*For Professional Advisers Only*

# A Spotlight On:
# IA Asia Pacific excluding Japan sector

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## Introduction to Sector

There are the obvious attractions to the Asian region, such as favourable demographics, growth in urbanisation and economic expansion. The region is home to a varied selection of countries with a broad range of economic and political characteristics. This includes wealthier, highly developed nations such as Japan and Korea as well as those which are in the early stages of their development such as Pakistan and Vietnam. The region also includes countries with strong demographics and a consumption hungry middle class such as China and India.

There are thousands of listed companies within Asia; from global behemoths and state-owned enterprises, to more entrepreneurial, often family-owned commercial businesses. For some of these countries, considerable progress has been made in terms of structural reforms, which aim to help develop the domestic markets and improve growth. These structural changes are impressive and in some cases game changing. For example, online sales as a percentage of retail sales in China and mobile payments over cash payments in India, China and Indonesia. More and more Asians are vacationing within the region and this intra-regional demand is bringing opportunities for investment. In short, the potential for returns from such a diverse opportunity set is a key attraction particularly for an active portfolio manager.

## Recent Sector Performance

Investing in Asia is not without its challenges. The sceptics would correctly point out that US equities have performed much better than Asian equities over the last decade with the S&P 500 returning nearly double that of the MSCI AC Asia Pacific ex Japan index. Even this year to the end of November, the S&P 500 was up by c. 25% in GBP terms. Despite election issues and Brexit, the FTSE All Share index was up by circa 15%. In contrast, the MSCI AC Asia Pacific ex Japan index was up by circa 11% over the period (some markets have performed better than others with China up by c.12%, India c.4% and Taiwan c.25%).

However, experts would point out that the environment has been quite different in the West, with developed markets having experienced unprecedented levels of stimulus (QE) over the last decade, facilitating a much more accommodative environment for business. In Asia, with a few exceptions, the conditions have been quite different and broadly governments and companies are in better shape today to weather tougher times ahead. Generally they have current account surpluses, fiscal surpluses and low inflation which means they have more room to lower rates if need be. In addition, valuations for emerging Asia are arguably more attractive than US equities.

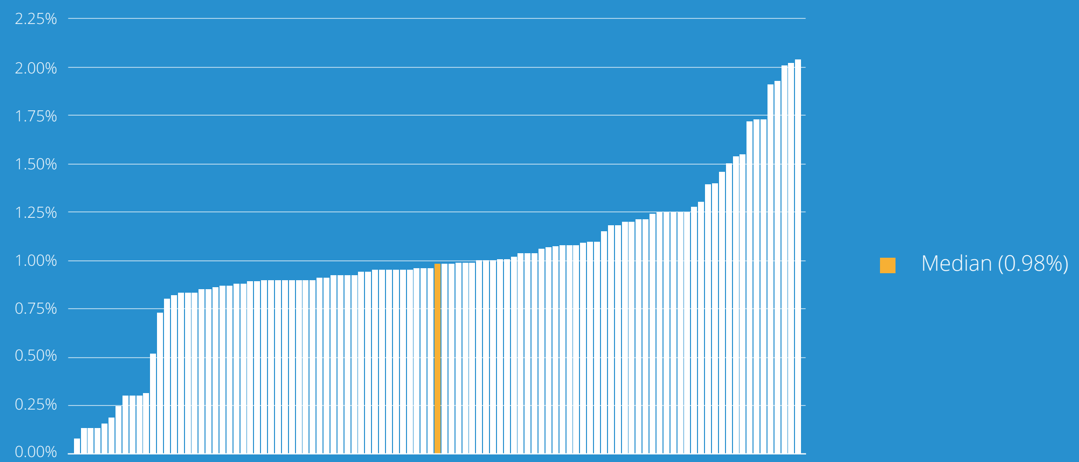
US-China trade tensions have been in the headlines for much of this year, as the fight between the two for economic leadership as well as for the next generation tech leadership continues. These issues have created volatility and uncertainty, which in general markets do not like, and concerns over global trade and global growth have not been lost on policymakers. Many central banks in Asia in recent months have taken a more accommodative monetary stance, reducing interest rates to help support growth. Whilst it might be tempting to only focus on the negatives, as mentioned earlier there are structural changes afoot in some of these countries, which present opportunities for companies and investors.

## Sector Nuance

Asia is a complex region with a fast pace of change, and so it does require careful analysis to identify the likely beneficiaries. There are currently 108 funds in the Investment Association's (IA) Asia Pacific excluding Japan sector, many of which have different performance objectives, investment approaches and risk parameters. Some are passive strategies seeking to closely match the movements of certain indices. For those investors who prefer a passive strategy for its low-cost characteristics, the suitability of the index being tracked should be assessed. In this regard, we believe it important to consider the management group's commitment to operating passive strategies, the size of the fund and its historic record of tracking the index.

However, there are also a wide selection of actively managed funds to choose from in this space. Within this group, some have an income or total return emphasis, others a growth or value style of management or have a pragmatic approach to investing. There are funds focusing on smaller companies or on certain geographies, such as ASEAN markets. Interest also appears to be growing for funds being run with a responsible investment mindset as well as strategies focusing on companies with good environmental, social and governance (ESG) practices or companies that are improving their ESG footprint.

The chart below highlights the broad spread of costs for the funds in the IA Asia Pacific excluding Japan sector and therefore it caters for all investor types. We believe that such costs should be looked at in terms of value for money and there are a number of factors to consider, such as the quality of the management team, their resources and trading costs.




Source: FE, 13th December 2019

*Figure 1: IA Asia Pacific Ex Japan Sector OCFs*

## Funds in Focus

Given the diverse range of funds with different objectives in the IA Asia Pacific excluding Japan sector, we do not believe that looking at a fund's performance relative to the sector average is useful or indeed relevant. Managers investing in the region can follow a range of different investment styles and it is important to consider this along with their objectives, the process they use to sift through the vast universe to find their stocks, their attitude to risk and the resources/firm support that they can use. The following funds share some common characteristics; an experienced manager or team, a proven investment process and good resources/firm support.

The managers of the Stewart Investors Asia Pacific Leaders fund aim to invest in companies they believe have sustainable businesses run by management teams they trust and who look to grow their business in a sensible manner over the long term rather than chase short-term profits. The managers also run the Stewart Investors Asia Pacific Sustainability fund with the same investment philosophy. They are looking for companies with businesses that they believe can benefit from or support the long-term sustainable development of the countries in which they operate. They do not screen companies on a purely ethical or moral basis, but they are unlikely to invest in those operating in the gambling and tobacco industries. Similar to Stewart Investors in terms of approach and philosophy, the First State Asia Focus fund is a strong and wholly viable option for long-term investors who wish to access the Asian region, but in a relatively conservative manner, where the emphasis is on identifying high quality growth companies. The team seeks to be long-term investors and they also assess companies on their own merits and not in comparison with other stocks listed on stock markets. They look for management with integrity and who have a longer-term vision of growth and returns, and a broader sense of corporate responsibility. We think all three funds have a sensible investment approach in a region that can have severe drawdowns but this approach can lead to significant positioning and performance deviations versus a standard regional index at times, and therefore may not suit investors seeking more index-like returns.

The manager of the Invesco Asian fund believes that investors' behavioural biases often give rise to market inefficiencies, such as when market participants overreact to short-term news. He and his fellow colleagues seek to take advantage of these biases which can mean taking a contrarian approach and investing in unloved stocks which have good upside potential and are trading on compelling valuations. This style of management, with its strong valuation discipline, can be a powerful way to add returns for investors over the long term, but by the same token, it can spell periods of underperformance, as it might take the wider market some time to recognise the true worth of the stocks in the portfolio.

The Matthews Asia Small Companies fund was launched in April 2013, but the fund's manager has been running the strategy since 2008 via the US-domiciled mutual fund, which is managed along identical lines. As the name suggests, this fund is focused on Asian smaller companies (excluding Japan). The manager is free to consider a range of different businesses across different industries and markets within the region. She aims to identify companies with sustainable businesses, which she believes are capable of growing profitably, are financially strong and can take advantage of Asia's dynamic growth potential.  We think the strategy provides long-term investors access to an attractive, but under-researched universe through a well-designed fund that has a long-term approach directed towards uncovering higher quality businesses with hardy business models.

The managers of the Matthews Asia ex Japan Dividend fund invest in large, medium and smaller companies located in or with substantial operations in the Asia Pacific region (excluding Japan). These can be internationally oriented or those focused on their local domestic markets with the managers preferring companies they believe offer attractive dividends or growing dividends.  They believe that Asia's long-term growth prospects are strong and invest in quality businesses that grow with the development of the region's middle-class lifestyles. For some managers investing in this region, they believe income generation provides a substantial portion of the total return over the long run. The Jupiter Asian Income fund focuses on providing investors with sustainable income and capital growth over the long term via a portfolio of around 30 to 40 large and liquid Asian companies. The fund's manager believes that dividend yields are still an under-appreciated element of a company's overall returns. Moreover, companies that can generate sustainable dividends and can compound their earnings steadily outperform over the long term. He therefore looks to invest in well-positioned, well-managed companies that have attractive dividend prospects and can increase their dividends as they grow over time.

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