QuotedData

Annual overview | Investment companies

30 October 2017

Pacific Horizon

Top of the pops!

Pacific Horizon (PHI) has benefitted strongly as both the Asia ex Japan region and technology stocks, to which PHI has a significant exposure, have rallied. This has seen it move up the competitor peer-group rankings so that it is first and second, in terms of NAV total return, over one and three years respectively.

PHI's manager, Ewan Markson-Brown, believes that the rising wealth of the middle class in Asia is likely to be the big driver of global growth over the next 20 years but that financial markets do not fully appreciate this yet. He expects to see a trend in global capital moving away from the US dollar, towards emerging markets, especially Asia, and a reassessing of the growth in these domestic economies. He believes that, while capital flows to the region are very cyclical, and says that any risk-off period (when nervous investors prefer investments that they perceive to be safe) will provide good buying opportunities for new all-time highs.

Focused on Asia ex Japan growth stocks

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.

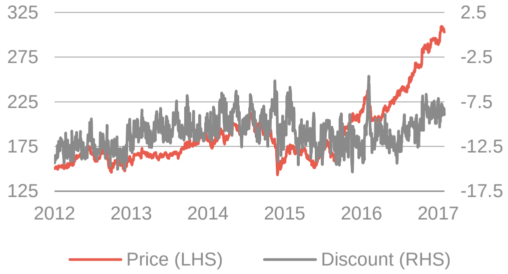
Year ended	Share price total return (%)	NAV total return (%)	MSCI AC Asia Ex-Japan TR. (%)	MSCI AC World total return (%)
30/09/13	4.4	1.7	5.0	17.4
30/09/14	17.8	15.6	8.1	11.2
30/09/15	(10.0)	(10.2)	(6.2)	(0.1)
30/09/16	33.8	37.1	36.2	30.6
30/09/17	34.9	29.3	18.8	14.9

Source: Morningstar, Marten & Co

Sector	Asia ex Japan
Ticker	PHI LN
Base currency	GBP
Price	303.0p
NAV	332.7p
Premium/(discount)	(8.9%)
Yield	Nil

Share price and discount

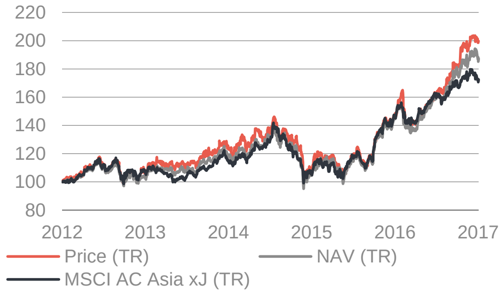
Time period 30/09/12 to 26/10/17



Source: Morningstar, Marten & Co

Performance over five years

Time period 30/09/12 to 30/09/2017



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	September 1989
Manager	Ewan Markson-Brown
Market cap	164.4m
Shares outstanding	54.3m
Daily vol. (1-yr. avg.)	62.8k shares
Net gearing	7%

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Fund profile

A unique approach focused on growth companies

Pacific Horizon (PHI) 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 (from Mike Gush).

About the manager

Baillie Gifford has about 100 investment professionals based in its Edinburgh office. It is structured as a partnership and encourages a collegiate approach to managing money, although it allows its portfolio managers the freedom to have the final say about their portfolios. It managed about £173bn at the end of September 2017. Baillie Gifford had £43.1bn invested in emerging market equities at the end of September. The emerging markets desk had £12.3bn of this. About 75% of the firm-wide and emerging market desk money is in Asia Pacific. PHI and the Baillie Gifford Pacific Fund (its open-ended equivalent) have combined total assets of roughly £491.5m.

Ewan joined Baillie Gifford in 2013 from PIMCO where he had been a senior vice-president in its emerging markets team. Prior to that he managed Asian funds at Newton.

Ewan says he is by nature a person who looks at the “big picture”. Considerations about the major themes affecting markets, and the development of industries and companies are always in the back of his mind. However, he thinks you only really get to see the big picture by looking from the bottom up. This is very much a stock-picking fund and the portfolio bears very little resemblance to the fund’s MSCI All Country Asia ex Japan Index comparative index (the active share, the proportion of PHI’s portfolio that was not represented in the index, at the end of September 2017 was 78%). Ewan spends most of his time meeting companies and undertaking stock-specific research.

Ewan is assisted with the management of the fund by Roderick Snell who has a degree in Medical Biology. Roderick has been at Baillie Gifford since 2006 and has managed the Baillie Gifford Pacific Fund since 2010. He has been deputy portfolio manager of Pacific Horizon since September 2013.

Manager’s view

The manager says that new technology is leading to increased digitalisation that is levelling the playing field for different parts of the world. This benefits emerging markets disproportionately

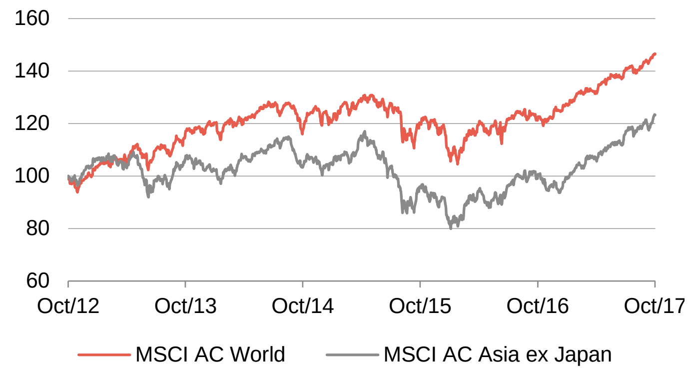
PHI’s manager has been making the case, for the last three years that technology emanating from the US, then China and more recently in India is accelerating the adoption of new types of hardware and systems, which is leading to increased digitalisation across the globe. This process is levelling the playing field across different parts of the world which, given their lower starting points, tends to benefit emerging markets disproportionately as they play catch up.

Traditionally, emerging markets have been late adopters of new technology. However, the manager believes that there has been an increasing realisation that emerging markets, notably China and more recently India, are now at the forefront of technological change. This has been particularly true over the past year. The manager also thinks that the adoption of new technology is accelerating. For one, emerging markets are less burdened by legacy systems and two, being frequently less burdened by regulation, they have more freedom to innovate. As an example, India's demonetisation exercise, when the government suddenly mandated that a large proportion of its currency in circulation would be replaced and forced people to deposit their old notes in bank accounts, has accelerated the shift towards a cashless economy.

The manager believes that the focus by investors, people and media on new technology (for example electric cars, autonomous vehicles, drones, artificial intelligence (AI), parallel computing, big data and cloud computing) is capturing investors' imagination at a time when earnings growth in these areas is accelerating.

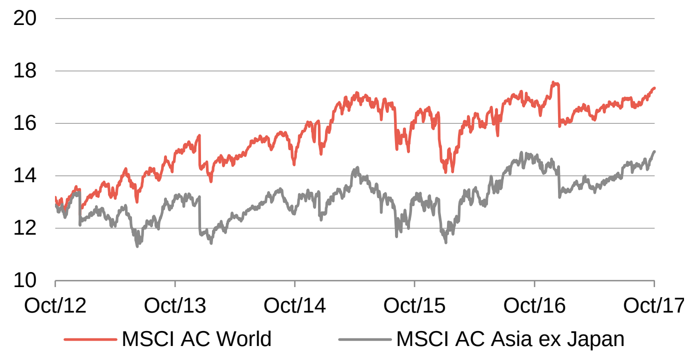
The manager attributes much of PHI's strong performance, since December 2016, to these developments. However, another consideration has been a marked improvement in sentiment towards China, which has also bolstered performance. For example, in mid-2015 market consensus was towards a significant devaluation of the renminbi and the end of the Chinese growth model; attitudes have changed since then. The manager believes that China is now in a cyclical upswing that could last between two to five years and that this changes the perception of implied returns. Ewan argues that if China's currency is likely to be stable, or even appreciating, financial markets will be better able to value stocks. He says that this is occurring at a time when the Chinese market is still very cheap versus western markets, for high-growth companies. In fact, the manager points out that Asia's much faster growth rates, versus developed markets, might suggest that its markets should trade at a premium.

Figure 1: MSCI AC Asia ex-Japan and MSCI AC World Index performance rebased to 100 over five years



Source: Bloomberg, Marten & Co.

Figure 2: MSCI AC Asia ex-Japan and MSCI AC World Index F12m P/E ratios over five years



Source: Bloomberg, Marten & Co.

Figure 1 shows the comparative performance of Asian markets against world markets while Figure 2 shows the difference in valuation, based on price/earnings (P/E) ratios.

> The manager believes that the rising wealth of the middle class in Asia is likely to be the big driver of global growth over the next 20 years

The manager expects to see a trend in global capital moving away from the US dollar, towards emerging markets, especially Asia, and a reassessing of the growth in these domestic economies. He believes that the rising wealth of the middle class in Asia is likely to be the big driver of global growth over the next 20 years but that financial markets do not fully appreciate this yet. He says that investing in the region is very cyclical in terms of capital flows, but believes that any risk-off period will provide good buying opportunities for new all-time highs.

Investment philosophy and process

The underlying approach

Baillie Gifford has a culture of sticking with its winners

Baillie Gifford believes markets are inefficient at pricing long-term growth, especially over a time horizon of at least three years, and that this creates an opportunity to earn alpha (excess returns over benchmark indices). For this reason, it aims to encourage a culture of long-term thinking within the firm. Baillie Gifford believes there is persistence of good company management, business models and stock prices. This translates into a culture of 'sticking with the winners'.

The company uses proprietary research. The team does a lot of this but will also often commission research from local research teams, academics and industry experts. Baillie Gifford also subjects some companies to forensic analysis, using the services of investigative journalists and forensic accountants. When it is talking to companies, the conversations with their management teams focus on the long-term prospects of the business.

All the money is managed from Baillie Gifford's Edinburgh office. Ewan believes that managing the money this way, rather than having regionally based teams, helps the team keep a sensible detachment from short-term 'noise'. He is convinced that teams that are split across two or more locations do not function well. Ewan is able to draw on the resources of the whole investment team when analysing companies and can sit in on meetings with companies outside his geographic remit. This is especially beneficial when he is trying to figure out how his companies stack up against competitors domiciled in other markets.

Each member of the team is assigned a geographical focus for research and these responsibilities are rotated every 18 months. Investment ideas are presented to the group but the lead portfolio manager makes the final decision. Ewan spends four to five weeks each year in Asia.

PHI's closed-end structure makes it easier to hold more illiquid investments than the manager's open-ended fund

The OEIC and PHI are run in parallel with some exceptions. However, while Ewan is lead portfolio manager on this fund, he is co-manager of the OEIC with Roderick Snell. This does introduce one small element of differentiation between the two portfolios. More significant differences arise because of the need to keep the OEIC's portfolio relatively liquid. There is an internal limit of holding no more than 12 days' volume in any stock across the whole firm but within this constraint, PHI has greater freedom to hold more illiquid investments than the OEIC. The OEIC has ended up with more of a large-cap bias as result, while PHI has more exposure to small-cap. names. There is considerable crossover in the stocks in the portfolio albeit the individual weightings may differ (54 holdings in common accounting for 83% of Baillie Gifford Pacific Fund and 80% of PHI at the end of September 2017). PHI, unlike the OEIC, also has the option of using gearing.

There is a small to mid-cap bias to PHI's portfolio. This reflects Ewan's belief that smaller companies grow faster than larger ones, although they exhibit higher volatility. He also subscribes to the view that smaller companies tend to be less well-researched which means they are more likely to be mispriced.

Building the portfolio

Focused on companies that are beneficiaries of positive trends

With over 6,000 stocks in PHI's universe to choose from and a target portfolio size of between 40 and 120 stocks, Ewan looks to focus on those that are beneficiaries of positive trends such as demographic shifts or technological change.

Blue-sky technology companies are only interesting if they are fully funded through to positive cash flow

Ewan is looking for companies that are capable of growing earnings and cash flow faster than market averages. He wants companies to exhibit some or all of the following qualities: good management teams; barriers to entry; positive cash flow; self-funded growth (he wants to avoid companies that need to keep coming back to the market for cash); and a high return on capital employed (ROIC), around double the market rate. Companies with blue-sky technology are only interesting to him if he believes that they are fully funded through to positive cash flow.

A typical investment should be capable of at least delivering growth in both its top and bottom line of 15% per annum over five years

A typical investment should be capable of at least delivering growth in both its top line (sales) and bottom line (profits) of 15% per annum over five years (this translates into a doubling over that period). The managers do not set target prices for stocks. Ewan is mindful of valuations, aiming to at least capture a company's earnings growth on the assumption that the P/E multiple in five years or so, when he is looking to sell, will be at least as high as it is when he makes the investment. There is an obvious problem if you buy on a high P/E multiple; the business case works out but the P/E multiple declines. As an example of this, Ewan would not buy most consumer staples stocks today because he believes that, in a desperate search for companies with stable revenues, investors have bid up valuation multiples to unsustainable levels.

The research process is flexible and can be carried out quickly if necessary – for an IPO for example. Ewan will typically have met the management before investing and the investment case will always be discussed internally. In addition, he or a member of the team may have produced a brief report, an internal model, a cash-flow projection and/or an extensive internal research note on the company. He will at times canvas analysts and external research providers for their opinion as well.

Baillie Gifford is an active investor and does not hold stocks just because they are large constituents of any benchmark

Baillie Gifford is an active investor and does not hold stocks just because they are large constituents of any benchmark. Consequently, there are few limits on country, sector or stock weightings imposed on managers. The initial size of a position will reflect the strength of the manager's conviction of the potential risks and rewards of the investment. One of the guiding principles of investing at Baillie Gifford is to run the winners (reflecting the belief in the persistency of good business models). However, PHI has a 'soft' upper limit of 10% exposure to any one stock. Ewan looks at the shape of the overall portfolio to ensure that he does not have too many companies exposed to similar thematic dynamics.

The mandate allows the manager to use derivatives to control risk and to alter the portfolio's exposure to markets. In practice, Ewan is not undertaking such activity. The managers have no plans to use hedging to alter the portfolio's currency exposure.

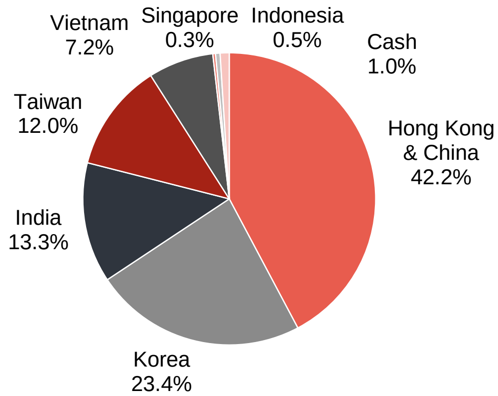
Sell discipline

Loss of faith in a company's management is an instant trigger for a sale

Loss of faith in a company's management is an instant trigger for a sale. Ewan will also sell if he feels the business model is not working. There have been a number of examples of this recently with the tidying up of PHI's Taiwanese holdings (see below).

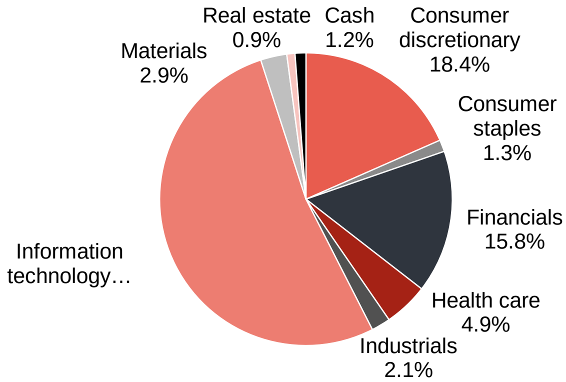
Asset allocation

Figure 3: Geographic allocation as at 30 September 2017



Source: Baillie Gifford

Figure 4: Industry sector allocation as at 31 August 2017



Source: Baillie Gifford

PHI's geographic weights are largely a consequence of the manager's bottom-up stock-selection decisions although, arguably reflecting the manager's long-term investment horizon, these are similar to when QuotedData's last note was published in October 2016. The most notable change is around a 5% increase in the allocation to Hong Kong and China, which is matched by a similar reduction in the allocation to South Korea. In both cases, this is largely a consequence of the relative performance of these markets.

PHI has an underweight exposure to South East Asia relative to the MSCI AC Asia ex Japan Index

PHI has had an underweight exposure to South East Asia for a number of years. The manager says that, broadly speaking, these countries are working through their problems and, with these markets de-rating he is becoming incrementally less negative on the region. The manager has not started buying yet, but thinks that markets may now be at a good way point for a larger move upwards, and he may consider adding where countries are looking cheap or starting to perform more strongly.

The portfolio continues to have no weighting to the ASEAN countries of Malaysia, Indonesia and the Philippines. In the case of Malaysia, the manager considers it is on a downward trajectory and does not see any need to invest there at all. With regard to the Philippines, the manager believes that this market has moved beyond its boom and so is happy to avoid it for now. The manager is planning to visit Indonesia later this year and so this could potentially see a change in allocation to that country.

PHI is overweight India

For India, a market in which PHI has an overweight position, the allocation has increased modestly. This reflects the net effects of both the strong performance of this market and the manager's decision to dispose of PHI's software technology holdings in India (three years ago these accounted for around 8% of the fund). The manager has been uncertain as to whether digitalisation would help or hinder these companies but has concluded that, reflecting the increasing commoditisation of their services, companies such as Infosys are suffering; this prompted the sales. From a top-down perspective, the manager favours India (because of a combination of Prime Minister Modi's government's reform programme, strong growth prospects and digitalisation) but feels that valuations are expensive.

The manager has initiated a small position in AU Small Finance Bank. PHI's manager thinks that the company has a very good management team, is well run and has very good growth prospects (he expects it to grow revenue and earnings at 40% compound over the next five years). Positions in ICI Prudential Life (India's largest life insurance company) and Max Financial (the third-largest life insurance company) have been added as well as a small stake in AIC Housing (mortgage finance). The manager says that he had hoped to see a greater decline in the Indian market, so as to create a greater buying opportunity, but considers that the local market is very knowledgeable and efficient, making it difficult to compete with.

The allocation to Taiwan has seen a modest reduction. Macronix (discussed below) has been added but the manager also engaged in some 'tidying up' with Hymax, Media Tech, Phyzon, Eclec, Delta and Hermes exiting the portfolio. Some of these companies were the subject of takeovers but, in other instances, sales were made because the manager did not see the progression that he was looking for.

Top 10 holdings

Figure 5: 10 largest holdings as at 30 September 2017

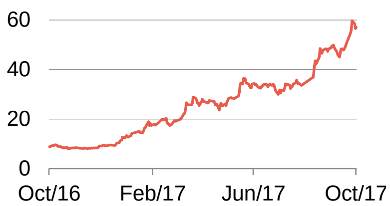
Stock	% of total assets 30 Sep 17	% of total assets 31 Aug 16	Change (%)	Sector	Business focus	Country
Alibaba	7.4	4.4	+3.0	Technology	E-commerce	China
Tencent	7.3	10.2	-2.9	Technology	Internet	China
Sunny Optical	6.4	3.2	+3.2	Technology	Optical products	China
Geely Automobile	4.5	2.6	+1.9	Technology	Auto manufacture	Taiwan
JD.com	4.4	3.1	+1.3	Technology	Online sales	China
Macronix Intl.	3.8	0.0	+3.8	Technology	Non-volatile memory	Taiwan
SK Hynix	3.2	1.9	+1.3	Technology	Electronic components	Korea
Samsung SDI	3.1	2.7	+0.4	Technology	Batteries and OLED	Korea
Ping An Insurance	3.0	0.0	+3.3	Financials	Insurance	China
Vietnam Enterprise	2.8	2.7	+0.1	Financials	Investment company	Vietnam
Total of top ten	45.9	39.1				

Source: Baillie Gifford, Marten & Co

Sunny Optical, Vietnam Enterprise and Geely Automotive were discussed in QuotedData's update note of October 2016, whilst Tencent was discussed in QuotedData's March 2016 initiation note. Some of the more interesting developments are discussed below.

Macronix

Figure 6: Macronix share price

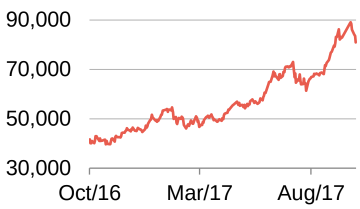


Source: Bloomberg

Macronix, which produces non-volatile memory products, is a new addition to the portfolio. In addition to NAND flash and ROM products, PHI's manager says that Macronix produces a special type of NOR memory for which it has become the global leader and is consolidating the industry. PHI's manager is very excited about Macronix. He believes that every single electronic device in a car is going to need some type of memory and that NOR memory will be the dominant technology.

SK Hynix

Figure 7: SK Hynix share price



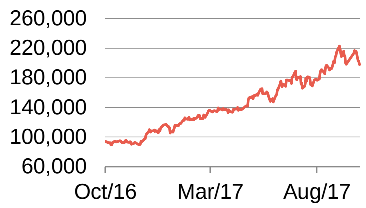
Source: Bloomberg

PHI's manager believes that we are currently experiencing one of the greatest semiconductor booms, probably of all time and says that the number of different technology products emerging at the same time, plus the move towards different types of chips requires more data, which mean that greater memory is also needed.

The manager says that NAND and DRAM (Samsung and SK Hynix) accounts for 80% of the global market and that there are various technology issues that mean the margins for these products should not be easily eroded (the manager says that quality considerations mean that demand has become less price sensitive for these products). The manager says that SK Hynix trades on 3.5x two years forward earnings and 4x next year's earnings. The manager's view is that the market does not understand these companies so that, despite SK Hynix's strong share-price performance, it is still very cheap.

Samsung SDI

Figure 8: Samsung SDI share price



Source: Bloomberg

Samsung SDI was a new entrant to the portfolio in August 2016. The manager has continued to add to the position. Samsung SDI provides exposure to energy storage systems and OLED production. Ewan thinks that with electric batteries, for both cars and ESS (energy storage systems), primarily for renewable energy, we are at an inflexion point, particularly on the storage side. Ewan says that these operations are currently loss making but he expects that they will turn profitable in two years and the company will scale up dramatically from there (5 to 10x over the following five years).

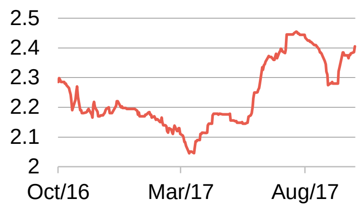
Samsung's product is its 'prismatic' lithium ion batteries. These are currently more expensive than Tesla's cylindrical batteries but Samsung's technology is very scalable and Ewan expects the per-unit price to fall more quickly so that, by 2020, the prices will be competitive. Ewan thinks that this technology will become adopted by the mass market.

Samsung SDI owns 15% of Samsung's OLED capacity. The latest Apple iPhone, the iPhone X, has a 100% OLED display, provided by Samsung. Ewan expects this to be a huge growth area and, because OLED is an organic product that is difficult to reverse engineer, the high margins Samsung earns will be highly resilient in Ewan's view.

Ewan says that the market is valuing Samsung SDI at book value, because, for the last 15 years, it has failed to generate a double-digit return on equity (ROE) for more than one or two years on the trot. However, he thinks the value strongly underestimates the company's growth potential and that it should be trading at 3 x book with a mid-20s ROE. Ewan reckons that, as Samsung ramps up the OLED business up over the next two to three years, the value of the OLED business could be more than $100bn, which is dramatic, Samsung SDI's share would be worth $15bn. Ewan says that given that Samsung SDI is valued at $12bn today, this suggests that, effectively, at the current price, no value is ascribed to the battery business (which could be worth a lot). Ewan thinks Samsung SDI is completely mispriced.

Vietnam

Figure 9: Vietnam Enterprise Holdings share price



Source: Bloomberg

Vietnam accounted for 7.1% of PHI's portfolio as at the end of August 2017 with Vietnam Enterprise Holdings (VNH), managed by Dragon Capital, a significant component (2.8% of the portfolio). VNH has had a strong run of performance during the last 12 months. The manager highlights that the Vietnamese economy has been performing well but he thinks that there has also been a benefit from the fund moving its listing from Dublin to London.

Performance

Annual results to 31 July 2017

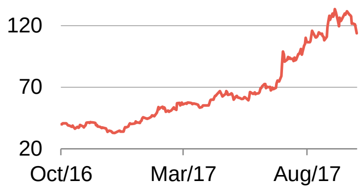
With NAV and share-price total returns of 38.5% and 42.5% respectively, PHI provided both strong absolute returns during the last financial year, as well as marked outperformance of its 'comparative index', the MSCI AC Asia ex Japan Index, which PHI says provided a total return of 28.6%. The manager says that its strong relative and absolute performance was largely a consequence of good stock selection, particularly in Hong Kong and China where exposure to certain consumer discretionary and information technology stocks proved beneficial.

The manager advises that all of the outperformance, and most of the absolute gains, occurred from December 2016, and he cites two key factors that have underpinned a marked uptick in PHI's fortunes, relative to recent years. First, technology stocks, where PHI has a significant allocation, have performed particularly strongly during the period. The manager ascribes this to a greater focus by investors on the technology space, reflecting both increased penetration and disruption that technology is causing within society. The second factor has been the depreciation of the US dollar during the second half of the company's financial year. The US dollar peaked around December 2016 but has been on a declining trend since. This reflects both the US' own internal challenges and, in the manager's view, a realisation that China's economy is now recovering and has not suffered the hard landing, with an implosion of its currency, that many commentators had previously predicted.

In terms of individual portfolio companies, the manager highlights Sunny Optical, Geely Automotive and JD.com as providing particularly strong performances. Each more than doubled its share price during the financial year.

Sunny Optical

Figure 10: Sunny Optical share price



Source: Bloomberg

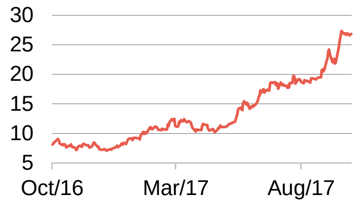
Sunny Optical, which produces optical lenses and is now number two globally, saw its share price increase by more than 200% during the period. The company has been providing revenue and earnings growth of between 70% and 120% per annum for the last few years, which has led to a rerating of the stock. The manager expects it to benefit heavily from the fast-growing car camera market, driven by moves towards autonomous vehicles. He believes that this technology is becoming increasingly complex and that there is a growing realisation that computers and other electronic systems will increasingly use visual inputs to navigate the world, be these cars, drones, robots or surveillance systems.

Despite the strong earnings growth mentioned above, the manager believes that we are actually in the early stage of the growth in the sector and that this long-term trend has many years to run. Reflecting this view, and the manager's philosophy of running its winners (so as to give them the best chance of delivering), the position size increased from 1.5% when it was initiated in April 2015 to 6.5% at the beginning of September, when it was trimmed modestly due to its increasing size.

Geely Automotive

PHI has held Geely in its portfolio for over five years and this provides another example of PHI running its winners. The manager considers that the company has exceptional management but believes that its relationship with Volvo is transformative for the company, as it brings Volvo's technology and design to China. This allows Geely to move from producing very dated vehicles, with little or no safety record, to modern vehicles designed and built to western standards. The manager says that this process has taken longer than he had anticipated but, following the launch of its first car using a Volvo design last year, Geely's sales have increased between 100 and 150% with a large increase in operating margin. PHI's manager believes that the joint venture with Volvo in its modular factory is transformative for Chinese auto manufacture and allows it to have more rapid product cycles, incorporating new technology more rapidly. The manager has trimmed the position recently, reflecting its strong performance, but it remains PHI's fourth-largest holding and the manager considers that there is still significant upside to come.

Figure 11: Geely Automotive share price

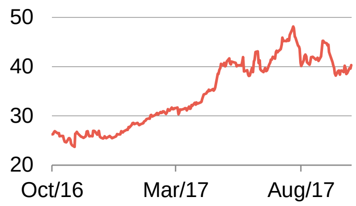


Source: Bloomberg

JD.com and Alibaba

PHI's two major e-commerce positions performed strongly during the year (JD.com increased 110% while Alibaba increased 90%). The manager says that both are continuing to grow very rapidly. JD.com is delivering top-line growth in the region of 40% per annum and, while it is currently loss-making, the manager expects it to be in profit by the end of 2018. He believes that there is an increasing realisation by the market that both companies have undergone significant changes during the last couple of years and have evolved so that they are now much more technology oriented than they were previously. For example, Alibaba has made significant investments in technology and big data to drive its customer and merchant experiencers and improve its marketing. By using sophisticated algorithms, Alibaba has been able to deliver very high profit growth, which is outpacing its revenue growth.

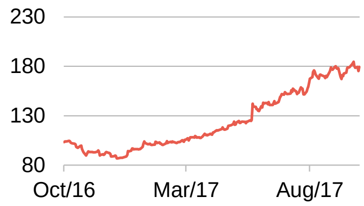
Figure 12: JD.com share price



Source: Bloomberg

JD.com, by comparison, owns its back-end logistics operations (Alibaba is largely outsourced) and is working to move to 100% automation within its factories. The manager thinks it is having success in this regard and that this IP will have significant value. Reflecting this, PHI has a higher weight in JD.com than Alibaba as the manager sees greater potential upside in terms of margins, but he acknowledges that JD.com is higher risk. Alibaba and JD.com have performed strongly and while the manager thinks that there may be a period of consolidation he thinks that both offer very good long-term value.

Figure 13: Alibaba share price



Source: Bloomberg

Biotech

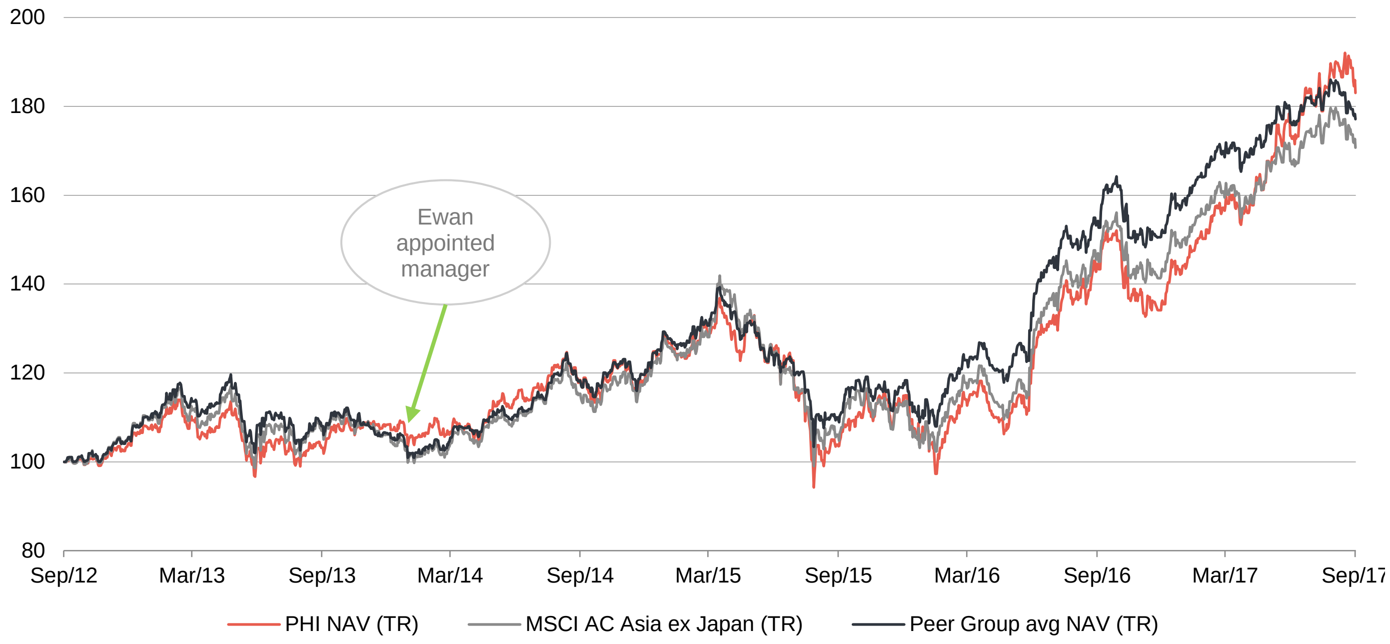
Biotech was the largest detractor from performance. The manager considers that the macro environment was more supportive for technology companies

Biotech detracted most from performance during the financial year, costing three percentage points. The manager says that there are no obvious themes (for example the strongest performer Medytox rose 36% whilst Bioneer fell 62%) other than, in his view, the macro environment was more supportive for tech than biotech. Some of PHI's holdings suffered as they missed their numbers or had contracts cancelled but, overall, the manager is watching these positions closely and does not see any significant problems with the underlying holdings. He sees the key issue as being the value that the market is prepared to place on these companies at present and he may add to these positions should he see positive news emerge and the market reflecting this in pricing.

MSCI Index changes

During the year, MSCI moved to include US-listed Chinese stocks within its Asia index series. This change has stimulated buying from index funds, which bolstered the performance of both the index and these new entrants. PHI, with its Asia ex Japan focus, and benchmark agnostic approach has investments in such stocks but has effectively been underweight and so the change has impacted on its relative performance. The manager estimates that PHI's relative outperformance might have been another seven percentage points ahead in the absence of the index changes.

Figure 14: PHI NAV performance compared to benchmark and peer group to end September 2017



Source: Morningstar, Marten & Co

Figure 15: Cumulative performance over periods ending 30 September 2017

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	18/3/14 to date (%)
PHI NAV (TR)	(2.8)	6.8	16.7	29.3	59.3	87.3	72.7
PHI share price (TR)	(1.4)	9.8	21.5	34.9	62.3	99.6	80.2
MSCI AC Asia ex Japan (TR)	(4.1)	3.2	7.6	18.8	51.7	72.3	68.1
MSCI AC World Index (TR)	(2.1)	1.8	2.2	14.9	49.8	95.6	58.8
Peer group avg. NAV (TR)	(4.7)	0.7	4.5	16.0	51.7	77.1	70.9

Source: Morningstar, Marten & Co

Peer-group comparison

Please click here for an up-to-date peer group comparison of PHI versus its Asia Pacific excluding Japan peers

The peer group shown in Figure 16 comprises all the funds in the AIC's Asia ex Japan sector excluding those focused on smaller companies or on income. PHI has provided the strongest NAV total return amongst its peers over the one-year time period and is second over three years. This is arguably reflected in PHI's discount which is one of the tightest. PHI's NAV total return is fifth over five years, but this includes a significant period during which Ewan was not managing the trust.

PHI is one of the smallest funds in the sector (only Martin Currie Asia Unconstrained is smaller) but this is not reflected in its ongoing charges ratio which is middle of the pack.

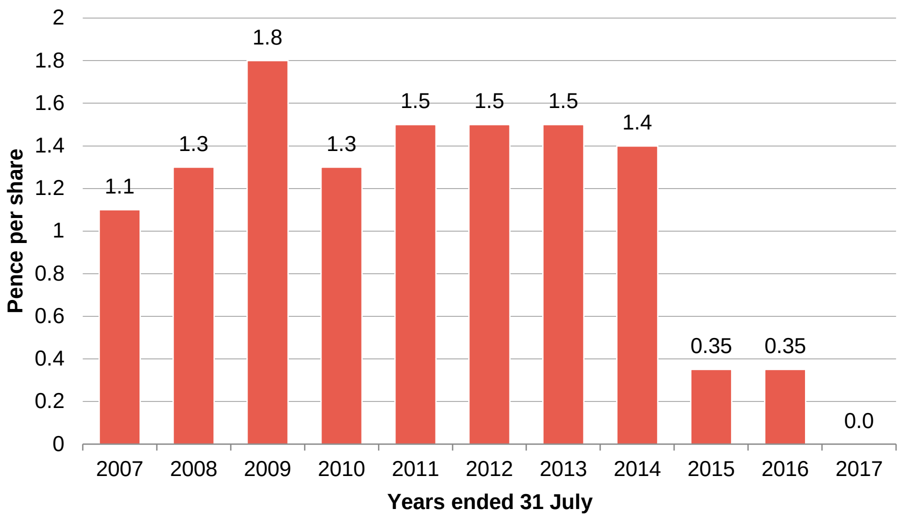
Figure 16: Asia ex Japan sub sector comparison table (data as at 26 October 2017 except performance)

	Market cap GBPm	Premium/ (Discount) (%)	Yield (%)	Ongoing charge (%)	NAV total return performance to 30/9/17 1 year (%)	3 years (%)	5 years (%)
Pacific Horizon	164	(8.9)	-	1.07	29.3	59.3	87.3
Aberdeen New Dawn	268	(13.0)	1.7	0.93	17.7	34.1	47.6
Edinburgh Dragon	687	(13.0)	0.9	1.12	15.1	35.0	47.7
Fidelity Asian Values	252	(9.2)	1.2	1.33	9.0	56.9	100.0
Invesco Asia	202	(13.2)	1.5	1.02	19.2	58.3	103.8
JPMorgan Asian	331	(9.1)	3.9	0.83	20.4	65.1	86.2
Martin Currie Asia Unc.	142	(12.8)	2.0	1.13	14.6	41.3	54.6
Pacific Assets	299	(4.9)	1.0	1.29	4.8	36.2	77.9
Schroder Asia Pacific	742	(12.3)	1.1	1.10	21.9	67.0	88.0
Schroder Asia Total Return	275	0.9	1.3	1.04	23.2	71.3	88.3

Source: Morningstar, Marten & Co

Dividend

Figure 17: PHI ordinary dividends, over the last 10 financial years.



Source: Pacific Horizon Investment Trust, Marten & Co

PHI is focused on capital growth. Its dividend is the minimum permissible to maintain its investment trust status

PHI's primary objective is to generate capital growth. The board's policy is that any dividend payable in the future will be determined as being the minimum permissible in order to maintain PHI's investment trust status and will be paid by way of one final payment per year. This occurs shortly after the company's AGM, which takes place in October/ November of each year. PHI's registrar offers a dividend reinvestment plan.

PHI's board recommends that investors requiring income should not consider PHI

As illustrated in Figure 17, PHI has not proposed a final dividend for the year ended 31 July 2017. All of PHI's expenses, including borrowing costs, are charged in full to its revenue account and, for the 2017 year of account, earnings per share were -0.38p (as opposed to +0.30p for the 2016 year). PHI's board has previously said that it "recommends that investors should not consider investing in this company if they require income".

Discount

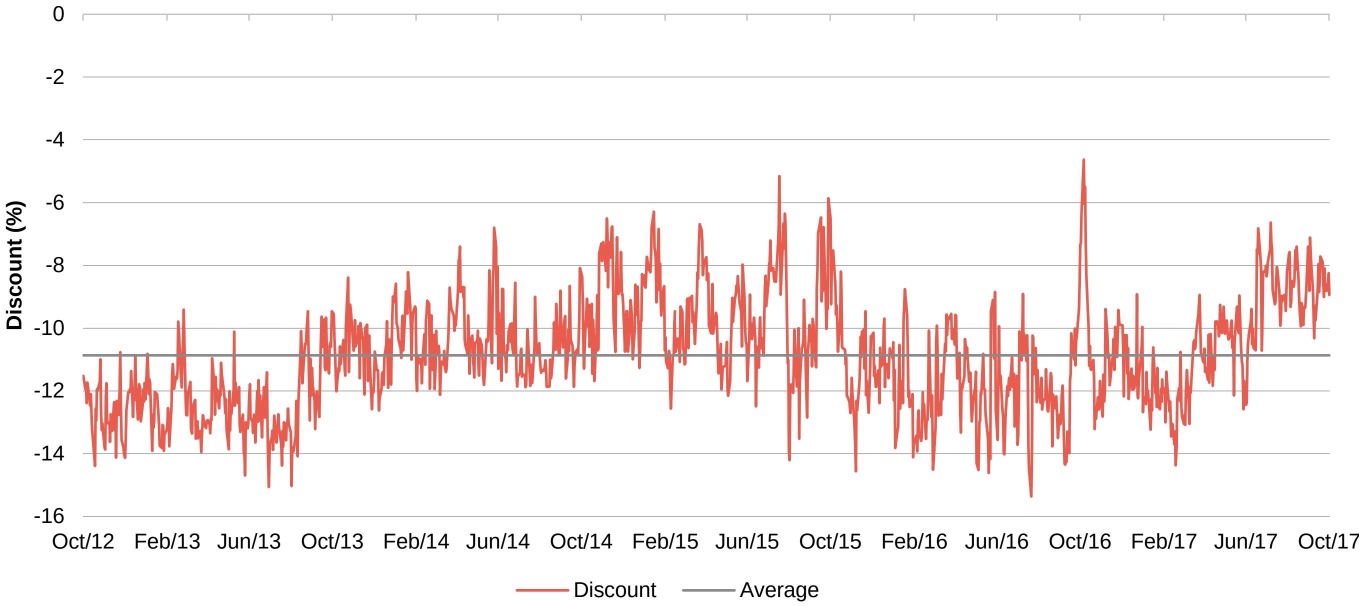
PHI has authority to repurchase up to 14.99% of its issued share capital, as well as to issue up to 10% at a premium to NAV. These authorities give the board mechanisms through which it can manage PHI's discount, or moderate any premium that should arise.

Potential 25% tender offer in 2019 has replaced bi-annual tenders

PHI's new tender offer structure is better suited to its long-term approach

In addition, PHI has historically offered biannual tenders for up to 5% of the company's shares at a 2% discount to NAV, less costs. These were held, at the board's discretion, in the event that the discount averaged more than 9% during the six-month periods to 31 January and 31 July. However, at the November 2016 AGM, shareholders approved a new mechanism. Under this, PHI will offer a 25% tender if its NAV, calculated at fair value cum-income, on a total return basis, fails to exceed the company's comparative index (the MSCI All Country Asia ex Japan Index in sterling terms) by at least 1% per annum over a three-year period to 31 July 2019 on a cumulative basis.

Figure 18: PHI discount over five years to 26 October 2017



Source: Morningstar, Marten & Co

The new mechanism was proposed following consultation with shareholders. The board received feedback from some investors that they require PHI to have liquidity and scale and found the size and frequency of the biannual tenders unhelpful. In addition, it was felt that the trigger for the biannual tenders (an average discount in excess of 9%) could be over influenced by market sentiment towards the asset class, rather than by the PHI's performance.

PHI's discount of 8.9% is below its five-year average of 10.9%. This may reflect PHI's recent performance and the credibility this provides to the strategy

As at 26 October 2016, PHI was trading at a discount of 8.9%. This is tighter than its five-year average of 10.9% and towards the middle of its one-year trading range (4.6% to 14.4%). This may reflect PHI's recent improvement in performance (see page 10) and the credibility that this may give to Ewan's longer-term investment strategy as well as a generally improving outlook for the markets in which it is investing. Further improvements could lead to further tightening of PHI's discount although, equally, a disruption to this consensus could also lead to a widening.

Fees and costs

An extra tier has been introduced to the management fee. Net assets in excess of £200m are charged at the lower fee rate of 0.55% (previously 0.65%)

PHI announced an improvement to its fee structure during the last financial year. Previously, PHI paid an annual management fee of 0.95% on the first £50m of net assets and 0.65% on the balance. However, with effect from 1 January 2017, an extra tier has been introduced so that for net assets in excess of £250m, PHI will pay a management fee at the rate of 0.55%.

All other terms remain unchanged. Management fees are calculated and paid quarterly in arrears and there is no performance fee. The managers may terminate the management agreement on six months' notice and the company may terminate on three months' notice.

The ongoing charges ratio for the accounting year ended 31 July 2016 was 1.13% (2015: 1.02%). The company says that the increase reflects the fact that shareholders' funds averaged less in the 2016 year partly as a result of the biannual tender offers (this is despite PHI's NAV per share increasing). Baillie Gifford also provides company secretarial services and acts as PHI's AIFM. These services are included as part of the management agreement.

Capital structure and trust life

PHI has a simple capital structure with one class of ordinary share in issue

PHI has a simple capital structure with just one class of ordinary share in issue. There were 54,262,282 ordinary shares in issue as at 26 October 2017. Each year, the company takes powers to buy back up to 14.99% of its shares at a discount to NAV. It also asks for permission to issue up to 10% of its issued share capital at a premium to NAV.

PHI offers shareholders a continuation vote every five years. The next is due in 2021

Shareholders are given the opportunity to vote on the continuation of the company every five years. The next vote will be at the Annual General Meeting of the company, to be held in 2021.

PHI's year end is 31 July. It holds its AGMs in October or November and, where applicable, pays its annual dividend shortly thereafter.

Gearing

Gearing has been used sparingly during the last 10 years

Gearing (borrowing) parameters are set by the Board and the manager operates within these. The range is set, currently, at -15% to +10% but this can go to +12% due to market movements. PHI's gross gearing was 9% as at the end of September 2017, whilst its net gearing was 7%. During the financial year ended 31 July 2017, gearing ranged between 1% and 8%. This situation is somewhat unusual as, prior to this PHI had only employed gearing in three of the previous 10 years.

None of PHI's borrowings are structural; all of its debt is provided through bank borrowing facilities

PHI has a £10 million one-year, uncommitted, unsecured revolving credit facility with BNY Mellon and a one-year £14 million unsecured multi-currency revolving credit facility with The Royal Bank of Scotland.

Board

All of the directors are non-executive and considered to be independent of the investment manager. Jean Matterson has been on the board for 13 years. Douglas MacDougall has indicated that he will not stand for re-election at the 2017 Annual General Meeting.

Figure 19: The Board

Director	Position	Date of appointment	Length of service (years)	Annual director's fee (GBP)	Shareholding*
Jean Matterson	Chairman	2 September 2003	14.1	30,000	157,628
Edward Creasy	Chmn. Audit Committee and Senior Independent Director	15 December 2010	6.8	22,500	16,400
Douglas McDougall OBE	Director	25 November 1992	24.8	20,000	823,853
Angus Macpherson	Director	28 February 2017	0.6		
Elisabeth Scott	Director	10 March 2011	6.6	20,000	6,103

Source: Pacific Horizon Investment Trust, Marten & Co *Note: shareholdings as per most recent company announcements as at 17 October 2017.

Jean Matterson stands for re-election annually, reflecting her length of service on the board. Angus Macpherson joined the board in February 2017. This ensures that the board will continue to number four following Douglas McDougall's retirement.

There is a limit of £150,000 for the aggregate of fees paid to directors which forms part of the company's articles of association. Shareholders would have to vote to approve any change in this limit.

Previous research publications

Additional information is available at the fund manager's website, www.bailliegifford.com

Readers interested in further information about PHI may wish to read QuoteData's previous research notes as detailed in Figure 21. You can read the notes by clicking on them in Figure 21 or by visiting the QuotedData website.

Figure 20: QuotedData's published research on PHI

Title	Note type	Date
Invest in Asian growth	Initiation	21 March 2016
Brave new world	Update	10 October 2016

Source: Marten & Co.

QuotedData

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