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Turning heads in Asia

Volatility, high turnover and regulatory changes in Asian markets can create alpha | UBS Asset Management

An interview with: **Adolfo Oliete**, Head of Asia-Pacific Investments, UBS Hedge Fund Solutions

What is the investment environment in Asia really like? Adolfo Oliete shares his take on the opportunities he sees in high-volatility, high-turnover Asian markets.

What is the current opportunity set in Asia?

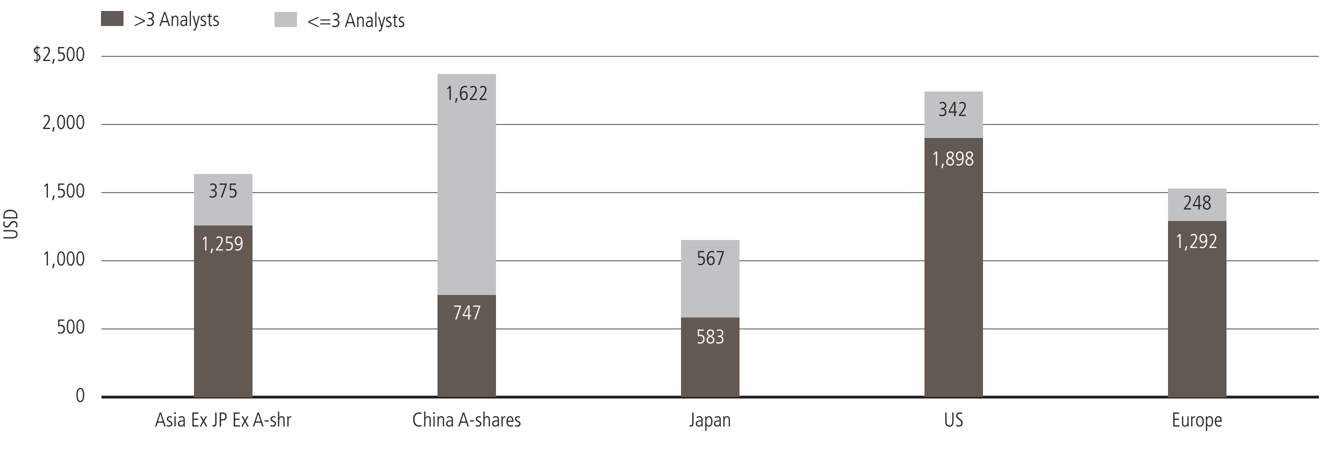
As we build our case for the year ahead, we take into account rapid structural and secular changes that could provide investment opportunities in emerging Asia, particularly China.

The rapid growth of China is underpinned by several reinforcing factors like the consumption upgrade cycle, urbanization and aging—with consumption at the forefront of China's overall economic growth. An increased demand for social services caused by factors including urbanization, has expanded education needs at the same time as aging communities have ever greater healthcare needs. Income growth has also prompted a shift in consumption trends as retail markets grow and online access increases. Additionally, there has been a big push for innovation and automation.

Crucially, Asian equity markets provide an attractive environment for alpha generation. The China A-share market is the second largest equity market in the world and one of the most liquid. Yet it remains hugely inefficient. Approximately 70% of the A-share stocks are covered by fewer than three analysts. This contrasts with the US and Europe where only 15% of stocks have such limited analytical coverage (see Exhibit 1). It is no coincidence that single stock dispersion, a measure of the opportunity for active managers to add value, is therefore nearly double in the Chinese equity market than it is in Europe and the US (see Exhibit 2).

Unlike other markets that have seen the level of crowding increase, Asian equity markets currently possess low levels of overall institutional and hedge fund capital that makes the aforementioned inefficiencies more pronounced. In China, the A-share market ownership is dominated by domestic retail investors, with foreign ownership at only 7.3%.[1] The dominance of retail investors in Chinese equities and their high portfolio turnover provides plenty of opportunities and liquidity to exploit dislocation. Average annual turnover over

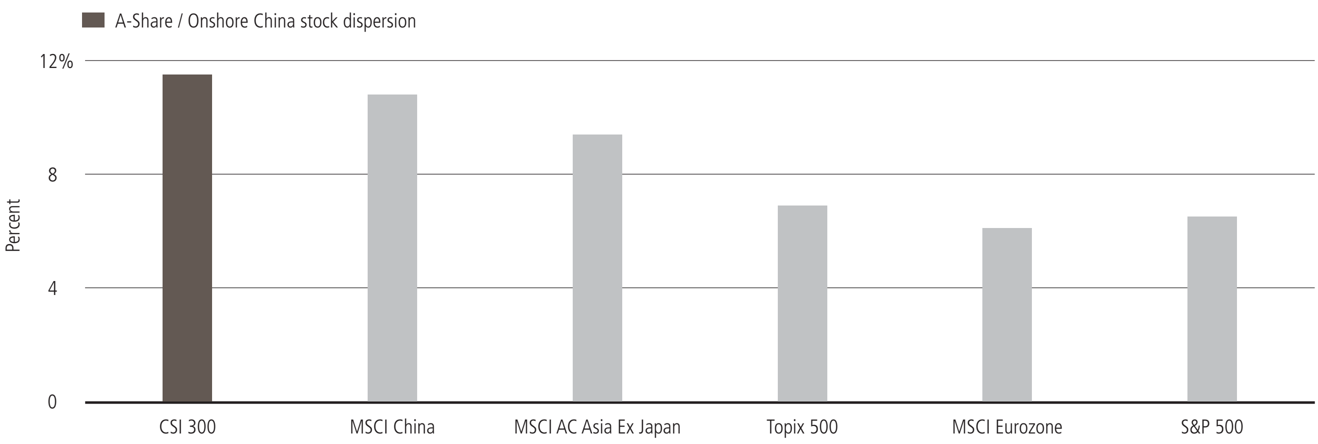
Exhibit 1: Coverage of companies with USD 500m market cap



Source: Reuters Eikon; UBS Hedge Fund Solutions, as of 12 Sep 2019. Universe is based on companies with >=$500m market cap and >=$0.5m average daily turnover. Universe is based on stocks listed in Japan, China, United States, countries within MSCI AC Asia, countries within MSCI AC Europe. Analyst coverage is based on Reuters Eikon.

[1] Source: Wind, CSRC, CIRC, NSSF, UBS-S. As of June 2019.
[2] World Development Indicators (The World Bank), UBS, as of 30 April 2019.

Exhibit 2: High dispersion of returns in China



Source: Thomson Datastream, UBS, as of 12 Sep 2019. Based on 5- year average standard deviation of constituents' monthly returns.

the past five years expressed as a percentage of total market capitalization has been significantly higher in the Chinese equity market (266%) than in other developed markets such as the US (126%).[2]

Outside of China, we also see opportunities arising from corporate governance improvements in Japan and Korea plus a continuation of high levels of idiosyncratic event activity. Since the introduction of stewardship/corporate governance codes and the new M&A guidelines in Japan, the last two years have seen record numbers of subsidiary sales or transfers and share buybacks.[3] The increased amount of private equity capital and activist campaigns in Japan has also resulted in more corporate activity, a renewed focus on shareholder rights as well as providing a catalyst for value creation.

How are you factoring market conditions into hedge fund portfolios?

We continue to favor Asia, and our allocation mainly consists of Equity Hedged managers that have shown outsized alpha generation and the ability to manage risk during high levels of volatility. In addition, we look for managers who have the ability to perform in volatile or dislocating markets by providing liquidity to the market, for example Multi-Strategy managers. In the near future, pending QFII regulation changes, we expect to be able to allocate to some Onshore China strategies that have not previously been accessible to offshore capital. Based on historic risk and return characteristics, we believe that these strategies are likely to provide strong diversification benefits.

As we look ahead, the evaluation of risk relative to reward remains paramount. With risk premia compressed across most asset classes, we are focused on identifying idiosyncratic opportunities. Most importantly, we focus on active management in the region. In an Asian hedge fund universe demonstrating high return dispersion, manager selection and exit decisions are paramount to the delivery of investment outcomes.

This article is part of our *Panorama: Investing in 2020* publication. For further insights, go to ubs.com/panorama.

[3] Sales/transfers source: York Capital, Citi Research, May 2019; Share buybacks source: York Capital, TSE/Holt data as of June 2019.

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