Pacific Assets Trust plc

Third Quarter 2016
1 July – 30 September 2016

Pacific Assets Trust plc investment objective

To achieve long-term capital growth through investment in selected companies in the Asia Pacific region and the Indian sub-continent, but excluding Japan, Australia and New Zealand (the 'Asia Pacific Region'). Up to a maximum of 20% of the Company's total assets (at the time of investment) may be invested in companies incorporated and/or listed outside the Asia Pacific Region, (as defined above) but whose economic activities are predominately within the Asia Pacific Region.

Commentary

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"Even a broken watch is right twice"

Buckaroo finance

The term 'irrational exuberance' belonged to a different era and is barely relevant today, for we have long-since crossed the Rubicon and are now well into the realms of 'rational indifference': everyone knows the game is up and yet it drifts on with minimal interest. Commentary from across the gamut of stakeholders suggests that even the wolf is crying wolf as central bank string-pushing reaches its zenith. Consequently we edge ever closer to the end of the most inequitable bull market in history and while previously thrill and euphoria have characterised market tops, today it appears to be a combination of despondency and apathy. We cannot time when things will crack, but we can do our best to prepare for it, as we have been doing for some time now. Today we are closer than yesterday and tomorrow we will be closer still and as markets continue to creak upwards, protecting shareholders' capital becomes more and more difficult for us.

For years now the stock market has served neither as a barometer nor a thermometer, but instead a cruise-control set by unconventional monetary policies; the disconnection between the economy and asset valuations has rarely been starker than it is today. At the same time market participants appear to have completely given up: arbitrary benchmarks ensure that institutional investors get dragged into the debasement game and individual savers themselves have capitulated by volunteering their hard-earned cash to algorithmic, passive Exchange Traded Funds (ETFs). As a result, markets have become little more than robots playing ping-pong. Never failing to disappoint, it is unsurprising that the investment community would choose a time like this, with the fuel gauge flashing empty and the mountainside filling the windscreen, to switch to autopilot and remove seatbelts.

Given the awareness that market participants ought to have regarding danger signs, it is perhaps not helpful to highlight specific flashpoints, but suffice to say that once again, debt is the main culprit. Total US corporate debt has doubled since 2007 to over $5 trillion, whereas corporate cash has only risen by $600 billion. This doesn't touch on student loans, credit cards, auto finance or the fact that the US government itself owes nearly $20 trillion. Europe's woes are well-documented and estimates that China's debt is over 250% of GDP are more likely to prove generous than conservative. All of this has been enabled by a combination of low global interest rates and quantitative easing, alongside short-term perspectives.

When credit is used to finance useful, productive investment, it will generate income to repay the debt. But as we learned last time around, if credit finances anything other than useful investment it is likely that these debts will prove to be unsustainable. Whereas the common psyche seems aware that this is the case for fiscal deficits, it seems still somehow more acceptable for the private or household sectors to borrow for purposes other than productive investment. Still we see companies taking out cheap debt to finance expensive share buybacks, banks lending money to speculators over entrepreneurs, loosening of mortgage and collateral requirements at precisely the point when they must be tightened.
The list of anecdotes highlighting ongoing danger signs can, and has, filled many books.

Commentary (cont)

Negative interest rate policies make lives impossible for banks and insurance companies. Only a long-term and absolute view allows adequate risk pricing and even then it will be impossible to avoid the fallout when the unsustainability of governments and companies raising money at below zero finally becomes apparent. As investors we have to ask ourselves what is the merit in holding expensive good banks or companies when bad ones are consistently bailed out. And if governments bailed out companies last time, who is going to bail out governments this time?

Furthermore, the collateral damage that comes with seemingly free money is widespread and extends far beyond financial metrics. Perhaps it would be OK if all assets were distributed evenly across populations, but that is never the case and hence, artificially inflated valuations are significantly increasing wealth inequalities and social unrest. A rising tide raises all boats, which is fine if you have a boat (or even a lifejacket), but for those who don't, life becomes very difficult.

So for now, we continue to watch market participants pile debt on debt on debt once again, in what has become a game of financial Buckaroo; each hoping they won't be near when the donkey kicks. All we can do is stick to what we believe in which is that holding quality, despite the valuation, is a better strategy than the siren call of 'cheap' and lower quality assets. This does leave us in an uncomfortable position with regards to the holdings in our funds. The valuations attributed to some of our favourite companies reflect broader concerns across the investment community which has placed a material valuation premium on many if not all of our investments.

It is difficult to envisage this premium withstanding a broader, systemic crisis. Portfolio performance in a market rout will be anyone's guess and whether or not expensive and good companies perform better than cheap and poor companies in the short-term remains to be seen. But we are struggling to find new ideas at acceptable valuations and we remain unwilling to descend the quality spectrum for the sake of a near-term multiple, believing that our investment philosophy will generate the best long-term, risk-adjusted returns irrespective of what the near-term holds.

In the meantime we may be accused of being unnecessarily pessimistic and unduly cautious while markets continue to defy gravity, but we have to weather those allegations because for the past eight years now, the time, according to our watch, is still one minute to midnight.

Significant Trust changes

During the quarter for the Pacific Assets Trust we did not initiate any new positions. Instead, we added to: Commercial Bank of Ceylon as it remains conservative while slowly expanding outside Sri Lanka; Delta Brac given its growth opportunities; Bank OCBC NISP as following a recent dip in the market it still remains a quality Indonesian Bank; and Selemat Sempurna, Unicharm and DGB Financial Group on compelling valuations.

We sold out of: Weifu High Technology having failed to gain enough conviction to build a meaningful position; Bata Shoe Bangladesh due to concerns it is potentially under-investing in brand building like their Indian cousins; Infosys in search for better quality franchises; and Container Corp as it has become very expensive. We also trimmed a number of other positions in the trust we feel have become expensive.

Proxy voting

During the quarter for the Pacific Assets Trust there were 213 company resolutions to vote on. On behalf of shareholders, we did not vote against any resolutions relating to corporate structure.

Should any shareholders like a full list of all proxy voting for the companies held in the Trust, please contact us directly.

Engagement

Company engagement is a critical part of our investment process. While we will never be able to calculate the exact investment contribution it makes, we are convinced that without it, our long-term returns would be lower and more volatile. Over the past decade we have spent much time trying to find a good way of reporting our company engagement activities. At one stage we simply published all our correspondence with companies. However, over time we have placed more emphasis on the importance of building long-term, strong relationships with company management teams in order to encourage and support change for the better. As a result, we have reviewed our current practice of reporting specific examples of company engagement and concluded that it runs the risk of having a negative impact on the engagement itself. While some companies are comfortable with us reporting our ongoing discussions in a public forum, there are many that are not. As a result, we have decided to stop reporting specific company engagement in our quarterly reports. Should any shareholder wish to speak directly to us on engagement, we will, of course, be delighted to discuss what we have been doing face-to-face.

Commercial Bank of Ceylon

Market cap
USD 882.5m

Shareholders since
January 2015

Sustainability classification
Responsible finance

Company description
Based in Colombo (Sri Lanka), Commercial Bank of Ceylon is one of the oldest private banks in Sri Lanka. 235 branches and 585 ATMs help one in five Sri Lankans access the services of Commercial Bank.

Investment rationale
Commercial Bank has a history of conservative plain-vanilla banking with a leading share in deposits among private sector banks, testimony to the trust they have earned of millions of Sri Lankans over decades. Commercial Bank is well placed to grow by slowly taking market share away from inefficient state-owned banks and providing access to affordable financial services in war affected areas of North Sri Lanka.

Business update

Research

It has now been a little over a year since as a business we announced that we would unbundle payments for research from trading commission and as a result pay for research from our own resources. The objective behind this decision was to improve transparency and gain greater insight into the value research providers are adding to the investment process, as well as to provide comfort shareholders that research costs are fully paid for by Stewart Investors.

Having been overwhelmed at the up-take from the first round of research tenders, we are currently waiting on the final completed research reports from the chosen providers and in time hope to be able to share and engage with you on these findings. We have progressed with round two.

Some themes that we tendered for in phase two included:

- Benefit corporations
- Alternative Measures of Gross Domestic Product (GDP)
- Brazilian Corporate Governance Improvements
- Labour Practises at Asian Banks; and Asian Manufacturers and Assemblers
- Water Scarcity
- IT Firms in India – Sustainable Employment Practises

For more information on research tenders please visit:
www.stewartinvestors.com/si/research

Team updates

We are delighted to welcome Sujaya Desai to the Sustainable Funds Group.

Prior to joining the team Sujaya was studying for her MPhil in Development Studies from the University of Cambridge. She also holds a BA (Hons) in International Relations and Anthropology from Brown University and has worked for numerous international development organisations during her studies.

Sujaya is based in our Singapore office and is responsible for generating investment ideas for the Sustainability strategies across all sectors in emerging and developed markets.

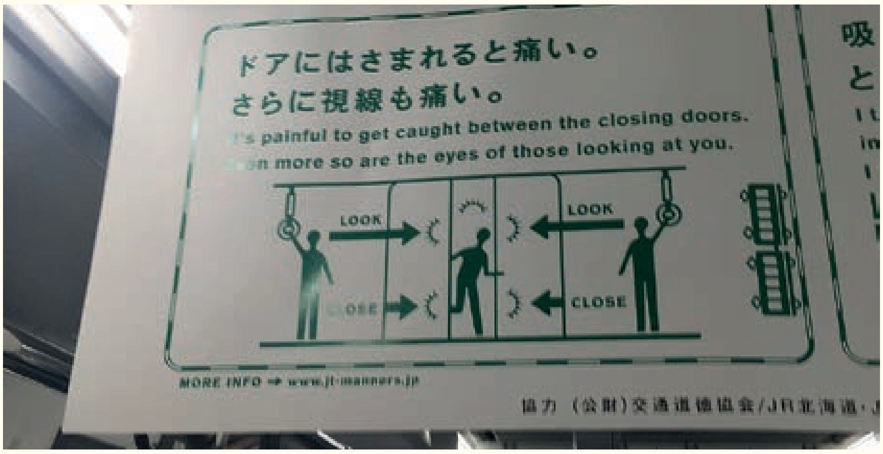
Unfortunately Kimberly Buncle, who joined the team in Edinburgh at the start of 2015, has left the company to relocate back home to the US. We were very sorry to see Kim leave, as she was a key member of the group and made a wonderful contribution during her time with us. We wish her all the very best in her next chapter.

We are also pleased to share that the Sustainable Funds Group team members based in Sydney have relocated to a new separate Stewart Investors office in Walsh Bay. If you are ever travelling through Sydney please do let us know, as we would love for you to drop in and visit the team and the new office.

Trip report: Japan

Note to shareholders

Although the investment objective of the Pacific Assets Trust is to make investments in the Asia Pacific Region and the Indian sub-continent but excluding Japan, Australia and New Zealand (the 'Asia Pacific Region'), it is possible for up to a maximum of 20% of the Trust's assets to be invested in companies incorporated and/or listed outside the Asia Pacific Region so long as their economic activities are predominately within the Asia Pacific Region. Unicharm the Japan listed manufacturer of disposable hygiene products, household cleaning products, and specialising in the manufacture of diapers for both babies and adult incontinence is an example of this.



"It's painful to get caught between the closing doors. Even more so are the eyes of those looking at you."
Source: SI Team, June 2015

The above is a sign from a packed subway line en route to the bullet train at Shinagawa Station. A sign that initially amused but then began to hold more power as a metaphor as the trip went on. In most other countries, a sign highlighting the pain that comes from getting trapped in a train door would be enough to deter passengers from trying their luck with some automatic doors. Why the second point and why the emphasis on that being the major deterrent to risky behaviour? After some Googling we find a form of social phobia, one which occurs primarily in Japan. Called *Taijin Kyofusho* it translates as 'the disorder of fear' – a social paranoia characterised by a fear of harming or offending others. The potential consequence of a culture that emphasises conformity?

This fear looks to continue from the commute to the board room. Those management teams and corporate cultures that have managed to overcome the pressure of conformism and take assertive risks, stand out as companies that have and should continue to thrive both domestically and on a global scale. It has been in the best interests of management and shareholders for these companies to show some 'irresponsible responsibility' and break from the herd. As we know in many facets of life (including investing) and in every corner of the globe, it is far better for the reputation to fail conventionally than to succeed unconventionally.

We met a number of primarily domestically-focused companies on this trip who at some point in their history succeeded in thinking unconventionally and recognised early in their journey that they should not be constrained by the traditional means of operating their businesses. Choosing instead to

Trip report: Japan (cont)

follow their own path, whether that be in consolidating a market (Miraca), creating a new market (MonotaRO or Kakaku.com) or thinking with long enough time horizons to align their franchise with the government's inevitable aim of reducing the country's healthcare costs (Ain), all have proven to be vitally important endeavours since unlike India, Japan lacks a tidal wave of demand that many investors hope will raise all ships.

Then there are those companies who chose to take on a greater task and the greater risk of non-conformity by venturing overseas. This would have been an almighty decision at the time but for those who have fostered contrarian cultures and have a franchise to back up these ambitions, there remains vast potential to thrive on foreign soil. Unicharm, Nippon Paint, Hoya, Nidec and Kikkoman have been able to establish quality franchises in growing markets where they successfully go toe-to-toe with global multinationals.

It is no surprise then that it is these companies that lead the way on governance, diversity and meritocracy. They are, of course, not perfect but they have at least (very consciously) made early moves to break from toeing the line and think a little differently about the importance of the people within the business. This must be respected. All look to have realised the importance in hiring local management within their foreign operations and the more progressive have allowed this thinking to rise to senior management and the board. Hoya is a great example of a non-conformist steward with a relatively young, multinational management team and an independent board. They show few signs of the reactive moves to corporate governance box-ticking that exist among the lesser quality corporates we have met around the world over the last few years. Omron talked candidly of the challenges they face in fostering diversity of thought and the associated risks to the long-term survival of their franchise. Domestically, MonotaRO is a fascinating illustration of a company swimming against the tide with its 40-year-old CEO and independent board.

Sadly, as a result of Japan's inheritance tax laws, it's very difficult for families to preserve control over a number of generations. There are very few multi-generational Ayalas or Tatas here. This makes life a little harder for the long-term investor to find suitable stewards of our clients' capital. The best we can do in the absence of such stewards is to find those management teams and cultures that exhibit values similar to the long-term owners we admire: think like owners with long time horizons which allows them to continue to invest in the business, exhibit contrarianism and a respect for all stakeholders. A lack of such values, combined with cash-heavy balance sheets, sadly increases the likelihood of Robin Hood shareholders coming to rob from the long-term to give to the short-term, usually in the form of aggressive buybacks and a leveraged balance sheet.

Those companies that incorporate all stakeholders within their decision making stand out when it comes to understanding the long-term threats to their franchise. Companies such as Unicharm, Kikkoman, Omron, Hoya, and to some extent Nippon Paint, are well placed to benefit and contribute to the sustainable development of the economies they operate within. Kikkoman should benefit from the increasing consumption of plant-based proteins and naturally brewed soy sauce, while Unicharm is making a considered move to reduce the environmental impact of their supply chain and continue to invest in the holy grail of affordable recyclable diapers.

Trip report: Japan (cont)

Many of the higher quality companies we met on this trip have strong brands built on technical competence and are guided by capable management teams with global attitudes. The next challenge many face is to continue this development and ensure success in new markets. Similar to conversations we have had with other companies within the region, China is where the majority complain of the almost impossible task of keeping pace with the demands of the growing middle class and the evolving distribution channels that feed these wants. Fortunately for many of the Japanese companies who have ventured abroad, the country's reputation for quality goods has afforded them a head start over many competitors. This is especially the case in industries where domestic brands have let down an increasingly informed consumer base (viz. adulterated milk or diapers). For consumer companies this has made brand-building a far easier exercise than it otherwise would have been. Unicharm for example can't simply follow the same strategy they applied in China and Indonesia in the Indian market as the Indian consumer doesn't hold Japanese products in similar levels of esteem. Bottom-up (no pun intended) brand-building is the only answer. Here Unicharm are saved both by their willingness to provide relative autonomy to local management and their ability to share and reflect upon mistakes made in other markets.

For these companies, new and growing markets offer the potential for greater sales, higher margins and healthier returns than what are commonly very competitive domestic markets. We mustn't overlook the fact that those companies that have managed to prosper through twenty years of deflation and zero interest rates will come to the global market armed with a cut throat mentality and should pose serious challenges to global competitors who have been fortunate to have an easier time finding growth, and have likely built up some fat in the process. This offers these companies the opportunity to invest cash flows in growing, profitable ventures that should ensure both the quality of their franchise and the quality of growth continue long into the future. Hopefully allowing them to avoid the closing doors of the economic and political malaise that much of the world finds itself in today.

Japan's leaders have had the eyes of the world on them for a few years now. Their quivers must feel increasingly light as their arrows struggle to ignite the growth craved to pull the country out from under (the rising) mountain of debt. An increasingly difficult task in a world with a slowing China, low oil prices (Japan is a net energy importer) and where their shrinking population has offset any advances in productivity. Today, however, Japan no longer stands alone. Much of the developed world now shares the characteristics of low interest rates, low inflation and stacks of debt. Unconventional monetary policy no longer feels that unconventional.

Companies don't operate in a vacuum but thankfully those whose management teams have taken considered risks, managed to diversify the cash flows generated by globally competitive franchises and have exposure to growing markets, should continue to be attractive long-term investments and survive the fluctuations caused by economies and short-term investors. We were fortunate to meet a number of such franchises on this trip but as is the case with most other regions in our investible universe, quality isn't cheap.

Pacific Assets Trust Plc - 30 September 2016

Fund Size £285.8m
Number of Holdings 58

Ten Largest Holdings

Stock Name	Portfolio Weight* (%)	Index Weight** (%)
Vitasoy International	6.6	0.0
Marico	4.8	0.1
Tech Mahindra	4.5	0.0
Standard Foods	4.3	0.0
Taiwan Semiconductor	3.9	4.1
Chroma ATE	3.3	0.0
Dr Reddy's Laboratories	3.1	0.2
Kotak Mahindra Bank	3.0	0.0
Manila Water	2.9	0.0
Ayala	2.8	0.1
Total	39.2	4.5

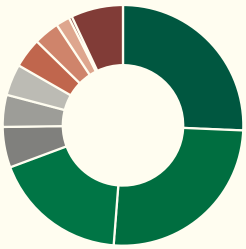
Additions - Three Months

Stock Name	Sector
No additions	

Disposals - Three Months

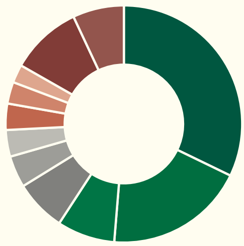
Stock Name	Sector
Infosys	Information Technology
Weifu High Technology	Consumer Discretionary
Container Corp of India	Industrials

Sector Allocations



Portfolio weight (Index weight)

Country Allocations



Portfolio weight (Index weight)

Market Capitalisation

	£0 to £500m	£500m to £1bn	£1bn to £2.5bn	£2.5bn to £5bn	£5bn to £10bn	£10bn+
Portfolio Weight	9.7	13.2	23.9	14.7	16.4	15.1
Index Weight	0.0	0.4	7.0	12.4	16.9	63.3

Style Research does not always have full stock coverage; weights may not total 100%.

Contribution Analysis - 12 months

Top 3 Contributing Stocks	Portfolio Weight (%)	Value Added (bps)	Bottom 3 Contributing Stocks	Portfolio Weight (%)	Value Added (bps)
Vitasoy International	6.6	377	Idea Cellular	1.6	-105
Marico	4.8	332	Tech Mahindra	4.5	-44
Taiwan Semiconductor	3.9	243	Dr Reddy's Laboratories	3.1	-37

Cumulative Performance (% in GBP) to 30 September 2016

Change (%)	Since Launch*	5 Years	4 Years	3 Years	2 Years	1 Year	6 Months	3 Months
NAV	112.7	113.1	70.7	57.3	30.1	30.4	21.9	8.2
Share Price	131.4	126.2	86.1	60.2	30.8	32.4	22.5	13.6
Benchmark Return	59.9	67.4	45.1	38.1	27.7	36.3	22.4	13.4

Standardised Discrete Performance to 30 September 2016

Change (%)	12 mths to 30/09/16	12 mths to 30/09/15	12 mths to 30/09/14	12 mths to 30/09/13	12 mths to 30/09/12
NAV	30.4	-0.2	20.9	8.5	24.9
Share Price	32.4	-1.2	22.5	16.1	21.6
Benchmark Return	36.3	-6.3	8.1	5.1	15.4

Performance since inception, Stewart Investors was appointed as Investment Manager with effect from the 01 July 2010.
NAV includes dividends reinvested, net of tax in Sterling.
The benchmark shown is the MSCI AC Asia Ex Japan Index (Net).
Source: Bloomberg and Lipper. Past performance is not a guide to future performance.

Important information

This report has been issued by Stewart Investors on behalf of its client Pacific Assets Trust plc. Pacific Assets Trust plc (the "Company") is an investment trust, incorporated in Scotland with registered number SC091052, whose shares have been admitted to the Official List of the London Stock Exchange plc. The Company is an alternative investment fund for the purposes of the Alternative Investment Fund Managers Directive (AIFMD) and acts as its own alternative investment fund manager ("AIFM"). The Company is registered as a small registered UK AIFM. The Company has delegated certain portfolio management responsibilities to First State Investment Management (UK) Limited.

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Absolute return mind-set refers to Stewart Investors' belief that capital preservation ought to be the foundation for long term capital gains. It does not guarantee or infer that a positive return will be achieved.

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