JPMorgan Asian

Update
04 December 2018

Summary

JPMorgan Asian seeks to outperform the MSCI Asia ex Japan benchmark and owns a portfolio made up of the best ideas backed by insights from a large proprietary research team. Country-level valuations are used to guide the PMs to shorter term tilts or where they look for ideas, but the main driver of return is stock selection rather than industry or country bets.

Returns have been strong since J.P.Morgan combined its Emerging Markets and Asia Pacific teams and standardised its research process, with the fund outperforming in rising and falling markets. It is currently the best-performing fund in the open or closed-end Asia Pacific ex Japan sectors.

The trust has paid out a dividend of 4% of NAV since October 2016, made up of quarterly payments of 1%, the majority of which comes from capital reserves. As a result, the trust offers a higher yield even than some of the income-focused portfolios in the combined open- and closed-ended Asia ex Japan peer group.

The trust is trading on a discount of 12%, within the range of 10% to 15% that is typical of the past few years.

It is the cheapest closed-ended option in the space in terms of OCF, and amongst the cheapest in the combined open- and closed-ended sector.

Price (p)	332
Discount (%)	-12.2
OCF (%)	0.73
Yield (%)	3.0
Ticker	JAI
Turnover Ratio (%)	46.1
Gearing (%)	1
Shares	94,081,493
Market cap (£)	312,350,557

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Kepler View

Recent performance has been impressive, with the trust outperforming in rising and falling markets. In both cases, it was good stock selection rather than country or industry selection which generated the excess returns, indicative of the benefit of the huge proprietary research team located globally with on the ground presence in Asia. The Asia Pacific region remains out of favour at the moment, but the dividend should, in our view, help to close the discount when appetite for the region returns. At 12% we believe the trust is too cheap given its outstanding performance record, attractive yield and the long-term growth potential in its markets.

Kepler View

BULL	BEAR
A track record of excellent stock-picking backed by insights from an on-the -ground research team	The dividend is likely to fluctuate given it depends on NAV not income
An attractive discount despite strong NAV performance	Gearing has always been conservative, which could hold the trust back in rising markets
A 4% dividend yield paid from capital and not provisional on portfolio income	China is over a third of the benchmark, so investors take some single country risk

Portfolio

JPMorgan Asian owns a portfolio of equities selected for their bottom up growth characteristics with top down analysis used to guide the managers to the most promising markets. The core of the strategy is proprietary research done by a team of 36 analysts following the same research framework in different industries and countries. Ayaz, Richard and Robert can also rely on the insights of country specialists on the Emerging Markets and Asia Pacific equities [EMAP] desk.

This extensive proprietary resource has been growing in recent years as JPMorgan has been able to bring on board talent from the sell-side as it reduces headcount. The most recent additions in resources have been focused on the domestic China A-Share market, and two of these new analysts are working from a new Shanghai office, with new additions to follow.

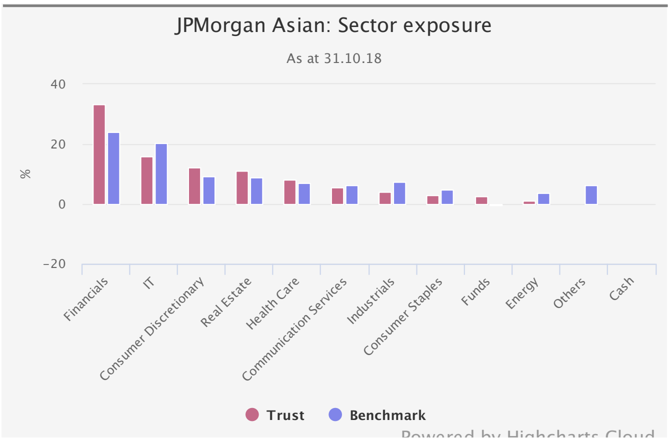
The focus of the fundamental research is on the economics – does the company produce good returns for shareholders – on duration – can those returns be sustained in the future – and governance – will those returns accrue to shareholders in full, or be impaired by poor governance. Analysts produce five-year return projections for their stocks, based on their expectations for earnings growth, dividends, valuation multiples and the effects of currency. The team's belief is that in the long run it is EPS and dividends which determine returns, even if valuation and currency can dominate the numbers in the short run.

It is down to the PMs to select the best ideas backed by research from the analyst team, and they pick stocks which fall into three buckets. First, core franchises are the long-term compounders which they expect to hold for over three years and are typically larger positions. Secondly, growth stocks are those which they expect to experience accelerated growth in the short to medium term. These are held for slightly shorter time frames, one to three years, as typically there is a short-term catalyst or the growth expected is front-loaded. Finally, the company also owns cyclical stocks or restructuring stories with a short-term catalyst, which they expect to exit in 12 to 18 months. The majority of the fund is typically held in the core and growth buckets, with the remainder in the cyclical stories. Valuations and earnings visibility dictate the balance.

The managers also draw on quantitative valuation models for the countries in the region. This top-down valuation-based approach gives the PMs ideas for where to tilt their portfolios geographically and where best to look for ideas. However, the dominant driver of returns is intended to be fundamental analysis of stocks, and attribution analysis bears out that it is stock selection which is the key driver of relative returns rather than relative positioning in geographies or industries, as we discuss below.

As of the end of October, the largest overweight was to financials. The trust holds 33.5% in the sector, with 17% in banks. This is the result of the team's bottom-up analysis: the banking sector broadly ranks high on five-year expected returns according to JPM's analysis.

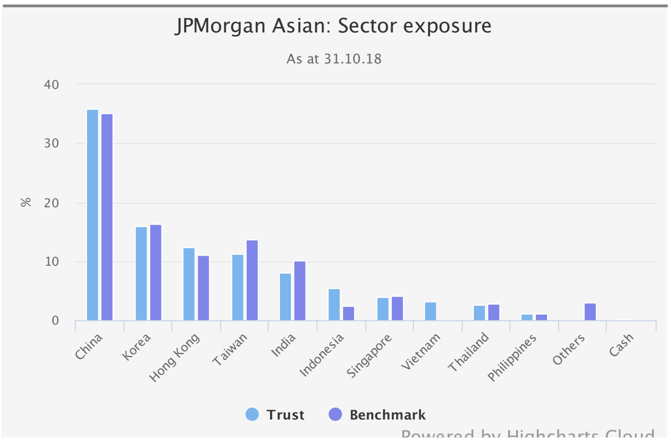
Fig.1: Asset Allocation



Source: JPMorgan

Aside from this, the fund is overweight consumer discretionary and underweight IT, energy and materials. The energy and materials underweights are likely to remain structural, as earnings are typically not visible and pricing power is low in these industries. The underweight to technology is more due to stock specific issues such as not holding Baidu, 1.4% of the index, and the managers have slightly reduced their holding in the Apple supply chain following disappointing numbers for the iPhone X. However, it still holds 25% in the sector, invested in areas such as e-commerce/ internet, semiconductor and in hardware components such as sensors and camera lenses.

Fig.2: Country Allocation



Source: JPMorgan

One intriguing holding is the 3.1% position in JPMorgan Vietnam Opportunities. The managers find the Vietnamese stock market illiquid, so prefer to take a position through this fund rather than in individual stocks.

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The managers have not taken huge bets against the index' country weightings, with the most significant relative positioning a 3% overweight to Indonesia.

Looking forward, the managers expect the earnings growth the region has seen over the last 18 months to continue and they expect this to drive markets rather than multiple expansion, which was a 2016 story. They view the 2018 sell-off in the region as healthy in blowing off a lot of the froth and throwing up opportunities in the best stocks. One area of interest is China A-Shares, which have been included in the main MSCI indices from earlier this year. The team expect to generate more ideas from this market as time goes on, with MSCI set to increase their weighting steadily in future.

Gearing

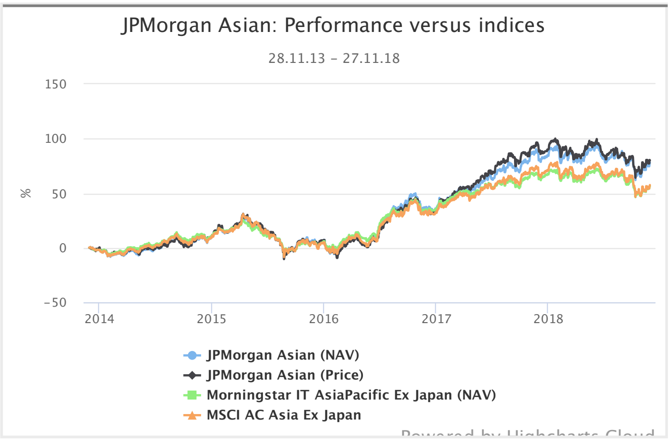
The board has given the manager discretion to borrow up to 20% of NAV, and they have facilities in place to do this. However, the trust is not geared at the moment, and hasn't been since the start of 2017.

This is because the managers use valuation signals from their macro models to decide when to gear, and following the rally in 2016 these models no longer indicated extreme levels of valuation. Given the strong returns in Asia in 2017 this was arguably a missed opportunity, but the downside of sticking to a valuation discipline is missing potential returns from the frothiest markets, and having a net cash position has helped the manager outperform in the weak markets so far in 2018.

It is also notable that the trust outperformed in NAV terms in 2017 without being geared. The managers anticipate this will remain true while Asian equities are trading above average valuations.

Returns

Fig.3: Five-Year Performance

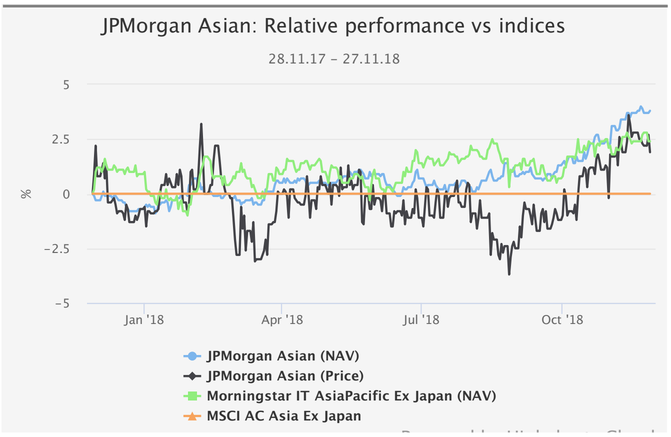


Source: Morningstar

Over five years the trust has outperformed the peer group and index thanks to strong relative performance in each calendar year since 2015, when J.P.Morgan merged the Emerging Markets and Asia Pacific equity teams. One-year returns are strong thanks to outperformance in both the rising market of 2017 and the falling market of 2018, but the trust is among the top performing closed ended funds in the sector over three and five-year periods as well – in fact it has the best NAV returns of any open or closed ended Asia Pacific ex Japan funds over the past three years.

In 2017, on both a geographical and sector basis it was stock picks that dominated relative returns. Picks in financials, healthcare and technology boosted the trust relative to peers and the index, while stock selection was particularly strong in China, which is some evidence that the resources allocated to that country by J.P.Morgan are bearing fruit.

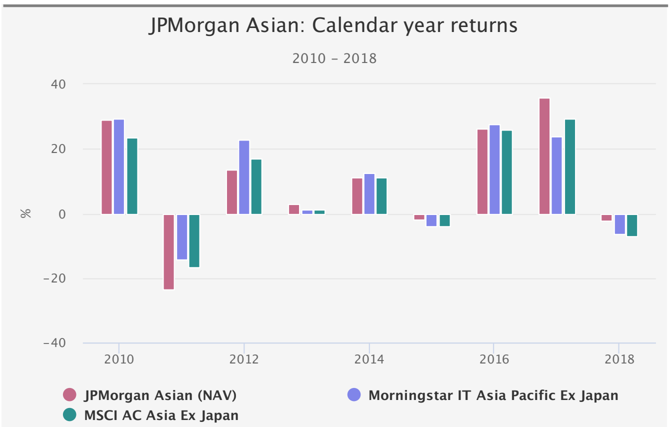
Fig.4: One-Year Relative Performance



Source: Morningstar

Good stock picks continued to drive the fund's returns in a very different market in 2018. The index fell 11.5% in sterling terms in to the end of October, but stock selection in South Korea and China meant the fund outperformed by over 4%. CNOOC, Samsung Engineering and Shenzhou

Fig.5: Returns



Source: Morningstar

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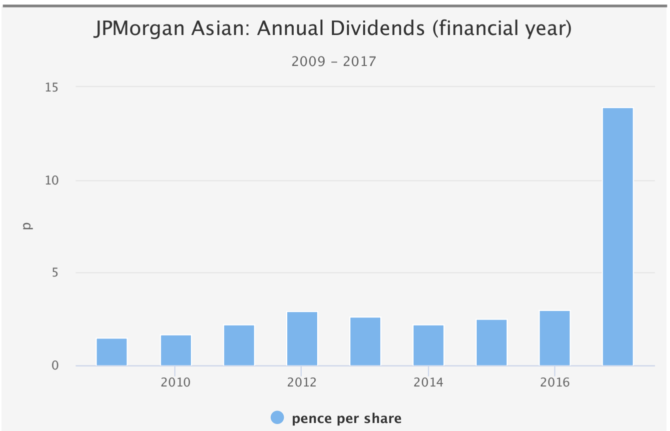
International Group were the greatest contributors on a stock level.

Looking at the peer group of open-ended IA and closed-ended AIC funds in the Asia ex Japan sectors, the good performance in 2017 and 2018 have left the fund the best performer over three years. The fund is also in the cheapest quartile, while the yield of 4.3% is higher than a number of income-focused portfolios, even though the objective is to generate total return rather than income.

Dividend

The trust pays 1% of NAV at the end of each quarter, absent unforeseen circumstances, having adopted this policy in October 2016. As a result, the dividends rocketed from 3p in 2016 to 13.9p in 2017, and the trust is now an option for income-seeking investors as well as those looking for long-term capital growth. The dividend can be paid from both net revenue and capital reserves. Revenue was only 28% of the 2017 dividend, but the trust has £272m in capital reserves, 114 times the payout. Despite the new dividend policy, the manager's objective remains maximising total returns.

Fig.6: Dividends



Source: JPMorgan

Management

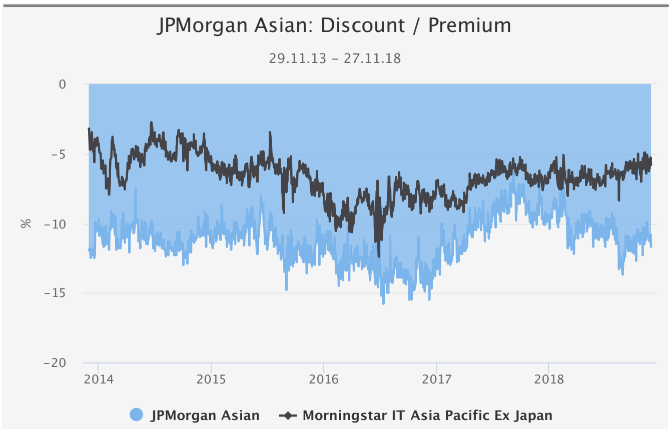
The strategy is run by the Emerging Markets and Asia Pacific (EMAP) equities team at JPM. Ayaz Ebrahim and Richard Titherington were joined as named managers in August 2018 by Robert Lloyd. Ayaz and Richard work together on the top-down analysis and asset allocation, while Ayaz manages the Trust on a day-to-day basis and leads on the stock selection. Richard has been with JPM for three decades and Ayaz joined in 2015 from Amundi; he heads up the Asia Pacific asset allocation committee. Robert, with 12 years' experience with JPMorgan, has run Asian portfolios since 2014 and manages several Asian regional portfolios together with Ayaz. His addition bolsters team resources particularly in stock selection. The managers can call on both research analysts and country specialist PMs for insights.

The core of the strategy is the extensive analyst team at JPM. Stock analysis and ideas come from both sector specialists, who tend to focus on the large caps in their industries, and product analysts, who are focused on small to mid cap companies by geographies. As discussed above, JPM has made large efforts to expand their coverage within China, and 12 of the overall research platform are dedicated to covering the Greater China region. A Shanghai office operating under a Wholly Foreign Owned Enterprise license since late 2016 should be staffed with four investment personnel by early next year, three of which research analysts, with more expected to come.

Discount

Over the past five years the trust has traded roughly in a band between 10% and 15% below par, although the discount came in further than this during the region's bull market in 2017. It is currently at the tighter end of this range. The board has buyback authority but last utilised it in early 2017 before discounts tightened across the sector.

Fig.7: Discount



Source: Morningstar

In December 2016 the discount was as wide as 16% before the rally in Asian markets saw sentiment improve. The trust's discount closed further than the sector's, likely due to the adoption of the new dividend policy and the wider starting point. In September 2017 the gap was as low as 6.3%. As Asia sold off in early 2018 on fears of a trade war between the US and China the discount slipped back closer to 15%.

We think the wide discount is not justified by the trust's strong NAV performance in rising and falling markets, and there could be value in this discount. NAV performance has been improving and the trust is one of the best performers over three years amongst its peers, and three-year numbers are often used by fund selectors. The trust is highlighted as particularly cheap in our new strategy piece.

Charges

The OCF on the trust is 0.73%, making it the cheapest Asia Pacific ex Japan trust according to AIC numbers. This includes a management fee of 0.6% of market cap, taken as the average of the past three month-end figures. Using market cap rather than NAV gives the manager an incentive to see the trust not trade on a discount.

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Important Information