



**MARKET INSIGHTS**

# INVESTING IN ASIA: VALUE MATTERS

OCTOBER 2015

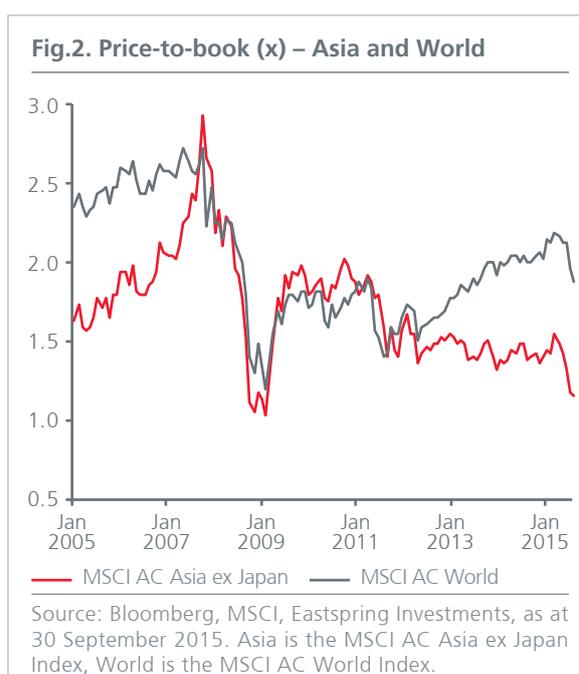
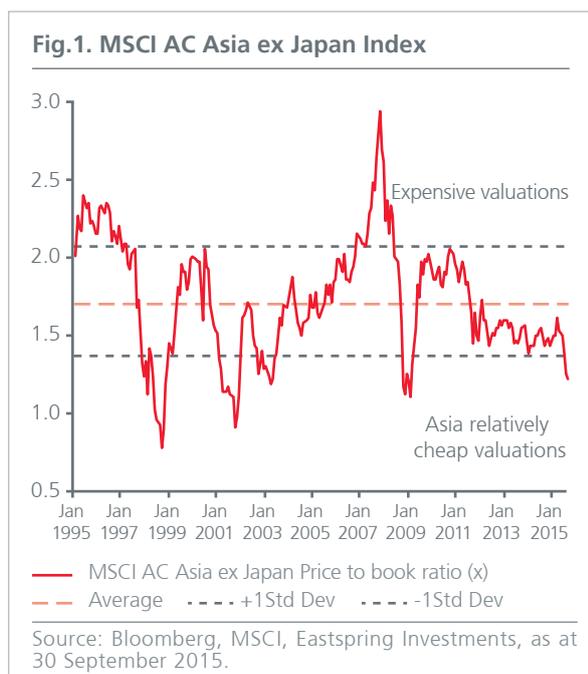
## ROADMAP

- › Asia is an attractively valued investment destination.
- › How did Asia get here?
- › How should long-term investors gain exposure to Asia?

## RISK-REWARD SKEWED IN ASIA'S FAVOUR

Asia (ex Japan) valuations suggest that the region has become a contrarian market.

As a market, Asia is trading well below its historical average price-to-book ratio – our preferred measurement of valuation. At 1.2 times as of end-September 2015, the price-to-book ratio of MSCI AC Asia ex Japan Index remains far away from expensive territory and suggests the region is attractively valued (Fig.1).





The valuation disparity between Asian equities and global equities is also stark. Valuations of global equities have been extended by the stellar performance of developed markets (“DM”) and especially the United States. Meanwhile, Asian valuations have lagged.

This divergence offers a compelling argument for considering an increased allocation to Asian equities in a global context. Relative to global equities (MSCI AC World Index), Asia’s price-to-book ratio is roughly 35% cheaper at 1.2 times versus 1.9 times of global equities – the most attractive it has been in 10 years (Fig.2).

Valuations suggest that Asia has become a contrarian market.

Valued at such a steep discount to global equities, one would think that Asian companies are less profitable than the global average. In truth, Asian companies are actually more profitable and deliver a higher return on equity relative to global peers (Figure 3).

Why do we place so much emphasis on valuation?

History indicates that a value approach to investing in Asia outperforms the market. While investment decisions should keep the macroeconomic picture in context, we believe that valuation must be the starting point for all investments. While never guaranteed,

**Fig.3. Return on equity (%) – Asia and World**



Source: Bloomberg, MSCI, Eastspring Investments, as at 30 September 2015. Asia is the MSCI AC Asia ex Japan Index, World is the MSCI AC World Index.

intuitively, cheap valuations offer a margin of safety in capturing the upside potential of Asian equities.

Current valuations suggest to us that – there are a fair amount of negativity built into Asian stock valuations. Longer-term investors can profit from this.

Starting valuation is very important.

**Fig.4. Asia ex Japan price-to-book (x)**

Starting valuation – price-to-book	% of observations	Subsequent average cumulative returns (%)		
		1 year	3 years	5 years
Less than 1.5x	30	26	43	100
1.5x to 1.75x	25	5	48	53
1.75x to 2x	25	3	-2	17
2x to 2.25x	13	-6	-20	-23
2.25x to 2.5x	5	-11	-31	-25
More than 2.5x	2	-53	-14	-17

Source: Bloomberg, MSCI, Eastspring Investments, as at 30 September 2015. Past performance is not necessarily indicative of the future or likely performance.



## HOW DID ASIA GET HERE?

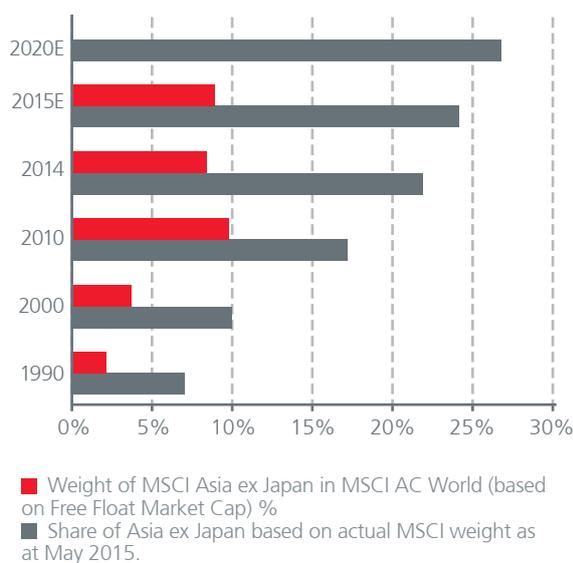
As observed from Fig.2, there has been a widening valuation disparity between Asian and DM equities.

Buoyed by dovish central bank policies and firming – but volatile – macroeconomic data, risk assets in developed markets, particularly US and Japanese equities, have outperformed. In contrast, optimism in Asia has been tempered due to mixed economic data, concerns over a maturing credit cycle, intermittent political uncertainty, and a margin-fuelled rally and correction in China.

Global investors are under-positioned in Asia.

Further exaggerating Asia’s valuation discount to developed markets, we believe global investors are also underinvested in Asia. As a vast majority of global savings originate from developed markets, the tendency for home-market bias has seen allocations to Asia lag its growing importance in the global economy.

**Fig.5. Global investment in Asia and share of Asia in global gross domestic product (%)**



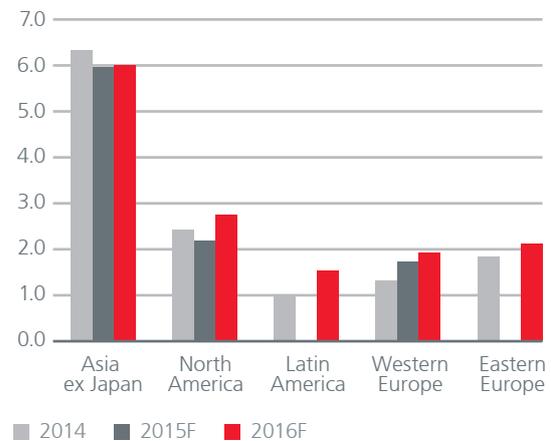
Source: Morgan Stanley Asia – GEMs Strategy, as at 31 May 2015. GDP estimates based on IMF forecasts. 2015 weight of MSCI Asia ex Japan based on actual MSCI weight as at May 2015.

## OPPORTUNITY TO GAIN EXPOSURE TO ASIAN GROWTH AT HISTORICALLY CHEAP VALUATIONS

For long-term investors, Asia remains attractive. In a global environment where economic growth is scarce, Asia stands out. Over the medium-term, consensus estimates Asia to grow twice as fast as North American economies and more than twice as fast as other major regions. This dynamism can be attributed to the diversity of Asian economies. Spread across matured and developing, domestic-oriented and export-driven economies, Asian equities are also diversified across a range of industries.

Asian growth remains relatively strong.

**Fig.6. Real GDP growth (%)**



Source: Consensus Economics, as at 10 August 2015.

Underpinned by its growth premium, Asia will grow to contribute more than a quarter of global gross domestic product in 2018 (Fig.7). Though Asia’s weight in the global investment basket has risen, it remains significantly below where it should be fundamentally. As Asia develops, Asian equities should be expected to grow into a larger representation in benchmarks such as the MSCI AC World Index. A highly topical issue has been the inclusion of mainland Chinese shares into global benchmarks.

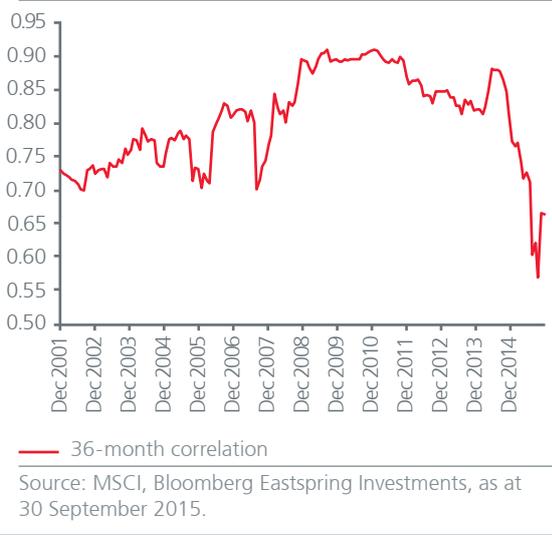


As capital markets in Asia widen and more Asian companies rise to prominence, global investors may find an increased allocation to Asia not only sensible, but also desirable.

Falling correlation to developed equities offers the benefit of diversification.

For global investors, an interesting trend has been the increasing diversification benefit of Asian equities in a global portfolio. In Figure 7 below, the rolling 36-month correlation of MSCI AC Asia ex Japan and DM equities, represented by the MSCI World Index, has declined to just above the lowest level since December 2001.

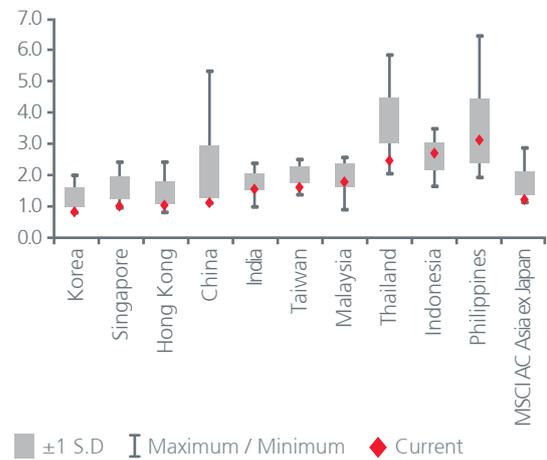
**Fig.7. Correlation between Asia and developed markets**



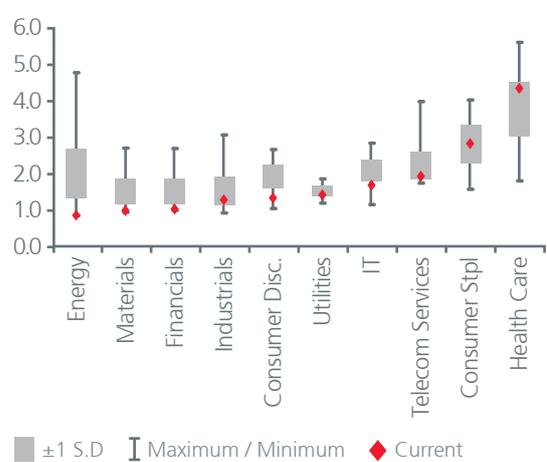
Potential to exploit Asia’s diversity and relative value opportunities.

One of the benefits of investing in Asia is the diversification found among its 10 major economies and range of industries. Asia is large and comprised of economies and industries at different stages of growth. As can be observed from Figure 8 and Figure 9, not only are valuations of Asia attractive at the broad market level, but there is further potential to exploit the relative value opportunities between countries and sectors.

**Fig.8. Countries in Asia – Price-to-book (x)**



**Fig.9. Sectors in Asia – Price-to-book (x)**



### HOW SHOULD LONG-TERM INVESTORS GAIN EXPOSURE TO ASIA?

Value investing has been a successful style in Asia over the long term. Since 1999, stocks in the cheapest quintile of Asia Pacific ex Japan (“APXJ”) have outperformed. As markets are typically inefficient in the short to medium term, investing in stocks where



market prices have diverged from fundamental value has delivered superior returns over the long term as price discovery tends to guide prices toward companies' fundamental value.

Value investing has been a successful style in Asia over the long term.

**Fig.10. Relative performance of value in AxJ (rebased)**



Source: Factset, Macquarie. PB ratio performance represents the return of the top and bottom quintile by Macquarie PB ratio in Asia ex Japan stock universe to 31 July 2015. This chart does not represent the performance of any fund or any security. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities illustrated by this chart.

In addition, as a contrarian approach, value investing offers diversification from other traditional styles of investing. The correlation with other styles is low to negative.

**Fig.11. Relative performance of value in Asia**

Style	Correlation coefficient relative to value*
Momentum	-0.65
Growth	0.19
Quality	-0.47

Source: Macquarie Quantitative Research, Mercer MPA, Eastspring Investments, as at December 2014.

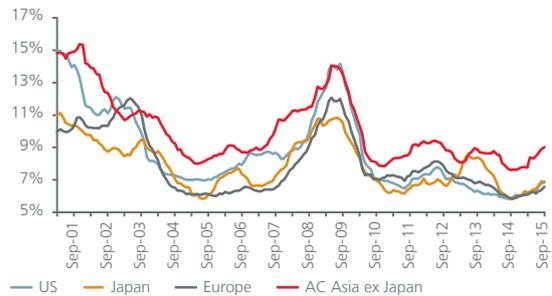
“Price is what you pay. Value is what you get” – Warren Buffet.

Asia also exhibits some of the highest dispersion of stock returns globally (Fig.12). The relatively high variability in stock returns can be partially attributed to the interplay between the region's diverse economies and different sectors. Furthermore, the correlation between stocks in Asia has fallen, in Fig.13, from elevated levels during the Global Financial Crisis and is close to historical lows.

These trends in Asian equities form a favourable environment for stock pickers such as Eastspring Investments. As stocks returns become less correlated, the value-add of stock pickers to invest in individual stocks that outperform should become a greater contribution to investors' returns over the long-term.

Benefit from stock picking in Asia.

**Fig.12. Monthly Dispersion of stock returns**



Source: Factset, Morgan Stanley Quantitative & Derivative Strategies, as at 30 September 2015.

**Fig.13. Average of every stock-to-stock correlation**



Source: Bank of America Merrill Lynch Asia Pacific Quant Strategy, MSCI, as at 30 September 2015. Asia Pacific ex-Japan stock-to-stock correlation six-month moving average.



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