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Fidelity Asia Fund

10/10/2017 **FAT-AUS-843**

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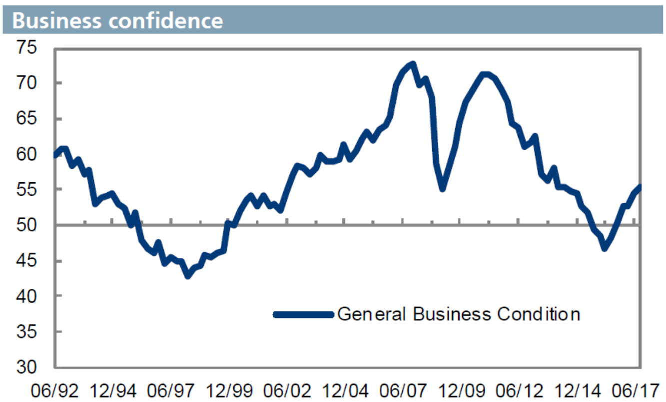
Getting out while ahead

Last week we reviewed the recent bullish developments in the Asia region with stronger exports while highlighting its longer-term prospects thanks to an improving manufacturing base. This week, we're providing a brief update on Asia's two largest economies China and India which recently reported another batch of economic data. Over the long-term, we retain our bullish view on the Asian region, however we downgrade our view on the Fidelity Asia Fund (APIR code: FID0010AU) to **Sell**.

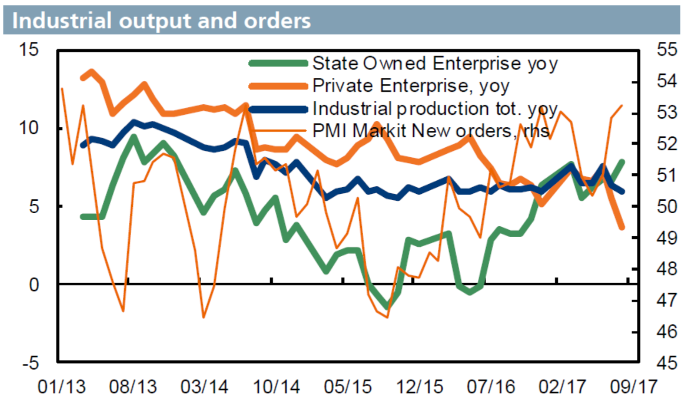
Before we look at the updates, we believe that the Fidelity Asia Fund has performed reasonably well over the two years since we have initially recommended it. However, as of late, the fund has been substantially underperforming its benchmark and we believe it to be high time to take profits while we remain ahead. Nevertheless, Members who still want exposure to the Asian growth story can do so with the better performing Platinum Asia Fund.

Moving on, we start off our update with **China**, one of the region's, and indeed the world's, growth engines. China recently beat expectations having reported a solid 2Q GDP which reported a solid annualised 6.9 percent year-on-year growth amidst a stable industrial sector while transport and logistics continue to accelerate.

This was mainly the result of recovering business confidence which in turn supported industrial output. For the 8-month period to August 2017, industrial output rose 6.8 percent year-on-year as manufacturing ramped up as a response to a sharp increase in domestic orders for heavy industrial goods.



Source: PBOC's Industrial Enterprise Survey by CEIC



Source: CEIC, IHS Markit.

Source: CEIC Data, IHS Markit

Retail sales continued to be robust with the latest figures in August reporting a 10.1 percent year-on-year growth. A closer look at the data shows that an increasing number of purchases are coursed online with more Chinese consumers relying on credit card and online platforms to shop. This will likely benefit financials and tech companies like Alibaba.

Consumer confidence remained high as the stronger economic activity also led to improvements in the labour market with more news jobs in the 2Q17. Most of the hiring is coming from the services sectors.

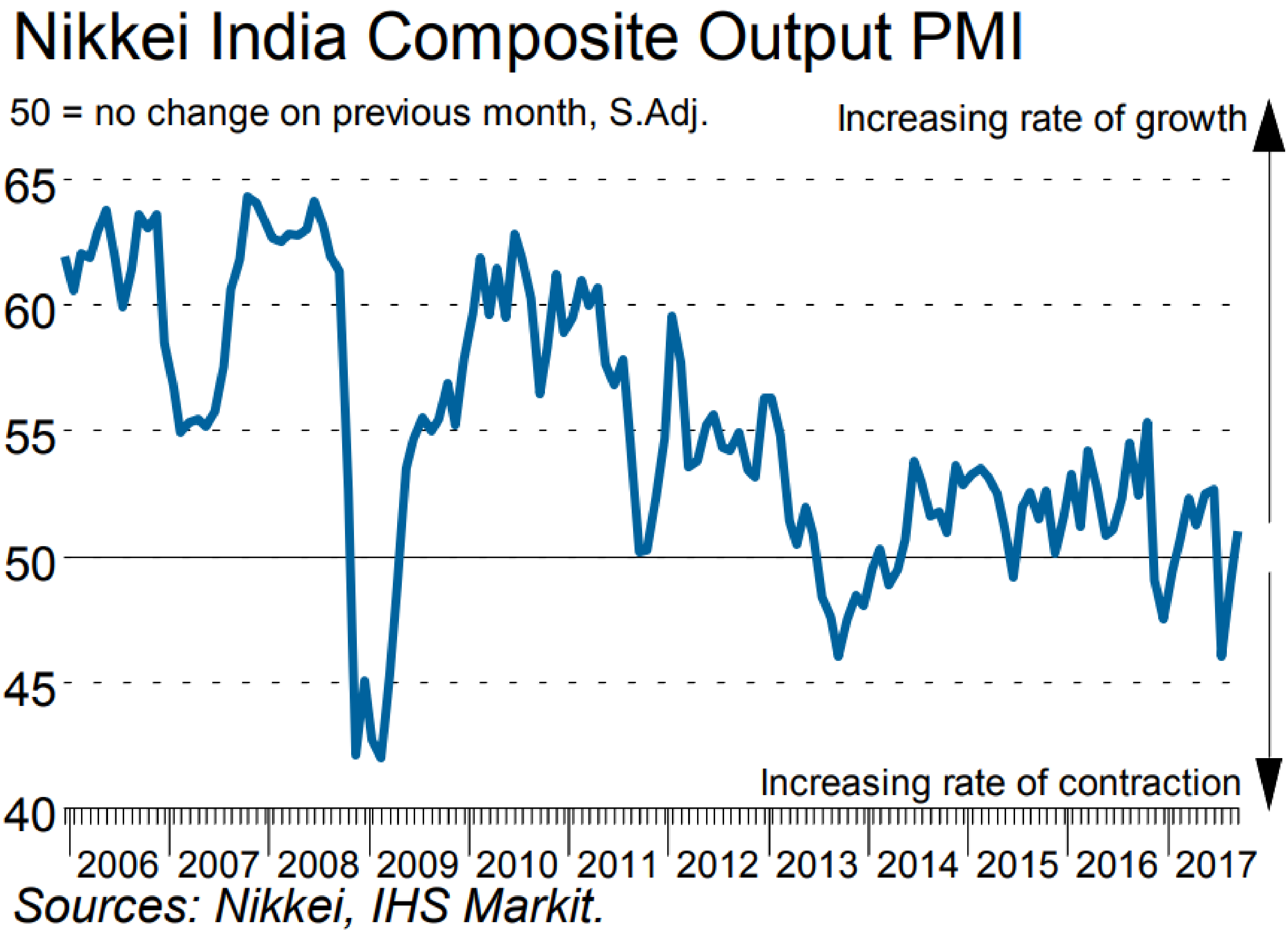
Capital Investment data also was continued to grow with the 8-month to August 2017 period growing at 7.8 percent year-on-year across both state and private sectors. Most of the growth comes from the transport and storage space due to increasing economic activity from the higher tier to the lower tier cities.

Next, we take a look at **India** which still seems to suffer some headwinds from PM Narendra Modi's aggressive policies.

The recent sector to take a hit in the July-September quarter was the real estate sector which reported a substantial 35 percent quarter-on-quarter drop in Housing Sales. According to a report from property market research firm, PropEquity, housing sales in the 3Q17 dropped to 22,699 units from last quarter's 34,809. The demonetisation drive last November had a substantial impact as Indians, especially in the higher income segments, prefer cash to maximise discounts.

Another sign came from the central bank itself with the Reserve Bank of India cutting GDP forecast by 60 basis points to 6.7 percent compared to the earlier 7.3 percent estimate. We believe this adjustment factors in the reduced economic activity from the combination of the demonetisation last November and the recent implementation of the Goods and Services Tax (GST).

Despite those headwinds, India's service sector returned back to growth having expanded for the first time in 3 months with the Nikkei PMI data hitting to 51.1 in September from 49.0 in August.



Source: Nikkei, IHS Markit

According to the IHS report, the services sectors went back to work ramping up their marketing activities after achieving compliance with the GST requirements. That aside, job creation was also at its fastest pace in 75 months as the GST implementation led to increased interstate activity just as we predicted a few months back in our previous coverage of India.

In our view, the Indian consumption story is intact and is unlikely to waver in the medium to long-term. While temporary cynicism and bumps in the road from new policies are part and parcel, on growth we are not overly concerned. We believe that the sector to benefit the most from the GST are consumer companies which have a wider reach, sell mass market products and have fewer SKUs (stock keeping units).

Overall, we remain bullish on Asia, however, given that the Fidelity Asia Fund hasn't performed up to par, **we prefer the Platinum Asia Fund and therefore recommend a SELL on Fidelity Asia Fund.**

Consequently, we are removing the Fidelity Asia Fund from the portfolio and will cease coverage.

Fund Details

Strategy

The Fidelity Asia Fund is a concentrated, long-only, high conviction Asian equity fund.

The objective of the fund is to achieve returns in excess of the MSCI AC Asia (ex-Japan) Index over the medium term by investing in undervalued shares, derivatives and cash. The Manager uses bottom up stock selection to invest in up to a maximum of 35 holdings.

The Manager targets companies with a compelling business model, an above-average earnings growth rate relative to the sector, the ability to allocate capital resources effectively, a track record of increasing returns on equity over time and attractive valuations. Cash of up to 10 percent may be held when undervalued securities cannot be found.

Investors in the Fund can expect the Portfolio to contain listed companies based in ten countries: China, Hong Kong, Taiwan, Korea, Malaysia, Singapore, India, Thailand, Indonesia and the Philippines. **The Managers suggest the fund is appropriate for investors with a minimum time horizon of five to seven years.**

Management

The fund is managed by Anthony Srom who has been with Fidelity since 2006 and he has been the portfolio manager of the Asia Fund since June 2014. Prior to this Mr Srom managed the Fidelity Thailand Fund from April 2008 to March 2012 and under his guidance the fund performed exceptionally well, generating a cumulative return of 132.6 percent over the three years from 2009 to 2011. He has also managed an internal Asia Pacific ex-Japan pilot fund and is based in Singapore, so has extensive experience in Asian markets.

Given his relatively short tenure at the helm of the Fidelity Asia Fund we cannot attribute the fund's past performance to Mr Srom's decision making, nevertheless we are satisfied with his track record of managing the Fidelity Thailand Fund and his length of tenure with Fidelity.

When considering investing in a fund it is important to look further than the Portfolio Manager to also consider the depth of the resources available to them to draw upon for research. In this case the Portfolio Manager is able to tap into the knowledge of more than 30 research specialists and 50 analysts who specialise in Asian Equities and are on the ground in Asia. The team is located in Shanghai, Dalian, Seoul, Hong Kong, Taiwan, Singapore, Mumbai and Delhi. They are further supported by Fidelity's global research team of 100 equity research professionals.

Risks

Given the concentrated nature of the portfolio, the risks associated with investing in emerging markets, currency exposure and its strong tilt towards China, an investment in this fund should be considered to be at higher end of the risk spectrum. Given the Manager's track record and growth potential of the region however we feel investors will be adequately compensated for these risks.

The Fund is long only so does not have a mandate to be able to short sell securities.

The Fund is not hedged back to Australian dollars so any appreciation of the AUD will reduce returns in AUD terms.

Fees and terms

The Fund's management expense has slightly increased to 1.19 percent per annum (previously 1.15%). This includes GST, administration and investment costs, and there is a buy/sell spread of 0.4 percent.

The minimum investment is A$25,000. Applications and withdrawals may be made every Sydney business day.

The fund may pay distributions annually on June 30. The latest cash distribution was at 30 June 2017 and amounted to A47.38 cents, with a reinvestment price of $16.63 giving a running yield of 2.84 percent. This was down markedly on the June 2015 distribution of A62 cents which generated a yield of 4.24 percent.

The fund size is A$95.92 million as at 06 October 2017. A smaller fund is often more agile in volatile markets with the ability to add to, or liquidate positions without moving the market. It also opens up the opportunity to invest in less liquid stocks that would otherwise be deemed un-investable by bigger funds, which increases the size of potential investment opportunities available to this fund.

Performance

Historically, the fund has outperformed the benchmark **(MSCI AC Asia ex Japan) by 2.0% per annum since inception back in 2005, net of management fees**. However, much like the classic mantra of "past performance not being indicative of future results" rings true as evidenced by the significant underperformance as of late.

Past performance net returns as at 31/08/17

Timeframe	1 mth %	3 mth %	6 mth %	1 yr %	3 yr % pa	5 yr % pa	7 yr % pa	10 yr % pa	Since inception (29/09/05) % pa
Fund	1.61	-1.36	11.96	12.08	15.82	18.51	12.34	5.86	9.68
Benchmark	2.00	1.79	15.75	18.28	11.75	14.86	9.01	4.44	8.04
Active return	-0.39	-3.15	-3.79	-6.20	4.07	3.65	3.33	1.42	1.64

Source: Fidelity Asia, 31 August update

Over the past quarter (3-month return) the fund's performance dragged behind the benchmark by 3.15% and likely dragged down by the fund's overweighting in consumer staples which were impacted by the policy moves in India and high inflation (+9.7% yoy) on vegetable staples in China due to bad weather.

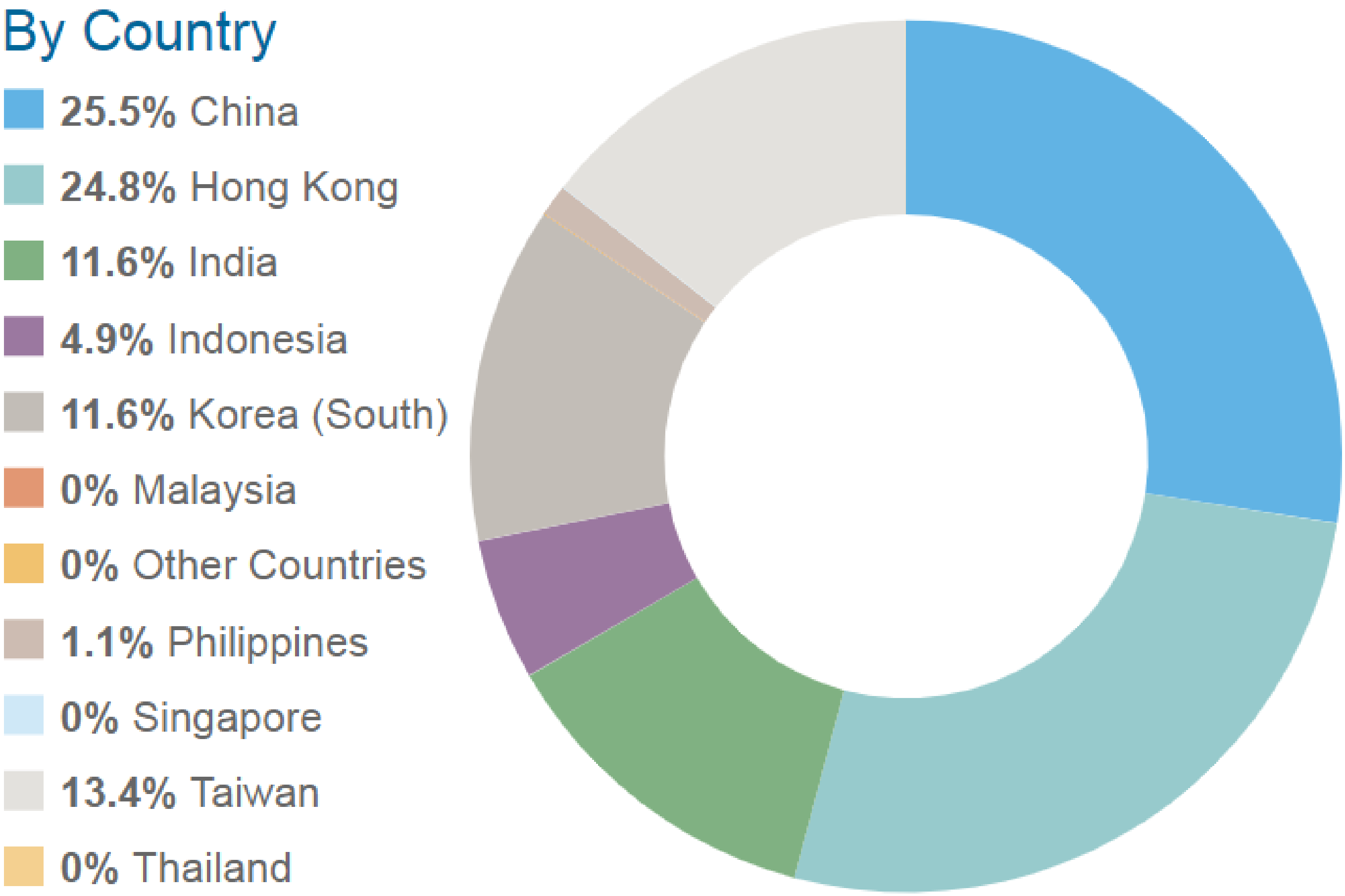
While over the 3 and 5 year periods, the fund performed substantially better than the benchmark (4.07% and 3.36%, respectively). However, we cannot directly attribute the longer term (5 year onwards) performance to the current fund manager as his tenure on the fund fits 3 years and 2 months and has inherited the historical positions from the previous.

Nevertheless, the fund's overweight positions in sectors such as Consumer and Financials benefitted the fund in the last five years.

Country & Sector Allocation

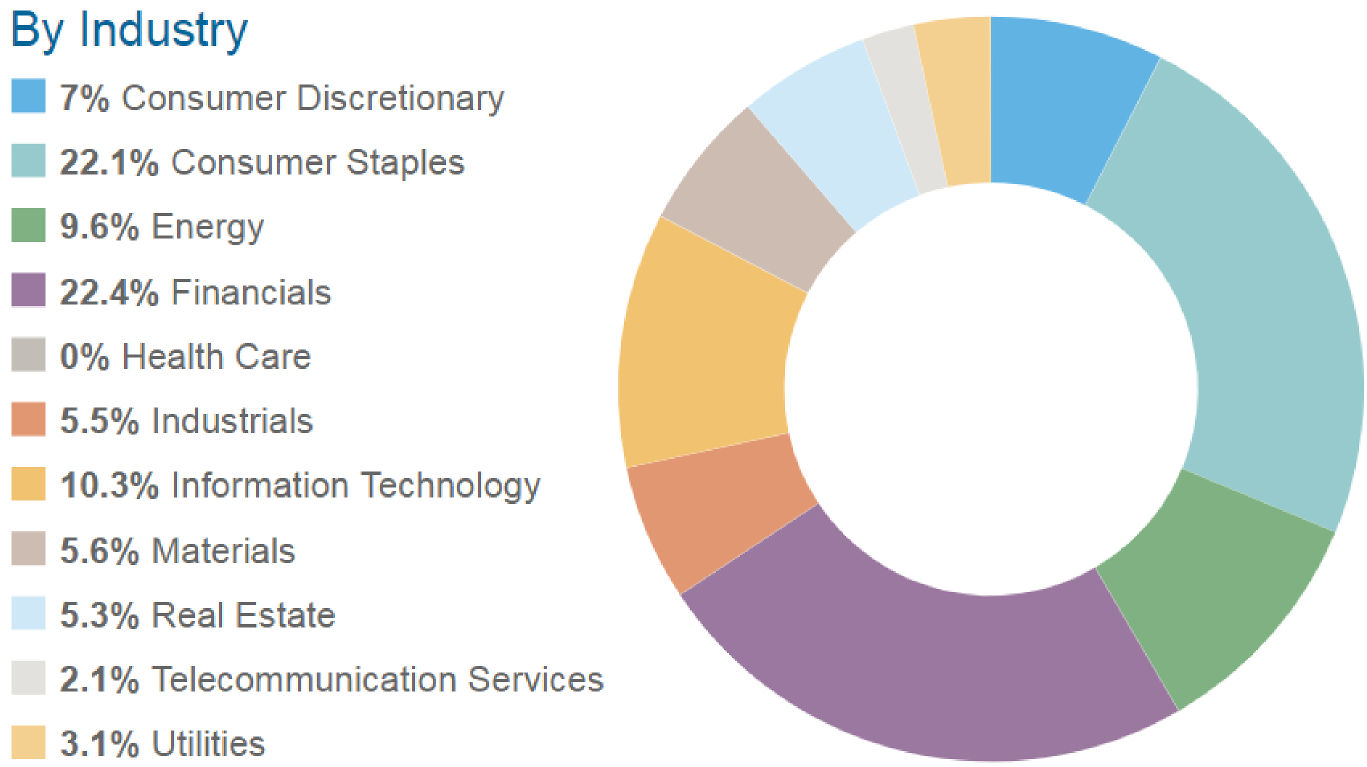
The graphic below illustrates the current positioning of the Fund, which has exposures in many countries across the Asian region though has a **substantial overweighting in the Chinese economy (China, Hong Kong and Taiwan) with an exposure of 63.7 percent (previously 56.2).** Compare this with the benchmark's 58.9 for the three countries.

While almost a quarter of the fund is invested in Hong Kong it is important to note that many Chinese firms are listed in Hong Kong so it is likely the true exposure of the fund is more tilted towards China than the above chart indicates at almost 50%. Therefore, movements in Chinese equity markets will have a disproportionate impact and, on the other hand, the recent rally in Chinese stocks will likewise be a disproportionately positive result.



Source: Fidelity Asia, 31 August update

Aside from the large position in China, the fund also has a larger exposure to **India** than the benchmark at 11.6% versus the benchmark's 10.1%. Since our last update, the fund has reduced their exposure to **South Korea**, from 16.2% to 11.6% and is also substantially underweight compared to the benchmark's 17 percent. The fund is currently holding circa 7.1% in cash, higher than our last review in April (6.8%), and leaves room for the manager to take new opportunistic positions.



Source: Fidelity Asia, 31 August update

In terms of sector allocation, the portfolio is heavily weighted towards Financials, the Consumer sectors, Industrials and Information Technology. These four sectors still make up more than half of the portfolio at 67.3% (previously 65%).

Since our last coverage, the fund has had some significant changes having reduced exposures to Industrials (-370 bps), Telecom Services (-350 bps), IT (-240 bps), and Consumer Discretionary (-210 bps) while substantially increasing exposure to Consumer Staples (+810 bps), Financials (+240 bps) and Energy (+200 bps) which we believe is the fund manager's efforts to position ahead of the recovery in India and the oil market.

Top 10 holdings

With a maximum of 35 holdings the Fund is relatively concentrated, and the top 10 holdings make up more than half (62.6%) of the fund. The top 10 holdings are solid blue chip companies which we would expect to be some of the key beneficiaries of economic growth in the Asian region, with a reduced level of risk when compared to smaller cap stocks. Now we look at select stocks from the top 10 holdings.

Top 10 holdings as at 31/08/2017

	% total net assets
TAIWAN SEMICONDUCTR MFG CO LTD	10.3%
AIA GROUP LTD	10.0%
KWEICHOW MOUTAI CO LTD	8.2%
HDFC BANK LTD	8.0%
CHINA PETROLEUM & CHEM CORP	5.5%
SUN HUNG KAI PROPERTIES LTD	5.3%
SK INNOVATION CO LTD	4.1%
SHANGRI LA ASIA LTD	4.1%
FOSHAN HAITIAN FLAVOURING & FOOD COMPANY LTD	4.0%
KOREA ELEC POWER CORP	3.1%

Source: Fidelity Asia, 31 August update

First off, we take a look at **Taiwan Semiconductor MFG Co.** (TSM), the world's leading semiconductor maker and also recommended as a **Conviction Buy** by our Fat Prophets Asia equities team. Since our last coverage, the fund's exposure to TSM has increased from 8.7% to 10.3% and now occupies the top spot.

The company recently announced that they plan to setup the world's first 30nm fabrication plant at the Tainan Science Park in southern Taiwan. Estimates on investment costs for the new plant are at around NT$500 billion or circa $16.467 billion and would cover 50 to 80 hectares (123 to 198 acres) of land. The company expects the project to completed by circa 2022.

That aside, the company's founder and chairman, Morris Chang has announced that he will retire in June 2018 and no longer be active in any TSM activities. This marks the beginning of an era of change for the company which owed its success to smartphones in the past but has now moved towards emerging technologies such as artificial intelligence and autonomous driving.

The company will now be under the dual leadership of Mark Liu as Chairman and C.C. Wei as CEO.

China's biggest distiller, **Kweichow Moutai** takes up the third spot with a weighting of 8.2% (previously 7.1%). The company produces high end Baiju liquor under the brand name Moutai that sells at Australian discount liquor chain Dan Murphy's for A$279.99 a bottle or A$3,326.40 for a case of 12.

The drink is considered to be one of the most revered of Chinese liquors, primarily consumed as a celebratory drink and favoured in state banquets and gifts for officials. The brand's aroma and taste are reminiscent of Soy Sauce, pear, walnut and almond.

The company is on the move to raise efficiency and reduce "brand abuse" by slimming down their total number of brands from 214 to 59. This move aims to prevent its franchisees and subsidiaries from passing off lower quality liquor under the Moutai label.

We like this recent development as it shows commitment to the company's plans to reform its manufacturing and distribution system. The discontinued will be disposed of by the end of the year.

That aside, the company has provided hints that their 3Q17 sales figures are on a rise with the announcement that they will supply 6,200 tonnes of liquor between August and September to match the strong demand for the Golden Week period, which is a holiday period that workers in Chinese companies have seven continuous days of holiday to promote tourism and consumption.

Over the longer term, Moutai has noted that they see substantial growth opportunities for the 26 countries along the Belt and Road region, which are Eurasian countries part of China's Silk Road project. As of the 1H17, sales in the region accounted for 19% of the total and management plans to study the markets in the region as well as setup franchise opportunities.

Summary

The prospects for the Asian region remain highly positive as supported by a good mix of economic data highlighting increasing business activity and interregional trade. Over the long-term we remain positive on Asia's investment story, with a rising and affluent middle class setting the stage for a large 'demographic dividend.'

While growth in Asia will not be without its challenges, we believe that improvements in key countries like India as well as emerging markets including Indonesia, Thailand, Vietnam, and the Philippines will drive investment performance and opportunities for the Fund.

Overall, we remain bullish on Asia, however, given that the Fidelity Asia Fund hasn't performed up to par, **we prefer the Platinum Asia Fund and therefore recommend a SELL on Fidelity Asia Fund.**

Consequently, we are removing the Fidelity Asia Fund from the portfolio and will cease coverage.

Snapshot FAF

Fidelity Asia Fund

Latest Closing Price: $17.4207

The objective of the fund is to achieve returns in excess of the MSCI AC Asia (ex-Japan) Index over the medium term by investing in undervalued shares, derivatives and cash. The Manager uses bottom up stock selection to invest in up to a maximum of 35 holdings.

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Market Capitalisation:$96.45M