Pacific Assets Trust

Strong performer with a sustainable focus

Investment trusts

Pacific Assets Trust (PAC) is unusual among its peers because of its sustainability-based investment process. Although not a narrow 'green' or 'ethical' fund, it seeks long-term absolute returns from well-governed companies in Asia (excluding Japan and Australasia) that both benefit from and contribute to the sustainable development of the region. Managed by First State Stewart under the current process since July 2010, the trust has produced a strong performance and is second in its peer group of 15 for NAV total return over one and three years and fifth since moving to First State (NAV TR +70.1% versus weighted peer group average of 59.9%). After a period of strong performance for Asian equities, PAC has taken some profits and currently has a relatively high cash weighting (c 8%) as it awaits more compelling valuations for its favoured stocks.

12 months ending	Share price (%)	NAV (%)	MSCI AC Asia ex-Japan (%)	MSCI World (%)	FTSE All-Share (%)
31/08/11	10.0	5.4	3.7	8.6	7.3
31/08/12	7.6	12.5	(0.3)	11.5	10.2
31/08/13	22.3	12.5	10.1	21.5	18.9
31/08/14	18.7	20.5	13.2	13.4	10.3

Source: Thomson Datastream. Note: Total return basis.

Investment strategy: In pursuit of sustainability

First State Stewart adopts a sustainability-based approach to managing PAC, seeking to identify companies that are particularly well-positioned to benefit from, and contribute to, the sustainable development of the countries in which they operate. The management team, based in Scotland and Asia, is looking for quality companies that can provide attractive long-term risk-adjusted returns, and as well as rigorous on-the-ground assessment of the management, the franchise and the financials before investing, the team will continue to engage actively with holdings on governance and sustainability issues.

Outlook: Strong recovery raises valuation questions

The past six months have seen Asian equities recover strongly after a period of underperformance versus world markets. Investors seem to have put off fears over China's adjustment to a lower growth rate, and have enthusiastically greeted the new government in India, driving the main Sensex Index up more than 30% year-to-date. Valuations in some Asian markets (as measured by forward price/earnings ratios) have begun to look a little stretched relative to history, although the aggregate Asia ex-Japan forward P/E is in line with its 10-year average, in contrast to the global aggregate, which is 16% higher than the long-term average.

Valuation: Stable in spite of strong performance

At 11 September PAC's shares traded on a 4.6% discount to cum-income net asset value, only slightly narrower than the one-year average in spite of producing a net asset value total return of 20.2% since our last update in March 2014. The discount is narrower than the averages over three and five years (8.0% and 8.1%) and also narrower than the peer group average of 6.1%.

12 September 2014

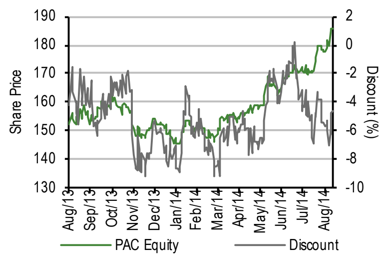
Price	**186p**
Market cap	**£217m**
AUM	**£224m**

NAV*	191.6p
Discount to NAV*	2.9%
NAV**	195.0p
Discount to NAV**	4.6%
Yield	1.4%

*Excluding income. **Including income. Data at 11 September 2014.

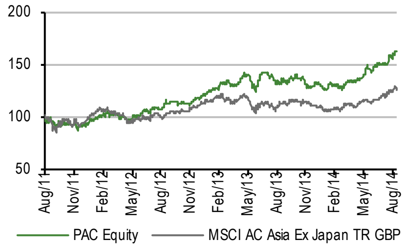
Ordinary shares in issue	116.9m
Code	PAC
Primary exchange	LSE
AIC sector	Asia Pacific – ex-Japan

Share price/discount performance*



*Including income. Positive values indicate a premium; negative values indicate a discount.

Three-year cumulative perf. graph



52-week high/low	186.0p	145.4p
NAV* high/low	194.9p	154.7p

*Excluding income.

Gearing (31 July 2014)

Gross	0%
Net	-8.3%

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Edison profile page

Pacific Assets Trust is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

Pacific Assets Trust (PAC) aims to achieve long-term capital growth through investment in selected companies in the Asia-Pacific region and the Indian sub-continent, but excluding Japan, Australia and New Zealand. Up to 20% of total assets may be invested in companies incorporated and/or listed outside the region if economic activities are predominantly within the region. The limit for a single investment is 7.5% of total assets at the time of investment. The benchmark is the MSCI AC Asia ex-Japan Index (total return, sterling adjusted).

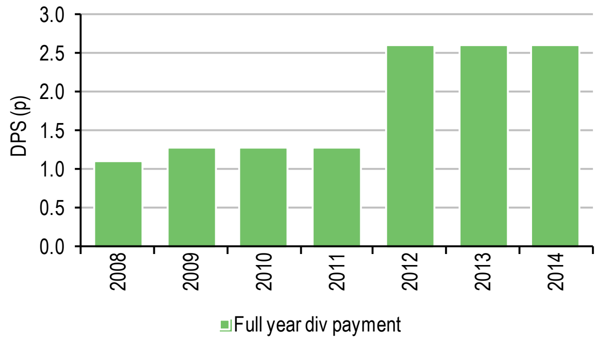
Recent developments

- 24 June 2014: All resolutions approved at AGM including payment of 2.6p annual dividend. Richard Horlick retires as a director.
- 20 June 2014: Interim management statement for the three months ended 30 April. NAV TR +6.6% compared with +5.0% for benchmark.

Forthcoming		Capital structure and fees		Fund details	
AGM	June 2015	Ongoing charges	1.3%	Group	Frostrow Capital LLP
Half-year results	September 2014	Net gearing	-8.3%	Manager	First State Stewart
Year end	31 January	Annual mgmt fee	0.75% of NAV +0.20% of mkt cap	Address	25 Southampton Buildings, London, WC2A 1AL
Dividends paid	June	Performance fee	Yes (see page 7)		
Launch date	January 1985	Trust life	Indefinite	Phone	+44 (0)20 3008 4910
Continuation vote	No	Loan facilities	None currently	Website	www.pacific-assets.co.uk

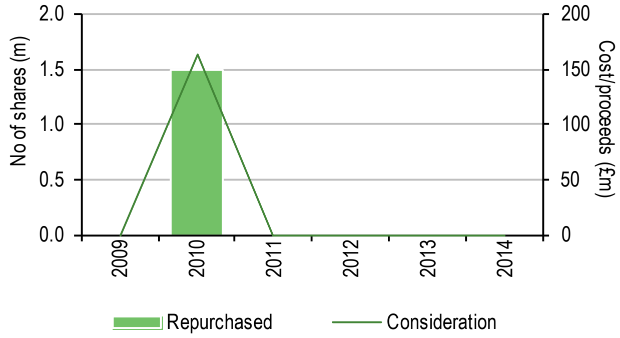
Dividend policy and history

An annual dividend is paid in June. PAC is focused on capital growth. Income generation is secondary and dividends are likely to fluctuate.

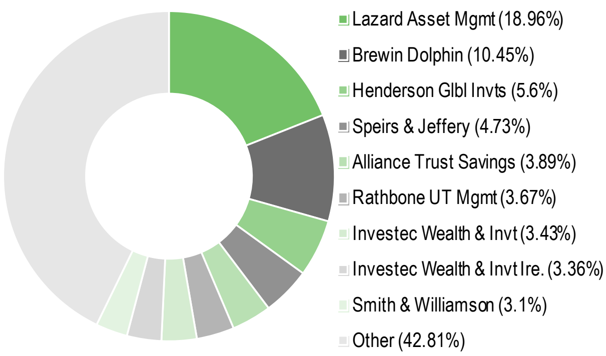


Share buyback policy and history

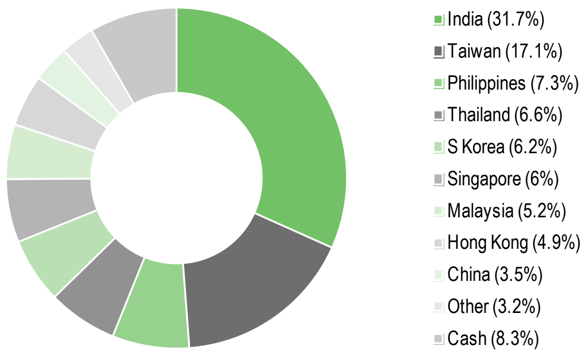
The board has a repurchase authority (14.99%), which it has not used since July 2010. New shares up to 10% of shares in issue may be allotted.



Shareholder base (as at 8 September 2014)



Geographical allocation of portfolio (as at 31 July 2014)



Top 10 holdings (as at 31 July 2014)

			Portfolio weight %		Active weight %
Company	**Country**	**Sector**	**31 July 2014**	**31 January 2014***	**31 Jul 2014**
Marico	India	Consumer Staples	5.8	5.3	5.8
Tech Mahindra	India	Information Technology	5.7	6.3	5.6
Taiwan Semiconductor Mfrg	Taiwan	Information Technology	3.8	3.8	0.7
Dabur India	India	Consumer Staples	3.8	3.5	3.8
Public Bank Bhd	Malaysia	Financials	3.4	3.3	2.9
Standard Food Corp	Taiwan	Consumer Staples	3.4	4.0	3.4
Delta Electronics (Thailand)	Thailand	Information Technology	3.4	3.2	3.4
Idea Cellular	India	Telecom Services	3.3	n/a	3.2
Kasikornbank	Thailand	Financials	3.2	n/a	3.0
E.Sun Financial Holdings	Taiwan	Financials	3.2	3.1	3.1
Top 10			**39**	**39.3**	

Source: Pacific Assets Trust, Morningstar, Bloomberg, Edison Investment Research. Note: *N/A where not in top 10 at end-January 2014.

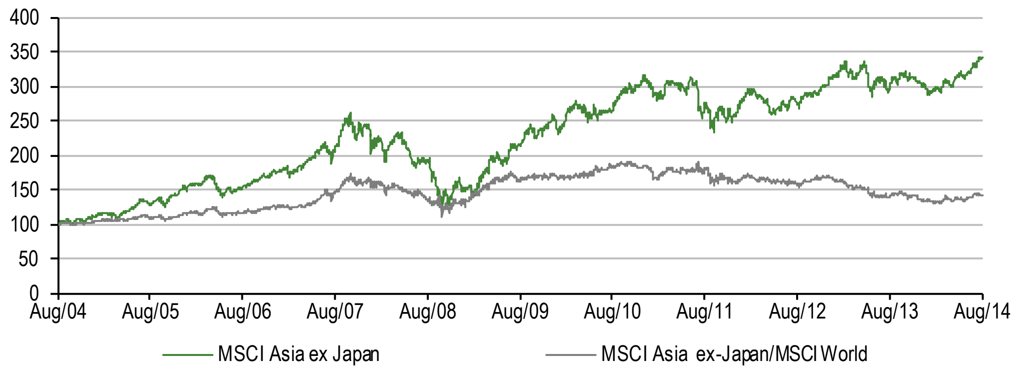
Market outlook: Clouds ahead after Indian summer?

Asian markets have enjoyed a sunny summer, driven to some degree by the landslide election victory of Narendra Modi's Bharatiya Janata Party (BJP). The main Indian market index, the BSE Sensex, is up 30.9% year-to-date (to 8 September) compared with a 9.7% rise for the MSCI AC Asia ex-Japan index (of which India represents c 9%) over the same period.

While stability under the military government in Thailand, election victory for a reform-orientated candidate in Indonesia and a lessening of tension between China and Vietnam have also provided some investor comfort, increased fears over property bubbles in Singapore and Hong Kong, and worries over bad debts in the Chinese banking system could prove headwinds. The end of QE in the US may unsettle markets, although Japan and Europe have taken up the baton to a degree.

As shown in Exhibit 2, Asian markets have performed strongly since the financial crisis, although returns relative to the MSCI World Index (the grey line) were more muted from late 2011 until early 2014. Evidence on valuations is mixed; while the forward P/E ratio for Asia ex-Japan as a whole is in line with its 10-year average, India is 14% above average, with Indonesia, Thailand and the Philippines 18%, 28% and 31% higher. These numbers should be seen in light of developed market valuations, however; the World index forward P/E is 16% higher than the 10-year average, with the US and UK respectively 19% and 22% higher. In such conditions, an approach that focuses on not overpaying for growth prospects could serve investors well over the longer term.

Exhibit 2: MSCI AC Asia ex-Japan Index, and relative to the MSCI World Index



Source: Thomson Datastream. Note: MSCI Asia ex-Japan Index is trust benchmark. TR in £ terms.

Fund profile: Long-term growth with social conscience

Pacific Assets Trust was launched in 1985 and has been managed since July 2010 by Edinburgh-based First State Investments, whose specialist Asian and emerging markets team rebranded as First State Stewart in 2012. The team managing PAC focuses on achieving attractive long-term, risk-adjusted returns by investing in companies that both contribute to and benefit from the sustainable development of the countries in which they operate.

The fund manager: First State Stewart

The manager's view: Keeping a close eye on valuations

With the QE printing presses still running in many regions and liquidity searching for a home, Asian equities have performed well and some good-quality companies are now quite expensive. As a result senior investment manager David Gait has adjusted some of the positioning in the PAC portfolio, taking profits in companies where valuations are beginning to look stretched.

Gait says he and the First State team are concerned about the impact of short-termism on financial markets, pointing out that the gains seen in the past few years are not necessarily representative of long-term returns. Cash levels in the portfolio are higher now than six months ago, 8.3% at 31 July compared with 5.8% at 31 January. Gait says while the team are not trying to time the market, they have a shopping list of companies they would like to own and an idea of what they would like to pay for them, so any correction could see new holdings bought if valuations begin to look more favourable.

The team has certain biases but regularly challenges these. First State recently commissioned a study of the steel and aluminium sectors, which Gait says was interesting but ultimately did not overcome his three main issues with resources companies: the impact on returns of external price pressures, the dominance of state-owned companies where minority shareholders' interests may not be paramount, and the increased likelihood of environmental, social and governance problems.

First State does not hedge currency exposure, but as a result will tend to screen out companies with currency mismatches – such as local currency revenues but dollar-denominated debt – as these are more exposed to foreign exchange movements.

Asset allocation

Investment process: Focus on sustainable development

PAC is managed with a focus on sustainable development – not as an 'ethical' or 'green' fund, but as one that seeks to invest in companies that can benefit from addressing the development challenges facing the whole world, not just Asia. These challenges include population pressure, land and water scarcity, poverty and inequality, and resource constraints. To meet these challenges, First State Stewart believes the world's focus needs to shift away from debt-driven and resource-hungry consumption growth and development, and towards a more genuinely sustainable path.

The investment team seeks to be a responsible steward of clients' capital, and looks to invest in companies that will act in a like capacity over the long term, while also contributing to sustainable development. Examples include Taiwanese firm Standard Foods, formed out of the local operation of Quaker Oats and well-placed to provide healthier eating options to a region where more Western diets are leading to a huge rise in cases of diabetes; and Hindustan Unilever, which is supporting local shopkeepers in rural India while benefiting from the growth in the personal-care market by selling items like shampoo and toothpaste in affordable small sizes. First State actively engages with its holdings to ensure adherence to its principles of sustainability and good governance.

PAC's seven-strong fund management team is part of the 33-person Asian equities team at First State Stewart. Team members are based in Edinburgh, Singapore and Hong Kong. There are no set geographical or sector responsibilities within the management team, so all potential investments can be debated and challenged by the whole team. The research process seeks to identify quality companies with sound growth prospects. Quality is determined by assessing the management, the franchise and the financials, as well as sustainability performance and positioning. Sustainability is seen as a key defining factor of quality, and an important contributor to future growth.

Investment decisions are made with a five-year time horizon, and with a focus on absolute returns rather than performance or positioning relative to a benchmark. Risk is defined as the possibility of losing money, and the managers pay as much attention to potential downside as to upside. Because sustainability is seen as a key driver of returns, it follows that risks to sustainability are a potential source of loss, and First State Stewart sees the identification of long-term sustainability risks as extremely important in overall risk management.

Holdings may be sold if there is a change in the investment case, if there are governance issues or the long-term growth outlook deteriorates, but in most cases exits from the portfolio are valuation-driven; the team is disciplined about selling stocks that have reached their long-term fair value.

Current portfolio positioning

At 31 July PAC had 54 holdings – a shorter stock list than the weighted average of 66 holdings for the AIC Asia Pacific ex-Japan peer group. Its portfolio was also more concentrated than the average trust, with the top 10 holdings accounting for 39% of the portfolio (33% for the peer group).

The trust's absolute return focus and sustainability-based process mean its portfolio bears little resemblance to the benchmark. The large overweight in consumer staples reflects the presence of firms like Marico (personal care products), Dabur India (Ayurvedic medicine) and Standard Foods in the top 10 holdings. Gait comments that consumer companies tend to attract hard-working, entrepreneurial management teams with a long-term view, and the fact that consumer products must be demonstrably safe and of acceptable quality is a good indicator of sustainability. Financials are the largest sector in absolute terms but also the largest relative underweight, in part reflecting the presence of real estate companies in the financials category (property development is fraught with sustainability risks, both political and environmental, as well as being vulnerable to market cycles), and in part because of a reduction in Singapore banks, an area of concern given exposure both to the uncertain Chinese banking system and the overheating local property market.

Exhibit 3: Sector analysis as at 30 June 2014

	Trust weight (%)	Benchmark* weight (%)	Trust active weight (percentage points)	Trust weight/ benchmark weight
Consumer staples	21.0	5.3	15.7	4.0
Telecom services	10.2	6.0	4.2	1.7
Utilities	6.4	4.1	2.3	1.6
Healthcare	2.5	1.5	1.0	1.7
Industrials	9.6	8.8	0.8	1.1
Materials	1.6	5.5	-3.9	0.3
Info technology	16.8	22.0	-5.2	0.8
Energy	0.0	6.0	-6.0	0.0
Consumer discretionary	2.2	10.1	-7.9	0.2
Financials	22.7	30.8	-8.1	0.7
Cash	7.0	0.0	7.0	n/a
Total	**100.0**	**100.0**		

Source: Pacific Assets Trust, Edison Investment Research. Ranked by active weight. Note: *Benchmark = MSCI AC Asia ex-Japan. Rounding errors mean some figures may not sum.

The exposure to India has risen from an already high level over the past six months and is now nearly 32%. This is partly as a result of performance – Indian stocks have rallied hard so far in 2014 following the election victory for Narendra Modi's BJP – although Gait says PAC's Indian holdings were largely unmoved by the result, which mainly benefited companies involved in infrastructure. However, the team also finds more of the kinds of companies it likes in India than elsewhere; while some areas may suffer from corruption and political interference, there are many long-established, family-run companies that have the quality and sustainability characteristics First State seeks.

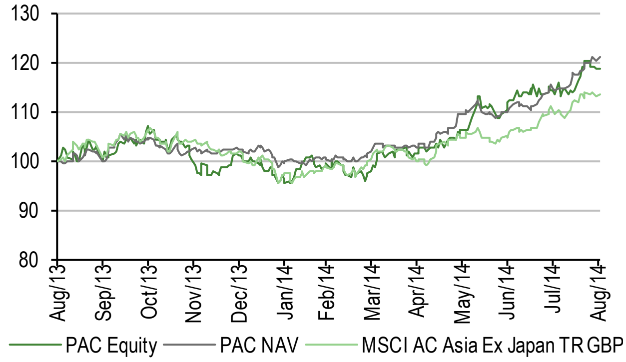
The portfolio remains defensively positioned. Strong performance from Asian companies has seen valuations increase, and the team has trimmed holdings in many of the more expensive companies. As a result the cash weighting has drifted up to c 8%, as the managers await buying opportunities.

In recent months, Indian IT company Infosys and Chinese consumer goods firm Uni-President have been sold, while a new position has been taken in Indian logistics firm Container Corp, the only state-owned enterprise in the portfolio. Holdings have been topped up in Kansai Nerolac Paints – an indirect play on expected Indian infrastructure investment, and deemed to have a sound environmental approach – and Idea Cellular, an Indian mobile phone company. The team sees the mobile phone as an empowering device, enabling, for example, farmers in isolated communities to keep up with the price of produce in the wider market.

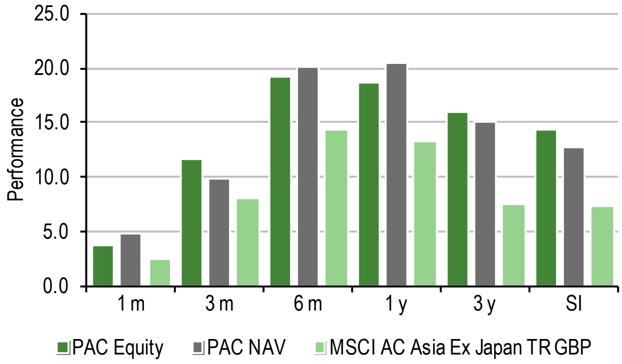
Performance: Beating benchmark over all periods

Exhibit 4: Investment trust performance

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



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: *Managed by First State Stewart from 1 July 2010. Three-year and since-managed (SI) figures are annualised.

Exhibit 5: Share price and NAV total return performance, relative to benchmarks (%)

	One month	Three months	Six months	One year	Three year	First State*
Price relative to MSCI AC Asia ex Japan	1.4	3.2	4.3	4.8	25.7	31.0
NAV relative to MSCI AC Asia ex Japan	2.4	1.6	5.1	6.5	22.8	23.4
Price relative to MSCI World	(0.1)	7.9	11.6	4.7	1.7	2.1
NAV relative to MSCI World	0.9	6.1	12.4	6.3	(0.6)	(3.8)
Price relative to FTSE All Share	1.6	11.0	17.6	7.6	8.1	3.7
NAV relative to FTSE All Share	2.7	9.2	18.5	9.2	5.6	(2.3)

Source: Thomson Datastream, Edison Investment Research. Data to end-August 2014. Geometric calculation.

Four years into its management by First State, PAC has beaten its MSCI AC Asia ex-Japan benchmark in both share price and NAV total return terms over all the time periods shown in Exhibits 4 and 5, going back to the manager's appointment in July 2010. Over five years it has also noticeably outperformed, although it lags the index in NAV terms over 10 years. The outperformance in part reflects a very strong past six months for the portfolio and Asian markets in general; the index total return of 14.7% in the six months to the end of August is in sharp contrast to the -1% total return for the period from end-August 2013 to end-February 2014.

As can be seen in Exhibit 6, PAC has outperformed the index significantly over five years in NAV terms, but not without setbacks. Some of the most notable outperformance has come when index returns have been negative – for instance, from the end of February to the end of August 2012, PAC's NAV total return was +8.0% while the index return was -6.8%, and between end-February and end-July 2013 PAC produced a total return of 2.3% while the index return declined 5.2%.

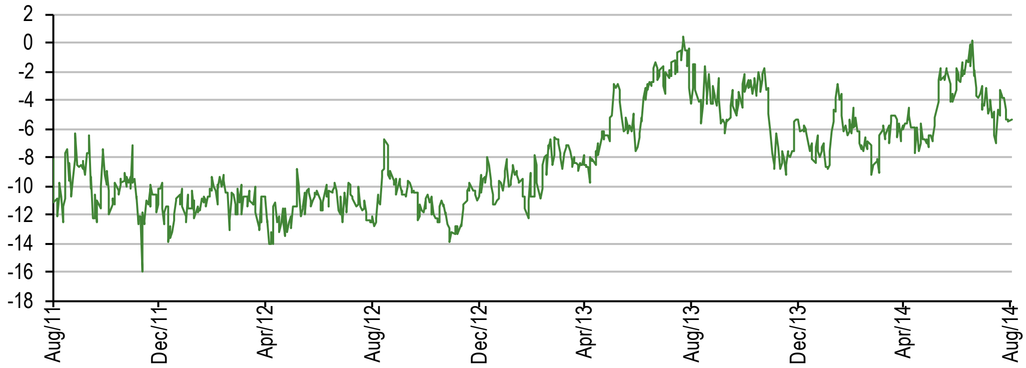
Exhibit 6: NAV performance relative to benchmark over five years

Source: Thomson Datastream, Edison Investment Research

Discount: In line with one-year average

At 1 September PAC's shares traded at a 4.6% discount to cum-income NAV. This is broadly in line with the one-year average of 5.2%, although during this period the discount has ranged between 9.2% in March and a premium of 0.2% in July 2014. Over three and five years the average discount is wider, at c 8%, having reached a five-year high of 15.9% in December 2011. While the board has the authority to buy back up to 14.99% of the issued share capital, there is no formal discount control mechanism and no buybacks have taken place since July 2010.

Exhibit 7: Discount over three years (NAV at fair including income)



Source: Thomson Datastream, Edison Investment Research.

Capital structure and fees

Pacific Assets Trust has an indefinite life and has one class of share, with 116.9m shares currently in issue. In contrast to many investment trusts, PAC has elected to become its own alternative investment fund manager under the EU Alternative Investment Fund Management Directive (AIFMD), with which all trusts had to comply by July 2014. This means it can reduce costs by not having to appoint a depositary. However, it does also mean the trust will no longer be permitted to use gearing. In practice this should have little impact since PAC has not been geared under its current manager; indeed, its net cash position of 8.3% at 31 July is the highest in a peer group where the average trust is 2.2% geared. The board is willing to reconsider the AIFM position should First State wish to institute a geared position; however, the manager has previously said he would only consider using gearing in periods of significant market distress.

First State Stewart receives a management fee of 0.75% on net assets and a performance fee of 12.5% of any annual outperformance in excess of 1.75% over the benchmark. The performance fee is measured on a rolling three-year basis and total fees payable in a year are capped at 1.75% of the average asset value during the year. Ongoing charges for the year ended 31 January 2014 were 1.3% excluding or 2.0% including performance fee (FY13 1.3% or 1.7% including performance fee). Company secretarial, administrative (including AIFM risk management support) and marketing services are provided by Frostrow Capital, which charges an annual fee of 0.2% of PAC's market capitalisation.

Dividend policy

PAC pays dividends annually in June, although its objective is to achieve capital growth and income is a secondary consideration. The dividend of 2.6p per share for the year ended 31 January 2014 was unchanged on a year before and was partly uncovered by earnings (2.5p per share), necessitating a small transfer from the revenue reserve. However, the reserve is sufficient to cover more than two years' dividends at the current level.

EDISON

Peer group comparison

There are 14 trusts with at least a one-year track record in the AIC Asia Pacific ex-Japan sector. PAC has the second-highest NAV total return over one and three years, and ranks fifth over five years. In terms of risk-adjusted performance as measured by the Sharpe ratio, PAC is fourth over one year and second over three years. It has the second-highest net cash position in a sector where most trusts are geared. Its discount is slightly below the weighted average for the sector, although the average is arguably skewed by three large income-focused trusts trading at a premium; excluding these the average cum-fair discount is 8.9%. Charges are in line with the sector average, although PAC is one of only four trusts with a performance fee. PAC's 1.4% yield ranks it mid-table but below the weighted average of 2.1% (1.2% excluding the income trusts).

Exhibit 8: Asia ex-Japan investment trusts

% unless stated	Market cap £m	TR one year	TR three years	TR five years	Ongoing charge	Perf. fee	Discount(-) /Premium	Net gearing	Yield	Sharpe NAV 1 yr	Sharpe NAV 3 yrs
Pacific Assets Trust	**210.9**	**21.2**	**55.3**	**98.8**	**1.2**	**Yes**	**-5.7**	**92.0**	**1.4**	**0.7**	**0.9**
Aberdeen Asian Income	412.1	7.1	43.3	112.3	1.2	No	1.4	104.0	3.7	-0.2	0.7
Aberdeen Asian Smaller	370.6	12.2	60.0	194.2	1.2	No	-3.0	109.0	1.0	-0.1	0.9
Aberdeen New Dawn	232.9	12.2	26.9	85.1	1.1	No	-9.7	106.0	1.9	0.0	0.3
Asian Total Return Inv Company	142.0	12.5	13.3	44.6	0.8	Yes	-6.4	99.0	1.7	0.0	0.0
Edinburgh Dragon	547.9	12.8	28.4	82.4	1.2	No	-10.5	108.0	0.8	-0.1	0.4
Fidelity Asian Values	162.6	20.4	34.9	85.3	1.6	No	-12.5	110.0	0.5	1.0	0.4
Henderson Far East Income	365.1	12.2	38.0	66.1	1.3	No	0.4	105.0	5.0	0.3	0.5
Invesco Asia	171.1	24.7	35.8	85.4	1.1	No	-10.7	106.0	1.8	1.2	0.4
JPMorgan Asian	212.6	11.6	13.7	42.8	0.8	Yes	-12.4	101.0	1.2	0.4	0.0
Martin Currie Pacific	116.2	5.1	20.9	42.4	1.3	No	-13.8	94.0	2.3	-0.3	0.2
Pacific Horizon	131.3	20.8	31.8	65.4	1.2	No	-11.6	102.0	0.8	0.9	0.4
Schroder Asia Pacific	458.5	16.5	38.9	96.8	1.1	No	-11.1	99.0	1.2	0.3	0.5
Schroder Oriental Income	438.6	11.5	48.0	129.0	1.0	Yes	0.8	101.0	3.7	0.3	0.8
Scottish Oriental Smaller Cos	274.6	15.5	53.8	158.4	1.0	Yes	-4.2	86.0	1.3	0.4	0.7
Sector weighted average		**13.7**	**38.7**	**101.3**	**1.1**		**-6.1**	**102.2**	**2.1**	**0.2**	**0.5**
PAC rank in sector	**10**	**2**	**2**	**5**	**4**		**6**	**14**	**8**	**4**	**2**

Source: Morningstar 4 September 2014. Notes: TR = total return. TER = total expense ratio or last ongoing charge. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is shown here as total assets less cash/cash equivalents as a percentage of shareholders' funds.

The board

The board has four members: David Nichol (a director since launch in 1985 and chairman since 2004), Nigel Rich (since 1997), Terence Mahony (2004) and James Williams (2013). Richard Horlick retired as a director in June 2014. All the current board members have lived and worked in Asia.

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