Quarterly Commentary

Q2 2022

CRUX ASSET MANAGEMENT

Fund Managers: Ewan Markson Brown & Damian Taylor

CRUX Asia ex-Japan Fund

“ Over the quarter we increased our exposure to Chinese consumer discretionary names and by doing so have shifted our country weight in China from slightly underweight at the start of Q2 to overweight by the end of the quarter. ”

Fund Performance

The CRUX Asia ex-Japan Fund returned -8.2%, underperforming the MSCI Asia ex-Japan index, which fell -0.1% over the quarter; this was due to poor performance in our materials, communication services and information technology names. The market continues to be highly volatile with macro-concerns over-riding most stock-specific news. Significant stock movements are often, in these times, caused by flow of funds rather than fundamentals. It's hard to see why this environment should materially change until we see a change in Fed policy. Our current goal is to attempt to manage this volatility, while still maintaining our exposure to our longer-term themes and ideas.

In terms of company specific attribution over the quarter, the main detractors to fund performance were Taiwanese ABF substrate manufacturer Unimicron, Korean music label and talent management company Hybe and Australian Copper miner Chalice Mining.

The main positive contributors to fund performance came from Chinese short video platform company Kuaishou Technology, Chinese electric two-wheeler manufacturer Yadea and Milkyway, a Chinese chemical logistics operator.

*Source: FE FundInfo 31.03.22-30.06.22 Bid-Bid in GBP, TR, net income re-invested.

Attribution Stock Level Q2 2022

Top 5 Contributors (%)	Bottom 5 Contributors (%)
Kuaishou Technology +0.53	Unimicron -1.32
Geely Autombile +0.50	Hybe -1.29
Yadea +0.44	Chalice Mining -1.03
Milkyway +0.42	Nickel Industries -0.95
Yatsen +0.42	Sea -0.94

Source: Bloomberg

Market Cap

	Fund
>$50bn	39.3%
$15bn-50bn	19.5%
$2bn-15bn	25.8%
<$2bn	14.0%

Source: CRUX Asset Management as at 30.06.22

“Over the quarter we increased our exposure to Chinese consumer discretionary names and, as a result, have shifted our country weight in China from slightly underweight at the start of Q2 to overweight by the end of the quarter.”

Portfolio Changes

Over the quarter we increased our exposure to Chinese consumer discretionary names and, as a result, have shifted our country weight in China from slightly underweight at the start of Q2 to overweight by the end of the quarter. We funded this by reducing our exposure to technology hardware and consumer electronics names in South Korea and Taiwan.

Highlighted new stock buys:
Baidu: Baidu once dominated the China internet in search and advertising but lost out to Alibaba and Tencent which created their own walled eco-systems. Over the last 5 years Baidu has invested heavily in artificial intelligence (AI), with a focus on autonomous driving/robotaxis and cloud/Transportation-as-a-Service. We think the market is ignoring the long-term opportunity for these businesses. There is also potential to see China’s internet pivot away from the closed (walled garden) platforms to open platform structures which would favour search engine technologies such as Baidu’s. We see this trading at 5-6x P/E in 2026.

Niu Technologies: A Chinese electric 2-wheeler (2W) manufacturer, Niu’s brand positioning is in the premium segment with a particular focus on attracting younger, fashion-conscious consumers looking for smart feature rich 2Ws. This complements our existing exposure to the electric 2W market in China with Yadea; both are exposed to the same secular drivers such as replacement of internal combustion engines (ICE) 2-wheelers with electric 2W, rising demand from delivery/logistics riders, and demand for affordable individual transportation solutions.

PinDuoDuo: PDD is China’s largest community group buying ecommerce platform. Recent results beat consensus expectations and marked the 4th consecutive quarter of profitability. Its value-for-money proposition has clear appeal with an annual active user base now over 880m. We expect revenues will grow at close to +20% compound annual growth rate for the next 3-5 years. Thanks to industry consolidation subsidy spending should remain in check, resulting in further margin improvement. With a 10% FCF yield (FY24), there is also ample opportunity for a re-rating.

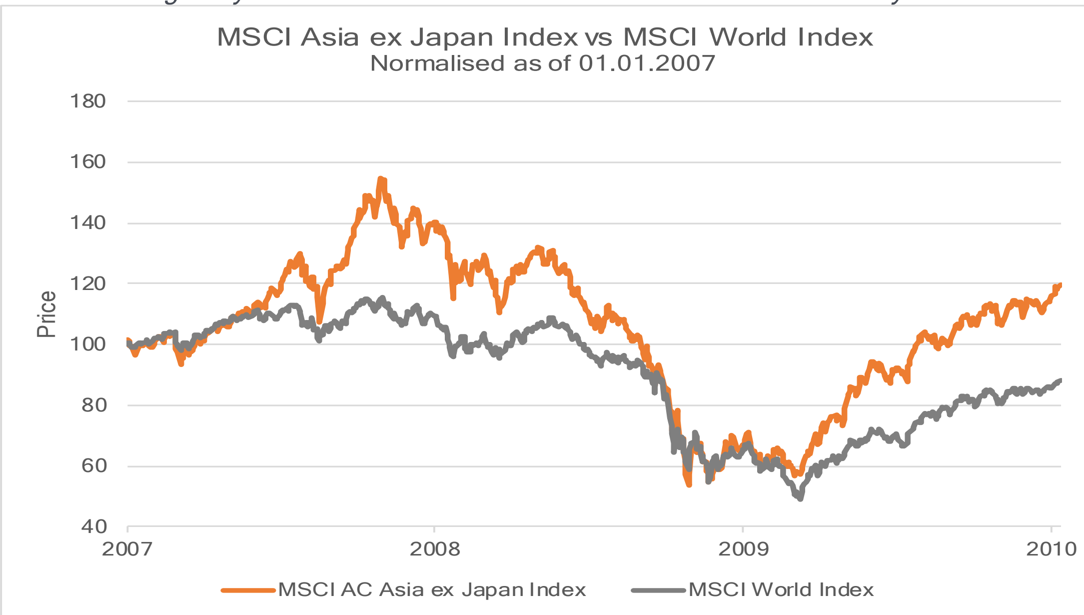
Outlook

We are facing probably the most difficult and confusing macro-economic, geo-political and populist-social environment any of us have ever had to deal with. We are dealing with shades of multiple different historical crises rolled into one: We have the over-exuberance and overvaluation signalled just before the dot.com crash in the early 2000s, we have areas of financial crisis, especially in Europe, similar to (albeit smaller) the 2008 crisis, and lastly, we have something few of us have experienced, the inflationary energy-crisis episodes from the 1970s. Western policy makers have reacted with, and adopted populist measures, tinged with authoritarian hues, which, inflationary in nature, will only prolong the crisis. While Cold War geo-political tensions have arisen with Russia and, to a lesser extent, concerns with China’s role in the world. Lastly, we are at the beginning of an energy transition from fossil fuels and discrete energy generation (diesel/petrol engines) to electric power.

To top this list off, we have central bank governors, whose mental models of the world are built upon the last 20 years of dis-inflation, where supply-side issues were temporary and could be solved quickly by the market. The chance of a significant policy error is high.

Usually in financial markets and economies, the shorter the timeframe the easier it is to forecast, and the later years become far foggier. Today, arguably, it is the reverse.

Chart showing 2008 period: Asia bottomed in October 2018 and outperformed for the following few years: Global Markets did not have their low until February 2009.



Source: Bloomberg/CRUX 30 June 2022

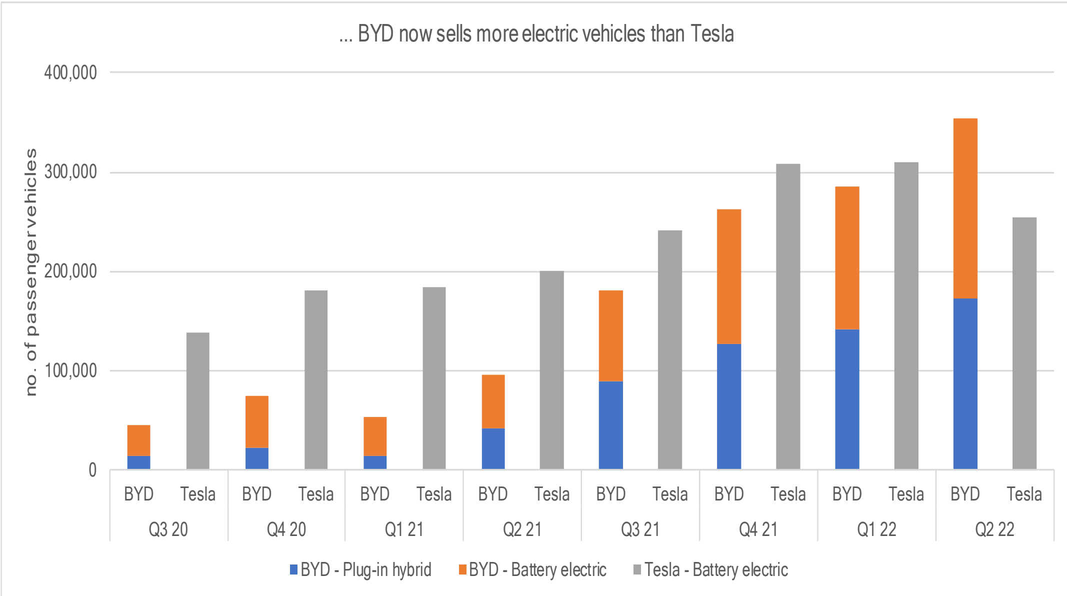
The Next Technology Transition

15 years ago, when Apple launched the first smartphone, little did we realise that this product would change the world. Today we mostly do not use the mobile phone to talk on, we use it as a gaming device, a social media experience, a navigator, a torch, a computer, a personal trainer, etc. If 15 years ago, we had bought the chip makers, the camera module companies, and all the associated widget makers that go into the phone, then these names would have been very successful; even more so had we owned the brands that made and marketed the new product. However, the best investments would have been buying the new software companies and eco-systems that arose once the smartphone became ubiquitous, for example, the social media and e-commerce companies. This one product created more equity market capitalisation than any other in history – we can call this 'The Digitalisation of Everything'.

Outside, of select Emerging markets this trend is now mature. The rise of the smartphone occurred in the turbulence of the 2007-2009 Global Financial crisis, within periods of stress, new ideas tend to arise, and new long-term trends are born. Within the COVID-19 crisis, we are seeing the start of some new longer-term trends.

We call this 'The Electrification of Everything'. Sometime over the next 5-15 years, the discrete ICE engine will be replaced with a fully autonomous electric vehicle. Again, we are likely to find out that we do not use this new technology solely for traveling from A to B but also as a gaming centre, an office, a (small) hotel, a meeting place, a distribution centre, a recycling machine, a new social habit. The companies that first build the components, the new brands and then create the new platforms and eco-systems are likely to become some of the largest in the world. This process is already underway, with the rise of Tesla in the US and BYD, CATL, Li Auto and other mega-caps in China. It is our contention that a combination of leadership, less existing sunk costs, lowest cost eco-system and the largest global domestic market, will allow China to lead this new technology. Eventually, like all technology trends, this will be highly disinflationary.

Graph showing the number of electric vehicles sold by BYD and Tesla



Source: Bloomberg/CRUX

The Energy Problem

The Western world is attempting to replace fossil fuels with an alternative source of energy driven by government fiat. This has led to historical under-investment in fossil fuel capacity globally due to uncertainty of regulation and returns. However, a longer-term viable energy source has not yet been found. To move to renewables, we would need an increase of fossil fuels to build the new power sources and a significant increase in metals and land use, on a scale probably beyond that which is feasible. To maintain economic growth for the developed world and to enable rising living standards in the emerging, we expect that we will need significant investment in both renewables and fossil fuels at a scale much larger than seen in the past. This is our inflationary and growth suppressing dilemma. Eventually a much cheaper source of energy, probably nuclear will solve this crisis. Countries that can cost-effectively increase their domestic energy production and consumption will significantly out-perform.

The next 2-3 years:

We have gone overweight China in our portfolios and have been buying into distressed technology/internet names.

1.The anti-monopoly regulation and regulation of the technology names has hit its apex.

2. The technology index has suffered its equivalent of a dot.com crash, falling 80% peak-trough. Earnings expectations are at a low and valuations are cheap - this is the opposite to Nasdaq names where there is significant risk to both valuations and earnings.
3. The clampdown on the property market has ended with significant relaxation ahead.
4. The government is re-focusing on growth as one of the greatest risks to social instability given high unemployment and especially youth unemployment.
5. We have passed the nadir in terms of lockdown severity with regards to the zero-COVID policy; incrementally the system will be better able to manage disruptions.
6. Geo-politics may incrementally become more pragmatic as increased trade can solve the US inflation problem and the Chinese growth issue in one fell swoop.

Most importantly China, and broadly Asia, does not have an inflationary problem. The West destroyed supply (lockdowns) and spiked demand (free cash payments), China and Asia did neither to the same scale and intent. This leaves Asia with much higher real interest rates than Western nations and with economies which are closer to the bottom of an economic cycle, rather than the top.

“ When riskier assets start to outperform in a down-market, we tend to take note as it is often a sign that a trend change is occurring. ”

Shades of experience:

During the NASDAQ technology bust MSCI Asia ex-Japan began to outperform from 2001, never making a further low in the broad markets, unlike US indices in 2002/2003. The region then went on to outperform for a decade until 2010, at which point the smartphone and US shale oil created the current US driven bull market. The Chinese stock market bottomed in October 2008 (including high-beta real-estate) and did not follow Western markets into a new low in 2009. When riskier assets start to outperform in a down-market, we tend to take note as it is often a sign that a trend change is occurring. China has out-performed for three months now, especially its high-beta internet names. If history is to repeat, any new leg down in US markets will not create a new low in Asian indices and it may possibly indicate a longer-term bull market for the region. The story to drive future returns is built around the electric vehicle and China’s dominance in renewable energy.