Henderson Far East Income

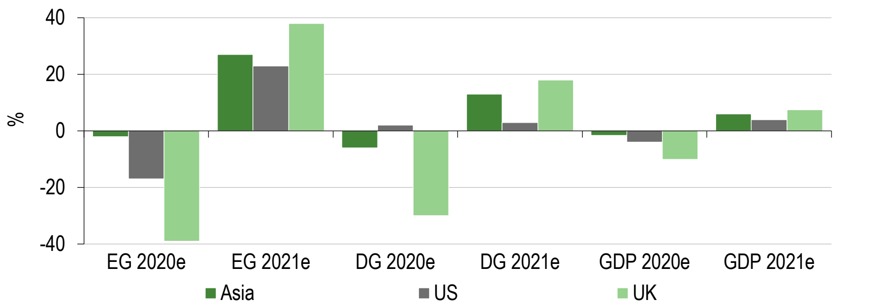
Keeping the faith and covering the dividend

Investment trusts
Asia Pacific equity income

3 December 2020

Henderson Far East Income (HFEL) has experienced a tough period of capital performance as market participants have focused ever more on growth and momentum rather than cash flows and dividends. However, in a year where the majority of investment trusts have needed to dip into reserves to avoid cutting their dividends, HFEL stands out in that it not only delivered year-on-year dividend growth of 2.7% for FY20, it fully funded its dividend from portfolio income and even made a small contribution to reserves to help underpin future dividend growth. Managers Mike Kerley and Sat Duhra remain convinced that market focus will return to value and yield factors, as seen in the quantitative easing era of 2011–13, given the 'even lower for even longer' interest rate outlook.

Asia is set to recover more quickly from COVID-19 shock than US or UK



Source: Henderson Far East Income, Edison Investment Research. Note: EG – earnings growth; DG – dividend growth; GDP – GDP growth.

The market opportunity

It is a well-rehearsed argument that the Asia-Pacific region offers superior growth prospects to the West, underpinned by such factors as a young and increasingly educated workforce, lower labour costs and an expanding middle class. However, the COVID-19 crisis has also shone a light on the superior preparedness for a pandemic in many countries that experienced SARS in the early 2000s, and the muted impact on earnings growth, dividends and economic activity in Asia (see chart) is testament to the region's resilience and continued attraction for investors.

Why consider investing in HFEL?

- Consistent investment approach, seeking companies whose sustainable cash flow growth is not reflected in current valuations.
- Dividend yield of over 7% is backed up by portfolio income (including from option writing) and growing reserves.
- Well placed to benefit from a market rotation towards value and yield.

Premium rating proves strategy's attractions

At 2 December 2020, HFEL's shares traded at a 2.6% premium to cum-income NAV. The trust has traded on average at a small premium over one, three, five and 10 years, and has continued to grow its dividend (current yield of 7.2%) despite a large increase in its share base through regular tap issuance to manage the premium.

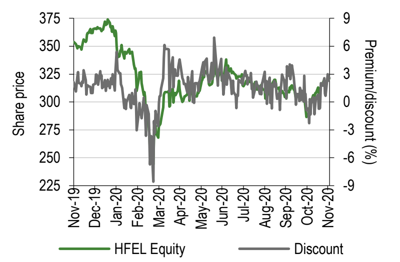
Price	**321.0p**
	NZ$6.07
Market cap	**£456.9m**
AUM	**£445.5m**

NAV*	310.6p
Premium to NAV	3.3%
NAV**	312.8p
Premium to NAV	2.6%

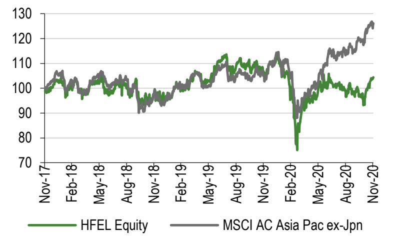
*Excluding income. **Including income. At 1 December 2020.

Yield	7.2%
Ordinary shares in issue	142.3m
Code	HFEL
Primary exchange	LSE
AIC sector	Asia Pacific Income

Share price/discount performance



Three-year performance vs index



52-week high/low	374.0p	244.0p
NAV* high/low	365.5p	266.9p

*Including income.

Gearing

Gross*	0.0%
Net*	0.0%

*At 31 October 2020.

Analysts

Sarah Godfrey +44 (0)20 3681 2519
Mel Jenner +44 (0)20 3077 5720
investmenttrusts@edisongroup.com
Edison profile page

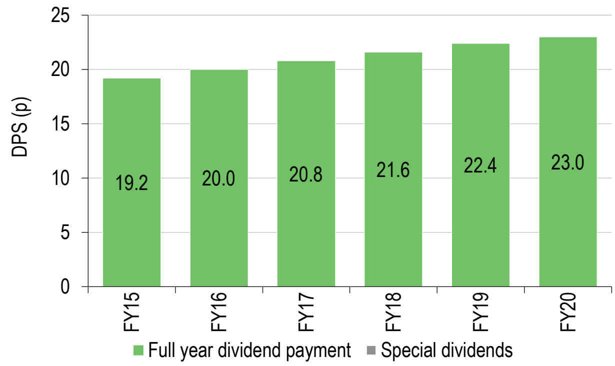
Henderson Far East Income is a research client of Edison Investment Research Limited

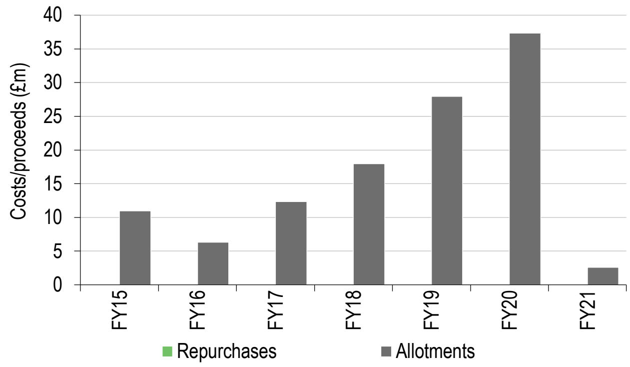
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
Henderson Far East Income aims to provide shareholders with a growing total annual dividend per share, as well as capital appreciation, from a diversified portfolio of investments in the Asia-Pacific region.	■ 4 November 2020: Annual results for the year ended 31 August. NAV TR -9.9% and share price TR -7.8%, compared with -7.7% for the MSCI AC Asia Pacific ex-Japan High Dividend Yield Index and +7.9% for the broad Asia Pacific ex-Japan market. Total dividends of 23.0p per share (+2.7% y-o-y), fully covered by FY20 income.

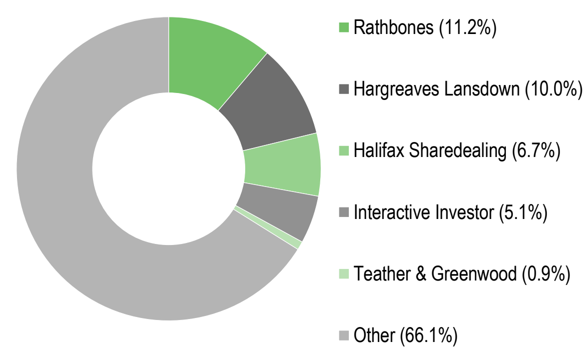
Forthcoming		Capital structure		Fund details	
AGM	January 2021	Ongoing charges	1.08% (FY20)	Group	Janus Henderson Investors
Interim results	April 2021	Net gearing	0.0%	Manager	Michael Kerley and Sat Duhra
Year end	31 August	Annual mgmt fee	Tiered (see page 10)	Address	201 Bishopsgate, London, EC2M 3AE
Dividend paid	Feb, May, Aug, Nov	Performance fee	No		
Launch date	2006 (as a Jersey co)	Trust life	Indefinite	Phone	+44 (0) 20 7818 1818
Continuation vote	No	Loan facilities	£50m	Website	www.hendersonfareastincome.com

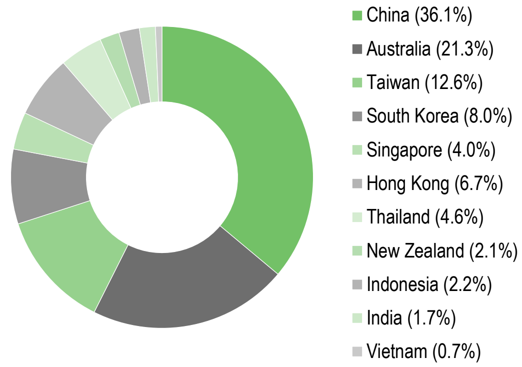
Dividend policy and history (financial years)	Share buyback policy and history (financial years)
Dividends are paid quarterly. The company aims to distribute substantially all its income (after costs) arising in each accounting period.	HFEL is authorised to repurchase up to 14.99% of shares, to hold up to 10% of shares in treasury and to issue up to 10% of shares each year.





Shareholder base (at 30 October 2020)	FY20 share of income by geography (year ended 31 August 2020)





Top 10 holdings (at 31 October 2020)

Company	Country	Sector	Portfolio weight %	
			31 October 2020	31 October 2019*
Samsung Electronics	South Korea	Technology	5.3	3.1
Taiwan Cement	Taiwan	Basic materials	4.0	N/A
Taiwan Semiconductor Manufacturing	Taiwan	Technology	3.7	3.9
Macquarie Korea Infrastructure Fund	South Korea	Financials	3.4	3.0
Citic Securities	China	Financials	3.2	N/A
China Vanke	China	Property	2.9	N/A
Mapletree Industrial Trust	Singapore	Property	2.9	N/A
HKT Trust & HKT	Hong Kong	Telecoms	2.9	3.0
Kweichow Moutai	China	Consumer goods	2.9	2.8
Macquarie Group	Australia	Financials	2.8	3.2
Top 10 (% of portfolio)			**34.0**	**30.4**

Source: Henderson Far East Income, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-October 2019 top 10.

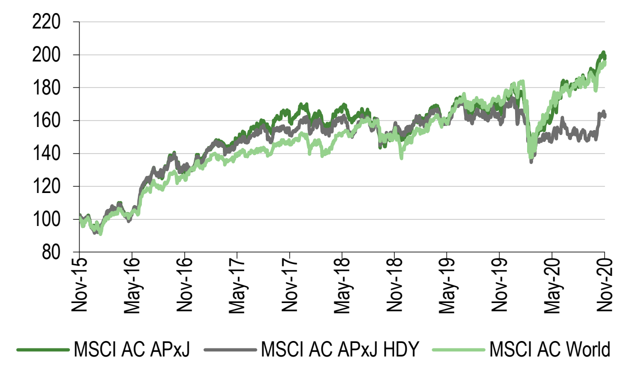
Market outlook: Crisis? What crisis?

While 2020 has been completely overshadowed by the human and economic effects of the coronavirus pandemic, the impact on equity markets may be less immediately evident to future historians. As shown in Exhibit 2 (left-hand side), both the MSCI AC World and MSCI AC Asia Pacific ex-Japan indices have more than bounced back from the severe market setback in February and March, reaching all-time highs on the back of seemingly insatiable investor demand for high-profile technology stocks, particularly in the US and China. Yet in spite of the performance of the Asia Pacific index actually outstripping that of the world index, forward P/E valuations for Asian equities (as measured by the Datastream Asia ex-Japan index) stand at a c 17% discount to the Datastream World index, wider than the 11.6% average discount over the past five years.

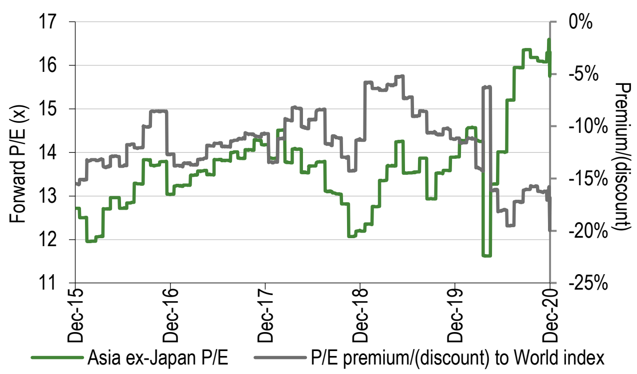
This seems to disregard the positive economic and demographic fundamentals that have underpinned the Asian equity story in recent decades. Asia is the only region where the International Monetary Fund expects to see GDP growth in 2020 (while the regional average forecast is for a decline of 1.7%, China, Taiwan and Vietnam are all expected to be in positive territory for the year) and is also the only area where growth in 2021 is forecast to more than offset the damage done in 2020. Similarly (see front page chart), while corporate earnings growth in the US in 2021 should be sufficient to overcome the declines seen this year with a small amount of surplus, Asian earnings on a nominal basis are set to be appreciably higher than in 2019, after seeing only small dip in 2020.

Exhibit 2: Market performance and valuation

Performance of Asia-Pacific and world indices over five years



Forward P/E for DS Asia ex-Japan index and relative to DS World index



Source: Refinitiv, Edison Investment Research. Note: Valuation data at 1 December 2020.

While it is hard to say Asian equities in aggregate look inexpensive (the current 16.3x forward P/E multiple for the Datastream index is 26% higher than the 10-year average), it is important to note this number is distorted by the hugely inflated valuations of a handful of mega-cap companies (mostly Chinese internet names) that dominate regional indices. Looking again at the left-hand chart in Exhibit 2, it is clear (at least until the recent market bounce on the back of positive COVID-19 vaccine news) the performance of high-yielding stocks in the Asia Pacific region has been lacklustre, with little in the way of a meaningful recovery from the Q120 sell-off. However, in a world where interest rates, and therefore yields on assets such as bonds and cash, are at historically low (and in some cases negative) levels, it would be reasonable to assume that at some point, investors will stop over-extrapolating growth rates for e-commerce and cloud-computing companies and begin once more to appreciate the attraction of a growing income backed up by sustainable cash flows. In such a rotation, a fund that already focuses on companies with high and increasing dividends could prove attractive to investors.

Fund profile: Capturing Asia's growing dividend culture

HFEL was designed to capture the change in dividend culture in Asia versus the rest of the world, which has gathered pace since the trust's launch in 2006 as a Jersey-incorporated successor vehicle to the onshore HFEL trust. It aims to achieve a high and growing income, as well as capital growth, by investing across the Asia-Pacific region (including India and Australasia). HFEL has no restrictions on country and sector weightings and may invest in Japan, although in practice this is likely to be only to a limited extent. Portfolio construction is largely bottom up and the only significant investment restriction is that no company may make up more than 10% of the total portfolio. As well as equities, HFEL may hold warrants, debt securities and equity-related securities, such as pre-IPO stocks that are expected to list shortly. The managers may write put or call options to generate additional income and the trust is permitted to gear up to 30% of gross assets, although it was ungeared at end-October 2020.

The trust's shares are listed in London and on the New Zealand Stock Exchange, and it is a member of the Association of Investment Companies' Asia Pacific Income sector. While it has no official benchmark, HFEL measures its performance with reference to a broad Asia Pacific ex-Japan index and the MSCI AC Asia Pacific ex-Japan High Dividend Yield Index.

The fund managers: Mike Kerley and Sat Duhra

The managers' view: Post-COVID-19 recovery will favour income

Rather than following fads or trends as the global equity market has become increasingly polarised, HFEL's managers have maintained a consistent approach throughout the challenges of the COVID-19 pandemic, focusing on domestically orientated companies with strong free cash flow and low leverage paying sustainable dividends, as well as looking for companies with good dividend growth prospects. 'We are probably a little more focused on dividend growth at the moment, as some areas that were 'sustainable' dividend payers, such as banks, have become less so,' says Kerley. Despite some Asian (and particularly Australian) companies having cut dividends in response to the coronavirus crisis, Kerley argues that the picture is much worse in Europe, and nowhere more so than the UK. 'It will be a while before people have faith in UK and European dividends, and Asia is therefore the obvious destination for income-focused investors,' he says.

The major hurdle the managers have faced in recent years is that value and income have been largely ignored by investors carried away by a multi-year focus on growth and momentum. Kerley points out that the top 25% of stocks by dividend yield in Asia are trading on forward P/E multiples roughly half that of the broad index average, the widest discount in almost 20 years. 'We have the highest yield in the AIC Asia Pacific Income sector and yield has been the worst-performing strategy, so it is not a big surprise for us to have underperformed lower-yielding income funds and the broad index,' he says. However, he adds, this dynamic ignores the needs of real investors, for whom a high and sustainable income may be of paramount importance. 'The shares we own, with sustainable yields, are getting ignored, so capital performance has been poor, but we are still trading at a premium and issuing shares, while other income funds are trading at a discount,' the manager says. 'The moves in the market reflect people trading strategies and themes, but the underlying client still needs income in a low-yield environment.'

Kerley sees echoes of the global financial crisis (GFC) in the likely path of the world economy over the next few years, which could trigger a change in investor focus. 'Looking back at 2008/09 and what followed, I suspect the reaction will be similar: a sell-off, then a bounce back with a period of euphoria as people believe growth will recover – but there are lots of reasons why it won't,' he says. 'Post-GFC it was the banks that didn't work; this time, unemployment and debt levels will curtail long-term growth, so we expect an anaemic period of growth supported by governments, as we saw in 2011–13, when dividend yield as a strategy went from a discount to a premium to the broad market.'

In financial market terms, one of the biggest impacts of the pandemic has been the widespread suspension or reduction of dividends, often mandated by regulators. However, HFEL has been relatively insulated from this trend. 'We have actually seen very few dividend cuts in the portfolio, says Kerley. 'One of the Chinese property companies did not cancel but reduced its dividend, and the Macau stocks – which are all tourism-related – removed their second interims as the border was effectively closed, but they are now back to c 25% of pre-COVID volumes. There was a slight reduction in dividends from Singapore REITs when the government brought in rent relief regulations.' This has been balanced by some companies paying higher-than-expected dividends, although the manager says that in aggregate, dividends in Asia are expected to decline by c 5% in 2020, mainly focused on banks – especially in Australia and Singapore, 'and anything to do with tourism, energy or travel'.

In terms of the outlook for HFEL's own dividends, Kerley says: 'We have a 7%-plus dividend yield, and at that level you either think that the stocks are cheap or you think the dividends will not get paid. Given we saw revenue growth this year and covered our dividend, it suggests our portfolio is too cheap.'

Asset allocation

Investment process: Cash generation is key to dividend growth

HFEL uses a consistent and disciplined approach to build a portfolio of c 40–60 stocks (currently 44) from across the Asia-Pacific region. The managers seek cash-generative companies with good growth prospects, trading at valuations that suggest the market is underestimating the value of their future cash flows, and blend holdings that have an attractive starting yield with those offering superior dividend growth prospects, aiming to provide an attractive total return.

Kerley, who is based in London, and Duhra, who works out of Janus Henderson's Singapore regional hub along with the analysts who support the team, meet frequently with companies around the Asia-Pacific region and also use industry research and quantitative screening to help identify companies with high yields and/or high dividend growth prospects. They seek to understand the business drivers and key risks of potential investee companies, and build proprietary models focusing on cash flow generation, to establish a target price range.

HFEL's portfolio is mainly made up of companies that have a market capitalisation of at least $1bn, with a bias towards mid-cap ($3–10bn) stocks and a tendency to be underweight mega-caps, which can be expensive owing to their high profile in indices, and may not pay dividends. The team generally does not buy non-yielding companies (where the absence of a dividend policy can make forecasting difficult), although some holdings may have relatively low yields in the 1–2% range.

Exhibit 3: HFEL portfolio metrics versus indices at 30 September 2020

Metric	HFEL	Broad Asia Pacific ex-Japan index	MSCI AC Asia Pacific ex-Japan HDY Index
Price/book (x)	1.4	1.8	1.0
P/E 12m forward (x)	10.7	15.2	9.0
Dividend yield (%)	4.8	2.4	5.2
Dividend yield est 12m forward (%)	5.1	2.6	5.4
Free cash flow yield (%)*	10.0	3.3	10.0
EPS growth est 12m forward (%)	8.3	26.3	9.1
Return on equity (%)	15.5	14.8	14.4

Source: Henderson Far East Income, Edison Investment Research. Note: *Excludes financials sector.

The fund's characteristics versus the broad and high-yield Asia-Pacific equity indices are shown in Exhibit 3. Given its focus on income-generating companies trading at attractive valuations, HFEL's holdings tend to trade on lower average P/E and price/book multiples than the broad index, as well as having higher dividend yields. The high free cash flow yield on the portfolio (at 10.0%, versus 3.3% for the broad index) gives the manager reassurance on the sustainability of dividends. It is worth noting that the index earnings growth forecasts are based on consensus numbers, and that the high expectations for earnings growth in the broad index over the next 12 months may reflect the recent share price momentum of a handful of heavily backed mega-cap tech stocks as much as it does their real underlying growth prospects.

Rather than simply relying on consensus forecasts, the HFEL team looks for the possibility of dividend surprises. Examples of such surprises since the onset of the pandemic (albeit based on FY19 earnings) include China Mobile (+31% versus expectations), China Resources Cement (+23%), Citic Securities (+11%) and Telekomunikasi Indonesia (+37%).

Portfolio turnover in FY20 was c 119%, which was somewhat higher than the typical c 70–90% range. All holdings are assigned a target price and are usually sold once this is reached. The team uses option-writing to enhance income and may write a call option on a stock that is nearing its target price.

Current portfolio positioning

At 31 October 2020 there were 44 holdings in HFEL's portfolio, a slight decrease from 46 a year earlier. Concentration was up somewhat, with 34.0% of assets in the top 10 holdings, compared with 30.4% at 31 October 2019. In geographical terms (Exhibit 4), the biggest change in weighting over the past 12 months has been a 5.9pp increase in China, where the managers added positions in China Railway Construction and China Resources Cement (both plays on increased infrastructure spending) during the course of FY20. Hong Kong saw an increase of a similar magnitude (+5.7pp), while Australia – probably the worst hit market in the region in terms of COVID-19 driven dividend cuts – saw the biggest decline in exposure, down 5.5pp. Singapore (where the property sector has been affected by rent holidays), and Thailand, which is heavily exposed to tourism (c 20% of GDP) both saw their weightings in the portfolio fall by 3.2pp over the year to 31 October. Versus the broad Asia-Pacific index, HFEL remains very underweight China (-12.9pp) and overweight Singapore (where the 7.5% exposure is more than three times the index weight) and Hong Kong (+4.8pp).

Exhibit 4: Portfolio geographic exposure vs broad Asia-Pacific index (% unless stated)

	Portfolio end-October 2020	Portfolio end-October 2019	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
China	26.5	20.6	5.9	39.4	(12.9)	0.7
Taiwan	14.4	14.6	(0.2)	11.8	2.6	1.2
Australia	13.0	18.5	(5.5)	14.2	(1.2)	0.9
Hong Kong	11.7	6.0	5.7	6.9	4.8	1.7
South Korea	11.3	10.2	1.1	10.7	0.6	1.1
Singapore	7.5	10.7	(3.2)	2.3	5.2	3.3
Thailand	5.5	8.7	(3.2)	1.8	3.7	3.1
New Zealand	2.7	2.3	0.4	0.7	2.0	3.9
United States	2.6	N/S	N/A	0.0	2.6	N/A
United Kingdom	2.4	2.2	0.2	0.0	2.4	N/A
Indonesia	N/S	4.3	N/A	1.2	N/A	N/A
Other	2.4	1.9	0.5	11.0	(8.6)	0.2
	100.0	**100.0**		**100.0**		

Source: Henderson Far East Income, Edison Investment Research

Kerley says he and Duhra have been navigating the pandemic by focusing mainly on domestic names. 'Export growth has been okay but not sustained, and while intra-regional trade is likely to be buoyant, you can't rely on consumer exports to the West to support growth in the next couple of years or more,' he explains.

In sector terms (Exhibit 5), while HFEL's largest absolute exposure, at more than a third of the portfolio, is in financials (also one of the biggest relative weights at +10.3pp versus the index), the manager says this reflects a preference for diversified financials and real estate rather than banks: 'At the moment, we are suffering a bit in the value bounce as we don't own [many] banks and haven't since the start of February.' (The exceptions to this are two state-owned banks in China, and Australian investment bank Macquarie Group.) On the whole, he says, this has been the right thing to do, 'but it means we missed the recent rally in banks'. In order for the managers to feel comfortable owning banks, Kerley says they would need to see compelling evidence of an economic recovery. 'Legacy non-performing loans are having an impact in some countries, and flat yield curves in the rest of the world mean banks are struggling with their net interest margins. They were undoubtedly oversold, but I am not sure how sustainable the bounce is,' he opines.

Exhibit 5: Portfolio sector exposure vs broad Asia Pacific index (% unless stated)

	Portfolio end-October 2020	Portfolio end-October 2019	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	34.5	36.9	(2.4)	24.2	10.3	1.4
Technology	13.9	11.9	2.0	22.9	(9.0)	0.6
Telecommunications	12.8	15.0	(2.2)	2.1	10.7	6.1
Industrials	10.8	8.2	2.6	8.6	2.2	1.3
Consumer goods	10.7	10.5	0.2	9.3	1.4	1.1
Basic materials	7.0	4.7	2.2	5.4	1.5	1.3
Consumer services	5.1	2.9	2.2	16.5	(11.4)	0.3
Utilities	4.1	4.1	(0.0)	2.3	1.8	1.8
Oil & gas	1.3	5.9	(4.6)	3.3	(1.9)	0.4
Healthcare	0.0	0.0	0.0	5.4	(5.4)	0.0
	100.0	**100.0**		**100.0**		

Source: Henderson Far East Income, Edison Investment Research

Instead of banks, financial holdings in the HFEL portfolio include insurers like AIA and Ping An in China (to which the managers have been adding as they have not participated in the recent rebound), brokerages such as Citic Securities in China, 'and we are still very keen on property'. Kerley explains that real assets tend to outperform in a low interest rate environment, when returns on financial assets such as bonds and cash are not particularly attractive.

'In terms of our property exposure, rent holidays in Singapore have been tough, especially in those REITs exposed to retail and offices,' he says. 'We came out of CapitaLand Malls Trust in March and we now own three Singapore REITs, two of which are industrial. We think the recovery from COVID-19 will be focused on manufacturing and keeping jobs, and it will be some time before we see any measures to boost consumption, so manufacturing will return quicker.' The manager adds that the other Singapore REIT is focused on logistics, which is a beneficiary in terms of online deliveries and warehousing. Retail-exposed property names in Australia have also been sold, although HFEL retains a holding in an office REIT (Dexus), which Kerley says is mainly focused on Sydney and Melbourne, where office demand is likely to hold up better than in other cities.

The gloomy outlook for areas such as travel and leisure means that consumer services is currently the biggest underweight (-11.4pp versus the index), although the absolute weight has actually increased over the past year (+2.2pp). Technology is both the second largest absolute weight and the second largest underweight (-9.0pp), reflecting both the broad opportunity set (particularly in hardware and components) in the region and the fact that the index is dominated by low- or non-yielding internet stocks trading at inflated valuations. 'The structural story is still there for these companies but they have got ahead of themselves in valuation terms', says Kerley. Telecoms – a stalwart of yield-focused portfolios given the sector's defensive income characteristics – is the biggest overweight (10.7pp) versus the index, and the third largest absolute weight, although it has seen a 2.2pp fall in exposure over the past year, partly as a result of poor performance from Telekomunikasi Indonesia.

Basic materials is a relatively small weighting at 7.0%, and also a small overweight (+1.5pp), but has been a particular area of focus for the managers over the past year, with new holdings added in

China Resources Cement and Australian firm Fortescue Metals, and additions to established positions in Rio Tinto and BHP.

Performance: Market focus on growth dents returns

Exhibit 6: Five-year discrete performance data

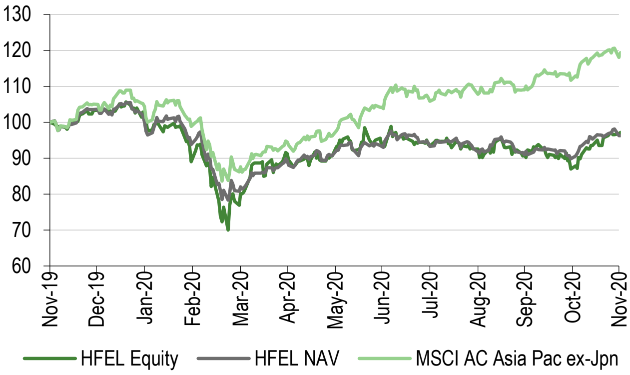
12 months ending	Share price (%)	NAV (%)	MSCI AC Asia Pac ex-Japan (%)	MSCI AC Asia Pac ex-Japan HDY (%)	CBOE UK All Companies (%)
30/11/16	28.0	27.5	30.8	32.1	9.9
30/11/17	16.8	14.2	21.6	14.2	13.7
30/11/18	(2.7)	(1.9)	(2.9)	2.4	(1.8)
30/11/19	10.1	11.0	8.3	3.8	11.3
30/11/20	(3.2)	(3.7)	18.0	1.1	(11.2)

Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

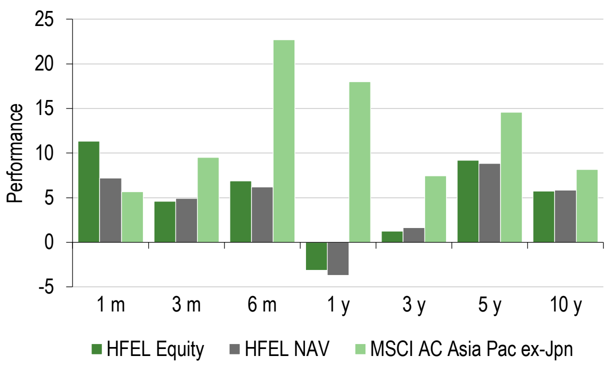
HFEL has struggled in both relative and absolute performance terms over the course of the COVID-19 pandemic so far, posting an NAV total return decline of -9.9% in FY20 (to 31 August) and -3.7% over 12 months to 30 November. The broad Asia-Pacific market (represented here by the MSCI AC Asia Pacific ex-Japan Index), buoyed by the strong performance of Chinese internet stocks, gained 7.9% in total return terms in the year ended 31 August 2020, and 18.0% over 12 months to 30 November. In such a strong rebound for growth stocks (particularly over the last six months, as shown in Exhibit 7), it is unsurprising that HFEL's value-tilted income approach lagged; however, the trust also somewhat underperformed the MSCI AC Asia Pacific ex-Japan High Dividend Yield Index over both FY20 and the year to end-November. The sharp rotation towards value stocks on the back of positive COVID-19 vaccine news benefited HFEL's performance in November, with share price and NAV total returns of 11.3% and 7.2% respectively outstripping the broad index's 5.7% gain.

Exhibit 7: Investment trust performance to 30 November 2020

Price, NAV and index total return performance, one-year rebased



Price, NAV and index total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

During FY20, the top contributor to HFEL's performance was Taiwan Semiconductor Manufacturing Company (TSMC). Kerley points out that while this company is a popular holding for Asian income investors, HFEL probably has a smaller position than most, given its focus on higher-yielding names. 'TSMC's share price has gone up so much this year that the yield has gone from 4.0% to 2.3%,' he explains, adding that the trust's sell discipline ('there is a price for everything') means he has taken the position down from c 5.0% earlier in the year to 3.7% at end-October 2020, although it remains HFEL's third largest holding. Samsung Electronics – which also made a small positive contribution to returns over the year to 31 August – is now the largest position; Kerley says that compared with TSMC, it is 'much more of a value proposition, but it hasn't done as well'. Most of the other top contributors to performance come from the basic materials space, particularly iron ore (BHP, Rio Tinto, Fortescue Metals) and cement (China Resources Cement and Taiwan Cement). Materials stocks have been buoyed by the infrastructure focus of government COVID-19 stimulus packages around the world, yet Kerley notes that many of these names still have attractive yields. 'Iron ore has gone from $70 to $120 a tonne, so the miners have lots of excess free cash, and I wouldn't be surprised to see special dividends from BHP and Rio next year,' he says.

The impact of the 10 biggest detractors from total return performance during FY20 (costing 9.15pp) more than offset the 8.52pp added by the top 10 contributors. The list of detractors was dominated by banks and property stocks, which have been among the areas worst affected by the pandemic.

While option-writing made a small (-20bp) negative contribution to total returns in FY20 (because of the opportunity cost of selling stocks that subsequently made further gains), the widespread market volatility meant option premiums were high, and the trust benefited from this in revenue terms. Of particular note was a position the managers took in Chinese internet giant Tencent, a holding that Kerley would normally view as 'cheating' for an income fund given its tiny (c 0.2%) yield. The manager says: 'For us to own a low-yielding stock it must meet our usual investment criteria of valuation, cash flow generation and the potential of yield. When the first two criteria are met, we may use derivatives to manufacture a yield, allowing us to tick all three boxes. This happens infrequently.' When Tencent's share price went from HK$450 to HK$330 in March, Kerley and Duhra bought a small position. 'It was c 1.5% of the portfolio and we wrote a put option against 1% at HK$450, and because volatility was through the roof we got a 5% premium,' Kerley explains. 'We bought at HK$350, sold at HK$450, and took a 9% yield, so added quite a lot in terms of income.' Although the stock subsequently rose to more than HK$600, the manager says HFEL's valuation criteria 'made the sell point obvious. We were writing calls on Tencent and TSMC when their share prices were rising, but we would have sold the stocks anyway,' he adds.

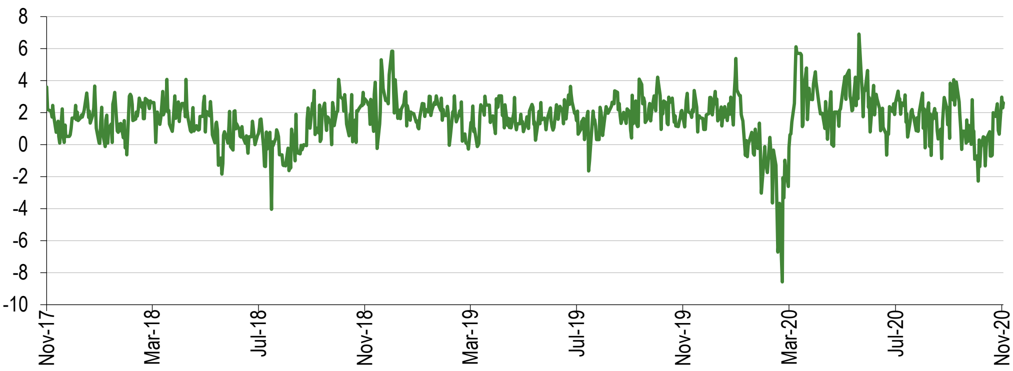
Exhibit 8: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to MSCI AC Asia Pac ex-Jpn	5.4	(4.5)	(12.9)	(17.9)	(16.4)	(21.4)	(20.2)
NAV rela to MSCI AC Asia Pac ex-Jpn	1.4	(4.2)	(13.5)	(18.4)	(15.4)	(22.6)	(19.5)
Price relative to MSCI AC Asia Pac ex-Jpn HDY	1.8	(4.6)	(3.3)	(4.2)	(3.5)	(4.3)	(5.5)
NAV relative to MSCI AC Asia Pac ex-Jpn HDY	(2.0)	(4.3)	(3.9)	(4.7)	(2.3)	(5.8)	(4.7)
Price relative to CBOE UK All Cos	(2.0)	(2.2)	(0.1)	9.1	6.8	27.8	(1.1)
NAV relative to CBOE UK All Cos	(5.6)	(1.9)	(0.7)	8.5	8.1	25.8	(0.2)
Price relative to MSCI AC World	2.3	(1.8)	(5.8)	(13.5)	(22.2)	(19.9)	(42.2)
NAV relative to MSCI AC World	(1.5)	(1.5)	(6.4)	(14.0)	(21.3)	(21.1)	(41.7)

Source: Refinitiv, Edison Investment Research. Note: Data to end-November 2020. Geometric calculation.

Discount: Back at a small premium after volatile spell

Exhibit 9: Share price premium/discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

At 2 December 2020, HFEL's shares traded at a 2.6% premium to cum-income NAV. As shown in Exhibit 9, the shares have traded more or less consistently above par over the past three years, with the exception (in common with most investment trusts) of a swift downward spike in March 2020 at the height of the coronavirus-driven global equity market sell-off, culminating in a three-year widest discount to NAV of 8.6% on 23 March. The bounce back was even swifter, with the shares reaching a c 6% premium to NAV in early April before powering on to reach a 10-year high premium of 6.9% in June. Since then the rating has settled back into its normal range of par to a small premium, albeit with a little more volatility in the rating than hitherto. The board continues to issue shares at a premium in order to meet demand, although so far this year there have been four months (March, May, August and September) when no shares were issued. The current premium to NAV is higher than the one-, three-, five- and 10-year averages (1.6%, 1.6%, 0.9% and 1.0% respectively).

Capital structure and fees

HFEL was set up as a Jersey-based closed-end investment company in 2006, and while it retains its Jersey corporate structure, during FY19 it moved its tax residence to the UK and joined the investment trust regime. It has one class of share, with 142.3m shares in issue at 2 December 2020. In order to manage a discount or a premium, HFEL's board has the authority to repurchase up to 14.99% or allot up to 10% of the trust's share capital each year. During FY20, 10.8m shares (8.3% of the share base at the start of the year) were issued at a premium to NAV, raising £37.3m, and 830k shares have been allotted since the start of FY21 (1 September 2020), raising a further £2.6m. The trust is theoretically permitted to use gearing up to 30% of gross assets, although its £50m multicurrency bank loan facility is equivalent to only 10% of gross assets, and is currently undrawn. Gearing tends to be used sparingly in practice, and has ranged from 2.0% net cash (September 2020) to 3.0% net gearing (December 2019 and February 2020) over the past 12 months, averaging 0.8% geared.

The trust pays its alternative investment manager (AIFM), Henderson Investment Funds, an annual management fee of 0.90% of net assets up to £400m and 0.75% thereafter, with no performance fee payable. Ongoing charges for FY20 were 1.08%, a 3bp reduction from 1.11% in FY19 despite net assets falling by 9.2% over the year.

Dividend policy and record

Since its launch in 2006, HFEL has paid quarterly dividends in February, May, August and November. Total dividends have increased every year, growing at a compound annual rate of 3.7% over the five years to FY20, and have always been fully covered by income. This is an unusual achievement in respect of FY20, given the impact of COVID-19 on company dividends around the world, and the fact that many investment trusts have had to draw on their reserves in order to maintain or grow their own dividends. While Kerley points out that many of the dividends HFEL received during the year were based on FY19 (pre-pandemic) earnings, he says the forecast decline for 2020 dividends across the region (including Australia, which has probably seen the worst of the cuts) is only c 5%, compared with c 40% for the UK market. The fact that HFEL's FY20 revenue return per share (23.71p) was higher (albeit marginally) than the 23.38p for FY19 is partly attributable to a 49.5% increase in option premium income, as the manager took advantage of volatile market conditions. The consistent record of a fully covered and growing dividend is all the more impressive given significant growth in the share base (10.8m shares issued during FY20). Just under £1m was added to the revenue reserve, which stood at £25.9m at 31 August 2020, equivalent to 0.8x the total FY20 dividend of 23.0p. Based on the current share price and the FY20 total dividend, HFEL has a very attractive yield of 7.2%.

Peer group comparison

HFEL is a member of the Association of Investment Companies' Asia Pacific Income sector. While three of the funds in the peer group (HFEL, Aberdeen Asian Income Fund and Schroder Oriental Income) specifically aim to generate an income from their investments, with capital appreciation being a secondary objective, the fourth, JPMorgan Asia Growth & Income (JAGI), invests mainly for capital growth and pays a set percentage of its NAV to shareholders as a quarterly 'income'. In a year when market returns have been dominated by high-growth but low-yielding technology stocks, it is clear to see that HFEL, which has always favoured higher-yielding investments alongside those with dividend growth potential, is not flattered by the comparison to JAGI, which has nearly 20% of its portfolio in Chinese internet stocks Alibaba and Tencent. In NAV total return terms, HFEL ranks last in the group of four over one, three, five and 10 years, reflecting the recent dominance of the quality/growth and momentum investment factors at the expense of value and income. However, the fact that the trust continues to trade at a premium to NAV (currently the second highest in the group) suggests that its shareholders continue to value its chart-topping 7.2% dividend yield in a world where yields on other asset classes continue to sink to new lows. HFEL is currently ungeared and, while it has the joint highest ongoing charges in the group, it does not pay a performance fee.

Exhibit 10: AIC Asia Pacific Income sector at 1 December 2020*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
Henderson Far East Income	**455.1**	**(3.7)**	**4.9**	**52.8**	**76.3**	**1.08**	**No**	**2.5**	**100**	**7.2**
Aberdeen Asian Income Fund	369.2	9.6	14.7	71.4	119.5	1.08	No	(11.1)	110	4.4
JPMorgan Asia Growth & Income	444.1	20.0	30.1	123.2	119.8	0.74	No	3.2	100	3.3
Schroder Oriental Income	670.8	9.5	17.6	73.8	159.6	0.87	Yes	(4.6)	105	4.1
Sector average (4 funds)	**484.8**	**8.9**	**16.9**	**80.3**	**118.8**	**0.94**		**(2.5)**	**104**	**4.8**
HFEL rank in sector	**2**	**4**	**4**	**4**	**4**	**1=**		**2**	**3**	**1**

Source: Morningstar, Edison Investment Research. Note: *Performance to 30 November 2020 based on cum-fair NAV. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

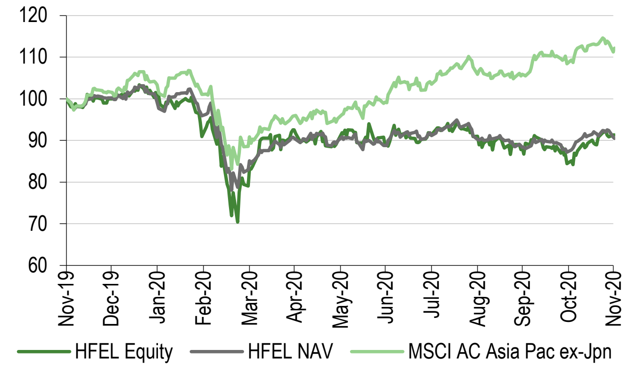
There are five directors on HFEL's board, all non-executive and independent of the manager. Chairman John Russell served on the board of HFEL's predecessor, HFEL Trust, before the launch of the new fund in 2006. David Mashiter has also been a director of HFEL since 2006. Julia Chapman was appointed in 2015, while, Nicholas George, who chairs the audit committee, became a director in 2016. The newest director, Tim Clissold, joined the board in 2018. The directors have professional backgrounds in financial services, in many cases including direct experience of the Asia-Pacific region.

Having previously indicated that Mashiter would retire during 2020 and Russell would step down in 2021, the board has put succession plans on hold as a result of the COVID-19 pandemic, preferring to keep its two most experienced directors in place to help navigate the current period of uncertainty. An update on the timing of succession planning is expected during FY21.

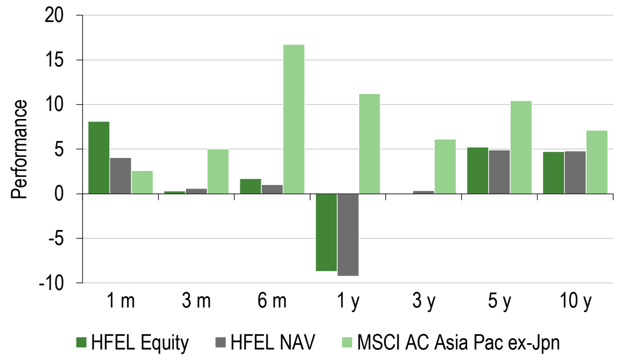
Performance tables in New Zealand dollar terms

Exhibit 11: Investment trust performance – in New Zealand dollar terms to 30 November 2020

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

HFEL's main listing is on the London Stock Exchange, but its shares are also listed on the New Zealand Stock Exchange so that shareholders there can trade more easily and receive dividends in New Zealand dollars. In Exhibits 11 and 12 we present the trust's performance and that of the broad Asia Pacific ex-Japan index in NZ dollar terms. A strengthening in the NZ dollar since the height of the pandemic fears in March has limited gains (or increased losses) for New Zealand investors over periods of one year and less, although long-term returns remain broadly similar to (albeit a little lower than) those experienced by sterling investors (Exhibit 7).

Exhibit 12: Investment trust discrete years' performance in New Zealand dollar terms

12 months ending	Share price (%)	NAV (%)	MSCI AC Asia Pac ex-Japan (%)	MSCI AC Asia Pac ex-Japan HDY (%)	CBOE UK All Companies (%)
30/11/16	(1.2)	(1.6)	0.9	2.0	(15.3)
30/11/17	30.7	27.7	36.1	27.8	26.8
30/11/18	(8.4)	(7.6)	(8.6)	(3.5)	(7.2)
30/11/19	19.5	20.5	17.5	12.6	20.4
30/11/20	(8.7)	(9.2)	11.2	(4.7)	(15.4)

Source: Refinitiv. Note: Total return basis, in NZ dollar terms.

Frankfurt +49 (0)69 78 8076 960	London +44 (0)20 3077 5700	New York +1 646 653 7026	Sydney +61 (0)2 8249 8342
Schumannstrasse 34b	280 High Holborn	1185 Avenue of the Americas	Level 4, Office 1205
60325 Frankfurt	London, WC1V 7EE	3rd Floor, New York, NY 10036	95 Pitt Street, Sydney
Germany	United Kingdom	United States of America	NSW 2000, Australia