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## Portfolio & Market Review

During the last quarter of 2016, the Panah Fund's NAV fell by -3.20% to $130.95 per Share, bringing the Panah Fund's annual gain for calendar year 2016 to +12.44% (net).

Although Panah focuses on absolute returns, investors might wish to compare performance to 2016 gains of +4.17% for the Bloomberg Asia Large-, Mid- & Small-Cap Net Return Index and +5.05% for the Bloomberg Asia ex-Japan Large-, Mid- & Small-Cap Net Return Index.

These regional indices have made small gains since Panah's inception in September 2013, and are still trading at the same level as they were nine years ago.

In the last quarter of 2016, most Asian equity markets and currencies retreated as the US Dollar surged alongside US interest rates, following the unexpected election of Donald Trump as president of the USA. Japan was the clear winner among Asian equity markets in local currency terms (+14.8% Topix; +16.2% Nikkei), although the -13.4% depreciation in the Yen meant that in Dollar terms, these indices were effectively flat (-0.2% Topix; +1.1% Nikkei).

Few other Asian indices managed to make gains even in local currency terms (+4.2% Australia's AS51; +4.0% SE Thailand; +3.3% Shanghai Composite; +1.0% Taiwan SE; +0.4% Singapore's STI), while in US Dollar terms only one Asian index other than the Nikkei 225 made positive returns (+0.4% SE Thailand).

Indeed, much of the damage in Q4 was inflicted by FX depreciation, with dramatic moves in many Asian ex-Japan currencies (-8.8% KRW; -8.0% MYR; -6.4% EUR; -6.0% AUD; -5.9% SGD, etc.) The better Asian FX performers still depreciated several percent against the US Dollar (-2.1% VND; -2.1% INR; -2.4% PHP). Several regional equity indices saw much worse Q4 performance (-10.3% Philippines Comp; -6.8% NZSE; -5.6% Hang Seng Index), making for a torrid end to a difficult year in Asia.

Perhaps the most curious feature of this year-end US Dollar rise was the concomitant strength of the rally in most many commodities during Q4, confounding the usual correlations, as investors gained confidence in the stabilisation of the Chinese economy and anticipated a stronger likelihood of fiscal easing in the US. Special mentions go to various industrial and energy commodities (+39.1% rubber; +35.1% iron ore; +16.1% Brent oil; +13.8% copper; +11.4% WTI crude oil).

However, a sharp setback late in the quarter – as China cracked down on commodities speculation – meant that several industrial metals did not make positive returns (-5.0% lead; -5.3% nickel). Precious metals and soft commodities, however, found it altogether more difficult to cope with the strong USD and higher real interest rates in the fourth quarter of the year (-23.0% cocoa; -17.0% silver; -13.4% sugar; -12.4% gold; -11.9% platinum; -9.6% coffee).

Just like the football cliché, 2016 was a game of two halves for bond and FX markets… A plunge in Developed Market bond yields and the US Dollar in the first half of the year was matched by a back-up in US yields and a resurgent greenback in the second half. Meanwhile, Asian and most globally-significant equity markets endured a stomach-churning plunge into mid-February on fears of aggressive Renminbi devaluation and economic weakness, before rallying reluctantly for the remainder of the year.

For 2016 as a whole, there was significant disparity in returns for Asian equity indices… Thai and Indonesian equity markets took the top spots for local currency and USD returns in 2016 (local returns: +19.8% SET; +15.3% JCI), while the losers were onshore Chinese equities (local returns: -12.3% Shanghai Comp; -14.7% Shenzhen Comp). There was something vaguely eschatological about this performance, as the last markets of 2015 became the first of 2016 (Thailand and

Indonesia), and vice versa (Shanghai and Shenzhen). Over 2015-16, there was consistently strong local currency performance from Vietnam and New Zealand (+21.9% VNINDEX; +14.3% NZSE), but consistent weakness from the H-Share Index, as well as stocks in Singapore and Malaysia (-21.6% H-Shares; -14.4% STI; -6.8% KLCI).

For the Panah Fund, 2016 was also a year of two halves, with positive double-digit returns in the first half (on a slightly defensive net market exposure[1] which fluctuated between 60-75%) and flat returns in the second (on a higher net market exposure of 68-84%). The largest contributors to returns on a single stock basis (contributing ~45% and ~40% of net returns respectively), were a Papua New Guinea gas exploration company (subject to a takeover bid) and a Korean semi-conductor equipment company.

Other individual stocks in Japan, Vietnam, Thailand and the Philippines also made solid contributions to performance. The largest country contribution came from Vietnam, which accounted for ~55% of net fund returns for the year.

Despite a positive start to 2016, gold stocks made only a small contribution over the full year (though these were enhanced by buying small positions in precious metal call options early in the year, and then put options in the second half).

The two largest detractors to fund performance on a single stock basis were two short positions in Hong Kong and Singapore, which hit net fund returns by ~10%. There were only two long positions which provided any headwind to fund performance (each with an impact of around -5% impact on net returns): one Hong Kong-listed company and another in Japan.

Pronounced FX tailwinds (especially for the Yen) helped fund returns in the first half of 2016, but these then reversed almost entirely in the second half. Over the whole year, our embedded FX exposure thus had a somewhat neutral effect, though FX hedging did help to protect capital.

## Portfolio Positioning

At the end of 2016, the Panah Fund's largest country exposures remain relatively stable: Vietnam (30.7% gross, 30.3% net; consisting of long positions in seven stocks and two closed-end funds, as well as a residual small short position in an ETF) and Japan (32.1% gross, 24.2% net; consisting of nine stocks long and two stocks short). There were no other major geographical concentrations in exposure for the fund's holdings, although the fund retains its allocation to precious metal companies (6.0% of NAV at end-Dec 2016); the fund had initiated precious metal hedges in reasonable size by the middle of Q4, though these had been closed out by the end of the year.

In the last quarter of the year, there were few substantial changes to the portfolio… In Vietnam, we trimmed our position in a closed-end fund and a real estate developer, and instead increased our positions in a diversified conglomerate and an IT company. In Japan, we gently topped and tailed several positions in line with share price movements. The fund's modest gold stock portfolio saw its usual ongoing rationalisation (a sad necessity in this somewhat volatile and poorly-managed sector): one large position was trimmed back to the roots, to be replaced with smaller holdings in two budding juniors which had been experiencing temporary issues. Panah had also entered the quarter with a reasonable amount US Dollar hedges (i.e., long Dollar against various regional currencies), some of which we closed in November after a sharp rise in the value of the US currency. During Q4, we also added two short stock positions in a regional bank as well as a diversified conglomerate with above-average valuations, generous accounting, and sensitivity to rising rates. In December, we also moved to pare back our position in an LNG stock which had been subject to a takeover bid; the stock had rallied after the bidder reiterated its interest, despite a delay caused by a court decision. On the operational front, the major new development for Panah was the change in our Prime Broker from UBS to Morgan Stanley, which went smoothly.

[1] Exposures are in 'net equity-equivalent terms'. Net equity-equivalent exposure adjusts for volatility and correlation between asset classes (i.e., commods, bonds, FX) to express net exposure in 'equity-equivalent' terms.

**Investment Strategy Review: 'Capital Allocators' versus 'Capital Alligators'**

In previous letters, we have described our preferred methods of screening and ranking. In a nutshell, this involves create rankings for various metrics with the intention to find good companies trading at a reasonable price. This then helps us to find interesting stocks, compare them across the region, and prioritise which companies to research first. Although 'quality' can be a somewhat nebulous concept, most investors emphasise metrics such as high and stable return on capital and margins. We also favour firms with a solid record of shareholder value creation over time, and so like to look at metrics such as long-term growth in book value per share (BVPS).[2]

One we have identified a 'quality' company which has also managed to grow adjusted BVPS at reasonable pace over time, the first step is usually to understand how this has been possible… Most companies which have managed to grow adjusted BVPS at a consistently high rate have been able to do so because their core business enjoys a competitive advantage (i.e., a 'moat') which prevents other companies coming in to compete away their high returns.[3] Such firms are typically much sought-after by investors (especially when they have a readily-understandable strong consumer franchise or brand), and so often trade at extremely high valuations. While some investors are comfortable paying high multiples for good quality businesses which compound capital at high rates over the long-term, our preference is to have more of a margin of safety for valuation when we invest. This is not least because it can be difficult to judge exactly how sustainable such high returns will be in the future. One always ought to consider the possibility that high BVPS growth over time might be disrupted by new technology or industry entrants.

We have also come across supposedly high quality companies with strong BVPS growth where we think that returns will almost certainly *not* be sustainable. For instance, high growth over the last business cycle might have been driven by a combination of a strong economic upturn (driving top-line growth), a temporary (if extended) lack of competition, high operating leverage, and a fully-depreciated asset base which might well need to be replaced soon at high cost.[4] This is why it is rarely enough just to look at the headline metrics; one must also do one's homework.

In this hyper-financialised world, most markets have already been picked over by plenty of investors, and so the truth is that it is unusual to find a company with truly sustainable high returns which is also trading at a reasonable valuation. The holy grail is of course to find a reasonably-valued 'compounder' (see Q3 2016 investment letter) which can *continue* to reinvest its cash flows at the same high rate of return. Since inception, the Panah Fund has managed to identify only a handful of these companies trading at reasonable valuations. Even when these stocks rerate to

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[2] It is necessary to make various adjustments to BVPS (e.g., to account for capital reductions). Depending on the company in question, there are also clearly drawbacks to being too reliant on BVPS, as inaccuracies can creep in for various reasons, for instance: property, plant and equipment are recorded at cost minus accumulated depreciation, but depreciation rates might be inappropriate and carrying values can underestimate the replacement cost of such assets; real estate and securities are recorded at cost in many accounting jurisdictions, which can be much lower than market value; the value of intangible assets (especially goodwill) can be overstated in the accounts; jumps in BVPS as a result of one-off asset injections and/or trading gains, etc. Nevertheless, accounting 'red flags' screening and further research into individual companies serve to highlight such issues, and it is always possible to make adjustments on a company-by-company basis.

[3] Typical competitive advantages might be: product differentiation (e.g., brand); strong distribution channels; high switching costs (i.e., customer loyalty); high capital requirements; technological edge (e.g., patents and IP); economies-of-scale (e.g., lowest-cost producer, network effect); government regulation and policy (including tax benefits and subsidies); other specific advantages (e.g., access to materials, unique location), etc.

[4] We have come across some companies in fairly 'ordinary' sectors such as low-end detergents, plastic pipes and cardboard boxes, that have managed to sustain high returns on invested capital of >25% for most of the last decade, and churn out strong BVPS growth of >30% for the last five years. However, we do not have strong conviction that such returns and compounded profit growth will be sustainable. We can envisage various challenges which might emerge, such as higher materials prices, more stringent environmental standards, more intense competition, or expensive capacity expansion needs. (Indeed, previously high returns and impressive BVPS growth for many Chinese low-end manufacturing companies proved unsustainable post-2011.)

higher valuations, we tend to remain happily invested, and look to add on weakness (provided the investment thesis remains intact). We are always on the lookout for more companies of this sort.

The good news is that there is another sort of company able to grow BVPS at a high and steady rate, but which seems to attract less attention from the markets, typically meaning that the shares are on offer at a more reasonable valuation. We are referring to companies run by good managers with above average capital allocation skills. As a great investor once noted, a true aptitude to allocate capital effectively is perhaps one of the rarest abilities to be found among company managers, but probably the most important.[5] Indeed, capital allocation decisions are those which determine whether and by how much the value of any company will grow over time.

These decisions can be split into two broad areas: raising new capital, and deploying it. Company managers have a few ways to get their hands on new capital: [A] issue stock, [B] issue debt (or hybrids), or [C] use cash flow from the business. When it comes to deploying capital, they can: [1] pay down debt (if any); [2] pay dividends; [3] buy back stock; [4] invest in existing operations; [5] invest in establishing a new area of operations; [6] acquire other businesses; [7] invest in the equity or debt of another company; or finally [8] just keep the cash in money market instruments on deposit at a bank (all too common in Japan, which is really just deferring an eventual decision!).[6] Those managers who on aggregate make good decisions over time are the 'capital allocators', while we refer to the bad decision-makers as the 'capital alligators', because they tend to devour investors' capital with very little to show for it!

At this stage, a couple of theoretical examples might help to illustrate the key points… A good 'compounder' company (e.g., a branded consumer goods company with strong distribution channels) is already in a fortunate position, as it is possible to generate a high level of cash flow from a relatively small capital base. Enlightened management have realised that the company's high returns are unlikely to be matched elsewhere (i.e., no better investment alternatives), and so they decide to deploy internally-generated cash flow to expand existing operations. In reality, capital requirements for expansion are not particularly high, and as time goes on it is not possible to utilise all internally-generated cash flow to expand operations. Management thus decides to pay out excess cash in the form of ever-increasing dividends. Investors are impressed, and are willing to pay a high valuation multiple to buy shares in the firm. Despite a high valuation, the company's share price rises over time as earnings and dividends grow. Everyone is happy until one day, a new CEO is appointed. He decides to pare back the dividend and instead uses excess cash to acquire another firm in a different industry, paying punchy multiples for this acquisition target (despite lower returns). Shareholders in the compounder company react by selling shares, as they anticipate that returns will deteriorate. Indeed, over time management find that they spend more energy dealing with the problem acquisition rather than focusing on the core business, and so they allow another competitor to win market share in their core business.

The average firm finds itself in a much tougher starting position. Indeed, most firms in most sectors only generate excess returns over the cost of capital for short periods of time (and maybe not at all over the course of an economic cycle). Rather than being able to reinvest capital in a fantastic business, management must make more difficult choices about how to raise capital and deploy it. A manager might have to think about whether to issue equity to pursue a potentially transformative but risky and expensive acquisition, or perhaps instead buy back the company's own shares (perhaps a good decision if the firm trades on a low cash flow multiple). Would it be better to gear up to increase capacity and increase industry dominance (to become the lowest-cost producer), or

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[5] "*After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business.*" (1987 Berkshire Hathaway shareholders letter). For those with further interest on Mr Buffett's views on capital allocation, his 1994 Berkshire Hathaway shareholder letter and AGM comments might also be of interest.

[6] This summary is drawn from the book '*The Outsiders*' by William Thorndike, which also includes eight interesting case-studies of companies lead by managers with notable capital allocation skills.

sit on the cash and wait to acquire a distressed competitor during the next downturn? It might only become apparent many years in the future what was the 'correct' choice.

Not all capital is created equal – it generates higher or lower returns depending on how it is allocated. It is possible for a CEO who runs a business in a fairly 'ordinary' sector (i.e., where competitive advantages are not easy to come by, and so where high, sustainable returns are more unusual) to grow the value of the company over time by making the best capital allocation decisions possible in the circumstances. A necessary skill seems to be the ability to balance the potential returns of the choices on offer, tempered by an appreciation for the probability-weighted outcome of such decisions. Buying back your own stock (at cheap enough multiples) is more likely to be value-accretive though is unlikely to be a game-changer, whereas gearing up to buy an expensive company operating in another industry is far riskier, but has the potential to be transformational. Another relevant consideration is whether a company's successful capital allocation decisions are primarily driven by an extremely talented individual, or whether there is a process-driven capital allocation culture within the company that has created value over time.[7]

The parallels with fund management are interesting… A fund manager might be able to point to a long-term performance track-record (ideally predicated on a bona fide and replicable investment process) to demonstrate his or her capital allocation skills. In the same way, perhaps a combination of adjusted BVPS growth and share price appreciation over time should be considered the litmus test for company managers. In any case, for fund managers and CEOs alike, we believe that the best way to keep risk at a reasonable level is to have a healthy respect for valuations. No matter whether a fund manager is buying a new stock holding, or if a company manager is embarking on M&A activity or building a new plant, it makes sense to pay less for the same cash flow stream!

Example 1: Japanese Consultancy Firm – current market cap JPY ~20.5b (US ~$180m)

Founded in 2000 by the Japan country director of a major international consulting firm and listed on the Tokyo Stock Exchange in 2002, this Japanese company had a near-death experience in the wake of the Lehman Crisis of 2008. Spurred on by this experience, management got religion and decided to move away from the previous strategy of levering up domestic consultancy earnings to acquire non-controlling stakes in speculative venture capital (VC) opportunities. Instead, the company started to focus on how best to grow earnings from its high-return consultancy business, and then how to deploy its income to acquire meaningful stakes in businesses which over time would be able to grow into stable cash flow generators.

Today, the consultancy division employees ~90 'business producers', and aims to hire the best and brightest graduates from Japan's top universities. They specialise in giving advice to Japanese companies on growth strategies through embracing new technology, M&A, as well as participating in government-led projects (such as the 'green city' initiative). They also provide consulting advice to Japanese firms entering foreign markets (as well as local businesses and governments), through their offices in Ho Chi Minh, Shanghai, Singapore and Mumbai. The consultancy business generated JPY ~2.4b of operating revenues in FY2016/3 (on assets of JPY ~1.2b), and operating income of JPY 1.4b; earnings have been growing at 10-15% for the last few years. The company aims to hire five new business producers each year; the largest constraint to growth is finding the right people.

In early 2011, the company acquired a majority stake in a niche insurance business (the #2 operator in the sector, with the lowest loss ratio), in which they still retain a ~64% stake. Market penetration for this niche insurance sector is only 5-6%, though over time is expected to rise to ~25% in line with other developed markets. The insurance division generated JPY ~7.9b of operating revenues in FY2016/3 (on assets of JPY ~7.5b). In recent years, operating profits have been depressed by large ongoing depreciation charges,[8] and then last year by a large one-off

[7] The classic example of the effective maverick allocator is Henry Singleton of Teledyne, while one might attribute the success of Jardines in Asia to a culture of process-driven capital allocation within the group.

[8] A peculiar requirement of Article 113 of the Japanese Insurance Business Law states that set-up costs must be amortised over ten years (i.e., depreciation of deferred assets); this process finished in FY2015/3.

increase in policy reserves. Adjusting for these charges, operating profits have increased from JPY ~175m to JPY ~500m over the three years to FY2016/3; this is despite the substantial ongoing costs devoted to scaling up the business.[9] Operating revenues have grown at 20-30% for the last few years, a pace which seems likely to continue.

As of end H1 FY2017/3, the company also had investment stakes in 42 additional 'incubation' businesses, operating in 'growth' areas such as digital media, environment & energy, and robotics. The value of 24 of these 42 companies had a recorded book value of JPY ~4b at the end of last September, while the company's conservative auditors have required that many of the other 18 investment stakes be written down to zero. This does not mean they are worth nothing, however. Indeed, one such minority stake in a robotics company looks set to be sold for JPY ~700m at an upcoming IPO. This holding is valued at zero on the balance sheet, and would be recorded as an investment gain when sold. Curiosities of this nature give a salient warning why book value should not be taken at face value, and why for this company, BVPS growth is a misleading metric! The unpredictable timing of such extraordinary gains and losses – dependent on the state of the IPO market – is the reason why this company does not offer earnings guidance. Local retail investors have acquired a habit of trading the company's stock around IPO announcements for the company's incubation investments. This can cause substantial share price volatility, and offers the opportunity for more fundamentally-oriented investors to increase and reduce position size.

In aggregate, the company does appear to have added value over time through the investments and divestments of these incubation businesses. For instance, a stake in a well-known teenage girls' fashion show company was sold in 2015 at double the acquisition price after three years. Another 'asset liquidation' firm (which trades excess inventory from manufacturing firms) was sold for a slight gain after several restructuring attempts proved unsuccessful, and despite five years of losses. Inevitably, there have also been mistakes – an investment in a firm which distributes Japanese medical equipment in Vietnam had to be impaired in FY2016/3 after a plunge in the share price following management issues, though to their credit they are now working to turn the firm around. The company's incubation division has recently formed alliances with strong VC houses in China, India and Silicon Valley, offering interesting minority investment opportunities which are simply unavailable to most other Japanese firms. Indeed, we think that the company's ongoing VC investment activities provide ample scope to find and build more cash flow-generating businesses.

Management believes that one of the main reasons that there are so few successful start-ups in Japan is that they do not receive enough money or support from heavily-diversified Japanese VC investors. This company, however, is not willing just to be another passive investor in its start-up incubation investments. If any investee firm shows promise and needs help, then the company is willing and able to dispatch its own employees (i.e., consultants with operational expertise in supporting start-ups) to help build these businesses. Conversations with top management – all of whom are substantial shareholders – have revealed that they are striving to create a process to find, invest in, and build more businesses which will in the future be able to generate sustainable cash flow. The company already has two 'cash flow pillars' (i.e., the consulting and insurance businesses), and at present two other businesses also appear to have exciting potential. One is a wholly-owned Southeast Asian digital marketing and social media survey company, which was launched in 2014 and will likely reach breakeven this year (and is not included among the 42 incubation investments mentioned above). Another is an investment stake in an online events-ticketing company with dominant market share for ticket resales in Japan.

How to best characterise this company? Probably as a small, growth- and cash flow-oriented consultancy conglomerate! Unsurprisingly, a firm of this sort attracts no sell-side analyst coverage, and we can find no peers with a similar business mix. We arrive at an appropriate valuation range by looking at the company on a sum-of-the-parts basis, comparing multiples for the consultancy business and the niche insurance business to other domestic companies operating in these areas. Without going into too much detail, the value of these two main businesses appears to exceed the

[9] All these figures have been adjusted to account for the firm's proportional interest in the insurance company.

market capitalisation (and enterprise value) of the company by a comfortable margin. While disclosure on incubation investments (excluding insurance) is more limited, we still see them as interesting 'free call options' with the potential to make a positive contribution in the future.

The company has no debt, and cash + marketable securities currently account for ~60% of total market cap. Much of this cash is restricted, in the sense that regulations require that it be kept within the insurance business for the time being. However, that seems likely to change in 2017, as the plan is to arrange an IPO for the insurance business. A partial divestment of this attractive business would free up cash now and in the future, as it would allow the insurance business to pay dividends. The insurance IPO might also be a catalyst for share price of its parent company, as it would become much easier for investors to value the company on a sum-of-the-parts basis.

In private, management admit that they are inspired by the Berkshire Hathaway approach to capital allocation. They also have an infectious enthusiasm for the growth potential of the new businesses in which they invest, and we have substantial confidence in their approach. Our only suggestion has been to consider hiring a few investment professionals as the company grows, to help implement the investment process effectively and assist on due diligence. Management seems to agree, but as always, the challenge is to find the right people. Panah first became a shareholder in mid-2014. We increased our stake on share price weakness in H2 2016, so that by end-December, 4.6% of the NAV of the fund was invested in this company.

Example 2: Vietnamese Conglomerate – current market cap US ~$350m

Established in 1977 as a state-owned enterprise (SOE), this private conglomerate now operates businesses in various sectors, including mechanical and electrical engineering services (M&E), air-conditioners, and real estate development + management; it also invests in various power and water infrastructure utility firms. This company was among the first in Vietnam to be equitised in the early 1990s, and was also one of the first to allow foreigners to acquire shares later that decade. The chairwoman has been in her role for more than 20 years, and has driven the development of the company through a period of rapid economic growth and substantial social change in Vietnam.

From the mid-1990s, it was the household and industrial appliance (i.e., air-con) business which drove growth. 2002 was a year of change as the company established an M&E division and also built its first major office building (on a site near Ho Chi Minh's international airport). This building was fully leased by 2005, when work began on the second office block on the same site; this was completed and leased in the following year. By 2010, cash flows had been reinvested to develop more office buildings and a sports complex at the same location. The company made a modest investment in a water company in the early 2000s and then a power utility several years later, but this was apparently just part of a wide-ranging investment approach which involved buying various listed and unlisted companies. It was not until the end of the decade that the firm started to deemphasise its diversified portfolio investments (during a difficult period for the Vietnamese economy and equity market), and instead started to focus on investing in utility companies.

The strategic pivot towards utilities did seem to make sense... As recently as 1995, as much as half the total Vietnamese population did not have any access to electricity (which was generated, transmitted and distributed entirely by State monopolies). Ambitious electrification targets had increased power access to ~93% of the population by 2004, which was when the Vietnamese government recognised that the power sector would need to be reformed in order to meet the demands of a rapidly-growing economy. This would involve breaking the government's monopoly on power, with a clear roadmap for power market reform. This would start with a move towards a competitive generation market with a single buyer of power (i.e., EVN) in the early 2010s, then a competitive wholesale market by the middle of the decade, and finally a competitive retail market in the early 2020s. While implementation has slipped, the direction of movement is clear. The government also announced ambitious targets for a large increase in aggregate power output to 2030. To incentivise the rapid addition of electricity generation capacity, there has been a recognition that Vietnam's power tariffs (among the lowest in the region, anchored by a ~40% mix of low-cost hydropower projects) should rise over time.

The chairwoman started to increase the conglomerate's investments in utilities by the end of the 2000s. One of the first major power investments was a rock-and-clay hydropower dam built during the Vietnam War era (and which is still expected to operate for a further >50 years); the company acquired a small stake in this plant at first, but is now the majority owner of this asset. In the intervening years, further steady investments in coal-fired and hydropower plants, as well as water treatment works, have followed. The common factor among these utility investments appears to be a bias towards fairly long-life assets which throw off steady cash flow, and where higher dividends can be extracted without too much trouble. These dividends are then paid back up to the holding company, to be reinvested in other areas. In the last couple of years, most cash flow has been reallocated towards increasing stakes in existing utility holdings as well as acquiring new ones, and also developing a high-end office complex near the Central Business District of Ho Chi Minh City.

This approach to capital allocation is not rocket science, and has weaknesses as well as strengths.[10] However, the company has been careful to buy at valuations which provide a margin of safety. One recent incremental share acquisition in a coal-fired power plant (admittedly in need of some upgrade capex) was transacted at an EV-to-FCF multiple of ~3.0x. As this conglomerate has become a de facto consolidator of Vietnamese power producers, management has found that its influence with relevant government bodies and other power companies has grown. They have also found it desirable to transfer talented employees among different portfolio companies to help encourage better operational and management practices. Even if it is theoretically possible for a foreign minority investor to buy small stakes in several cheap listed utility companies, in practice it would be extremely difficult to replicate this conglomerate's strategy, as it is unlikely that a foreign investor would have the same level of operational knowledge or practical influence.

The company has managed to generate more than VND 1t (~US 45m) of net operating cash flow over the last two years,[11] with around a third of the cash flow contributed by each main business area (i.e., [1] M&E + air-cons; [2] real estate; and [3] utility investments); the exact breakdown varies from year-to-year depending on developments in each division. This VND >1t in cash flow is free to be reinvested in real estate development projects or utility companies (depending on which investment opportunities meet the company's hurdle rates). Given the growth of the utilities sector in Vietnam and the role of this company as a consolidator, we are confident that attractive utilities reinvestment opportunities will continue to be on offer in the coming years. Undeployed cash flow is then paid out to shareholders as dividends. In practice, over the last two years the company has paid out slightly less than half its cash flow in dividends (implying a current dividend yield of >5%).

Panah first became a small shareholder in mid-2015, and then increased our stake in the second half of 2016 to ~6.5% of NAV. The fund's share purchases took place at modest valuations, at an average EV-to-net OCF multiple of 5.0x. A share price rally late last year increased the size of this position to 8.4% of NAV by end-December 2016. Despite the rally, in our view valuations remain attractive, given an EV-to-net OCF multiple of ~6.5x and anticipated growth of >15% per annum. After all, this is a company which has managed to grow adjusted BVPS at a compound rate of ~25% since 2004. We are also encouraged that a much larger pan-Asian conglomerate (with a good track record of capital allocation and long-term stewardship) has become the largest shareholder in this company in recent years, and controls a board-seat.

[10] For instance, over time there will probably have to be more consideration of contingent liabilities such as eventual upgrade or decommissioning costs for some of the power plants in which they are invested.
[11] Operating cash flow is adjusted to include dividends from investment assets, less maintenance capex for operating assets; it excludes discretionary spend on new projects and investments.

**Market Outlook and Investment Implications**

And so begins another year, marked with the usual round of predictions from the media and sell-side community. Although one might have hoped that surprises of 2016 would give pause to prognosticating pundits, they have nonetheless been keen to dust off crystal balls and gaze deeply therein. Most forecasts involve a prediction that this year will be “unpredictable”, just like last year. After all, 2017 will witness the inauguration of a US president who revels in his ability to shock, substantial political uncertainty surrounding various European national elections, as well as the likely revelation of the terms on which the UK will exit the European Union.

Leaving politics aside, in reality there appears to be a strong market consensus for the year ahead… Monetary accommodation will transition towards fiscal stimulus (i.e., an infrastructure build-out). Inflation will pick up gradually, allowing the Federal Reserve (though not yet other central banks) to increase rates two or three times. The long-end of the curve will also drift up (the 10yr towards 3%), dragging the US Dollar along with it. This process should be supportive of US equities (especially financials) and even credit, although the upside is limited as valuations are somewhat stretched. The stronger Dollar will pressure Emerging Market currencies. EM equities seem likely to come under pressure because of incremental tightening from China, as well as the risk of a US trade tensions with countries such as Mexico and China.

This outlook does not seem unreasonable, probably because it describes the trends which started to play out during the last six weeks of 2016. Indeed, by early 2017 many of these themes had already been priced into markets to some extent. It is thus perhaps unsurprising that in early January we have already started to see some consolidation, especially in interest rates and the US Dollar. What about the rest of the year?

Perhaps the biggest surprise of 2017 might be that despite all the GFC-angst and central bank shenanigans over the last eight years, investors quickly become inured to the melodrama of Trump-eted Shakespearean tweets – “*Told by an idiot, full of sound and fury/ Signifying nothing*”[12] – and this turns out to be a business cycle which ends just like any other… A tighter labour market leading to stronger wage gains, in turn stoking inflation, which is then eventually choked off – along with economic growth – by belated rate hikes from the Fed and other central banks.

It is certainly true that we are starting to see higher inflationary pressures in the US and elsewhere, which likely reflect both structural and cyclical factors… The most recent era of Globalisation saw much of the Developed World’s manufacturing capacity transferred to China and other EM countries, and cheap labour costs allowed them to export deflation for a while. However, wage costs in these countries have already been rising in real terms for several years. We would also note that the current global protectionist backlash against free trade and the free movement of labour, as well as the trend towards income redistribution, can only be inflationary. It is as well to note that the stabilisation of the Chinese economy (since April 2015) has increased demand for commodities. This, together with the recovery of the oil market, are already contributing to rising headline inflation. Global monetary policy is still loose, and large excess reserves at the major central banks might fan the flames of inflation as the velocity of money starts to rise. It is also easy to forget that inflation is a common late cycle phenomenon, which accelerates as unemployment falls and companies increase wages to attract workers. This now appears to be happening in the US.

Although higher inflation in 2017 seems likely, we are less certain about global growth. While US leading indicators have picked up sharply following the presidential election, this has so far been driven by a spike in sentiment, while activity indicators remain lacklustre. What about fiscal stimulus? We are on balance doubtful that discretionary spending can provide a large boost to US growth in 2017 (owing to uncertainties surrounding the likelihood and timing of Congressional approval, and scepticism about the actual size of such a stimulus). Nevertheless, any fiscal easing in the US would further tighten a labour market which has already reached ‘full employment’, thereby increasing inflationary pressures. In the Eurozone, the economy is currently stable despite political angst. Japanese leading indicators have started to turn up. In China, while the pace of last year’s

[12] ‘*Macbeth*’, Act 5, Scene 5.

crazy credit growth might have moderated, the authorities seem determined to keep the economy stable until the 19th Party Congress in autumn 2017; the greatest risk appears to be the potential impact of renewed capital outflows on the Renminbi. While markets remain sanguine about India, the risks to growth are surely to the downside after an aggressive demonetisation.

In summary, we have more conviction about a pick-up in inflation rather than growth, which is why the word 'stagflation' has crept into our recent quarterly letters. While global interest rates have risen somewhat after reaching a 5,000-year low[13] during the deflation scare of mid-2016, there is still plenty of room for a sharp upward movement in rates even under a modest inflation scenario. This might materialise once investors realise that central banks are behind the curve and will have to play catch-up later in the year. What might this mean for other asset classes? Stagflation would not be kind to US equities; as labour cost rise, margins will likely come under pressure and multiples derate. However, if commodity prices remain stable or even make further advances, this should provide support for EM equities (which might even manage to rally in H1 if monetary policy remains sufficiently loose). As always, much depends on the path of Chinese growth. Despite lots of well-rehearsed reasons for staying long the US Dollar in 2017, this might prove *not* to be a one-way street, with significant volatility and variation depending on investor positioning, and on what happens to the other leg of the trade (e.g., can 'commodity currencies' continue to be resilient, and will the Euro strengthen during periods when Bund yields rise faster than US Treasury yields?).

If reality were to diverge significantly from this outlook, what might be different? There is a possibility that growth might accelerate faster than anticipated, driven by US fiscal stimulus or more likely a pick-up in private capex (which has so far been curiously absent this cycle, but might accelerate as the oil price recovers). In that scenario, the upward movement in bond yields would likely prove to be even more dramatic, the US Dollar would no doubt follow suit, and equities would suffer. The key downside risk would be if the increasingly fraught rhetoric of resurgent populist nationalism bubbles over into something altogether more serious. While deteriorating US-China relations are an obvious cause for concern, sadly the general geopolitical status quo has become more fragile, and cracks might appear in any number of places. However, in a worst-case trade war scenario, might US stocks outperform on a relative basis as capital comes home?

Despite all these macro conjectures, investors should be reassured that while we do try to keep abreast of consensus views and employ macro hedging in modest size (designed to protect capital from uncertain and unexpected market outcomes), our conviction stock holdings are not bought and sold on the basis of 'macro maybes'. As always, our primary occupation remains unearthing and investing in solid companies trading at reasonable valuations. Finally, our New Year's Resolution this year is to be kinder to investors, by keeping the length of each quarterly letter to only ten pages of commentary. Like all good resolutions, we have just about managed to keep this one for the first few weeks of January. We are strengthening our resolve, to ensure that this resolution can survive the trials and tribulations of the markets in 2017, the Chinese year of the 'yin Fire Chicken'. Feng Shui masters tell us that this year will be prone to disharmony and unpredictability, which suggests that they have also been reading too many investment strategy reports. No matter what the year brings, we wish our investors the best of luck for all endeavours.

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[13] For those who wish to fact-check this statement, we would recommend '*History of Interest Rates*' by Sidney Homer and Richard Sylla. In our letter to investors for Q3 2016, we suggested that the rock-bottom level of global rates had been distorted by misguided policy initiatives, and from a fundamental perspective could only really be justified by an expectation of banking crises in China and the Eurozone.

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