eastspring investments

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FUND INSIGHTS

2015
EQUITY INCOME OUTLOOK

EASTSPRING INVESTMENTS – ASIAN EQUITY INCOME FUND
DECEMBER 2014

ARE YOU POSITIVE ON THE FUNDAMENTALS OF ASIA PACIFIC EX JAPAN?

The Equity Income team is still positive on the long-term fundamentals of Asia Pacific ex Japan ("Asia"). Market valuations look attractive as the price-to-book multiple of the region is trading below its long-term average. Over one year, that same multiple has fallen by 3% as of end-November 2014[1]. Both developments indicate weak investor sentiment in the region. We think this is unwarranted for a number of reasons and that such an environment is conducive for uncovering undervalued investments that pay attractive dividends.

1. Asian companies are still profitable. The return on equity in Asia is high. Asian companies' return on equity is 12.6%, in line with developed market peers. Forward-looking earnings growth remains robust with consensus expecting a compounded annual growth rate of 7% from FY2014 to FY2016. Despite this, Asia trades at a 27% discount to developed markets when compared using price-to-book valuations and 21% discount on relative forward price-to-earnings multiple.[2]

2. Cash returns to shareholders are attractive. The dividend yield in Asia Pacific ex Japan is 3.1% and Asian companies as a group return on average 40% of their earnings to shareholders. We have observed more and more Asian companies increasing dividends over the past decade and expect this to continue.

While share buybacks are not as commonplace as the United States, they are making appearances. In one of the more recent high profile developments, Korea's largest chaebol purchased US$2 billion of its own stock, boosting cash returns to shareholders on top of its regular dividend. This marks a sea change in Korea – the lowest dividend-yielding market in the region. Encouraged by taxation changes, companies there are reviewing their dividend policies with a view to raise shareholder returns.

3. Economic growth remains robust. As a diverse collection of economies, Asia exhibits a high growth rate relative to other developed and emerging markets. Export-oriented sectors and economies are also a beneficiary of a global recovery as economies with accelerating growth, such as the US, support expectations of rising imports.

4. Lower energy prices. Sustained weak crude oil prices are a potential positive for Asian economies, businesses, and consumers. Asian economies (ex-Malaysia) are net importers of energy and should benefit by paying less for crude oil imports. Weak oil prices should, in turn, lower inflation expectations as the cost of energy is a large component of inflation in Asia. Countries such as India and Indonesia have significant fuel subsidies which they are beginning to deregulate. Lower oil prices allow them to continue, reducing the fiscal burden and allow improved productivity.

[1]Source: MSCI, Eastspring Investments, 30 November 2014. [2]Source: MSCI, Bloomberg, Datastream, Eastspring Investments, 30 November 2014.
FY = Financial year.

5. China. Finally, we believe that investors have been overly discounting Asia's largest economy – China. The Chinese government has walked a fine, but measured line in achieving its stated goals of economic reform and supporting growth. Understandably, investors have been focused on potential banking system credit losses and decelerating economic growth. We believe that the market's short-term apprehension overlooks the medium-term reforms that are positive for China. Furthermore, we believe that the government is monitoring the situation closely and will introduce more measures to support the economy where needed to meet both its medium-term targets.

HOW DO YOUR THOUGHTS ABOVE READ INTO ASIAN EQUITY INCOME INVESTING IN 2015?

We do not forecast market outcomes. Over the shorter term, markets respond to investor emotions that can irrationally drive markets away from fundamental value. This makes it almost impossible to form accurate near-term predictions.

On a medium-term horizon, Asian equities are still priced attractively. We believe that with starting valuations just above crisis levels, many Asian stocks are discounting existing headwinds. Research has shown that starting valuations matter as a barometer of long-term equity performance in Asia. Furthermore, a wide dispersion of valuations exists between countries, sectors, and individual stocks. In line with our process, we are focused on investing in attractively valued names with dividend yield that we can identify as attractive candidates for our equity income strategies.

In contrast, we are mindful of companies where valuations do not reflect fundamental realities. We have observed that names in defensive sectors have become "expensive defensives". An example of this is PT Unilever Indonesia Tbk. "New economy" stocks such as Tencent Holdings have also performed well. The market usually invests with the path of least resistance in well-discovered investment themes; often driving prices far away from fair value. We are wary of these companies given very low dividend yields. Their stretched valuations offer little margin of safety should future operational or financial results disappoint.

WHAT ARE YOUR VIEWS ON GLOBAL INTEREST RATES AND HOW DOES THAT IMPACT AN EQUITY INCOME STRATEGY?

In the wake of the Global Financial Crisis, global interest rates are near a cyclical bottom – anchored by ultra-low interest rates in developed markets. It should be expected that global interest rates will normalise as the global economy recovers. An emerging signpost has been positive American economic data that hints of a sustainable recovery in the world's largest economy.

However, economic forecasts are inherently inaccurate and we have no view on the timeframe of interest rate hikes. We, as interested observers, would highlight the example below. Fed Funds futures, the market's prediction of benchmark US interest rates, consensus economic forecasts, and median predictions from the US Federal Reserve's estimates have diverged – underscoring the difficulty of interest rate forecasting. Time will tell who is right.

Rather than focus solely on interest rates, we try to understand what drives them.

In the case of the US, increasingly positive economic growth expectations look to pull interest rates higher. In Japan and Europe, the Bank of Japan and the European Central Bank have committed to supporting growth in their respective economies through accommodative monetary policies. It is clear that policymakers are focused on growth. A robust environment for economic growth in the US, Europe, and Japan – key Asian trading partners – will help Asian export sectors.

The impact to an Asian equity income strategy may be two-fold. Conventional wisdom can point to historical patterns where rising US interest rates have been headwinds for Asia and an equity income strategy.

For Asia, rising financing costs and a strong US dollar are historically correlated to weak Asian equity performance. In addition, rising bond yields may prompt some investors to rotate out of equity income strategies as they shift their asset allocations to fixed income.

We view such concerns as over simplified and too short term. At the regional level, these risks are well-flagged and are in the price at current valuations. In addition, we at Eastspring Investments have the potential to benefit as bottom-up stock-pickers. Not all companies are hurt by rising rates; some may benefit. The lack of distinction between the two groups allows our strategies to accumulate shares of fundamentally robust companies on the cheap and with better yields.

Furthermore, with growth biases emerging in developed market economies, excessive volatility should not last. Our patience to capitalise on indiscriminate deviations from fundamental value should be rewarded in the longer-term. Finally, the impact of a stronger US dollar has the benefit of decreasing the US dollar cost of Asian exports and may promote stronger export growth which we have seen some evidence of.

Structurally, the search for yield and dividend investing will not fade.

The changing demographics of the world – and in Asia – foreshadow a greater need for retirement planning. Driven by aging populations, income generating assets are likely to be much sought after. Providing a blend of capital appreciation and income, equity income strategies are an increasingly important role to play in Asia equity investing.

We look to Australia's superannuation industry as a window into the future for yield investing. Introduced as a scheme to assist Australians saving for retirement, the superannuation industry has tracked the rising wealth and income of the country. Australia's superannuation industry has over US$1.5 trillion[3] in assets, making it one of the top five largest pension systems globally. What makes Australia unique is the dominance of defined contribution funds. These funds allow their trustees the flexibility to invest for the long-term, instead of being concerned by matching liabilities. As a result, Australian super funds have shown a bias for investing in domestic Australian stocks – usually those with high dividend yields. We view this as the beginning of a trend that should play out in varying degrees across greying economies.

HOW ARE YOU POSITIONING YOUR STRATEGIES?

To capture the dividend theme in Asia, the Eastspring Investments – Asia Equity Income Fund (the "Fund") seeks to deliver a yield premium to the region at attractive valuations. As a consciously constructed portfolio, the Fund has cheaper valuations than its benchmark while its investments deliver a sustainable nominal yield premium to the benchmark dividend yield. This is driven through diligent security selection. Across sectors and countries, the Fund earns a higher yield than the market on its investments making it a true-to-label high dividend strategy. Our dual focus on yield and valuations aims to deliver risk-adjusted returns with lower volatility than the market on a medium-term horizon.

As at the end of November 2014, the Fund stands overweight telecommunication services, financials, and materials. Information technology, consumer discretionary, and industrials are the Fund's largest underweights.

The Fund has invested in many attractive opportunities in Hong Kong and Australia, driving our overweight in these two markets.

The Fund is underweight Korea and Malaysia due to the lack of dividend opportunities in the former and expensive valuations in the latter.

Investments in the telecommunications sector generate a high level of sustainable dividends. The companies are

[3] Source: Association of Superannuation Funds of Australia, Eastspring Investments, September 2014.

a quality, high-yielding proxy for consumer discretionary and staple names which are looking very overvalued. However, we are mindful of valuations given that our investments have performed very well. Financials and materials provide cyclical yield. Trading at cheap relative valuations and high yield, the two sectors are levered to economic growth as banks benefit in a rising rate cycle while accelerating growth drives demand for material companies goods.

WHERE ARE YOU FINDING VALUE?

We began 2014 stating our conviction behind our Chinese bank investments. Concerns of a credit bubble and slowing economy de-rated the banks to very attractive valuations, providing a suitable margin of safety. Some banks were even trading below valuations during the Global Financial Crisis. Over the year, we have increased our China bank exposure selectively, adding to existing investments that were cheap with high yields. Chinese banks' operational results remain strong. They continue to generate over 20% return on equity with a forward dividend yield of about 7%[4]. While credit losses have risen, they are well within expectations, and our research shows the banks are provisioned to absorb a severe economic downturn. Since the first quarter, Chinese bank shares have recovered. We retain our call that Chinese banks are undervalued – trading below book value – offering a compelling investment opportunity for both income and capital appreciation.

WHAT HAS HELPED PERFORMANCE OVER THE PAST YEAR?

Over the past 11 months of 2014, our focus on uncovering fundamental value of a company and contrarian approach was the foundation for strong outperformance. Year to date, our top performing holdings have been concentrated in India, Indonesia, and were mainly financials. These were two markets that fell out of favour in 2013 as investors feared a slowdown in both economies. Indian and Indonesian financials were hurt in the emotional sell-off and were trading at anomalous valuations. The cheap valuations, premium yield, and strong underlying fundamentals provided the basis for our team's conviction. We were happy to retain our conviction and patiently waited for price to reflect fundamentals. In 2014, positive election outcomes installed reform focused governments. Reinvigorated, both equity markets outperformed the region and these investments re-rated, providing strong gains.

Fund performance has been further helped by the underweight to the low-yielding Korean market which has lagged the region. Stock selection also aided as our overweight investments outperformed while benchmark stocks that we were underweight retreated in line with the market.

In contrast, stock selection in Thailand was a detractor from relative performance as the market raced ahead due to fading concerns of political unrest post the military coup earlier in the year. Healthcare has also detracted as the sector with expensive valuations and low yield continues to outperform. Standard Chartered has also been a negative contributor as an off-benchmark holding due to the market's concern over the banks' declining profitability and asset quality. The Fund retains its active weight in the lender on account of attractive relative valuations and the premium yield of its shares relative to the market.

LOOKING AHEAD

We will continue to apply our valuation-oriented process to analyse investments that offer an attractive yield for our clients. As we've experienced in 2014, the divergence of price from fundamentals can be exploited – the price of undervalued stocks can snap back very rapidly.

[4] Source: Bloomberg, Eastspring Investments, 30 November 2014.

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