eastspring investments

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FUND INSIGHTS

INVESTING IN ASIA: ASIA'S VALUE OPPORTUNITY

EASTSPRING INVESTMENTS – ASIAN EQUITY FUND
APRIL 2014

ARE INVESTORS OVERLOOKING ASIA'S VALUE?

Since 2010, investors have chased higher equity markets supported by easy monetary policies in the US, Europe, and Japan. Over the same period, Asia (ex Japan) markets have been discounted due to concerns over political uncertainty, an export-led slowdown, and credit-driven asset bubbles. This trend continued in 2013 and as a result, out of favour Asian equities continued to under-perform most developed markets.

Amidst the clamour for developed market equities, we believe investors have overlooked the growing value opportunity in Asia.

Asia (ex Japan) is relatively well-positioned within global equities. Fundamentally, Asian companies are expected to generate record high profits. Yet, investors in Asia have historically low valuations on their side given that Asia (ex Japan) has been neglected.

Over the long-term, an investment style grounded by fundamentals and valuations has been shown to generate superior returns in Asia. Savvy investors understand that weighing the price one pays for an investment versus its underlying fundamentals is a crucial step to successfully navigating volatile markets.

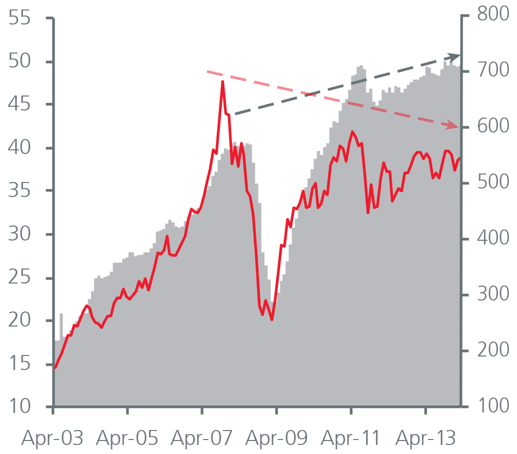
LOOKING AT THE EVIDENCE

With respect to history, Asian companies are robust and attractively valued.

Asian (ex Japan) companies have recovered from the Global Financial Crisis (GFC). The grey bars in Figure 1 show the future earnings power of Asian companies are close to record levels and forecast earnings are now 22%[1] higher than the highest pre-GFC level.

In contrast to the strength of forecasted corporate profits, the prices of Asian companies have unexpectedly diverged from fundamentals. As of end-March, Asian companies, represented by the MSCI Asia (ex Japan) index in Figure 1, stand **20%[1] lower** than their pre-GFC high.

Fig.1. MSCI Asia ex Japan 12 month forward earnings per share (LHS) & price index (RHS)



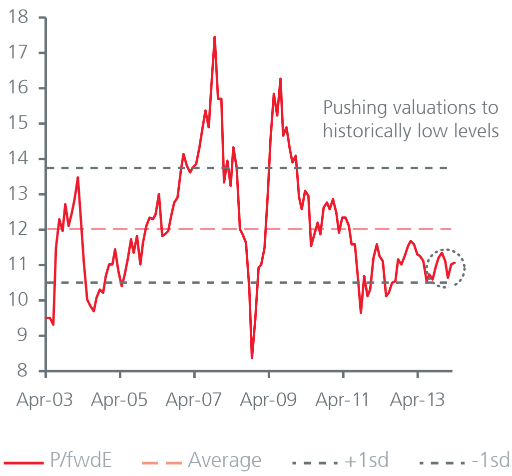
Source: MSCI, Datastream, Eastspring Investments (Singapore) Limited, end-March 2014. Left hand side (LHS). Right hand side (RHS).

Prices of profitable Asian companies are at **historically wide discounts.**

AN OPPORTUNITY

This divergence between price and fundamentals makes valuations compelling. When comparing the price an investor pays to potential profits (the price-to-earnings ratio) of Asia (ex Japan) companies, it can be clearly seen that current valuations are at historically low levels, (Figure 2).

Fig.2. MSCI Asia ex Japan price-to-forward earnings (x)



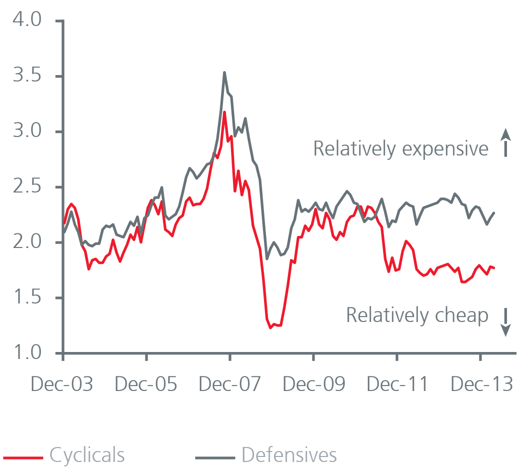
Source: MSCI, Datastream, Eastspring Investments (Singapore) Limited, end-March 2014. The horizontal lines represent the average (the middle line) and one standard deviation (sd) on either side of this average for the period shown. Nearly 70% of all values shown lie within the range shown.

[1]MSCI, Datastream, Eastspring Investments (SIngapore) Limited, end-March 2014.

BOUNCE BACK OF ASIAN CYCLICAL STOCKS

Within Asia, investors have gravitated towards companies with "defensive" qualities such as a high degree of earnings certainty. Meanwhile, companies highly leveraged to the economic cycle – cyclicals – have been neglected as global growth has been below trend. However, a number of cyclicals now trade at attractive discounts to their intrinsic valuations and are undervalued relative to defensive stocks. (Figure 3).

Fig.3.Asia ex Japan equity cyclical vs. defensive price-to-book valuations (x)



Source: Company Data, MSCI, Credit Suisse estimates, Eastspring Investments (Singapore) Limited, end-March 2014.

ASIAN EQUITIES BACKED BY CHEAPER VALUATIONS

In addition to the trends within Asia, Asia (ex Japan) as a region trades at a significant discount to global equities and developed markets. This makes them cheaper relative to other equity markets and attractive on a relative basis. Compared to Europe and the United States valuations, Asia is not expensive. (Figure 4).

Fig.4. MSCI Asia ex Japan vs. U.S. & Europe price-to-earnings (x)

Source: MSCI, Bloomberg, Eastspring Investments (Singapore) Limited, end-March 2014

Investors in Asia are well placed to benefit from the **fundamental strength** of Asian companies while a **generous margin of safety** exists between stocks with cheap and attractive valuations versus stocks with expensive and demanding valuations.

WEIGHING IT ALL

While the above does not guarantee absolute returns, robust fundamentals and low valuations tilt the balance of risk-to-reward in favour of Asia (ex Japan).

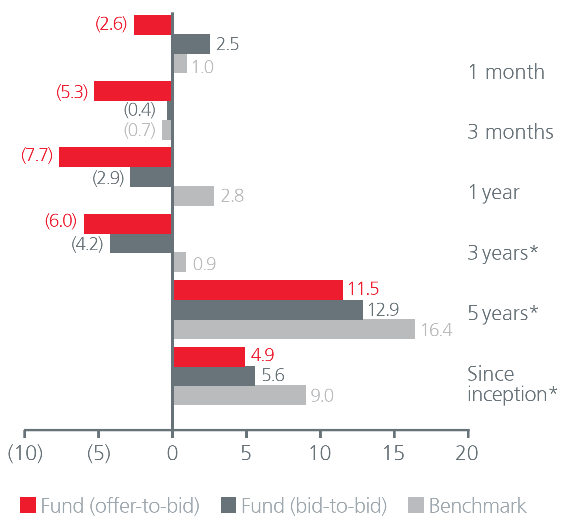
- Asia is profitable.
- Cheap valuations to its history.
- Cyclicals are heavily discounted relative to defensives within Asia.
- Asia is an inexpensive region within the world.

HOW WELL HAS THE FUND PERFORMED IN THE ABOVE ENVIRONMENT?

At Eastspring Investments, we have a value-oriented, fundamental research driven approach to investing. As a result of the relative value opportunity in cyclical stocks, the Eastspring Investments Asian Equity Fund has been selectively adding cyclical exposure. Given that Asia has been out of favour and attractively valued companies have been neglected by investors, Fund performance has been challenged.

The Fund has underperformed its benchmark by 5.1% (bid-bid basis) per annum over three years till end-March 2014. Since inception, the Fund has underperformed its benchmark by 3.4% (bid-bid basis) per annum.

Fig.5. Fund performance as of 31 March 2014 (%)



Fund: Eastspring Investments – Asian Equity Fund Class A

Source : Eastspring Investments (Singapore) Limited; USD; Net income reinvested; Offer-bid includes 5% sales charge. Prior to 1 August 2012, Initial Sales Charge was 5.75%.; Inception Date: 26/08/2005. Benchmark: MSCI AC Asia ex Japan Index. From inception to 30 September 2008, the Sub-Fund was benchmark against MSCI AC Far East Fr ex Japan. Prior to 1 May 2012, benchmark returns were on a Gross Dividend basis. With effect from 1 May 2012, benchmark returns are changed to a Net Dividend basis. *Annualised.

WHAT CAUSED THE UNDERPERFORMANCE OF THE FUND?

The combination of stock specific decisions and headwinds to our style of investing has detracted from Fund performance. Key stock detractors can be grouped into three broad categories – stocks which were misjudged, stocks which the Fund invested too early, and stocks which the Fund stands underweight relative to the benchmark.

In the first group of stocks, the fund manager's investment case did not pan out. For these stocks, once the investment rationale expires, exposure in the Fund is cut. AU Optronics Corp., the largest Taiwan manufacturer of liquid crystal displays and plasma display panels, is one example. The fund manager established a position in the company on the basis of rising demand for TFT panels. However, the positive up-cycle for display panels did not materialise and the fund manager exited the stock from the Fund.

For the second group of stocks, the fund manager's investments into these companies were premature. Yet, upon further monitoring and analysis, the investment rationale remained solid and the stocks continued to be attractively valued. As a result, these stocks remain in the Fund. An example is Parkson Retail Group Ltd. The company operates a national network of department stores in China. Brick-and-mortar department stores continue to be challenged by online retailers in an environment of slowing economic growth. Despite the challenging business environment, the fund manager sees intrinsic value at current prices in addition to the company's efforts to grow by opening stores in mid-size Chinese cities that remain underserved by department stores.

In the last group, benchmark stocks that the Fund is underweight, but have performed well, hurt relative performance. However, the fund manager does not believe that companies which are overvalued and trading with unrealistically expensive and unsustainable valuations are good investments. For example, the Fund has no weight in Tencent Holdings Ltd., one of the leading Internet and telecommunications companies in China and operator of the popular QQ and WeChat messenger platforms. The company is at an inflection point as it seeks to monetize its asset base in mobile messenger, e-commerce, and mobile games. Despite an unproven business model, Tencent trades at extremely expensive relative valuations that leave a very narrow margin of safety. The fund manager believes that there are more attractive risk-reward opportunities in the market.

ENHANCEMENTS AND IMPROVEMENTS

Given the underperformance of the Fund, various enhancements to the investment process have been implemented.

A dedicated Regional Asia focus team has been formed to focus solely on investments in the Fund's investment mandate.

A new fund manager, Hugh Maxwell-Davis, has been appointed to run the fund. Hugh is currently the team leader of the Regional Asia equity team and was previously Eastspring's Head of Equity Research. Hugh has over 18 years of investment experience and a strong track record in Asia.

The team continues to be intensely focused on bottom-up fundamental stock research. The team's value-oriented investment style is directed towards adding stocks with attractive relative valuations.

FORWARD LOOKING OUTLOOK AND STRATEGY

Asian stocks as a whole are cheap relative to history. Within Asia, the Fund has active positions in the energy and financial sectors. These sectors are leveraged to economic growth and will benefit as Asian economic growth picks up. Stocks in these sectors are also attractively valued, trading below their historical valuations and with respect to the overall market.

A slow but apparently steady economic recovery in the United States and the deceleration of Europe's banking and economic crisis may herald a recovery of global consumption.

In line with the above trend, the World Trade Organization forecasts world trade growth to accelerate in 2014. We expect to see nascent signs of export recovery in China, Korea and Taiwan.

This can provide solid opportunities for Asian earnings growth and a rebound of valuations by whetting demand for the region's exports.

A **rosier outlook ahead** driven by an economic recovery in the West.

OUR VALUE ADD

Eastspring Investments as a fundamental, research-driven investment manager is well-positioned to capitalise on this opportunity due to its value-oriented investment process.

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