Value investing in Asia: A multi-year opportunity

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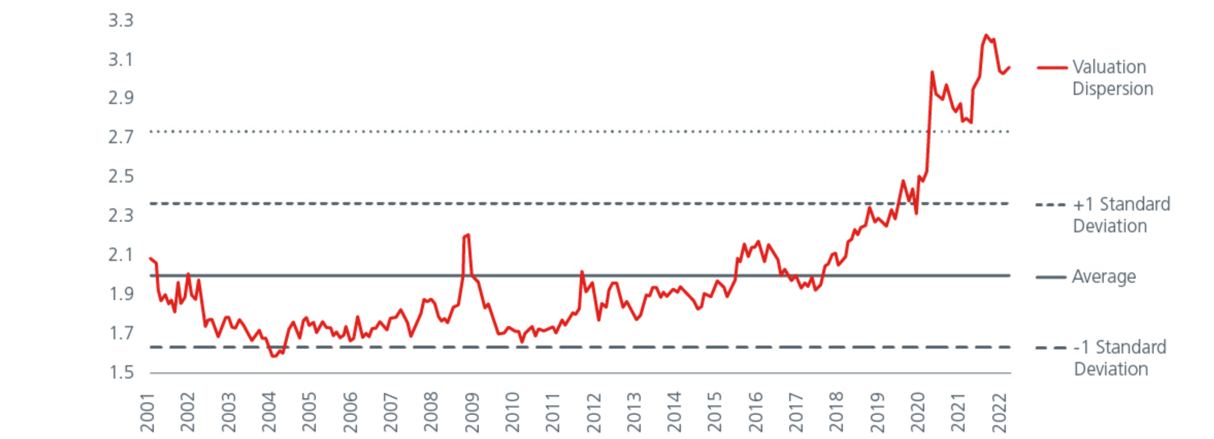
Strategic shifts towards decarbonisation and dual supply chains, inflation and rising cost of capital are starting to revert investors' focus back towards corporate profits and cashflows. This move is supportive of value investing in Asia ex Japan. Cyclical, old economy and financial stocks are likely beneficiaries.

Value equities in Asia ex Japan have had a strong rebound since Nov 2020, outperforming the regional index by 15%.[1] We believe this re-commencement of value's outperformance has just begun in Asia, well supported by the economic cycle, implied market expectations, and investor positioning.

As the pendulum starts its mean reversion journey from one end (optimism over growth stocks) to the other end (renewed focus on profits and cashflows), we see significant mispriced stock opportunities for bottom-up value investors in Asia.

Fig 1: Valuation dispersion (and hence alpha opportunities) stays large despite the recent value outperformance versus growth



Source: Eastspring Investments, 31 March 2022. Asia Pac ex Japan equity valuation dispersion of the top quintile divided by the bottom quintile by Forward 12 month Price-to-Earnings ratio.

Source: [1]Refinitiv Eikon Datastream, MSCI Asia ex Japan Index versus MSCI Asia ex Japan Value Index, total return indices, USD to 29 April 2022.

ECONOMIC SHIFTS AND INVESTOR POSITIONING

Global decarbonisation, the focus on sustainable growth and the shift to dual supply chains are driving strategic shifts in Asian Corporates, leading to far different outcomes in their investing and operating behaviours than the prior decade of asset light growth.

The change in expectations around inflation and interest rates is refocusing the market's attention towards profitability and free cashflows, unlike the TAM/GMV[2]-only focus of growth investors over the prior decade. Similar investing trends around the globe too bode favourably for their suppliers, who are mostly in Asia. We believe the resulting economic cycle in Asia is supportive of value investing. Beneficiaries are likely to be cyclical, old economy and financial stocks.

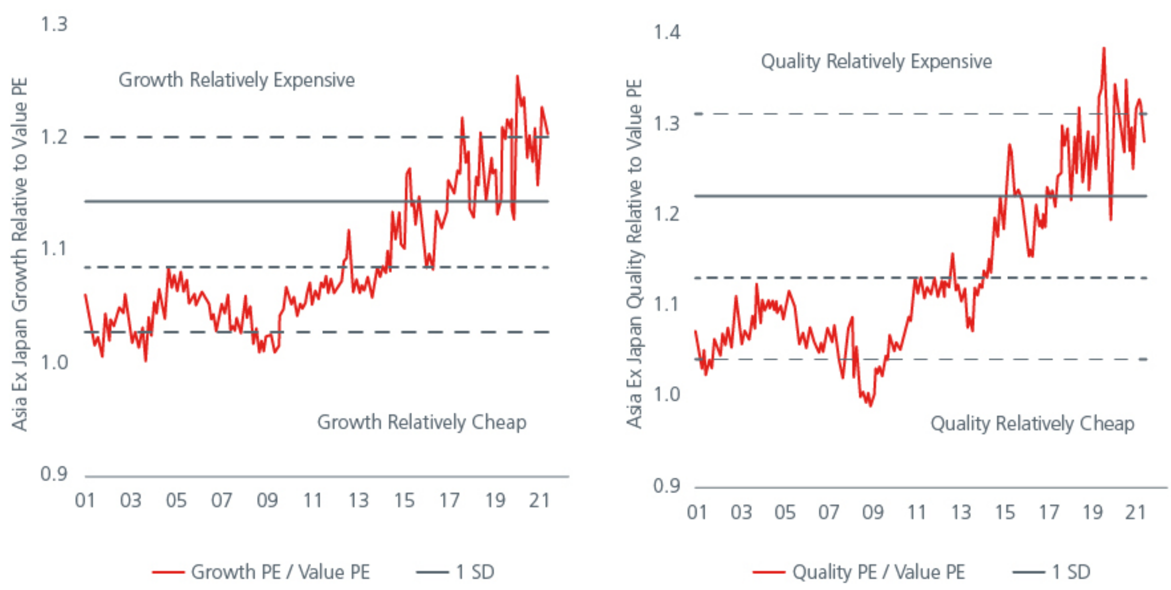
Mr. Market having enjoyed years of growth investing is not yet reflecting any of this potential regime shift. This is reflected in the extreme valuation dispersion between value and growth and quality stocks, and the continuing overweight positioning in growth sectors as reflected in sell-side surveys.[3] See Fig. 2.

The sharp value underperformance over the prior decade led to several investors giving up on value investing philosophically. Career risk and the inertia to look beyond the next quarter also explains the slow shift out of the yesteryear's winners. We believe this contrarian positioning offers us a unique advantage to exploit the opportunity using our differentiated investment process.

DE-RATED ASIAN MARKETS PRESENT ATTRACTIVE PICKINGS

Asia ex Japan markets declined 21% over the last year[4] driven by a slower re-opening than the rest

Fig 2: Asian Value names substantially undervalued compared with Quality and Growth stocks



Source: Eastspring Investments. Macquarie Quantitative Research, 31 March 2022. Relative PE (price-to-earnings) of top quintile of quality and growth (by Macquarie quality score) versus top quintile of value (by Macquarie value score) stocks in MSCI Asia Ex Japan. PE: Price-to-Earnings. AxJ: Asia ex-Japan.

Source: [2]Total Addressable Market/Gross Merchandise Value. [3]Bank of America's Fund Manager Survey, April 2022. [4]Refinitiv Eikon Datastream, MSCI Asia ex Japan Index USD total return index as of 29 April 2022.

of world and regulation in China. This has driven valuations to a price-to-book ratio of 1.7x versus 2.9x for MSCI World, the widest since the tech bubble selloffs in the late 1990s. See Fig. 3.

This discount is out of range compared to the shorter post-2014 history, a period of significant outperformance in growth stocks. As several of the macro and style trends of the post 2014 cycle reverse, it presents opportunities for Asian value names to reduce this discount.

SIGNIFICANT VALUE OPPORTUNITIES

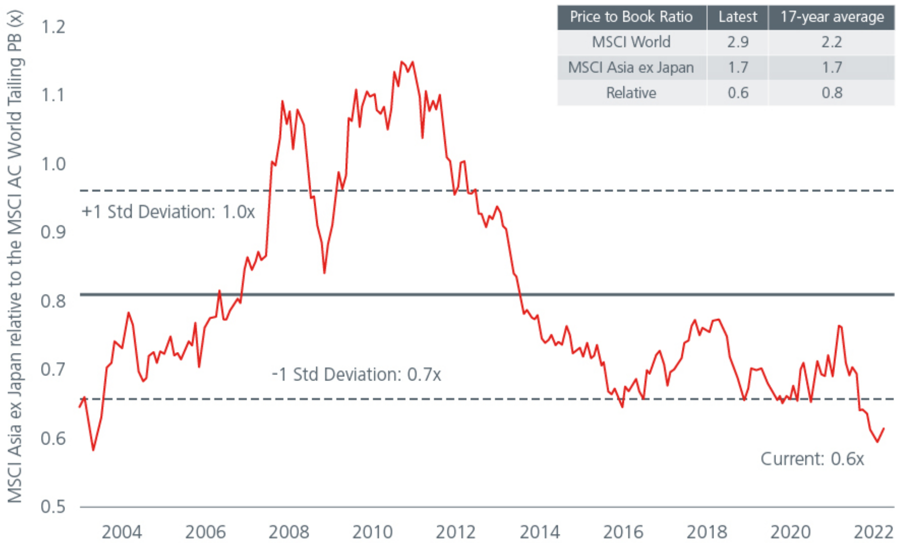
We see significant value in banks in both developed and emerging Asia. The strategic shift among Corporates (as discussed earlier) combined with higher interest rates and higher inflation provide banks with a good opportunity to grow their earnings after years of low margins (in developed economies) and poor asset quality (in emerging economies). ASEAN banks further benefit from asset quality normalisation coming out of the delayed reopening in their economies over 2021. Market implied returns and investor underweight positioning suggest we are getting paid to take on this normalisation, without running into investor crowding.

We continue to like several restructuring opportunities in Asia where management teams are driving large-scale change in a firm's culture, operations, and balance sheet to revert returns to their historical mean. We believe our understanding of this internal change and an edge in understanding normalised returns beyond the next few quarters allow us to take outsized positions in these companies, without worrying about short-term macro volatility.

We are also seeing mispricing opportunities in large public-sector companies in China. Many companies have de-rated over the last 2 years due to the US sanctions, the property downcycle and the trade war concerns despite no negative impact to their medium term cashflows and improved visibility in their ESG journey. As we look beyond the recent COVID-induced lockdowns, we are also attracted to the services sector i.e., travel, leisure, and advertising. These businesses have robust moats and positive cashflows and are outside the limelight of their crowded bigger peers.

Fig 3: Asia ex Japan equity markets are attractive versus the world

Price to Book Ratio	Latest	17-year average
MSCI World	2.9	2.2
MSCI Asia ex Japan	1.7	1.7
Relative	0.6	0.8



Source: Eastspring Investments, Refinitiv Datastream, MSCI, as of 31 March 2022. Total returns in USD.

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WHY WE ARE INVESTED IN VALUE

At Eastspring, our value philosophy is premised on the observation that human emotions and behavioural biases distort investment decision making. This leads investors to focus on the recent past, extrapolate into the near future, and thus overpay for the promise of growth and perception of quality.

Our disciplined value approach relies on a proprietary screening of outlier de-rated stocks within our Asian investment universe, a focus on medium-term sustainable returns, and an experienced team of investors debating the best investment opportunities from this basket of mispriced stocks. Our investment edge is in understanding the range of medium-term outcomes in this opportunity set, versus what is implied in the current market expectations.

We believe the starting point for Asia ex Japan's valuations, the re-commencement of value's outperformance, and the distinct regime shift in the economic cycle and corporate strategies bode well for Asian equities. The investment style allocations over the last five to seven years and investor crowding in 'me-too' strategies should get re-evaluated at this point.

This is the seventh of a series of eight articles which examines the different investment strategies investors can adopt to tap on the opportunities that are emerging in Asia.

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