobile. Strong performance was behind the increased weighting in Tencent and Ewan has trimmed the position.

Sunny Optical

Sunny Optical makes a range of optical instruments including microscopes, cameras, lenses and analytical instruments. Part of the attraction for Ewan is Sunny's business supplying cameras to both phones and cars. Ewan says that the average car has 0.5/0.6 cameras, to assist with reversing, for instance. However, self-driving cars may have as many as 50 cameras. Sunny's camera phone business includes the supply of both cameras and lenses to a number of manufacturers. Sunny reported a 50% uplift in earnings per share for the six months ended 30 June (year-on-year). Zhejiang Sunny Optical Intelligence Technology Company, a subsidiary of Sunny Optical, was launched in 2015, in Hangzhou. This company is responsible for the research and development, marketing and sales of three-dimensional, intelligent optics products. This might appear to underscore a theme explored in QuotedData's initiation note – that Asian companies are, increasingly, generating their own research and development rather than exploiting western technology.

Vietnam Enterprise Investments Limited

Vietnam Enterprise Investments Limited, managed by Dragon Capital Markets, is one of the largest (close to $1bn of assets) and longest running (launched in 1995) funds investing in Vietnam. It listed in London in June 2016. Over the five years to 22 September 2016 it has beaten its local benchmark, the VN Index, by 13.2%. PHI has been an investor in the fund since June 2006.

Geely Automobile

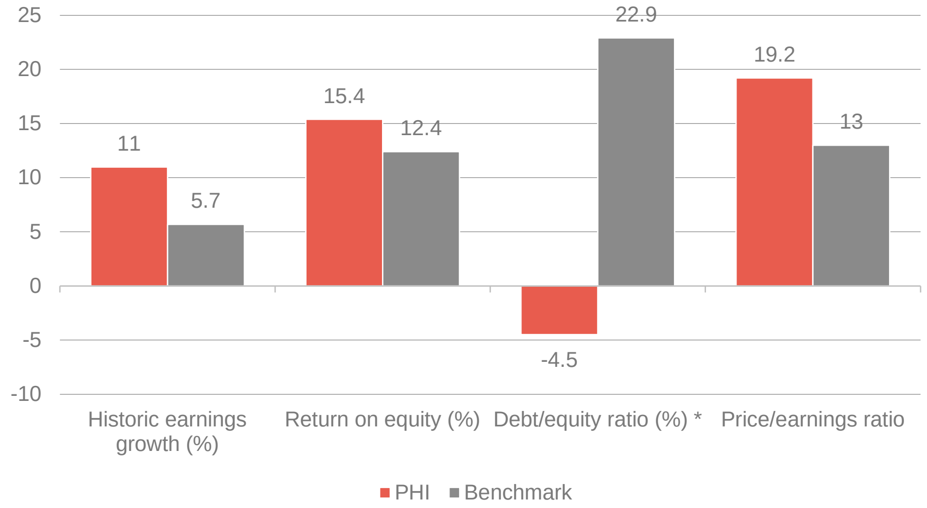
Geely Automobile sold almost 400,000 vehicles over the first eight months of 2016. Most of these were sold within the domestic Chinese market. About 16% of Geely's sales are of sports utility vehicles (SUVs) but this segment is growing fast (47% year-on-year) as China's affluent middle class trades up from more utilitarian models. Ewan says that Geely is forecasting that SUVs could generate around 50% of their sales within three years. China's car sales rose fivefold over the decade from 2005 to 2015 and China is now the world's largest automobile market. Geely ranked tenth by cars sold in China in 2015, but is achieving growth rates ahead of the market as a whole.

Five years ago Geely bought Volvo and Ewan believes that this has improved the look and feel of its cars. He thinks that improved quality of Geely's product means that it could soon start to target western markets. Geely has been focusing on new electric and hybrid models; its new Emgrand electric vehicle has a top speed of 140km/h, a range of 253km and can be charged in 48 minutes. By 2020, Geely expects that 90% of all its new cars will be electric vehicles or hybrids.

Portfolio characteristics

PHI targets growing companies and the statistics shown in Figure 10 reflect this. An analysis of the portfolio at the end of July shows that, on average, PHI's holdings have achieved earnings growth at twice the average of the MSCI Asia ex Japan index and that they deliver a higher return on equity. The faster growth comes with a higher price tag resulting in a higher p/e ratio (but this is also distorted because many of PHI's holdings are at a relatively early stage it is ploughing money into research and development and funding expansion. While many investee companies generate substantial amounts of cash, the level of investment means that they do not have the free cash flow of more, low growth, mature businesses, consequently PHI's holdings are much less likely to be financing themselves with debt.

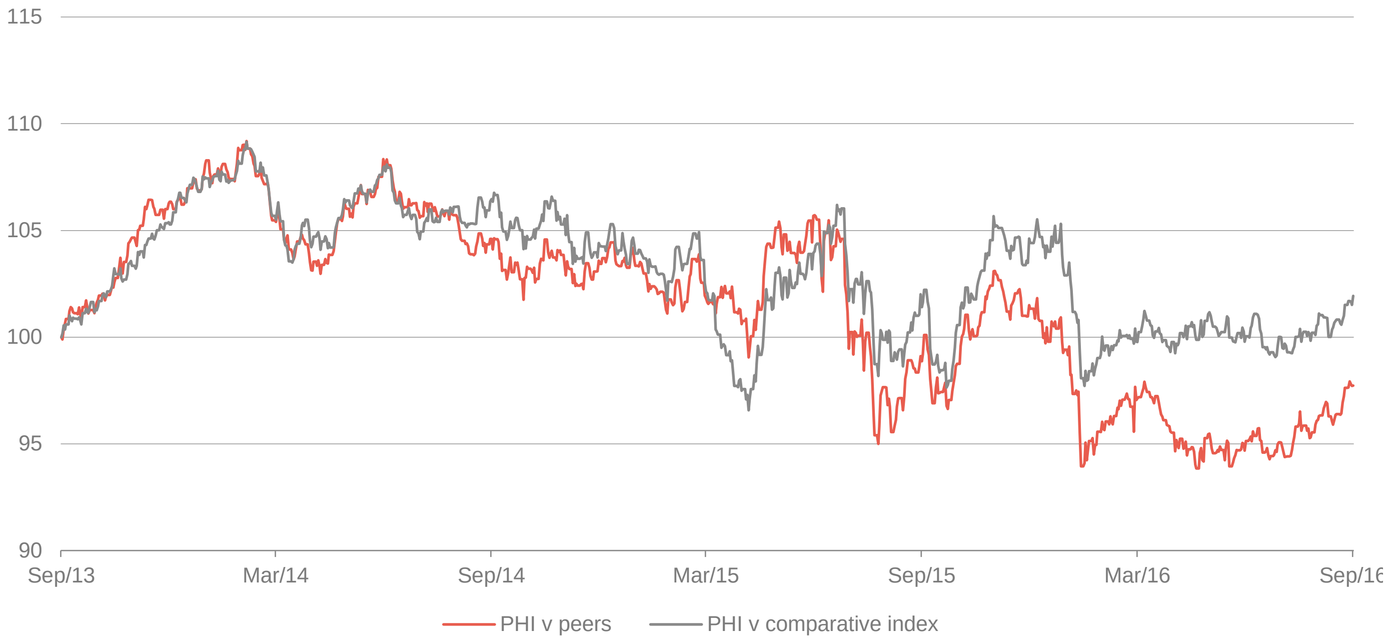
Figure 10: Portfolio characteristics as at 31 July 2016



Source: Pacific Horizon Investment Trust (from UBS), * Debt/equity ratio excludes financials

Performance

Figure 11: PHI NAV relative performance over the three years to 30 September 2016



Source: Morningstar, Marten & Co

While, as outlined in QuotedData's initiation note of March 2016, the low interest-rate environment and other distortions created by the efforts of governments and central banks to stimulate growth, have not worked in PHI's favour, its fortunes improved over the six months ended 30 September 2016. PHI has outperformed the comparative index by 2.6% and its peer group by 0.8%.

Figure 12: Cumulative performance over periods ending 30 September 2016

	3 months (%)	6 months (%)	1 year (%)	18/3/2014* to date (%)	3 years (%)	5 years (%)
Pacific Horizon NAV (TR)	15.8	25.0	37.0	33.4	40.8	66.7
MSCI AC Asia ex Japan (TR)	13.3	22.4	36.2	41.6	38.1	67.4
MSCI AC World Index (TR)	8.4	17.7	30.6	38.2	45.0	98.7
Peer group avg. NAV (TR)	12.1	24.2	38.5	47.5	44.2	79.2

Source: Morningstar, Marten & Co, * Note, Ewan Markson-Brown took on the management of the portfolio on 18 March 2014

Attribution

PHI has published performance attribution analysis covering the year ended 31 July 2016 that gives a strong indication of what has driven the improvement in its relative performance.

The five largest positive contributions to performance came from Sunny Optical, Tencent, Naver, Geely Automobile and CrystalGenomics. Collectively, these five positions added 5.3% to PHI's NAV.

- Sunny Optical, as described above, has been benefitting from increased sales as it rolls out new products. Over the first half of 2016, sales rose 27% year-on-year.
- Tencent's profitability, driven largely by its online gaming business, has been growing strongly, but it is developing many new ventures including music streaming. It is now Asia's largest company by market cap. In June it bought Supercell (owners of the Clash of Clans video game franchise).
- Naver, the Korean internet portal, has been benefitting from excitement about its SNOW photo editing app which is now being used by more than 70m users worldwide. Second-quarter profits rose 26.3%.
- Geely Automobile, as discussed on page 7, has benefitted from accelerating auto sales and good prospects for its SUVs and electronic vehicles.
- CrystalGenomics announced a deal with Aptose Biosciences in June to co-develop a cancer drug and its shares spiked by 130%. Ewan felt the valuation was full following this move and sold the position.

On the downside, positions in Jumei International, a relative underweight position in Samsung Electronics, JD.com, Haier Electronics Group and Seegene cost PHI 4.1%.

- Jumei International is an online cosmetic company that the manager bought when it first listed. However, the cost of acquiring new customers started to soar and consequently the stock de-rated. Having reviewed the prospects for the company, Ewan decided to sell the position.
- Samsung Electronics' share price has been strong this year (up 27%) despite a stream of bad news related to product recalls of the Galaxy Note 7 and its top load washing machines.
- Ewan believes that JD.com's underperformance compared to the wider Chinese market has been caused by hedge funds shorting JD.com as a way of shorting the Chinese currency, the renminbi, – he thinks that the share price move does not reflect the fundamentals of the company and has been adding to the position.
- White-goods manufacturer, Haier Electronics, suffered in the early part of the year as sales slowed on weak consumer demand. Its shares are down about 15% year to date.
- Seegene's shares haven't really gone anywhere in 2016. Overall, Ewan says that the Korean biotech portfolio cost PHI 40bp despite the good news from CrystalGenomics. He believes that the Korean national pension fund has been

focusing on large caps and that this has distorted index returns in Korea, leading to underperformance for his small-cap biotech portfolio.

Ewan also highlights Just Dial where he lost faith in the management team's ability to execute its strategy. This stock was 2.5% of the portfolio at one point and Ewan thought that it had the potential to go up 10x, hence the size of the position. This stock cost PHI 1% of NAV.

Peer group comparison

Figure 13: Fund of fund subsector comparison table (data as at 6 October 2016 except performance)

	Market cap (GBPm)	Discount (%)	Yield (%)	Ongoing charge (%)	NAV total return performance to 31 August 2016 1 year (%)	3 years (%)	10 years (%)
Pacific Horizon	125	(14.3)	0.2	1.02	37.0	40.8	66.7
Aberdeen New Dawn	228	(15.1)	2.0	1.08	33.4	21.2	50.0
Edinburgh Dragon	592	(14.5)	1.0	1.15	35.7	26.4	57.8
Fidelity Asian Values	229	(11.5)	0.6	1.42	49.5	63.1	104.0
Invesco Asia	200	(12.8)	1.5	1.03	41.9	55.6	89.5
JPMorgan Asian	271	(15.4)	0.9	0.82	41.3	45.3	72.3
Martin Currie Asia Unc.	121	(17.3)	2.3	1.21	35.8	23.5	51.3
Pacific Assets	285	(4.2)	1.3	1.33	30.3	56.5	110.3
Schroder Asia Pacific	587	(14.6)	1.2	1.05	40.8	51.5	98.0
Schroder Asian Total Return	192	(5.2)	1.4	0.99	37.5	53.3	79.8

Source: Morningstar, Marten & Co

Visit QuotedData.com for an up to date comparison of PHI and its Asia ex Japan peer group.

Currently, PHI is smaller than its board and manager would like it to be and its discount is slightly wider than the peer group average. The focus on growth stocks means that PHI's yield is relatively low. However, PHI's ongoing charges ratio is towards the bottom end of its peer group, which is impressive given its size. While PHI's recent performance has improved, the market's aversion to growth stocks, over the past few years, has held the fund back relative to its peers.

Previous research publications

Additional information is also available at the fund manager's website: www.bailliegifford.com/individual-investors/funds/pacific-horizon-investment-trust/

Readers interested in further information about PHI may wish to read the initiation note *Invest in Asian growth,* published on 21 March 2016. The contents pages have been reproduced below. You can read the notes by clicking on the menu below or by visiting our website.

Invest in Asian growth – 21 March 2016

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