# Fidelity Asian Values

**FAS's unique positioning could offer investors diversification benefits...**

Update
01 August 2024

## Overview

Nitin Bajaj and Ajinkya Dhavale, co-managers of Fidelity Asian Values (FAS), aim to provide investors a unique portfolio of smaller-cap equities from across Asia. They look to differentiate the trust by using a bottom-up benchmark agnostic approach to identify potential stocks, combined with a strong valuation discipline. This has contributed to a portfolio that is significantly differentiated from the benchmark and most other vehicles investing in the region. This has contributed to outperformance over the long term.

Ajinkya has recently been promoted to co-manager, having previously been Nitin's assistant manager since 2020 (see **Management**).

FAS' differentiation is best exemplified by Nitin and Ajinkya's current 'anti-tech' positioning, based on the belief that valuations are too high as a consequence of momentum rather than quality driving share prices. In contrast, the managers are significantly overweight China, an allocation that has recently been increased and refocused on the domestic consumption story (see **Portfolio**).

The trust's **Gearing** level, while still modest, remains above historical averages. Fidelity's house style is to use derivatives instead of traditional borrowing facilities which also allows the managers to take short positions in stocks they believe will fall. As at 31/05/2024, net exposure was 107.7% and gross exposure 114.3%, both figures being somewhat above their long-term averages.

Another unique feature of FAS is the variable management fee (see **Charges**). This is designed to align the interests of the manager with investors, by changing the fee depending on performance relative to the benchmark. Should the trust underperform, the charges are reduced, and vice versa for outperformance.

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## Analyst's View

Asian small caps are an overlooked asset class that we think can act as a portfolio diversifier. However, FAS has taken these diversification benefits even further through managers Nitin and Ajinkya's benchmark agnostic approach and strong value discipline, which leads to a highly differentiated portfolio from the wider market and peers.

We believe this is particularly apparent in the current positioning (see **Portfolio**). Whilst a number of industry commentators have highlighted elevated valuations following the run up in the tech sector, few have taken such an explicit stance as Nitin and Ajinkya in their 'anti-tech' positioning. As such, we believe FAS could offer diversification benefits to a wider portfolio by being used as a complementary holding alongside those with a tech bias, or India-focussed vehicles, which the managers believe is a consensus, momentum-driven trade that is also overvalued.

Instead, the managers have focussed on the Chinese domestic consumption story which is available on much lower valuations and offers a significant margin of safety. They believe this provides the trust with optionality – if they are wrong, much of the downside is already priced in, but if they are right, there is significant upside on offer (see **Performance**). The trust's **Gearing** could also add to the upside potential.

This potential could be further enhanced by the trust's **Discount**, which is currently wide versus its own history. We believe this could offer long-term investors an attractive entry point. Furthermore, the board has begun share buy-backs which we believe is an indication the board believes there is value at the current discount level.

| BULL |
| --- |
| Portfolio offers considerable diversification benefits from the index and peers |
| Stock selection has led to outperformance over the long term |
| Unique charging structure looks to align the interests of the manager and shareholders |

| BEAR |
| --- |
| Gearing can amplify downside as well as upside |
| Trust is overweight the under-pressure Chinese consumer |
| Weakness in near-term performance has dragged down long-term relative returns |

# Portfolio

Fidelity Asian Values (FAS) owns a portfolio of predominantly small-cap equities from across the Asian region. Long-standing manager Nitin Bajaj has recently been joined by Ajinkya Dhavale, who has been working on the trust since June 2020 before being promoted to co-manager in February 2024. Nitin and Ajinkya will continue to take a bottom-up approach to identifying potential holdings, with a value-orientated mindset.

The managers' philosophy is to identify good businesses rather than just good stocks. As such, they focus on those with easy-to-understand business models, managed by experienced and honest management teams and trading at attractive valuations that offer a margin of safety. The managers have significant freedom in portfolio construction, with sector and country weightings determined by where they are finding the best opportunities from a portfolio of between 100 and 200 holdings. The formal benchmark is the MSCI AC Asia ex Japan Small Cap Index, though the managers are agnostic to this when selecting ideas, as can be seen in the high active weights of the top ten holdings.

## Top Ten Holdings

| HOLDING | COUNTRY | FAS % | INDEX % |
|---|---|---|---|
| Axis Bank | India | 3.0 | 0.0 |
| Bank Negara | Indonesia | 2.6 | 0.0 |
| LIC Housing Finance | India | 2.6 | 0.3 |
| HDFC Bank | India | 2.5 | 0.0 |
| Genpact | United States | 2.5 | 0.0 |
| Indofood CBP Sukses | Indonesia | 2.5 | 0.0 |
| KT Corporation | South Korea | 2.2 | 0.0 |
| BOC Aviation | China | 2.1 | 0.0 |
| Federal Bank | India | 2.0 | 0.3 |
| TSMC | Taiwan | 2.0 | 0.0 |
| **Total** | | **24.0** | **0.6** |

Source: Fidelity, as at 30/06/2024

To identify these companies, and to gain an informational edge, Nitin and Ajinkya use the strength and depth of Fidelity's sizeable analyst team which we have detailed in **our previous note**.

In that note, we also described the overweight allocation to China as a result of the valuation focus. This has increased further, with the country now a 30.1% weight as at 30/06/2024 up from 29.9% at the end of 2023. The benchmark weight is 9.9%. This has been driven by stock specific factors rather than a macro call. The managers have found many good businesses trading on attractive valuations, having experienced temporary earnings weakness. They believe that sentiment is at a historic low but can reverse. They point to China being the world's second largest economy despite going through a prolonged slowdown, as well as being a major component of global supply chains as supporting factors. Furthermore, the government has been encouraging an increase in dividend payouts and share buybacks which should support markets.

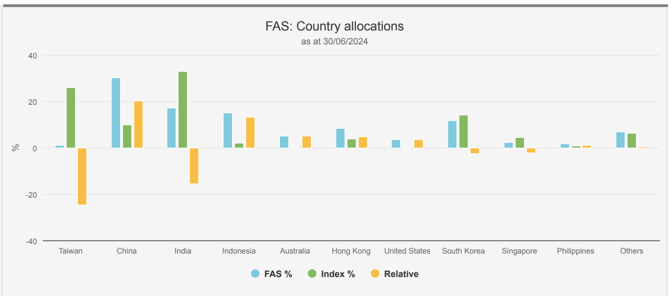
Within China, Nitin and Ajinkya have been rotating exposure into companies with greater exposure to domestic consumption, and away from export-led businesses to help reduce the trust's exposure to external factors and to capture attractive valuations.

For instance, the managers hold Yihai International, the largest condiment producer for Chinese soup-based hot pot cuisine that can be prepared both at home and is popular in the restaurant segment as well. It is the main supplier of soup bases for Haidilao, a leading Chinese hot pot restaurant chain that relies on Yihai for nearly 80% of its domestic demand. The managers highlight that this firm has executed well, and its fortunes are unlikely to be affected by a China–US trade war.

Nitin and Ajinkya like the prospects of select Chinese pharmacies as they believe the sector is set to benefit from government support to move prescription drug sales from hospitals as part of a broader healthcare push to increase accessibility to pharmacy chains that have a wide footprint. They have also added good quality property services providers. Whilst the broader property sector is still struggling, the managers believe these firms will continue to benefit from ongoing maintenance of existing properties. They point to them being asset light businesses with contractual revenues as positives, as well as being available at attractive valuations, including offering good dividend yields.

The managers have reduced the likes of China Hongqiao, an aluminium producer. As we discuss in **Performance**, this firm has performed well, and the managers have begun taking profits to rotate into better value ideas elsewhere.

## Fig.1: Country Allocations




Source: Fidelity

The rotation into domestic consumption names has been a drag in the short term though, but the managers believe the valuations are too compelling to ignore and maintain their significant overweight to China.

The significant underweight to Taiwan is a standout allocation. This comes from the managers' belief that the shares of very few companies currently offer value. This has been particularly true in the tech sector and has led to the managers adopting an 'anti-tech' positioning. In their view, valuations are being driven by momentum rather than quality. The managers have sold down all of their memory exposure and are significantly underweight tech which is a big portion of Taiwan. However, the managers still own TSMC, an off-benchmark position that has performed well.

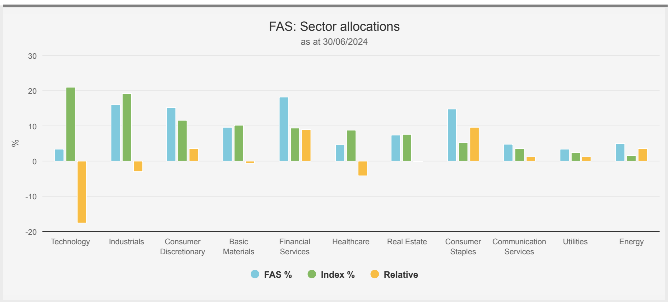
Nitin and Ajinkya are underweight India which they believe is very overvalued. One exception is the financial sector, particularly banks. This has been a fairly consistent position as they believe it is one of the few areas of value in the country. Furthermore, they continue to hold PTC India, the largest power trading company in the country.

In contrast, Indonesia is a significant overweight. The managers believe the country exhibits similar traits to India in that it has a young, populous workforce and a government focussed on reform. However, they note that valuations in Indonesia are more attractive and have identified several opportunities. Banks are one, further contributing to the financial sector overweight, though consumer staples are also in favour, with strong franchises among preferred positions. The managers have taken exposure to noodle makers, tiles and nappies. Collectively, this has contributed to an overweight allocation in Indonesia of c. 13%.

Nitin and Ajinkya have narrowed their Korea underweight in the past year. They believe the government's push for governance reform could be encouraging if it yields positive outcomes from Korean corporates. The managers have taken positions in Korean stocks where there is considerable margin of safety built into current valuations to limit the downside, but there is potential for gains if their management teams improve the shareholder outcomes they deliver.

The chart below shows sector allocations. As a result of finding good value in financial firms, particularly banks, this is one of the largest overweights. Technology is a significant underweight due to the managers' anti-tech view. We believe this means FAS offers significantly differentiated exposure to the wider peer group, including the large-cap sector.

### Fig.2: Sector Allocations




Source: Fidelity

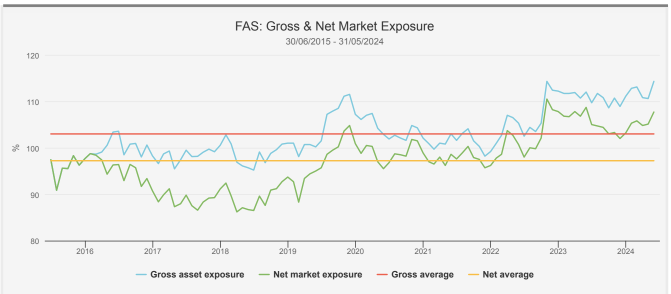
## Gearing

The managers believe that the selective use of gearing can enhance long-term capital growth. However, rather than a traditional borrowing facility, additional exposure is taken through derivatives, such as contracts for difference (CFDs). These are financial instruments that allow the managers to take more exposure than the amount invested, hence acting as gearing without the traditional borrowing facilities. They also allow Nitin and Ajinkya to take short positions to benefit from a fall in share prices. This is a strategy Fidelity uses across their investment trust range, which they argue is a more efficient and flexible form of gearing. It also allows for specific gearing on individual stocks, rather than for gearing to be applied across the whole portfolio.

The level of exposure taken will depend on the number of valuation opportunities Nitin and Ajinkya identify. Should the managers find a large number of stocks they like, they will increase the level of gearing, whereas this will lower should there be fewer ideas. The formal policy allows for a maximum gross exposure of 40% of NAV, consisting of a 10% maximum in short and 30% in long positions, though the board has set a goal of net market exposure to be between 90% and 115%.

The level of market exposure has increased slightly in 2024, with gross market exposure at 114.3% as at the end of May, compared to 111.1% at the beginning of the year. The May figure consists of long exposure of 111%, and

### Fig.3: Gearing



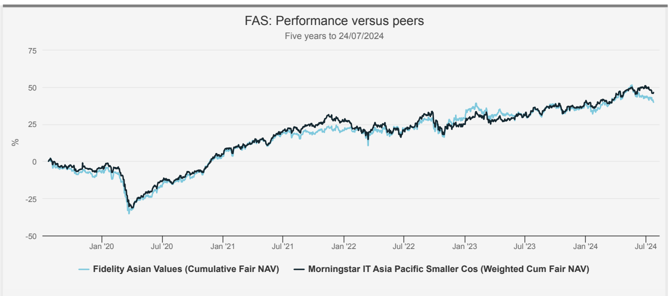

Source: Fidelity

short positions of 3.3%. This is notably above the average level seen over Nitin's management tenure of c. 103% and above the five-year average of 106.3%. We understand this is to take advantage of the significant number of opportunities in China. However, the managers are conscious of the risks of this exposure and are therefore unlikely to add further. The gearing would likely have a significant impact on relative performance should a recovery in China come to fruition.

## Performance

Whilst there have been many periods where FAS has outperformed its benchmark, the MSCI AC Asia ex Japan Small Cap Index, during Nitin's tenure, and good returns in absolute terms, a pull-back in the near-term numbers has led to underperformance over five years, with FAS having returned 39.7% to 24/07/2024 versus the benchmark of 58.6%. The managers' benchmark agnostic approach means that stock selection will be the primary driver of performance and, as we discuss later, the overweight position in China and underweight in India as a result of the valuations on offer, has been a headwind. Whilst Ajinkya has recently become co-manager (see **Management**), the process has remained the same. The managers are supported by the strength and depth of the analyst team at Fidelity which provides research from on-the-ground specialists. This is particularly beneficial in smaller companies when research is often limited and therefore stock pricing is inefficient. The manager's valuation bias will also have an impact on relative performance which we have detailed in our **previous note**. We have shown the long-term performance of FAS in the chart below versus the three-strong peer group, all of which have also struggled versus the benchmark in this period.

### Fig.4: Five-Year Performance




Source: Morningstar

***Past performance is not a reliable indicator of future results.***

Stock selection has had a significant impact on near-term performance too. There have been a number of positive contributions from off benchmark positions, with one example being TSMC. Despite being a large cap, the managers have taken advantage of the flexibility in the process to hold the stock. As such, the position has delivered significant alpha due to strong performance, adding 61 basis points in the year to 31/05/2024. SK Hynix was similarly beneficial, though this has since been sold in line with Nitin and Ajinkya's valuation discipline. Both firms have been beneficiaries of the increased demand in AI-related computing and therefore seen a boost to earnings. We believe these are good examples of the managers' flexibility, as they are able to invest in companies with good growth opportunities which may not feature in the benchmark, but can still deliver alpha.

Another example is China Hongqiao, an aluminium producer which has performed particularly well. This has helped offset some of the weaker outcomes from China. In line with the managers' valuation discipline approach, they have begun to take profits from China Hongqiao following its strong performance.

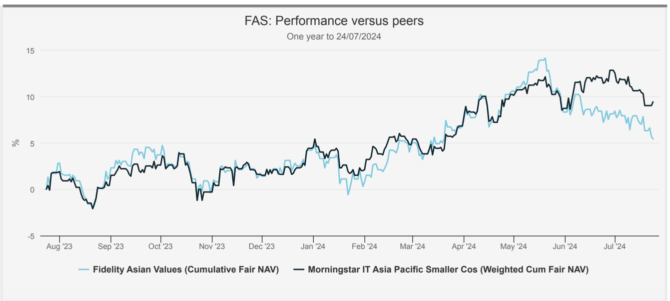
Whilst stock selection has provided positive attribution, asset allocation has been a drag more recently. As we have discussed in Portfolio, Nitin and Ajinkya select stocks purely from the bottom up and based on where they see value. This has led to an underweight in India as the managers have struggled to find good value opportunities. This has detracted 2.4% from returns in the year to 31/05/2024, though this notably eased in the final three months of the period, only detracting 0.4%.

In contrast, the managers are overweight China. Whilst over 12 months to 31/05/2024, China has detracted 1.3% from performance, the final three months saw a positive contribution of 1.7%, making China the biggest positive contributor on a country basis in the period.

Indonesia has been an area of weakness. The managers point to the fall in the Indonesian rupiah as the primary factor hurting sentiment towards domestic stocks, though they maintain conviction in the long-term prospects for their holdings.

Whilst FAS has had good periods of performance over the long term, the managers' near-term positioning has seen the trust experience a more challenging period recently, having returned 5.4% versus the benchmark return of 14.7% over the 12 months to 24/07/2024. Reassuringly, stock selection, the primary factor behind long-term returns has continued to contribute positively over the year, adding 11.4% to the end of May 2024. However, this hasn't been enough to offset the asset allocation which detracted 17.5%. Despite this, the managers believe that eventually investors will move on from being negative on China and recognise the value that exists in the market. They are positioned for this potential recovery, in contrast to many peers, and we believe they are well placed to outperform should this come to pass.

### Fig.5: One-Year Performance




Source: Morningstar

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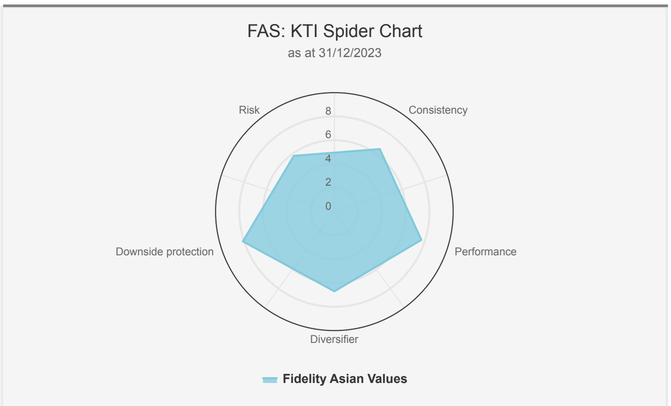
Our proprietary KTI Spider Chart is shown below. This shows how FAS has performed versus a wider peer group of 13 investment trusts from the Asia Pacific region over the past five years, in some key categories. Each category is scored out of ten and scores are normalised to the peer group, with a higher score indicating a superior characteristic. FAS scores above average on all scores. The highest score is for downside protection as a result of significantly above average scores for both downside capture and the trust's worst five-month period. The score for performance is also significantly above average due to the high alpha generated over the five-year period. We note that this includes a wider peer group containing large-cap and equity income trusts. The diversifier score has been driven by lower-than-average correlation versus a bond index and the benchmark, which we would attribute to the value style and benchmark agnostic approach. The above average score for consistency is a result of a higher-than-average hit rate. The risk score is FAS' lowest though is still above average in comparison to the peer group. We believe this is particularly impressive considering the predominantly larger-cap peer group. This has been helped by a superior score for volatility.

### Fig.6: KTI Spider Chart




Source: Morningstar, calculations by Kepler

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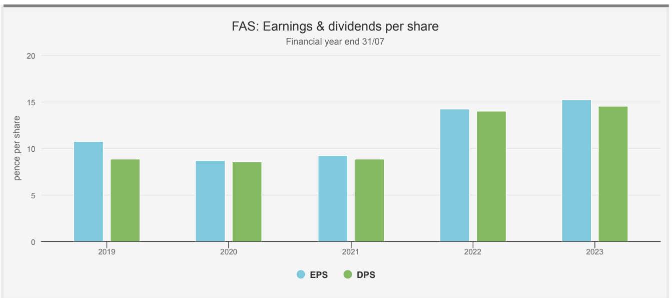
# Dividend

Whilst it doesn't have an income objective, FAS has a track record of paying a modest dividend. This is an outcome of the managers' approach of looking for undervalued opportunities, which often leads to higher yielding stocks. Nitin and Ajinkya also look for companies that have good free cash flow and robust balance sheets, both of which are typical characteristics of dividend paying firms. The managers treat a stock's yield as a comfort factor, rather than the primary reason to invest, meaning dividends are likely to be a small part of the total return of the trust.

The trust's most recent annual divided, paid in November 2023, was 14.5p per share. This was fully covered by revenue. This equates to a yield of c. 2.9% based on the current share price making FAS the highest yielder amongst smaller companies peers. The revenue reserves, as at the date of the interim report on 31/01/2024, were the equivalent of 11.3p per share, though this was only two months after the dividend was paid, therefore we expect these to be higher by the financial year end in July. This should provide good dividend cover going forward.

We believe the dividend should be seen by investors as an additional positive of the trust as the managers' focus is primarily on capital growth. We would caution investors against relying on it as a significant part of total returns.

### Fig.7: EPS & DPS




Source: Fidelity

# Management

Nitin Bajaj is the portfolio manager of FAS, having taken over management in April 2015. Nitin has been at Fidelity since 2003, where he started out in the London office as a research analyst before becoming assistant portfolio manager for the Fidelity Global Special Situations fund, one of the most well-known open-ended funds in the UK. In 2009, he moved to Mumbai to take over management of Fidelity's domestic Indian equity funds, before moving to Singapore in 2013 to assume management of FAS, as well as the open-ended version Fidelity Asian Smaller Companies. Nitin is a chartered accountant, as well as a holder of a Bachelor of Commerce degree from the University of Delhi and an MBA from INSEAD.

He is joined on the trust by co-portfolio manager Ajinkya Dhavale, who is also based in Singapore. Ajinkya has been working on the trust since June 2020 and was promoted to co-manager in February 2024. Prior to this, he was an analyst covering small-cap equities, with a particular focus on Korea and Taiwan, as well as the technology sector. Ajinkya is a chartered accountant as well as a CFA charterholder and holds a Bachelor of Commerce degree from the University of Pune.

The managers have access to the wider Fidelity research teams across Asia, including offices in Hong Kong, Shanghai and Singapore. This is one of the largest on-the-ground research teams in the sector and includes specialist teams for IPOs and shorting, of which Nitin is one of the analysts. Despite this wide shared resource, each portfolio manager is allowed to undertake their own investment style. Nitin has a bias towards value investing, although he still has a strong focus on quality.

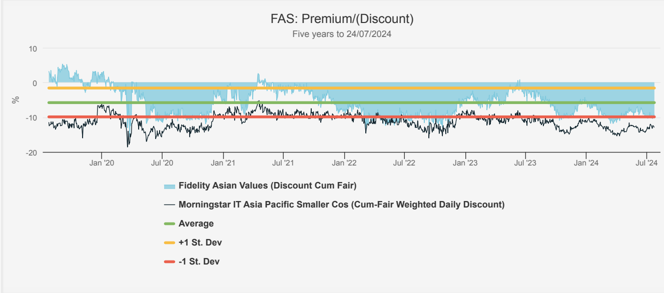
# Discount

The discount on the shares of FAS has widened to c. 10% as at 24/07/2024, compared to a five-year average of 5.8%. The discount has been particularly volatile in the past year or so, having traded at NAV as recently as June 2023 before widening out to a double-digit discount a number of times in 2024. We believe this volatility could provide a good entry point for long-term investors.

Furthermore, FAS has typically traded at a narrower rating than the weighted average of the peer group in the past five years, at an average difference of 5.4 percentage points. However, this figure has notably reduced in the past few months, with the most recent figure, as at 24/07/2024, standing at just 2.9 percentage points. We believe this adds further weight to the discount being a potential opportunity at the current level.

The board has begun buying back shares, with the first buybacks since November 2022 occurring from October 2023 onwards. In total, c. 724k have been bought back since, with the most recent being on 19/07/2024. Whilst this amount isn't significant (c. 1.0% of the initial share count) we believe it does indicate support from the board and could help lessen the discount volatility. Furthermore, any shares bought back at a discount are accretive to NAV.

**Fig.8: Discount**




Source: Morningstar

# Charges

One of the standout features of FAS, in our opinion, is the unique charging structure where management fees can vary depending on relative performance. We believe this creates further incentive for the managers to outperform, though also reduces fees should they underperform.

The approach starts with a base management fee of 0.7% of net assets, though up to 0.2% can be added or taken away based on NAV performance relative to the trust's benchmark. This is calculated daily and based on three-year rolling performance. For each percentage of outperformance, 0.033% is added to the management fee, to a maximum of 0.2%, with the inverse for any underperformance.

The most recently published OCF was 0.96% as at 31/05/2024 which compares to a weighted average for the sector of 0.94% according to figures by JPMorgan Cazenove as at 03/07/2024, although this group only consists of three trusts including FAS. The KID RIY is 1.47% versus a sector average of 1.48%, though we would caution that calculation methodologies may vary.

# ESG

The consideration of environmental, social and governance (ESG) risks is integrated into the stock analysis across the Fidelity business. They are considered alongside the fundamental analysis performed on each company by the analyst within each investment team and given a proprietary score called the Fidelity Proprietary Sustainability Rating, which has been in place since 2019. This incorporates factors from 99 individual and unique subsectors.

The managers cite ESG risks as one of the key characteristics to look for when determining whether a potential holding is a good business, rather than simply a good stock. Whilst all factors are considered, governance is paramount. They believe that the quality and conviction of management teams is vital to the investment case and this analysis has been part of the process for a considerable time. They believe that in smaller companies, the influence of management teams is particularly important, hence the strong focus in FAS. Environmental and social issues are now more formally incorporated into the process since the implementation of the new model and are driven by the managers' belief in the stewardship of investors' capital. They are conscious of the nuances of the Asian market when considering the proprietary ratings derived by the analysts, which they use alongside the fundamental scoring, although they are not driven by these scores. It is true that those companies with poorer ratings are often those that are detractors to the portfolio, but a low score does not preclude investment. One factor he does consider is engagement. If a management team are willing to engage in order to address issues that the analyst identifies, this is looked upon favourably.

Morningstar rate the trust as 'below average' for ESG, scoring the trust as only one out of five globes on their sustainability rating. We note though that the portfolio is only c. 87% covered by Morningstar. This means that a notable percentage of the portfolio will be given no score for sustainability factors which might bring the score down.

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