PORTFOLIO ADVISER

Guide to Asia and Japan

LAST WORD

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EDITOR'S LETTER

Investors in Asia had a torrid time of it in 2015, with returns on funds in the IA Asia ex Japan sector dropping by 25% in the six months in the middle of the year.

There has been a distinct recovery since, with the same sector up 35% in the past 12 months. Even IA Japan has grown by 30% in that time. But is this rally sustainable in the long term?

Asia is arguably more stable politically and economically than the west and as this filters down to a company level, there is an increasing number of opportunities for stockpicking fund managers.

We interviewed fund managers who are experts in the region to garner their views on what and where is attractive. Fund selectors also give their opinion, with at least one of them arguing the case for individual country allocations, rather than treating Asia as a homogenous group.

What are you going to do with your allocation to Asia?

Gary Corcoran

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OVERVIEW

LURE OF THE EAST

With low correlation between the returns from Japanese and Asia-Pacific markets, investors may be best served by separating their exposure between the two regions

Amaya Assan
Senior investment research analyst, Square Mile Investment Consulting and Research

For the long-term investor, there are the obvious attractions to the Asian region, these include favourable demographics, rapid urbanisation and economic expansion.

The countries that make up the region all have their own characteristics and idiosyncrasies, from the wealthier nations such as Japan, Korea, Hong Kong and Singapore to the likes of India, with its strong demographic advantage and growing middle class, which is set to become globally significant in the consumption stakes.

There are thousands of listed companies from truly global behemoths to the state-owned enterprises, as well as the more entrepreneurial, often family-owned commercial businesses.

In some countries, considerable progress has been made in terms of structural reforms, which aim to help develop the domestic markets and improve growth. The potential for returns from such opportunities are the key attractions to an active portfolio manager with a flexible mandate.

Most asset allocators in the UK separate out Japan when they consider Asia and a quick look at either the Investment Association Asia Pacific including Japan sector, or the offshore Equity Asia Pacific including Japan sector, attests to a fairly limited range of UK and Luxembourg-domiciled funds.

The correlation between the Japanese and Asia-Pacific markets has been quite low over the past 10-15 years, which suggests there are diversification benefits to using such a strategy.

The Asia ex Japan region has provided superior risk-adjusted returns over this period but Japan has had lower drawdowns.

There are a number of good quality funds on offer and, importantly, including Japan as part of your Asian portfolio can mean a bigger pool of opportunities. Whether one is looking to include or exclude Japan, the decision to invest to in the region is really down to individual preferences.

Evolving Japan

Investing in Japan today is very different from 15-20 years ago. There are both well-established companies with strong brands focusing on selling their wares globally, but many Japanese companies are also growing their market share by focusing on business opportunities across Asia.

As economies evolve and move higher up the value chain, from selling low-end to higher-end products, there are more and more companies adopting technology in their processes to improve productivity and keep one step ahead of the competition.

The trend of robotics and automation, an area in which Japan has tended to excel, is forecast to increase in China and other Asian countries over the next decade.

Asian complexity

Of course, Asia is a complicated region with a fast pace of change so it does require careful analysis to identify the likely beneficiaries. A good working knowledge of companies and markets is generally a good edge to have.

This is a volatile asset class and returns do not only rest on the performance of the underlying companies but also the political and

macroeconomic environment within the region.

It should be noted that for UK-based investors, these are funds that are investing overseas and exchange rate risk can be significant.

Also, the decision to have a significant active exposure (or underexposure) to Japan can affect returns for better or worse when measuring an actively managed fund's performance relative to its benchmark index. For example, a large underweight to Japan can prove painful when the Japanese market is rallying hard.

If the stock fits...

Managers with good stockpicking skills and proven track records are hard to come by. However, in our opinion, there are a number of attractive strategies currently investing in this region.

A good example is the Matthews Asia Dividend Fund, which includes Asia and Japan in its investable universe. There is also an ex Japan version, Matthews Asia ex Japan Dividend, managed with the same philosophy and approach.

Matthews International Capital Management is a San Francisco-based asset manager and has specialised in Asian investment since the 1990s.

The managers think of this fund from a total return perspective, which is a combination of capital growth and income. They are looking for compound returns in the region of 10-12% over the long run. If they can accomplish this with lower volatility than the broader market this would be regarded as a good achievement.

'ABERDEEN BELIEVES GOOD RETURNS ARE AVAILABLE IN ASIA BY FOCUSING ON WELL RUN, HIGH-QUALITY COMPANIES THAT CAN BE INVESTED IN FOR THE LONG TERM'

The fund does not have a specific yield target but it does seek to produce a level of income that is higher than the yield generally available from Asian equity markets over the long term.

The fund managers seek companies that can be held through the investment cycle. These are firms that can offer an attractive absolute dividend yield and/or that can grow their dividends in a sustainable fashion through the different business cycles.

They aim to balance the portfolio with companies that pay an attractive yield and companies with good dividend growth, adjusting the mix depending on where the best valuation opportunities are.

The fund has delivered on its objectives historically but performance can be quite variable relative to a regional index over shorter time frames. We think this is a sensible approach and might appeal to long-term investors attracted by the region's income and growth potential.

The Aberdeen Asia Pacific & Japan Equity Fund also looks at the region in a very sensible manner. Aberdeen believes that good returns are available in Asia by focusing on well-run, high-quality companies that can be invested in for the long term.

The firm has a large team based in Asia, which is overseen by some experienced investors who are well versed in the peculiarities of investing in the region. Companies are assessed on their own merits and not in comparison with other stocks listed on the stock market.

The team's mantra is quality, which they define as a stable business franchise with recurring earnings growth, balance sheet strength and good management.

The team has a firm focus on a company's corporate governance record and look to take long-term positions with organisations they feel they can trust to look after all shareholders fairly.

Aberdeen's team of analysts will undertake first-hand research of a company to consider these factors and only a small proportion of the companies listed in the region have historically had the characteristics the group seeks.

In general, in more exuberant markets when riskier stocks are in fashion, this fund is likely to lag behind its peers. But while the strategy is rarely the most exciting, in what is a dynamic sector, the risk-averse approach has served fund holders well throughout its history. **LW**

SEEKING STABILITY

As Brexit, Trump and elections in Europe rattle the west, Japan and Asia are looking increasingly attractive

Adam Lewis

Prior to the UK's Brexit vote, Trump's presidential triumph in the US and this year's elections in Europe, investors considered the west to be the home of political stability, while Japan and Asia were viewed as riskier regions.

Historically, Japan has repeatedly promised investors economic reforms to no avail, while those considering Asia have long questioned the stability of the region's regimes.

But could political uncertainty in the west be turning these perceptions on their heads? Is Asia now becoming a safe haven for investors as the west struggles with the disruption of populism?

In Japan, Shinzo Abe's election put an end to the revolving door of prime ministers. Now in his fourth year, he is expected to be re-elected leader of the Liberal Democrat party again this year and will likely be prime minister until 2021.

Elsewhere in the region, the investment story is also becoming stronger, with China's successful transition to a consumer-led economy and India's economic and structural reforms offering investors opportunities that are insulated from the current political turbulence of western markets.

The risk-off call

Paris Jordan, an analyst at the London-based boutique asset manager Sanlam Four, says with-

'ASIA OFFERS AN OPPORTUNITY OUTSIDE OF THE POLITICAL RISK IN DEVELOPED MARKETS, SPECIFICALLY THE UNCERTAINTY OVER THE EU'

Paris Jordan, analyst, Sanlam Four

in equities, it has been overweight to pan-Asia for more than a year, primarily through its exposure to Asia ex Japan.

Attractive relative valuations, strong consumer stories and improving economic fundamentals mean Sanlam Four is unlikely to change its position on the region anytime soon, she adds.

"We do not expect this overweight to change in the next 12 months. Reforms in India offer strong opportunities, especially from infrastructure-led growth.

"China's consumer story is compelling, given the rise of the middle class and a transition from an investment and export-led economy to a consumer-led one.

"We see other pockets of value in smaller countries, including Indonesia, with its young population and high capacity for growth.

"Asia offers an opportunity outside of the political risk in developed markets, specifically the uncertainty over the future of the EU, and the mixed signals coming out of Trump's administration.

"While there are clearly risks in Asia, we still think our Asia ex Japan overweight is justified while valuations remain attractive in the region versus other markets."

Positive prospects

Ian Goodchild, an investment manager at wealth management and employee benefit services giant Mattioli Woods, says in broad terms it is positive about the prospects for Asia during 2017.

He says: "Asia is in a much stronger position now. The economic landscape remains on a broadly improving trend, buoyed by brighter predictions for the global economy as a whole. However, the protectionist rhetoric and ostensible Sinophobia of Trump is a conversation topic with fund managers.

'WE SHARE THE VIEW THAT THE TRUMP EFFECT WILL NOT BE AS MEANINGFUL AS FEARED AND THAT THE PRESIDENT'S BARK IS WORSE THAN HIS BITE'

Ian Goodchild, investment manager, Mattioli Woods

"We share the view that the Trump effect will not be as meaningful as feared and that the president's bark is worse than his bite. And there is a greater resilience and internal focus within the Asian region.

"In fact, the withdrawal of the US from the Trans-Pacific Partnership trade agreement could open the door for China to have a leading role in the Regional Comprehensive Economic Partnership free-trade agreement.

"India has a specific allocation within our portfolios as it is well insulated against potential global headwinds. Prime minister Modi's continued progress with his reform agenda and the structural improvement in the domestic economy has been rewarded with a strong performance of his BJP party in the recent elections.

"This strengthening of power in the Upper House should enable swifter legislative action and support Modi in his reform agenda."

Game changer

In the past, investors in Japan have experienced repeated false dawns as reforms and economic growth have stalled. So are things really changing?

Emma Howard, an analyst at specialist investment and advisory firm Newscape Capital, spells out why she believes Japan is breaking with its problems of the past .

"From a consumer standpoint, Japanese wage growth is starting to emerge, which is a function

'THE ABE-INSPIRED MONETARY AND FISCAL REFORMS ARE BEGINNING TO HAVE AN IMPACT. JAPANESE COMPANIES ARE FLUSH WITH CASH'

Emma Howard, analyst, Newscape Capital

of higher full-time employment. This, in turn, can only be a positive for consumer spending and the domestic economy. The upturn in the global industrial cycle benefits the export sector, where Japanese companies are still competitive.

"Japanese companies have been notorious for holding large amounts of cash on their balance sheets. Excess cash dampens returns and restricts future growth.

"With this in mind, the government has attempted to tackle the problem through the creation of the JPX Nikkei 400 index.

"This index ranks eligible companies based on various qualitative and quantitative factors, one of these being three-year average return on equity.

"The aim here is to encourage increased investment and a return of cash to shareholders through dividends and buybacks. Since inception in 2013, the change in the overall value of capital investment made by companies was positive in 10 out of the past 11 quarters.

"The Abe-inspired monetary and fiscal reforms are beginning to have an impact. Japanese companies are flush with cash and they are finally loosening their purse strings. Japanese stocks are cheap versus other developed markets and are poised to benefit from a synchronised global upturn."

Choice investments

To invest in the region, investors have three choices: pick a fund in the Investment Association's Asia including Japan sector; select a fund focusing on Asia ex Japan, or one that solely invests in Japan.

Ian Hart, an investment director at the independent financial adviser Unbiased Portfolio Management, says his preference is to allocate to a single country, so he can focus on the optimum allocation.

'YOU CAN BLEND STYLE, MARKET CAPITALISATION AND CURRENCY TO REDUCE THE VOLATILITY OF A PORTFOLIO WITH THE POTENTIAL OF MORE UPSIDE'

Ian Hart, investment director, Unbiased Portfolio Management

"You can blend style, market capitalisation and currency to reduce the volatility of a portfolio with the potential of more upside. This is why we are up 200% over the past 12 years.

"The Japanese market is extremely volatile, it is also affected by the swings in the yen. Some funds we are able to access with a hedged share class.

"This provides us with more control as year to date we have a range of returns +/- 6%. But the allocation to the country brings diversification benefits.

"The Indian market is enjoying its place in the sun with year-to-date returns of approximately 20%. But valuations are getting rich and it provides little diversification benefits to reduce the risk in our portfolios.

"Also some far eastern funds include Australia, which can reduce fund volatility but also returns." **LW**

SUMMARY

- Asia is more politically stable, while the developed markets look more risky.
- A greater resilience and internal focus within the region means the Trump effect is unlikely to be as bad as first feared.
- Japanese stocks are cheap versus other developed markets and are poised to benefit from global upturn.

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Matthews Asia

A GAME OF TWO HALVES

Matthews Asia ex Japan Dividend Fund manager Yu Zhang talks about building portfolios to deliver higher-than-average dividend yield and growth

What is your investment approach to Asian dividends?
We employ a total return approach focusing not only on underlying dividend yields but also on the potential growth the underlying dividend can deliver.

So it is a combination with both dividend yield plus dividend growth. We try to maintain a higher-than-market-average dividend yield and at the same time also want the portfolio to deliver a higher-than-market-average growth rate for the dividends.

How do you balance income and growth?
We own two types of stocks in the portfolio. One part of the portfolio will be invested in traditional dividend stocks, for example typically large-cap, matured businesses that have a fairly steady dividend.

They may not be able to provide robust growth compared with some of their smaller peers but they do deliver a relatively consistent and stable dividend payout.

These companies will normally be in industries such as telecoms, utilities, real estate investment trusts and also some heavy infrastructure type of businesses.

This part of the portfolio gives us stability and allows us to look more aggressively for the growth opportunities which make up the second part of the portfolio. These are often medium or even small-cap companies that exhibit much higher growth potential.

We seek to balance strong and compounding dividends with rigorous growth; although these companies are not giving you too much of a yield pick-up, they may deliver a higher rate of growth due to their fast-growing underlying cash earnings.

Moreover, dividend policies put in place by their controlling shareholders, often times the

'DIVIDEND POLICIES PUT IN PLACE BY THEIR CONTROLLING SHAREHOLDERS OFTEN HAVE TIES TO THE ORIGINAL BUSINESS FOUNDERS'

Yu Zhang, fund manager, Matthews Asia ex Japan Dividend

original business founders or the founding families within the Asian context whose financial wellbeing very much relies on the cash flow coming from those listed vehicles, means these growing cash earnings are likely to translate into rising dividend incomes for shareholders.

We view these stocks as dividend growers. The portfolio is always a combination of stable payers and potentially fast-growing dividend growers, with the overall make-up depending on the market cycle.

What sectors and geographies do you favour?

We favour companies that can generate strong organic cashflow. So naturally domestic-focused, consumption-driven

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types of businesses are a big part of our portfolio.

At a sector level, this means we have a meaningful weighting in consumer staples, consumer discretionaries, as well as certain industrial sectors.

Within the industrial sector, we prefer asset-heavy infrastructure businesses such as toll roads, container ports and even airports, because these companies – once they finish their capex cycles – will be left with cash-generative assets.

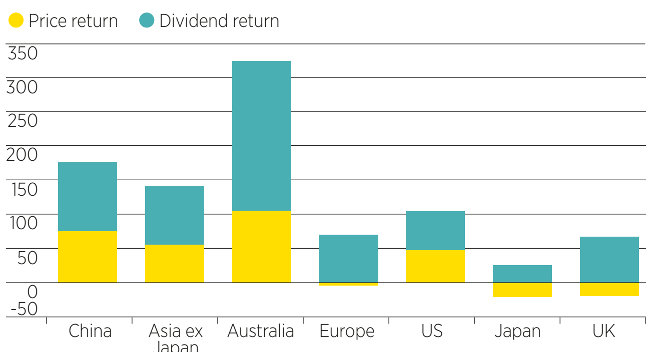
Geographically, while we do consider macro factors when making long-term investment decisions, the Matthews Asia ex Japan Dividend Fund is very much a bottom-up driven strategy.

So really, the geographical allocation is a by-product in terms of where we are able to find a suitable individual stock from a bottom-up perspective.

Right now, the portfolio has a fairly large overweight in some of the frontier markets, such as Vietnam, Bangladesh and Sri Lanka.

Dividends contribute to total return

Breakdown of total returns (since 2000, MSCI indices) %



Local currency returns. Time period: 31 Dec 1999- 31 Dec 2016. Past performance is no guarantee of future results. It is not possible to invest directly in an index.
Source: MSCI Barra, Matthews Asia

> 'RIGHT NOW, THE PORTFOLIO HAS A FAIRLY LARGE OVERWEIGHT IN SOME OF THE FRONTIER MARKETS, SUCH AS VIETNAM, BANGLADESH AND SRI LANKA'

While they are not part of our benchmark index, the reason we have close to a 18% weighting (as of 31 March 2017) in these frontier markets is because we have been able to identify a number of companies we believe have strong business models, are well run by competent management teams and are offering an attractive combination of high dividend yields and fast growth in the underlying dividends. ●

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We see more in Asia

The retail landscape in Asia is changing dramatically with the growth of e-commerce. In 2017, consumers in the region are expected to spend US$1,053 billion – compared to US$660 billion by their U.S. counterparts. But scale is only part of the story.

Without the history of bricks and mortar retail development in many cities, this explosive growth is bypassing traditional business models. We see innovations in payment processing, warehousing and delivery changing the business landscape and creating opportunities for investment across Asia.

For over 20 years, our sole focus has been on investing actively in Asia where our ability to understand these changing dynamics has helped us to identify the companies with the vision to benefit from this thriving environment.

See our in-depth perspectives at
global.matthewsasia.com/seemore

Matthews Asia

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LAST WORD

FULL STEAM AHEAD

Despite recent jibes from president Trump and short-term bumps, Asia is set to be a key, long-term growth sector, says Nomura Asset Management's Peter Jenkins

Cherry Reynard

As Donald Trump seeks to "make America great again", much of his ire has been directed at Asia. The region is, he believes, making goods for US companies and consumers that could reasonably be manufactured in the US. With part of the Asia growth story premised on free trade and capital flows, does the stance of the US administration represent a threat to long-term growth in the region?

East is east

For Peter Jenkins, investment specialist for the Nomura Funds Ireland Asia High Conviction Fund, a Dublin-based Ucits sub-fund, Asian growth has deeper roots. While the US government position on trade is a setback, it does not derail the long-term prospects for the region.

He says: "The region is moving beyond its dependence on the US. There is plenty of intra-regional trade and the consumer is an increasingly important growth engine."

Equally, having been through its own crisis, it has avoided many of the mistakes currently troubling western economies: government debt is relatively low and monetary policy within Asia is conservative.

At the same time, growth looks more sustainable and less volatile than in other emerging regions around the world.

Within stock markets, Jenkins feels valuations are unchallenging. Asian equities in aggregate are trading near lows last seen during the global financial crisis, while earnings are improving. He admits governance remains patchy but is improving.

However, Asia is not homogenous. China and India, for example, are clearly unique countries, with distinct cultures, dynamics and politics, at different stages of development.

Not all parts of the Asian economy are growing equally strongly. The region is slowly weaning itself off export and infrastructure-led growth towards consumer-led growth, but there are still legacy businesses and state-owned enterprises whose prospects are lacklustre.

Select crop

Nomura's fund manager is seeking ideas in the growth areas of Asian economies. "Countries such as China and India have big populations with relatively low levels of income and consumption. There is pent-up demand and the potential for a far larger domestic consumer base. Indonesia, for example, is huge and has lots of interesting opportunities."

'ANALYST COVERAGE REMAINS POOR ACROSS A LOT OF ASIA. INFORMATION FLOW IS STILL NOT AS OPEN AS IT SHOULD BE'

Peter Jenkins, investment specialist, Nomura Asia High Conviction Fund

The manager is only looking for a handful of the best opportunities. The Nomura Asia ex-Japan High Conviction Fund holds just 25-35 stocks and is a concentrated, best-ideas fund, drawing on ideas from the group's team of analysts based in the region.

The key priority is to find market inefficiencies, where companies' growth prospects are under-appreciated by investors. The manager believes Asia still has plenty of these companies.

Jenkins says: "Analyst coverage remains poor across a lot of Asia. Information flow is still not as open as it should be – often they are family-owned companies adjusting to becoming fully-fledged public companies.

"Equally, many investors within the market are large international funds. They are buying based on the big picture. At the same time there are lots of small, retail investors buying on short-term stories and news flow. We take a long-term approach. Short-term noise can create mispricing, which we use to our benefit.

"Mispricing is greatest at a stock level and this fits well with our bottom-up, stock specific approach."

Open minded

The fund has no consistent sector biases, it depends on the attraction of different areas at different times. That will change on a fairly regular basis, though turnover on the fund remains relatively low at 60-80% per year. The fund has an active share of more than 80%.

Jenkins describes it as an "all-weather" fund, capable of performing in most market conditions. He says: "If you get a big sentiment-driven rally, where stocks become very expensive and continue to get more expensive, we would naturally be positioning against that.

"If stocks are falling dramatically, we will be picking up the bargains. Investors should be prepared for a bit more volatility than in a core fund, but we believe we can add value in most markets."

At the moment, Nomura is finding value in selected Chinese financials such as insurance group Ping An. Insurance still has low penetration in China and should be a beneficiary of a rising middle class.

It also likes some of the technology companies. In particular, the manager has a high weighting in some of the 'new economy' names in China. This includes networking group Tencent and online retailers such as Alibaba.

The fund also holds a number of resource companies.

This would seem to place the fund firmly in the reflationary camp but Jenkins claims this is more a function of valuations.

"The portfolio has a cyclical flavour. In some areas, such as consumer staples or utilities, there is simply less to go for as valuations are higher. However, while we like cyclical names, we are wary on the quality."

Among the largest positions are China Mobile and Singapore Telecom.

Hands on

In selecting companies for the portfolio, Nomura likes to get to grips with the numbers, but this is only the start of the process.

The group screens on quantitative factors, providing a guide to what is attractive on a valuation basis. It is a way of managing down the universe of stocks available but, says Jenkins, the decision to buy will always be qualitative, not quantitative.

The analysts will meet the management teams of all the companies in the portfolio. This gives them an understanding of how a company will look in future.

Jenkins says: "We need to understand what a company will look like in five or 10 years, not just where it has come from. We are trying to answer questions about a company's future development and potential."

For ongoing monitoring, the group maintains regular contact with the companies, along with suppliers, competitors and industry sources. This is easier to do, given the relatively small number of holdings, and it helps minimise any nasty surprises about a company's prospects.

At each review, the analysts ask whether the company will surprise on the upside. Are there stock-specific issues around the investment cycle? Has there been a management change, change of approach or a poor investment? Any or all of these would be a signal to rethink the holding.

Equally, a stock may be replaced purely on valuation grounds. Jenkins says: "If the multiple of a stock rises dramatically or, quite simply, if there is another stock that is more attractive, we would replace it.

"We have review targets for stocks but not hard-and-fast price targets. This is a concentrated fund with a small number of holdings, so the manager knows all of them very well."

In the meantime, Nomura remains optimistic on the region as a whole. Jenkins says: "There are some short-term concerns but the longer-term story is good.

"We are aware of the debate around the US administration's approach and we are watching closely. To date, markets seem relatively unaffected by the noise and have started the year pretty well.

"To our mind, it is an environment that calls for higher conviction in a portfolio and, in that, it plays to our strengths." ●

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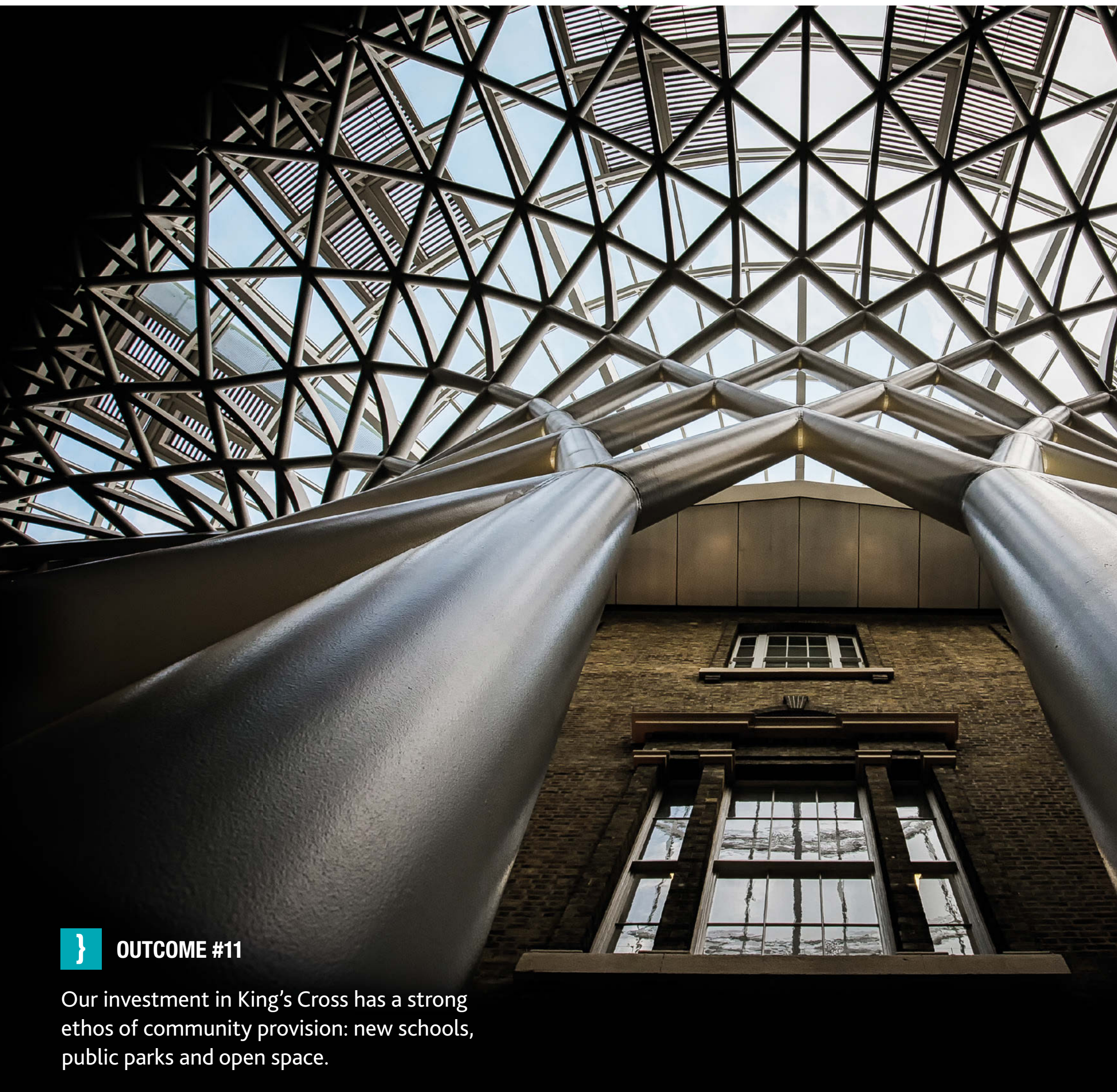

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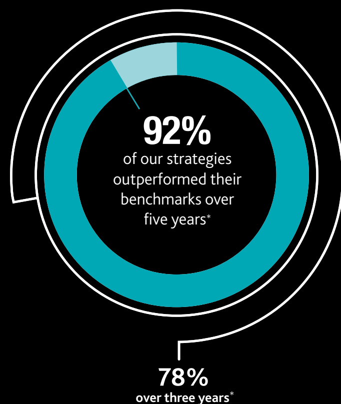
OUTCOMES BEYOND PERFORMANCE



*This is calculated by Hermes, using published benchmarks and for open products only. If a product doesn't have an official benchmark a performance target is used. A representative portfolio for each strategy has been used and not all portfolios are included in these calculations. It excludes closed products, private equity and infrastructure, as well as other open products that do not have the required track record. All data as at 28.02.17 excluding Real Estate, which is as at 31.12.16.

At Hermes we believe that excellent investment performance goes hand-in-hand with contributing to society. Creating outcomes for all clients that go beyond strong financial performance and positively impact society, the environment and the wider world.

Our investment in the redevelopment of King's Cross has delivered 25%** annualised returns whilst creating a sustainable and community-centred asset.

The value of investments and the income from them can fall as well as rise and you may not get back the original amount invested. Issued and approved by Hermes Investment Management Limited which is authorised and regulated by the Financial Conduct Authority. Registered address: Lloyds Chambers, 1 Portsoken Street, London E1 8HZ.

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