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INSIGHTS

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In Conversation With Our Indonesia Equity Fund Manager

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The SICAV Indonesia Equity Fund ("the Fund") recently won the Edge Lipper Fund Awards Best Fund over 5 years, delivering strong risk-adjusted performance. What is behind your winning strategy?

Eastspring Investments follow a bottom-up, valuation-driven investment approach, with disciplined portfolio construction at the core of our process. Security mispricing driven by investors' "greed and fear" is an enduring phenomenon, which can be successful exploited through our long-term investment horizon. We believe that disciplined application of our valuation-driven investment approach helps us avoid the behavioural biases that lead to the mispricing in the first instance. Our competitive advantage is a combination of our investment horizon and our discipline, which enable us to back strong valuation signals, un-swayed by short-term noise in the market.

Our primary focus is on stock selection, which has consistently proven to be the major source of our excess returns. Our research and valuation work focuses on understanding the long-term drivers of value of companies we follow, rather than near term earnings outlook. The stock selection process is complemented by sector allocation decisions. We generally construct portfolios that are diversified across sectors, but may increase allocation of risk budget to sector allocation when our research identifies extreme valuation signals encompassing whole sectors.

We value highly a team-based approach in our investment practice. We seek to attract and retain smart, intellectually curious investors who bring unique investment insights, diversity, and constructive challenge to all our investment thinking and decisions. The Fund is managed and supported by an investment team made up of highly experienced members, with average and cumulative experience of 16 and 297 years respectively.

Source : Eastspring Investments (Singapore) Limited, Mar 2013

Why are the attractions of investing in Indonesia?

One of the fastest growing economies in Asia

Indonesia is the largest economy in Southeast Asia and the sixteenth largest economy in the world in purchasing power parity terms. It is also one of the fastest growing economies in Asia and the 2nd fastest growing economy among G20 countries (data from OECD). Going forward, Indonesia's real GDP is projected to expand at an average annual growth rate of 6 – 7%, faster than most Asian countries with the exception of China (Asian Development Bank).

Resilient economy due to strong domestic demand and low dependence on exports

Indonesia's economy has been relatively resilient, weathering several global situations like the Lehman debacle and the European debt crisis. Its real GDP grew 4.5% in 2009 (Bloomberg, Mar 2013) when most Asian economies experienced economic contraction. Strong domestic demand and relatively low reliance on exports have buffered the Indonesian economy from the impact of slowing external demand.

Favorable demographics with growing middle class underpins consumption boom

Indonesia has a relatively young population with increasing working population and growing middle class. The country is poised to benefit from the structural consumption boom driven by rising incomes across a population of 254 million (Bloomberg, Mar 2013). The increase in per capita income arising from demographic dividend and declining dependency ratio is expected to underpin private consumption, which accounts for more than half of GDP.

Investment emerging as new engine of growth

The country's large domestic market, improving business sentiment, as well as decline in cost of capital have contributed to record direct investment inflows in 2012. Direct investment has been mainly driven by the manufacturing sector, which bodes well for job creation and wage growth, in turn supporting a virtuous cycle of economic expansion.

Healthy economic fundamentals

Since the Asian financial crisis, Indonesia has made great strides in reducing the level of external debt and instilling fiscal discipline. The country has seen a number of sovereign rating upgrades by various credit rating agencies since 2001 due to improvement in its macro fundamentals, with Fitch and Moody's raising its credit worthiness to investment grade. In view of the country's economic resilience, healthy fiscal position and declining debt ratios, Indonesia is well-positioned to deal with evolving economic challenges and potential external shocks.

The Jakarta Stock Exchange was a laggard last year relative to other emerging markets. What were the reasons behind this?

The Indonesian market was susceptible to profit taking in 2012 following a prolonged period of re-rating, which saw the Jakarta Composite Index (JCI) rising 182% over a 3 year period (Bloomberg, Mar 2013).

Other factors that have contributed to the JCI's underperformance last year include:

- Risks of political tension and populist actions hindering sound policymaking leading up to the 2014 election.

Source : Eastspring Investments (Singapore) Limited, Mar 2013

- Deterioration of the country's external balance, with the current account slipping into a deficit of US$24.2 billion or 2.7% of GDP (Bloomberg, Mar 2013).
- Weakness in the Rupiah currency, partly triggered by risk aversion and the deterioration in external balance.

Nonetheless, the JCI still rose 12.9% in local currency terms in 2012 (Bloomberg, Mar 2013).

What is outlook for 2013?

We remain positive on the outlook for Indonesia in view of its healthy macro fundamentals and strong growth prospects. Private consumption is expected to remain strong, underpinned by rising income and the country's growing middle class. Indonesia's large domestic market, buoyant business sentiment and low interest rate environment should continue to attract strong foreign direct investment inflows, which should in turn support employment growth and lead to a virtuous cycle of economic expansion.

We are mindful of the risk of currency volatility during periods of risk aversion due to the country's current account deficit and reliance on external funding. We are also cognizant of the risk of political tension and populist actions hindering sound policymaking leading up to the 2014 election. However, market valuation is no longer demanding following the JCI's underperformance in 2012, which suggests that these concerns have been largely discounted. We would view any sharp market correction as an opportunity to accumulate fundamentally strong companies at more attractive valuations, in line with our long-term investment horizon and bottom-up, valuation-driven investment approach.

Based on your outlook, how would you be positioning the portfolio in 2013?

The portfolio is close to fully-invested in Indonesian equities as we remain positive on the country's outlook and macro fundamentals.

Within the country, the portfolio is overweight banks and property stocks in view of their attractive valuations and positive growth prospects, and underweight consumer stables due to demanding valuation.

Indonesian banks are among the profitable banks in Asia, with high net interest margins and return on equity. The large banks' asset quality and balance sheets are also strong, with low non-performing loan (NPL) ratio, high NPL coverage and strong capital position. Current low loans penetration in the country is expected to underpin loans growth going forward.

Valuation of Indonesian property stocks remains attractive as they are trading at significant discount to their net asset values. Rising income and the fall in interest rates have made residential property in the country more affordable. The improvement in affordability, combined with favorable demographics, is expected to support residential demand going forward. Acceleration of infrastructure development with the passing of the Land Acquisition Bill is also expected to improve the accessibility of developers' land bank, resulting in faster capital appreciation.

Source : Eastspring Investments (Singapore) Limited, Mar 2013

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