One-on-one interview

Consistent outperformance through mispriced opportunities

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Our Asia ex Japan Equity strategy has been consistently generating excess returns over benchmark by outperforming in all calendar years since Sanjiv Duggal took over as lead portfolio manager in August 2013[1]. In this interview, Sanjiv Duggal and co-portfolio manager Arwen Liu discuss what is happening in the markets, where they are finding the most compelling investment opportunities, and how they are positioning the strategy.

What have been the key drivers of the Asian equity market over the last year?

Since 2017, we have been seeing signs of strong earnings growth after years of lackluster earnings in Asia ex Japan. Earnings upgrades was the key driver of 2017's 42% returns in the region. Return-on-equity (ROE) fell for years after peaking in 2010; and the downward slide ended in 2016/2017 when ROE began to pick up on the back of strong earnings growth of around 22% for 2017E. Asia ex Japan equities have now had 19 consecutive months of earnings upgrades.

The Asia ex Japan equity market had been underperforming against global markets since 2010, and it was only up until recently that the trend has reversed (see Figure 2). Valuations, meanwhile, are still attractive in Asia ex Japan, even with the rally in 2017. Currently, the price-to-book ratio of the Asia ex Japan market is in line with its long-term average, and ex-tech sectors trade 10-15% lower than the long-term average. Compared to the US, Asia ex Japan remains a lot more attractive (trading at 46% discount). Averages can be misleading, so we look behind the average to find mispriced opportunities.

Fig 1: Earnings growth on a strong trend following years of stagnation[1]

Year	EPS yoy growth	Market returns
2014	4.5%	4.8%
2015	-1.5%	-9.2%
2016	1.8%	5.4%
2017E	22.2%	41.7%
2018E	13.7%	?

Note 1:
Source: Bloomberg, Credit Suisse, MSCI, HSBC Global Asset Management, as of 31 January 2018. Total return of the market is represented by the MSCI Asia ex Japan Net Return USD Index (with dividends reinvested). Investment involves risks. Past performance is not indicative of future performance

Fig 2: Multi-year downtrend has been reversing for Asia ex Japan relative to global equities

MSCI AC Asia ex Japan / MSCI AC World
12/31/2004 rebased at 100

Source: Bloomberg, MSCI, HSBC Global Asset Management, as of 12 February 2018. Total return of the market is represented by respective MSCI indices. Investment involves risks. Past performance is not indicative of future performance

What are your thoughts on the recent volatility in early February?

Financial markets around the world and across asset classes experienced increased volatility in February. Asian equities are also impacted by this global trend. Given the very strong performance of Asian equities in 2017 and in January 2018, the correction in February does not come as a surprise. Volatility has been remarkably low in the past couple of years, so larger daily moves really represent a return to more normal volatility levels in Asian markets. We see volatility as an opportunity given our investment process, our discipline and the screening tools that we utilize. We remain positive on Asian equities and will take this pullback as an opportunity to add to stocks we like.

HSBC Global Asset Management

What are the main investment themes of your Asia ex Japan equity strategy against this market backdrop?

While we are not thematic investors, there are some major opportunities we are seeing. In China, for instance, we see a fast evolving consumption upgrade as consumers get richer and demand better products and experiences. We believe this will continue to play out.

We are also finding structural and cyclical opportunities in Indian financials. Engagement with financial services has accelerated in India especially post demonetisation. On the corporate side, we see non-performing loans (NPL) peaking out and banks will benefit on the back of this.

Korea is a market that remains one of the cheapest in Asia and valuations are especially attractive in the technology sector. Korean tech leaders are trading at multi-year low multiples despite improved corporate governance.

In Southeast Asia, demographics look attractive, particularly in Indonesia, where consumption is a long term growth trend. We think Indonesia's cyclical downturn in consumption is an opportunity to buy.

In healthcare across the region, there is a growing aspiration to innovate and move up the value chain through R&D. We have identified a few ideas to capitalize on this trend.

How is your strategy positioned in the technology sector given that internet stocks have done well in 2017?

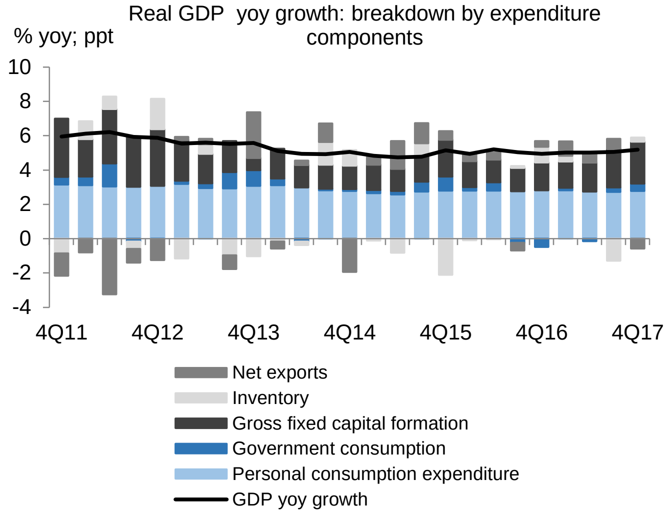
We are currently underweight tech, including Chinese internet names. Internet stocks did well in 2017, which hurt our performance in 2H 2017. We were a bit early – in early and out early – because of our contrarian nature and valuation discipline. The tech sector is the biggest sector in Asia, making up about 1/3 of the market. Our stock selection in technology has driven a significant part of our portfolio's alpha over the last 4.5 years (since Sanjiv became the lead manager).

Do you foresee any improvement in Indonesia's macro outlook?

Indonesia's current account position has improved significantly. This means there will be more scope for government policy, including consumer stimulation, and the country is also in a better position to stabilize its currency.

There are a number of reasons surrounding the cyclical downturn in consumer weakness in Indonesia, including employment, wage growth, as well as subsidy cuts. However, these factors should all improve in 2018 and we foresee a steady recovery in Indonesia's macro environment, while being more positive in the consumption area.

Fig 3: Indonesia private consumption is a major growth driver



Source: Central Bureau of Statistics as of 31 January 2018

Why is the Korean tech sector trading at a discount?

Although some Korean tech companies are global leaders, generally net cash (no debt), and have been increasing dividend payouts, they still trade at low valuations. Forward P/E of the Korean tech sector is at around 7.0x.

The low valuation is partly due to some historical issues related to corporate structure and governance concerns, but they are currently being addressed. One of the world's biggest tech companies (in Korea) is now changing the way they reward minority shareholders and is focusing on returning cash flows to investors. This company has done multiple buy backs and their dividend yield has gone from practically no dividend to an expected 4% dividend yield in 2018. There are changes at a policy level within Korea as well, which is encouraging companies to pay out more dividends. There is also a policy emphasis on restructuring *chaebols* (conglomerates).

Fig 4: Korean technology leaders at P/E lows

Source: Bloomberg, MSCI, HSBC Global Asset Management, as of 31 January 2018

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What are some specific equity examples in your strategy?

We are positive on a Chinese ecommerce company, which sells out-of-season apparel for different global and local brands. When the price of this stock was falling, we met with the company while sell side analysts were downgrading the stock on concerns about falling sales and overexpansion of human resources. However, we saw a lot of value in the company and believed the business would turn around. We picked up a sizable position in the company, and subsequently big Chinese internet companies bought stock in the company which later led the stock price to double. We continue to remain positive on this company and see significant upside. This is an example of a position that took off quickly and paid off.

Another example is an Indian pharmaceutical position. The Indian pharmaceutical sector has experienced a de-rating in the past 2-3 years due to a number of reasons, including regulatory pressure, currency headwinds and distributor consolidation. While the concerns are valid, we are positive on one particular Indian pharmaceutical company which has been disproportionately penalized against this industry backdrop. We see a lot of upside in this company, including in their R&D efforts. The company bases its R&D facility in Switzerland, which gives it better access to technology and to people. Its R&D expenses have been going up by 30-40% on a compounded annual growth basis in past 2-3 years, but this future value is not being built into its valuations. This is in contrast to Chinese pharmaceutical companies whose R&D efforts are attracting a premium valuation.

We have an overweight position in a Taiwanese large cap technology company – a global leader in the semiconductor foundry space. In 2013, our sophisticated support tool ranked the company in the top quintile in terms of profitability and valuation. Since, the position's return on invested capital (ROIC) has gone up sharply (from 23% to 38%). This is still a key holding in our strategy and one which has paid off over time.

How has your Asia ex Japan strategy fared against recent market developments?

Our Asia ex Japan equity strategy has been resilient across a range of different market conditions and has proven to be an all weather strategy. Our Asia ex Japan equity strategy has seen strong and consistent outperformance in the 4.5 years since Sanjiv took over as lead manager[2]. The strategy outperformed its benchmark in all calendar years between 2014 and 2017 and has also achieved strong cumulative performance. This consistency is attributable to stock selection success, a disciplined investment approach, and a willingness to weigh into mispricing controversies.

Note 2: Source is HSBC Global Asset Management, data as of 31 December 2017

Asian equity risks

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested.

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- **Emerging market risk:** Emerging economies typically exhibit higher levels of investment risk. Markets are not always well regulated or efficient and investments can be affected by reduced liquidity
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