STORM IN A TEACUP?

The short-term impact of external factors such as Brexit and the US election need to be considered but Eastspring is still a long-term, stock-picking investor with a keen eye on company valuations

Cherry Reynard

Donald Trump's election as US president may be causing waves across emerging markets, with a fall in many Latin American and Asian currencies, but Kevin Gibson, chief investment officer, equities, in Singapore for Eastspring, is keeping his head. He believes the long-term picture for emerging markets is still sound and valuations remain compelling.

This is a challenging environment and Trump's election has made it more so. Nevertheless, he says: "We do not lose a lot of sleep about the US election. Certainly, it will have a short-term impact on markets and therefore we will spend time looking at the reaction."

If anything, he suggests, the sell-off in emerging markets and currencies has created opportunities to buy into good companies at cheaper valuations.

This is typical of the Eastspring approach, which has built its philosophy on value investing. Eastspring is Prudential's Asian asset management arm, managing around $140bn (as at 30 Jun '16), of which over $35bn (as at 30 Sep '16) is in equities with a particular focus on Asia, Japan and global emerging markets. It aims to differentiate itself on its fundamental analysis on stocks and a disciplined approach to valuation.

Gibson says: "We spend time trying to understand what is implied in share prices and trying to take part in pricing episodes, looking at where the market has got it wrong. We believe there are inherent behavioural biases among investors that we can exploit through our disciplined valuation process."

'WE ASK WHAT IS THE SHARE PRICE IMPLYING? AND WHAT IF WE ARE WRONG? WHAT WILL IT DO TO THE VALUATION OF THAT COMPANY?'

Kevin Gibson, chief investment officer in Singapore, Eastspring

All about value

The process is naturally contrarian and long term, hunting in out-of-favour areas and waiting for them to adjust.

"We aim to be far-sighted in our approach," says Gibson. "A lot of what we do is about understanding what is the sustainable return a business can generate through the cycle and what equilibrium returns look like."

It has been a tough time for value, and Gibson admits that momentum strategies have been very prevalent. In particular, he says, there have been extreme episodes around quality stocks with low variability of profits, defensive staples and bond proxies.

He adds: "These companies have been bid to extremes and that has been a persistent trend over the past three to four years. There has been a lot of money swirling around the system from quantitative easing and chasing these stocks."

Nevertheless, value styles have had a better time this year. The group's valuation style does not come with any inher-

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ent biases to individual sectors or countries, says Gibson, but is simply focused on where they see value.

The fund has also benefited from its positioning in commodities and financials, having bought when they were unpopular and ridden the rally higher.

Currently he believes there are strong arguments for Asian and emerging market equities. Perhaps most importantly, they are cheap.

He says: "Our analysis suggests that Asia Pacific equities are one standard deviation cheap. They have only been this cheap a handful of times, usually at a time of crisis, such as the bursting of the technology bubble or the global financial crisis."

He does not believe the current environment merits crisis-level valuations.

Blame it on the weatherman

Lower valuations are leading to a generally positive view on emerging markets in spite of recent developments in the US: "There has been a substantial de-rating of emerging market equities," says Gibson. "They were trading at a 10% premium, but since then they have performed very poorly and are now at a 40% discount."

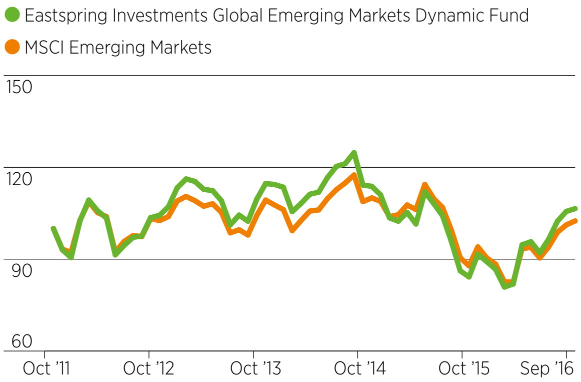
The longer-term picture for emerging markets is still robust, he believes: "After the Asian crisis, emerging markets have been phenomenal performers and there has been a good macroeconomic rationale behind that. Since the global financial crisis, they have been under pressure and we are now at an inversion point. We are seeing earnings revised higher for emerging market companies, but expectations are still very low and valuations reflect that. To our mind, this is a catalyst for stronger performance."

However, Eastspring is selective in where it takes exposure. Gibson believes there is significant disparity between stocks, sectors and countries, with some oversold relative to their long-term earnings potential while others have become crowded trades, highly correlated and expensive. China and Korea are favoured markets. The disruption in the Chinese market earlier this year, in particular, created some real opportunities.

In contrast, Gibson considers markets such as the Philippines and India too expensive at current levels. Although macroeconomic reform is likely to be good for emerging markets, in many cases – India particularly – it is reflected fully in valuations.

Eastspring Investments Global EM Dynamic Fund

5 yrs %



Source: Eastspring Investments

Brazil has been another area of focus. Gibson says: "The market had become very undervalued and we took advantage to increase our exposure there. We respond to where we see valuation opportunities." However, now that Brazilian recovery has been largely 'discovered' by investors, the group is paring back its position.

In a more contrarian slant, the group's global funds also have an overweight position in Russia. The oil price is stabilising and Russia has been widely unloved by international investors. This is changing slowly, Gibson believes, and in the meantime valuations remain attractive.

SUMMARY

- Eastpring's fund managers are out-and-out stock pickers with around 80% of overall portfolio risk coming from stock picking.
- CIO Kevin Gibson makes a strong case for emerging markets, including a contrarian view on Russia and, until recently, Brazil.
- To work their way through the increasing levels of uncertainty, from Brexit to Trump and onwards, a valuation focus is key.

That said, the overall macroeconomic positioning of the group's global funds comes from the selection of stocks rather than vice versa, with around 80% of the overall portfolio risk coming from stock picking. But macroeconomic factors are not ignored, with the group aiming to capture them in its fundamental analysis. For example, the group will incorporate views on currency or interest rates in its risk analysis.

However, the group does not aim to generate returns from forecasting the likely direction of economies. Gibson says: "We believe forecasting is very difficult. The future is inherently uncertain and so we try to avoid a strategy based on forecasting accuracy."

Stable foundations

Risk management takes a number of forms at the group. Gibson says that before they run the traditional risk analytics, they will try to understand the potential downside for any stock in forensic detail: "We ask what is the share price implying? And what if we are wrong? What will it do to the valuation of that company? We spend a lot of time stress-testing," he says.

As part of this, when building the portfolio, the team strive to have as many uncorrelated positions as possible. If there is a significant upside, they may be more comfortable with introducing a more highly correlated company, but the barrier is commensurately higher.

He adds: "We have a quantitative analysis team, who partner with the fund managers in the portfolio construction process. They act as a third-party consultant to ensure all unintended risks are understood."

He acknowledges the industry is becoming increasingly short term, with investors and company management teams looking to judge performance over shorter and shorter time periods, but they aim to take advantage. Gibson says: "We are happy to stand on the other side [of investor short-termism]. We have a valuation anchor and we will seek to take advantage of short term share price movements. Markets are increasingly interpreting cyclical factors as structural factors."

From Brexit to the US election result, these are unusual times in markets. Increasingly, the most significant political risk is centred outside emerging markets, even though they are caught in the cross-fire. For Eastspring, focusing on valuation is the best way to navigate this unpredictable environment.