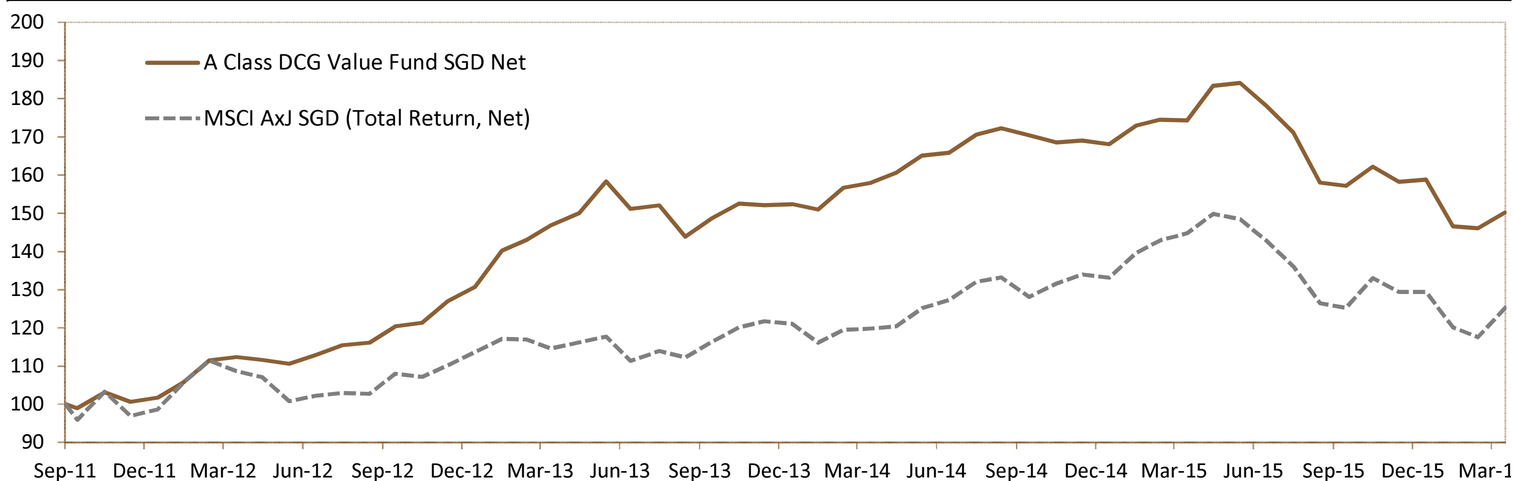
DCG Asia Value Fund

March 2016
NAV: SGD150.2 ('A' Class)

Fund Overview

The investment objective of the Fund is to achieve long term capital growth through investments primarily in publicly listed and traded stocks and shares of companies in Asia ex-Japan. The Investment Manager employs a value investing approach in managing the Fund. Using a bottom-up approach, it will seek to identify from within the above mentioned investment universe, attractive long term investment opportunities that the Manager reasonably believes adequately satisfy stringent selection criteria in terms of quality and valuations.

Cumulative Fund Returns SGD* VS MSCI AxJ SGD[1]



Monthly Net Returns*

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	MSCI AxJ YTD
2016	-7.7%	-0.3%	2.8%										-5.4%	
MSCI AxJ	-7.2%	-2.2%	6.5%											-3.3%
2015	2.9%	0.9%	-0.1%	5.2%	0.4%	-3.3%	-3.9%	-7.7%	-0.5%	3.2%	-2.4%	0.4%	-5.5%	-2.8%
2014	-1.0%	3.8%	0.8%	1.7%	2.8%	0.5%	2.8%	1.0%	-1.1%	-1.1%	0.3%	-0.6%	10.3%	10.0%
2013	7.2%	2.0%	2.7%	2.2%	5.5%	-4.6%	0.6%	-5.4%	3.4%	2.6%	-0.3%	0.2%	16.5%	6.5%
2012	4.1%	5.3%	0.7%	-0.6%	-0.9%	2.0%	2.3%	0.6%	3.7%	0.8%	4.8%	2.9%	28.6%	15.3%
2011									-1.1%	4.2%	-2.4%	1.1%	1.7%	-1.4%
Inception to Date[2]													**50.2%**	**25.1%**

*Current year returns are unaudited. Past performance is not indicative of future results. References to the MSCI AxJ SGD index are based upon published results net of fund expenses, management fees and incentive reallocation. The net return shows an accrual of incentive allocation every month, although the fee is charged at year end. Based on an original investor subject to stated fees (i.e. 1.25% management fee and 12.5% incentive fee).

(1) MSCI Asia ex-Japan SGD Index (total returns, including dividends reinvested)

(2) Inception-to-date performance for SGD A Class and MSCI AxJ are computed from 16 September 2011, the date of Fund inception.

Statistical Analysis

Risk/Return[3]	The Fund	MSCI AxJ
Annualized Return	9.4%	5.1%
Standard Deviation	10.5%	12.5%
Sharpe Ratio	0.70x	0.24x
Sortino Ratio	1.18x	0.39x
Information Ratio	0.58x	N/A
Peak to Trough	-20.6%	N/A

(3) Since inception. Applicable to A Class shares only

Portfolio Concentration[4]	
No. of holdings	53
Top 10 holdings	25.3%
Top 20 holdings	45.7%

(4) Holdings include one short term bond

Fund Exposure

Country Exposure	
HK/ China	44.6%
Singapore	15.6%
Indonesia	6.3%
Vietnam	4.8%
Thailand	4.3%
Taiwan	2.9%
Korea	2.4%
Philippines	1.7%
Malaysia	1.5%
Sri Lanka	0.6%
Cash	15.4%
Total	100.0%

Sector Exposure	
Financials	25.9%
Consumer Discretionary	17.4%
Information Technology	14.9%
Industrials	10.8%
Consumer Staples	8.3%
Energy	6.2%
Materials	1.1%
Cash	15.4%
Total	100.0%

Fund Details

Size (equities)[5]	
Small Cap (<US$1b)	34
Mid Cap (US$1b-$5b)	7
Large Cap (>US$5b)	11
Total	52

(5) Median market capitalization US$498 mil

Top 5 Holdings

Luk Fook Holdings International
Valuetronics Holdings
HKR International
HTL International Holdings
China Aviation Oil Singapore

Fund Information

Domicile	Cayman Islands
Fund Administrator	Portcullis Fund Administration (S)
Custodian	Deutsche Bank AG, Singapore Branch
Fund Auditor	Ernst & Young Solutions LLP
Legal Counsel	Rajah & Tann LLP
Fiscal Year End	June 30th

Terms

Minimum Initial Investment	S$250,000
Minimum Subsequent Investment	S$100,000
Early Redemption Fee*	3% in 1st year; 2% in 2nd year; 1% in 3rd year
Redemption Frequency	Once a quarter at quarter-end NAV, with 1 month notice
Subscription Frequency	Once a month at month-end, with 1 week notice
Management Fee / Performance Fee	1.25% / 12.5%

**Retained in the Fund for Fund investors*

Contact Information

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Monthly Net Returns*

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD	MSCI AXJ YTD
2016	-8.1%	0.9%	7.2%										-0.6%	
MSCI AxJ[1]	-7.6%	-0.9%	11.2%											1.8%
2015			-0.8%	8.6%	-1.2%	-3.2%	-5.6%	-10.3%	-1.3%	4.8%	-3.1%	-0.1%	-12.7%	-13.0%
Inception to Date[2]													-13.2%	-11.5%

*Current year returns are unaudited. Past performance is not indicative of future results. References to the MSCI AxJ index are based upon published results net of fund expenses, management fees and incentive reallocation. The net return shows an accrual of incentive allocation every month, although the fee is charged at year end. Based on an original investor subject to stated fees (i.e. 1.25% management fee and 12.5% incentive fee).

(1) MSCI Asia ex-Japan Index (total returns, including dividends reinvested)

(2) Inception-to-date performance for USD A Class and MSCI AxJ are computed from 01 Mar 2015, the date of USD A Class inception

Dear Investor,

Performance

The Fund's net asset value ('NAV') ended the first quarter of 2016 (1Q16) at S$150.2, down 5.4% from end-2015 and compared to the MSCI Asia ex Japan benchmark's 3.3% decline.

Currency movements significantly impacted 1Q16's performance as the USD and HKD, which together made up 36% of the Fund's assets, depreciated sharply against the Singapore Dollar ('SGD') resulting in some currency translation loss.

It was a very volatile quarter as the New Year started with a resounding crash of all major equity markets, led by Shanghai's 6.86% slide on the first trading day. Investors' concerns centered on the Chinese economy's deteriorating outlook and free-falling oil prices. Several dire prognostications made the rounds, including a collapse of the Chinese banking system and sharp Renminbi devaluation. Better communication from the Chinese leaders and PBOC, particularly after the National People's Congress and People's Consultative Committee meeting ('Liang hui') soothed market fears. Prices have recovered to some extent from the lows, and calm restored.

Since its inception in September 2011, the Fund's NAV has increased from S$100 per share to peak at S$184.10 in May 2015. The Fund's annualized return outperformed its benchmark (MSCI Asia ex Japan, total return in SGD) by 6.7% p.a. Since then, the NAV went down by March 2016 to S$150.5, an 18.2% drop vs the benchmark's 15.7% fall.

While the Fund's performance is satisfactory against the benchmark over the life of the Fund, we of course strive to turn around the recent periods of underperformance.

We will analyze the past few months of investing to find lessons we can learn and improve on. We believe we can and are determined to bring the Fund's NAV to the May 2015 high and beyond, sticking to our value investing philosophy.

Meanwhile, a lesson learnt from our recent experience is the importance of a better understanding and appreciation of the influence of psychology on markets. In this regard, it was particularly helpful re-reading Howard Marks's January 2016 letter when he wrote extensively about it. [1]

Marks's letter reminded us to be careful about how to interpret market events and media reports of events, and how emotion and psychology can cloud our judgment when making important investment decisions. In particular, he cautioned against imputing to the 'market' more credit than it deserves of knowing what lies ahead.

[1] Howard Marks is Chairman of Oaktree Capital, a well-known and successful value investor.
Forbes puts his net worth at USD 2 BN (2015). Howard Marks's letters are available on Oaktree Capital's website: https://www.oaktreecapital.com/insights/howard-marks-memos

"Investors", he noted, "have a tendency to overlook negatives or understate their significance for a while, and then eventually to capitulate and overreact to them on the downside."

"Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. This is one of the biggest mistakes you can make. As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously. Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings."

For us at DCG, in the past quarter, several of us repeatedly asked: "What is the market price telling us?" or "Why is the index down so much today?" Clearly, imputing intelligence to the market that was probably never there.

Investors tend to assess the world with emotions rather than objectivity. Sometimes, investors "take note of only positive events and ignore the negative ones, and sometimes the opposite is true. And sometimes they view events in a positive light, and sometimes it's negative. But, rarely are their perceptions and interpretations balanced and neutral," according to Marks.

"Most developments have both helpful and harmful aspects. But investors generally obsess about one or the other rather than consider both."

He cited oil as an example to illustrate negative thinking. When oil prices fell precipitously, it was interpreted as an ominous sign of global economic weakness and investors focused on the negative implication for oil producers and energy companies, forgetting (or ignoring) the positives for the most part of the world that is not oil producers but oil consumers.

Marks suggested a number of elements to cope with potential 'human error':

Understanding psychological influence – By having an understanding of psychological influence on the market and dealing with it. For us at DCG, it is important to remember during serious downdrafts that we should not to be overly influenced by market psychology but to remain objective and rational.

Control over one's emotions – Marks highlighted the importance of keeping optimism and fear in the appropriate balance. At DCG, we try to think long-term and rationally, and not be swayed by the market's short-term emotional reactions to events.

Control one's circumstances – Marks suggested structuring one's operating environment to "limit the impact of other people's emotional swings". For us, an application point may be how we filter out the 'noise' that we receive daily from the media, sell side research, and other sources.

Contrarianism – Taking advantage of other investors' emotional swings and turning it into a tool. Like Buffett, Marks thinks it is highly desirable to become more optimistic when others become more fearful and vice-versa.

Portfolio Update

One new position we have added is a Chinese property developer, one of the biggest in the North East of China with over 20 years of operation. The company's land bank was mostly bought many years ago at less than RMB 1,000 per sqm whereas the market prices are now in the RMB 3,000-6,000 per sqm range. The province that this developer operates in has a large population of over 90 million with a lower urbanization rate compared to other regions. It also has favourable demographics **–** 21% of the population is below 15 years of age compared to the 15% national average. Despite property prices in the capital city rising an average 7.2% p.a. in the last 4 years, affordability ratios remain very reasonable. Demand is mainly from genuine end-users like first-time home owners or upgraders and less from speculators and investors.

Healthy property sales and cashflows have enabled the company to significantly reduce its net gearing from 64% in 2014 to 32% at end-2015. Taking advantage of prevailing low interest rates, it is now refinancing its high cost debts which will result in better shareholder returns.

China Aviation Oil Singapore ('CAO') is the largest Asia-Pacific physical jet fuel trader and sole supplier of imported jet fuel to China. It is 51% held by state-owned China National Aviation Fuel Group Corporation, and 20% by British Petroleum. CAO has a market capitalization of USD 531 MM and net cash of USD 171 MM on its balance sheet. The stock trades at a PB of 0.9x and PE of 8.5x and 3.6% dividend yield. 5-year average net profit runs between USD 50 MM to USD 70 MM a year. In 2015, it made USD 61 MM. The profit stream can be carved into Investment Income from its JV and associates; and Trading. Historically, investment income formed 55-80% of CAO's profit after tax and minorities, while trading makes up the rest.

Some investors, including some of us initially in DCG, may view CAO as a commodity trader. The mental model is that CAO is a giant black box that is too hard to understand. With some diligence and effort, we've come to disagree with this view. We see CAO as misunderstood. It is primarily an easy-to-understand passive investment in Shanghai Pudong International Airport ('Pudong Airport') jet fuel demand with a careful, stable profitable trading operation attached.

Variant Perception 1 – CAO has several loss-making minority investments, which we won't discuss but the cash cow is a 33% stake in Shanghai Pudong International Airport Aviation Fuel Supply Company ('SPIA') which owns and operates **ALL** refuelling facilities at Shanghai's Pudong Airport. Every single aircraft refuelling at this airport must procure fuel through SPIA at an appropriate cost plus mark-up. Domestic flights will use onshore produced + 17% VAT (generally Sinopec- or PetroChina-refined) jet fuel while international flights will use VAT-free imported fuel (via CAO).

CAO's SPIA investment will share **<u>33%</u>** of the monopoly's profits and dividends that arise from increased fuel demand at Pudong Airport, including domestic flight demand (which CAO's fuel import operation has no exposure to). Pudong Airport's aircraft movement and passenger growth rates will continue to rise at high single- to low double-digit rates for the foreseeable future. SPIA contributes USD 36-45 MM of after-tax profits to CAO's shareholders every year. We deem this number sustainable, steadily growing with Disneyland opening imminently in June 2016 and Dreamworks Shanghai in 2017.

Variant Perception 2 – Most Singapore investors recall the risks of a poorly controlled trading operation when CAO collapsed in 2004 under the previous management. Fast forward to 2016, we believe BP has brought real change to CAO's trading. The role of risk management in a trading firm is similar to a wet blanket at staff parties **–** nobody wants to be the unpopular (i.e. sane) voice pooh-poohing senior management's misguided enthusiasm.

Risk management committees need to be headed by individuals of sufficient seniority and experience so they can: a) understand what traders are doing or omitting to do; and b) be willing to stand up to the firm's senior traders and management (who make 2-3 times the pay of other staff). This was one critical failure in the first version of CAO and is no longer true today. The senior trading staff came through BP's highly regarded trading program and the current chairman of CAO's risk management committee is BP group treasurer Alan Haywood, who has a decades-long background in supply and trading in Europe. CAO's trading continues to be physical supply-driven with paper trading on the side to provide hedging. Gross trading profit from middle distillates continues to provide USD 30-40 MM pa. We see CAO's ability to grow profit in line with underlying volume growth of Chinese outbound travel.

<u>Outlook</u>

Business conditions remain challenging in a slow-growth global economy. There are still concerns over a possible hard landing in China and the health of its banking system. We do not foresee any major bank failure but non-performing loans are definitely set to rise.

Although the Yellen-led Fed has shown a bias towards dovishness, the US unemployment rate is inching closer to full employment and may force the Fed to resume its interest rate normalization course after last December's 'lift-off'.

Following Howard Marks's good advice to maintain an appropriate balance of optimism (positives) and pessimism (negatives), we should likewise consider some of the positives.

First, Asia ex-Japan remains a relatively bright spot with ADB forecasting a 5.7% advance for developing Asia in 2016-17. Many ASEAN economies will still post decent mid-single digit growth.

Second, valuations have become a lot cheaper. Regional markets now sell at an average PB of 1.3x while price earnings multiples have declined to much more reasonable levels. This implies very modest earnings expectations. Interest rates in Asia are lower than they have been in a long time

and likely to remain low. In fact, in countries like India, China, and Indonesia, there is still considerable scope for rate cuts. A lower interest rate environment is not only conducive to economic growth but also support stock valuations.

Third, for China and much of the rest of Asia, there is still a long runway of growth. While China's economy is now the world's second largest, its GDP per capita is only about one-seventh of the US and 22% of Japan's **–** plenty of room to catch up. As HSBC economist Frederic Neumann pointed out in a recent note, despite talk of an aging population, China still has an enormous reservoir of 'under-used' rural workers – some 190 million below age 40 by his estimate. As China continues to urbanize (currently only 54%), more of these able-bodied workers will join the urban workforce. The second reason to not bet on China's decline, Neumann argued, is the rapid improvement in education. The annual number of graduates has jumped from 1 million in the early 90's to 6.6 million last year. Fifteen year-old middle school students in Shanghai top the world not only in mathematics and sciences but also reading, according to a recent study by OECD.

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