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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. To mark the start of Chinese New Year - the year of Water Rabbit - we're focusing our attention on Asian equity markets in this special bonus episode. Richard Sennitt from Schroders joins us to explain what's gone wrong with Chinese equities, their future and where he's finding income opportunities today in Asia. Throughout the interview, Richard discusses Asia from the perspective of an investor looking to generate an income and, unless otherwise specified, all fund positioning will relate to the Schroder Asian Income fund.

Sam Slator (SS): I'm Sam Slator from FundCalibre. And today I've been joined by Richard Sennitt who manages the Elite Rated Schroder Asian Income fund, Schroder Asian Alpha Plus fund, and the Schroder Oriental Income Trust. Thank you for joining us today, Richard.

Richard Sennitt (RS): Well, thank you very much for having me.

[INTERVIEW]

SS: So, maybe we could start with China - because Chinese New Year's just around the corner - it's the biggest economy in the region; it's been previously billed as the world's engine for growth, but with underperforming markets in the last 12 months, what's gone wrong? Why has it performed so poorly?

RS: Yes, it's certainly been a very tough year for the Chinese markets, where China really has been under pressure based - not only from cyclical reasons, but also structural ones.

So, if you look at the last two years, we've seen an increased backdrop of regulation for a lot of the private sector companies. And that's included those names in the internet sector, in particular. And this increased focus on regulation, and actually more of a focus I guess, on the social prosperity agenda, has impacted the potential returns of some of these companies in the eyes of the market and that has seen some of these companies derate.

At the same time, we've also seen an increase in geopolitical tensions around Taiwan and between the US and China, which has also obviously depressed sentiment.

From a sort of cyclical perspective, so more short-term, I think that one of the areas where there has been quite a slowdown has been in the property sector, which has been well documented and, because that makes up roughly sort of 25% of the economy, that has obviously led to concerns that economic growth would continue to slow down.

More recently, we've seen sort of some stimulatory measures on that front to try and improve the outlook for the property sector and certainly the chances of a tail-risk event there have diminished, in my view, although we would expect the property sector to remain relatively weak for some time.

The other thing of course, which has been much more topical more recently, has been the impact of zero-Covid policy on the economy. Obviously, as Omicron came to the fore at the beginning of last year, that zero-Covid policy became harder and harder to enforce, and that resulted in a lot of lockdowns, which obviously impacted economic growth quite meaningfully, and saw the markets under pressure again from that side of things. So, in short, yes, the year of the tiger was definitely a difficult year for Chinese markets.

SS: With all that in mind, what's your view on China today and does that change the way you've positioned your funds at all?

RS: Well, the biggest change we've seen over the last few weeks of course has been the rapid movement of opening up and away from zero-Covid policy. The speed at which this has occurred has been a surprise I think, not only to us, but to many, given how tightly sort of the zero-Covid policy had been managed previous to that. And there's a still a quite a large … particularly as there's quite a large tranche of the elderly that weren't fully vaccinated, we thought that perhaps the opening up would occur in a more staggered manner, given that. Still, the opening up post-Covid is obviously helpful from an economic perspective, given the lockdowns and increased uncertainty that it all had on the market.

All that said, the market has moved up very fast on the back of this, and whilst the market was arguably oversold at the end of October, valuations are not looking particularly attractive now, given the rally that we're seeing, particularly amongst the better quality companies and actually some of the opening up plays. And these companies had actually held up relatively well through the downturn on opening up hopes. Given all that, from the funds perspective, we still have a sizable underweight to China but in part this has been offset by an overweight in Hong Kong where valuations still look relatively attractive and should benefit from any recovery in China.

Action-wise, we've been looking for ideas, are looking for ideas to add to and at the margin we have been doing that. And so, we've added, for instance into some of the financial names. But overall, we do still remain quite underweight from a combined Hong Kong - China perspective.

I think it's probably worth saying that, from an income perspective, it is likely that we're going to be underweight from a China context, given that really quite a large chunk of the index there is made up of quite low-yielding names, including a number of their internet names. And so, that tends to mean that we are underweight.

SS: And you mentioned the income perspective there. Looking at the Schroder Asian Income fund in

particular, I mean, it's consistently returned first and second quartile performance over most time periods, has this been down to stock selection or is it… have the dividends - reinvesting dividends - helped that?

RS: Yeah well, I think, you know, the fund being an income fund definitely means that it does have naturally a bit of a value bias given its approach [and] given income is obviously a value factor.

This does mean that over shorter timeframes which style is in favour can impact returns. So, for instance, growth was strongly in favour during 2020, and that was a headwind for the fund, but that largely unwound through '21 and '22 where value performed better, which was a tailwind as obviously interest rates rose, which impacted the more expensive sort of growth names within the marketplace.

However, as you say over the longer term, the fund has outperformed and I think this is in large part down to our approach and that really is that we do believe that the Asian markets are inefficient, and that the best way to extract those inefficiencies, is through a bottom-up fundamental approach.

So, what we don't do is just screen the universe for the highest yielding names and backfill the portfolio with those stocks. What we are trying to do is to look for names or look for companies which have got upside to their fair value but have also got an income rationale for going into the portfolio. And I think by focusing on the better-quality names, that is those which in our view have got better management, better corporate governance, appropriate balance sheets for the businesses and have decent market positions and sustainable business models, we hopefully can add value over the longer term by applying this approach consistently.

SS: And the other powerhouse in the region of course is India. It's had a great last 12 months in particular. But the Asian Income fund doesn't actually have any exposure there at the moment. Is that because there's no income opportunities there or are valuations simply so high you don't think it's worth investing there?

RS: Yeah, you're right, we don't have any India at the moment. And although we have done in the past, India is generally a low yielding market, so it yields roughly sort of one, one and a half percent. And what we tended to find is that the companies that do yield more than that are generally businesses that we don't like from a bottom-up perspective. So, it has meant that our exposure within the fund has been relatively small to India ,if we have anything at all.

All that said, there are stocks which, you know, if they were at the right valuation, we would be interested in looking to put into the fund. So, we do look at India as an opportunity for income ideas. But at the moment, you know, we need to see a pullback in valuations in some of those areas.

And clearly the market has done well post-Covid and has been implementing reform and that has seen valuations actually get to quite full levels in the short term. So, yes, we like the longer-term growth prospects, but we want to see the market pull back before … in particular, before adding there. And, to give you some context in our non-income portfolios, we have been taking some money out of India selectively and are now slightly underweight versus the index.

SS: For investors who are thinking about investing in Asia, but perhaps need that push to actually do it, what would you say Asian markets give you that you can't get anywhere else? And what might the region offer in a wider portfolio?

RS: Yeah, no, I think when you look the opportunity set of stocks, which is a very diverse set of companies that isn't always found in markets such as the UK. So, from an income perspective in particular, I think the Asian markets really can bring… can help bring you diversification for anyone that's holding a lot of UK income, for instance. And that's because payouts are relatively low, balance sheets are quite lowly geared versus other regions. And for an income investor such as myself, the income is relatively well diversified.

So, to give you a feel for that, roughly 50% of the income from Asia comes from about 35 companies whereas if you do the same sort of calculation for the UK, as you know, it's much more concentrated, it's much more like eight or nine [per cent]. So, there isn't that stock specific risk from an income perspective, which you can get in a more closely focused market. And the fact that, you know, payout ratios are relatively low and gearing is also relatively low, does provide some resilience, if you like, I think to some of the dividends which potentially come out of the stocks across Asia.

I suppose the other thing that you get - and I suppose sometimes it's a bit arguable as to the relationship between sort of GDP growth and sort of market returns – and, whilst we could debate that, I think, you know, it's fair to say that the sort of Asian growth from an economic perspective, there is a higher growth rate that we are likely to see coming out of that region versus more developed areas of the world. And I think, as a backdrop in which to deliver dividends that, to me, is a better backdrop than perhaps one where there is no growth at all. So, from that perspective, I think, it also has an advantage.

SS: And we've discussed China and India. Are there any other countries or sectors that look really interesting to you today?

RS: Yeah, I'd say that North Asia, particularly some of the names in [the] IT sector in Korea and Taiwan, look attractive at the moment. These are obviously markets which have been beaten down by [the] slowing global economy and weaker demand for stuff as people sort of came out of Covid and transferred spending more towards services and so on.

But, given that slow down, valuations have obviously come back quite a long way, and given this, I think the longer-term attraction of some of these names within the sector is pretty high at the moment. I mean, we have some of the world's best semiconductor companies and technology companies, they have generally high market shares in the markets that they're operating in and have robust balance sheets. So, from that perspective they're attractive and given the sell-off that we've seen in these names, the valuations now are also pretty attractive, trading towards the lower end of their longer-term ranges.

And to give you an example, in Korea for instance, the memory names have been sold off as we've obviously seen this weakness in demand and inventories go up, but we are now starting to see cuts to the supply side. So, production is starting to be cut and CapEx [capital expenditure] in some companies has been starting to cut and we think that should bode well for the sector as a whole. And therefore, I remain overweight within the IT names.

SS: Just to wrap up, having sort of gone through that very generally, could you let us know what the current positioning of the fund is?

RS: Yep. I guess from a country perspective, we sort of touched on some of that with regard to [being] underweight in China and being partially offset by the overweight to Hong Kong.

But we also have quite an overweight in Singapore and there we like the banks and also a telco name there, which looks particularly attractive to us from a valuation perspective. But perhaps more interestingly, if you want to look at it from a sector perspective, and if you took the three larger sectors in the fund - so, financials, technology and real estate - we're overweight financials, and there we continue to like the banks that are benefiting from rising rates and the valuations still look reasonable versus their longer term history, and we think that their ability to pay dividends is still … remains pretty good.

We also, as mentioned, like the technology names in South Korea and Taiwan in particular. So, that leaves us overweight for how I described earlier. And then we also have an overweight in real estate. And now I should say that that's not in the sort of Chinese private developers, which were the area of the market … where people were most concerned about, given the high leverage in some of the private developers there. We've … obviously our focus has been much more around the landlords, so the commercial property sector, including those in Hong Kong and to a lesser extent in China, but those names in Hong Kong that do have exposure into China as well.

And these companies to us, are trading at attractive discounts to their valuation, so to their longer term NAV [Net Asset Value] and actually have been improving their returns to shareholders, which we believe over the longer term should allow that discount to NAV to narrow, which is why we still think that they look attractive. And so we continue to like that sector.

And then if you look at some of the other areas of the market, we still don't really find much value amongst the defensive names because they tend to be relatively fully valued in our view. So, here I'm thinking about utilities, where I don't have any exposure; healthcare, where I don't have any exposure; underweight sort of staples, although we do continue - I do continue - to like a number of the telco names which to me still look pretty attractive.

SS: That was a very thorough overview of the region and the fund. Thank you very much, Richard.

RS: Thank you.

[CLOSING]

SW: The Schroder Asian Income fund gives equity investors access to the higher growth Asian economies, excluding Japan but including Australia and New Zealand. It has been run by Richard Sennitt since 2001 and invests in 60-80 companies, the majority of which are currently larger firms. Richard also runs the Elite Rated Schroder Asian Alpha Plus fund and Schroder Oriental Income Trust. To learn more about any of these products visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.

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