

Asia equities: strategy Q&A

Asian equities across the board from small to large with Shou Pin Choo, Portfolio Manager for the Asia Equity All Cap HALO strategy and Raymond Wong, Portfolio Manager for the Asian Smaller Equities strategy.

Shou Pin Choo, Portfolio Manager Asia Equity All Cap HALO

Broadly speaking, how did the Asian equity space perform in 2020?

2020 was a year of huge change and challenges and we think 2021 will likely play out the same way.

Despite the impact from COVID-19 in 2020, equity markets did well, as long-standing trends, such as premiumization, recovered quickly.

COVID-19 triggered a move to online and technology, which benefitted companies in those sectors.

Trade and technology disputes also created winners and losers.

Clean energy trends emerged as more countries, notably China, committed to Net Zero Carbon Emissions, leading to winners such as electric vehicles (EVs) and battery makers.

In 2021, some of these trends will continue, for example, digital transformation and adoption of 5G.

Several of the key beneficiaries will be Asian tech companies and financial service providers. Economic recovery plays should also benefit.

How did your strategy perform and how did it evolve during the year?

After a promising start to 2020, market sentiment began to turn in late February, becoming a full scale rout by March, as investors began to comprehend the impact of a global outbreak of COVID-19 on economic activity.

Equities began to recover in the second quarter, and ended 2020 on a high note as policy makers delivered measures that look set to support growth in coming months.

While assessing the impact of COVID-19, we focus on companies that were strong enough to withstand economic dislocation for 12-24 months – these are typically companies with a combination of low fixed costs, low interest burden, and low operating expenses.

In our portfolios, we own companies that benefitted from trends accelerated by COVID-19 and also those that were challenged in the short-term (e.g. banks, refiners, petrochemicals) but might benefit from a cyclical recovery when COVID-19 concerns fade. Later in the year, we selectively added to our cyclical exposure to capture a potential recovery over the last few months.

Finally, we believe our predominant exposure on long term, domestic themes could help to cushion our portfolio from external tensions. These areas include the increasing share of discretionary spending and premiumization, China's rebalancing into services and consumption, increasing spending on R&D and technology leading to innovations and under-penetration of credit across many Asian markets.



Asia tech seems to be a key theme for you, but it is a broad area. Can you highlight two or three trends within Asia tech that you see as attractive from an investment standpoint?

Asia's status as a manufacturing base for products such as PCs and mobile phones has underpinned the IT sector in Asia in the past.

And over time Asian companies have moved up the value chain and industry clusters have emerged across various geographies. Now, Asian companies have become global leaders in their respective industries.

As digital transformation and disruption both continue and accelerate, we believe the 5G era will bring new applications and disruption, and drive an exponential increase in data creation, processing, transmission and storage.

This trend has been accelerated in part by the COVID-19 and geopolitical trade tensions, which have highlighted the importance of supply chain security. At the same time, China is aggressively investing in the semiconductor industry in order to achieve a greater degree of self-sufficiency.

We expect this will drive demand for advanced semiconductor chips. More powerful chips will be required to provide computing power to Artificial Intelligence (AI)-type applications and also to consume less power as mobility remains a critical requirement.

There are a small number of companies in Asia that possess the technological leadership to manufacture such advanced chips and we expect that these companies would do well as critical enablers in the era of digital transformation.

You have talked before about premiumization and the Asian consumer. High-end liquors are a common example of this, but could you highlight some other ways that the premiumization trend is playing out?

One of the prevalent and sustainable trends in the region is changing consumption patterns.

As Asian economies develop and grow more affluent, consumption and spending patterns are shifting away from basic necessities toward discretionary goods and services.

We also see demand is shifting to higher quality, premium brands in individual product categories.

The growing popularity of premium liquors is one well-established trend, but we also see this trend across a variety of grocery and personal care products. We see similar trends also playing out in other, more expensive product categories, like automobiles and education, across Asia.

In Asian equities, China is no doubt a large part of the growth story. But Southeast Asia is also growing rapidly. Where are the opportunities there? Any thoughts on the Vietnam stock market?

ASEAN represents a large population with relatively good demographics, and we do find stock-specific opportunities therein, particularly in Indonesia and Thailand.

ASEAN's population of 668 million is bigger than the European Union's 448 million.

The recently-signed Regional Comprehensive Economic Partnership (RCEP) agreement, together with US-China trade tensions, will make South East Asian countries even more attractive as manufacturing regions.

In terms of GDP, RCEP is the biggest trade agreement in the world. It makes Asia as a bloc more attractive as a regional manufacturing hub, as it lowers barriers to the movement of intermediate goods between countries, thereby making Asian supply chains more efficient.

Vietnam is also a beneficiary of the RCEP. We believe Vietnam will be one of the fastest growing economies in the region in the next few years. Despite the impact of the COVID-19 pandemic, Vietnam reported positive economic growth in 2020 of 2.91%, and foreign direct investment of USD 17 billion.

MSCI currently classifies Vietnamese equities as Frontier Markets and the stock market is still developing in terms of number of attractive opportunities, liquidity and transparency. Apart from investing directly in Vietnamese equities, we can also get exposure to Vietnam's rapid growth through regional companies that manufacture products sold to Vietnamese consumers and businesses.

Thinking about investment strategy, how do you differentiate between market noise and market signals when it comes to deciding factors / news that could be important to your portfolio?

They key to differentiating market noise from relevant factors is firstly to have a well-researched long-term investment thesis on a company, along with specific and quantifiable/measurable milestones and signposts, and then to evaluate how these might be impacted by market noise/news and other factors.

Thinking longer term helps us to sift the market noise from more longer-term, structural changes in the industries and companies.

While sell-side brokers and other more short-term oriented investors may focus on the next year's earnings and sometimes the next quarter, we focus on where the company and industries are headed in the mid to long term.

The market inefficiency that we are taking advantage of could be referred to as "time arbitrage" and this helps us to add value to our portfolios over time.

Raymond Wong, Portfolio Manager Asian Equity Small Cap

What's the opportunity set for Asian small cap equities right now? Is this a good time to invest?

Asian small cap companies offer investors a unique opportunity set.

Small and mid cap companies in Asia can give investors exposure to long-term fundamental trends, like premiumization and innovation in these fast-growing markets.

At the same time, demographics trend younger in some of these markets and the middle-class is expanding rapidly, giving local companies both talent and a ready market for innovative services and products.

Asian small cap companies lagged in the general rally of 2020. As the economic recovery becomes more broad-based, this should benefit smaller companies which were hurt more in the downturn.



What are the advantages to investing in small companies versus large companies in Asia?

The Asian small and mid cap universe represents more than 3,000 companies, in growing and dynamic markets.

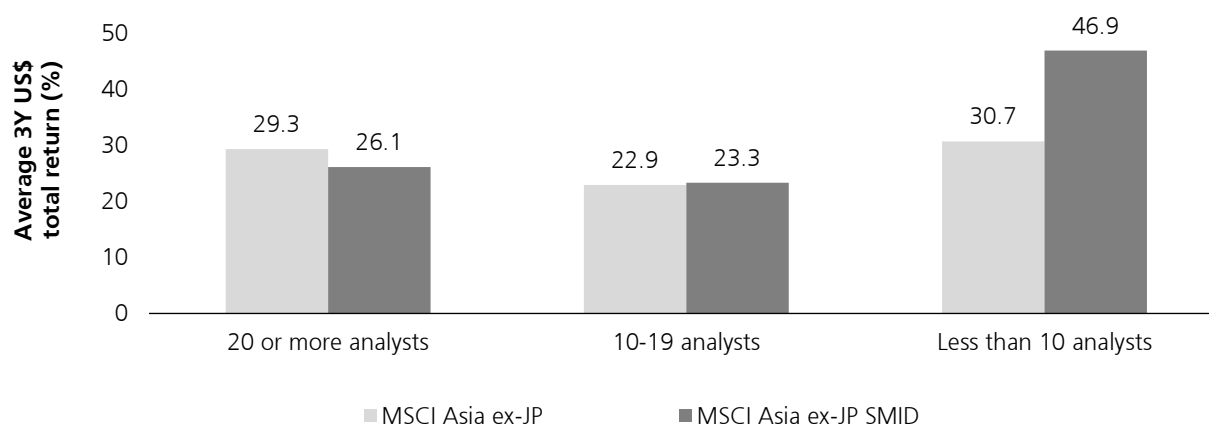
These offer:

- **Higher alpha opportunity** (ie. Performance over the general market). The small and mid cap companies are under researched by sell-side analysts, which provides more opportunities to outperform by exploiting knowledge inefficiencies.
Smaller companies in Asian markets tend to attract scant analyst coverage, creating a less efficient market for smaller caps. Over the last 10 years, almost half of the fastest growing Asian companies had very limited or no analyst coverage at all. Overall, less researched stocks consistently delivered stronger performance over the last three years. For investors with local, boots-on-the-ground expertise, this can be an advantage (see charts below).
- **Higher growth** given they are growing from a smaller base. The law of large numbers would imply that large companies tend to see slower growth due to their size. Through smaller companies, investors are able to invest in structural themes at an earlier stage and benefit from a longer runway of growth.
- **Diversification** compared to Asian large cap funds. Most of the largest Asia ex-Japan funds focus on a much smaller number of large cap companies, with a fair amount of overlap in top-ten holdings between these funds. However smaller cap funds tend to look more dissimilar given the large and diversified universe.
- **Better focus on promising segments** of industries and markets.
Large cap companies tend to be spread across different business lines, while small cap companies can be more focused on specific areas. For example, a large IT company may be involved in semiconductors, mobile phones, and other business lines while a smaller IT company may focus on manufacturing semiconductor components only.

Asia small and mid cap equities: 4 benefits for investors

- #1 Higher alpha opportunity
- #2 Higher growth
- #3 Diversification
- #4 Better focus

Stocks with fewer analysts covering them delivered stronger performance (MSCI Asia ex JP SMID) – 3 years performance (%) Based on average stock performance



Source: Factset alpha tester, MSCI, Jefferies as of Aug 2020

Is ESG/Sustainability relevant or important to smaller companies?

We believe sustainability is important to smaller companies just as it is for large.

Although some Asian markets have been slower to adopt sustainability reporting standards than European and US markets, sustainability awareness is growing quickly in Asia.

Over the past few years, all major Asian stock exchanges have implemented ESG reporting as a listing requirement.

Investors are increasingly using ESG databases as a quick way to screen for better quality companies.

However these databases tend to have less coverage of small and mid cap companies (due to the same reasons as why these companies are under-researched) and small and mid cap companies may also have less resources dedicated to investor relations and ESG marketing.

This is another area where having boots-on-the-ground analysis is an advantage.

Our team enhances external ESG reporting data with our internal proprietary quality assessments of companies to ensure a better understanding of the companies we are investing in and to ensure we do not miss a good quality company that may have a weak ESG database score due to their lack of resources for investor education.

Why do you have a big underweight in Real Estate and a big overweight in Consumer sectors?

The real estate sector is one where larger companies have an advantage due to their scale, balance sheet strength and ability to get lower-cost funding. The smaller real estate companies may be riskier and thus we have generally been underweight in real estate.

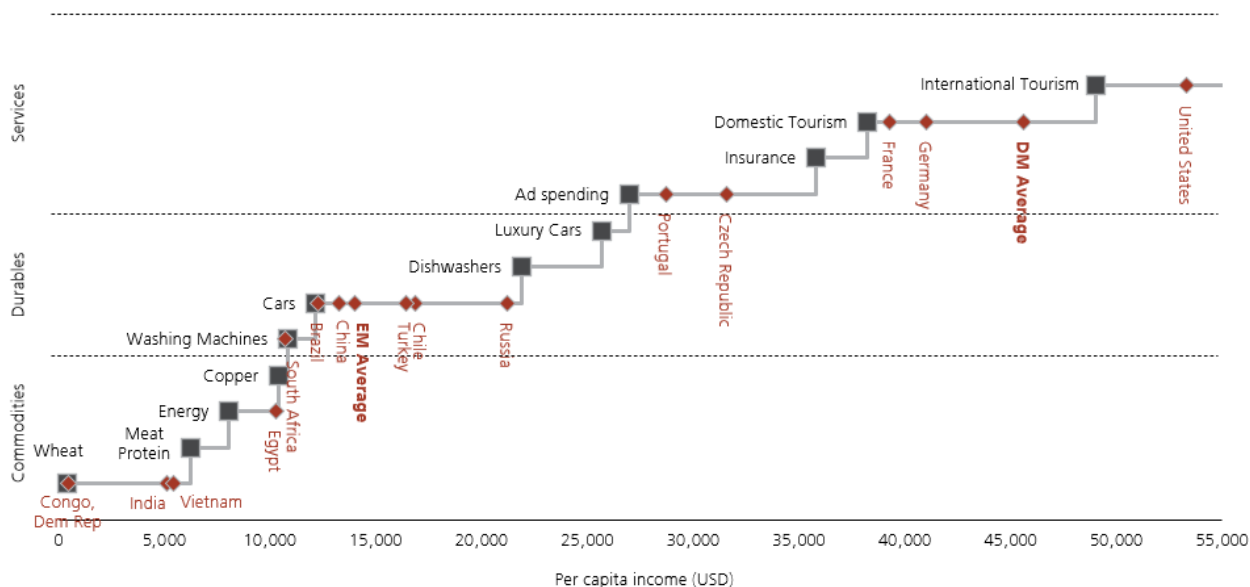
We are overweight to the consumers sector as we believe we can find interesting opportunities in line with trends we are focusing on, like :

#1 Wallet share shifting toward discretionary consumption

As countries move from lower income (~USD 1,000 per capita) to middle income (~USD 5,000 per capita), consumers tend to upgrade their purchases from basic goods to higher quality and discretionary goods and services, as has been the experience in developed markets.

Markets such as India, Indonesia, and Philippines are all poised to transition to mid-income levels in the coming years. We expect that growth rates for categories such as home improvement, education, leisure & entertainment and health care services should accelerate, while growth rates for basic staples should start to plateau.

The shift in consumer habits as income grows



Source: Goldman Sachs Research, as of December 2019

#2 Premiumization

Apart from change in wallet share, we also expect changes within the same category as Asia sees a rapid increase in the number of high- and middle-income households.

Our research across industries and sectors shows that Asian consumers in higher income brackets are willing to pay a premium for better quality products and services.

In markets like China, these consumer trends are visible across segments such as beer, dairy, spirits, cosmetics, condiments, branded foods and four-wheelers.

In India, the premium home and personal care segment is growing at 2x the overall category growth rate, while the share of premium 2 wheelers is also rising.

In general, we believe that players providing premium products and services should continue to gain market share and benefit from this trend.

Could you please give an example of a small-cap stock that was unloved and misunderstood initially but have now grown to be a mid or large cap stock?

China Meidong, a company running mid- to high-end car dealer services across China, was one company to benefit from resilient demand in the luxury auto space during the pandemic.

A major success story within the Asia small and mid cap space, China Meidong is well exposed to the premiumization trend in China, i.e. growing demand for premium products, which we believe is underpinned by the growing middle class and consumers' desire to trade up for better quality goods and services.

Another fast-growing company was China condiments supplier, Yihai, which we added several months after its IPO. At that time, the company saw low trading volume and was underappreciated as a condiments supplier to fast-growing hotpot chain Haidilao.

Then in 2018, Haidilao also launched its IPO and its expansion pipeline became clearer. The company also focuses on R&D to create new products independent of Haidilao's business and the take-home sauces/packs and instant hot pot helped the company benefit during the pandemic when people preferred to cook at home.

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