

À la carte or dish of the day?

How to best approach Asian equities? **Janine Mace** finds most experts believe in active investing, rather than taking whatever the index “serves up”.

While this can be a big decision when it comes to picking dinner, it is also an interesting question for Australian investors considering where to place their Asian investment dollars.

Most Asia experts believe careful selection rather than taking whatever the index serves up is the route to an enjoyable meal.

“It is more about individual companies than countries. You need to find the best-of-breed companies,” argues Stuart James, senior investment specialist at Aberdeen Asset Management.

David Urquhart, portfolio manager for Fidelity’s Asia Fund, agrees: “The diversity of performance in stocks and markets at the moment means you need to be careful. Do you want a company that exports to Europe, or one that is more focussed on the domestic market, as there will be a big difference in performance. You need to look for companies in a growth environment and with exposure to middle-class expansion.”

He believes an index-based approach brings many risks.

“There is definite potential to add value through stock selection in Asia and you need the ability to take the opportunities as they arise. For Asia, stock picking is definitely the preferred approach,” Urquhart argues.

As an active manager, Premium China Funds associate director and head of distribution and operations, Jonathan Wu, agrees this is the best path for getting a slice of Asia’s growth opportunities.

“As long as Asian markets remain inefficient, you will do better with active management,” he argues.

James agrees: “It is a very difficult time for investors, but there are opportunities out there and they need to focus on the best companies.”

This emphasis on careful stock selection means active management – despite the extra cost.

Craig Mowll, CEO of Certitude Global Investments, believes an Asian equity allocation needs a good hands-on manager with an intimate knowledge of the region.

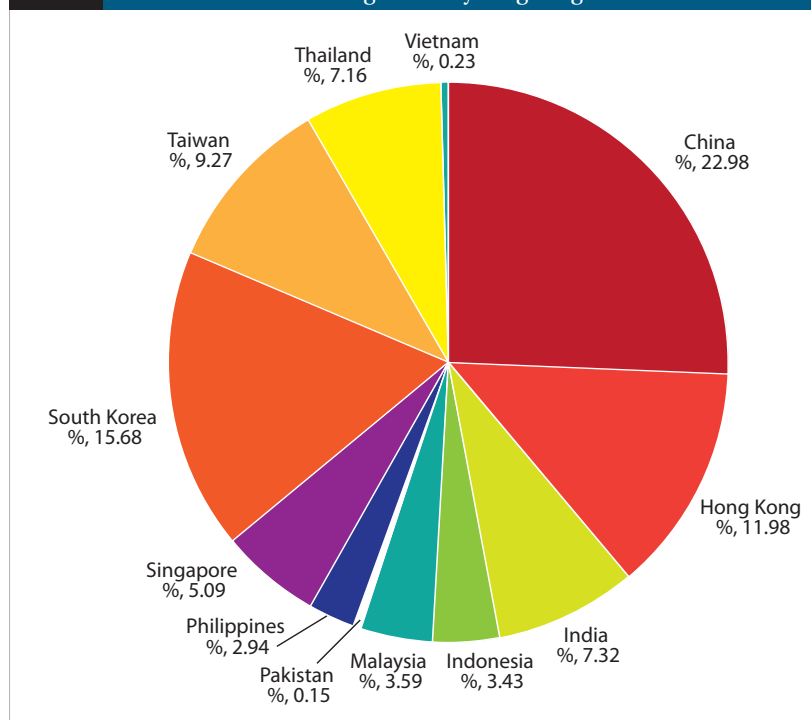
“Asia is a complicated market and difficult to understand at the individual equity level, making it difficult for individual investors,” he argues.

“This isn’t just a case of buying an index, it needs an active manager with good local intelligence. Transparency levels are not good in many Asian companies until you know how to access the information.”

Wu also points to the importance of the manager understanding and anticipating changing government policy, such as China’s new pharmaceutical scheme. “The way to pick stocks in Asia is not only through finding good value, but also by being aligned with government policy.”



Chart 1 Asian share funds’ average country weightings



Source: Morningstar (August 2012)

Unpicking the index

Understanding how the benchmark index is constructed is critical when it comes to this sector.

“The underlying Asian index is very skewed towards certain countries, with 60 per cent of the Asian benchmark consisting of China, Korea and Taiwan, and those countries are very dependent on exports. Among the better performers last year was the Philippines at 27 per cent, but it only represents 1.3 per cent of the index. China is 23.4 per cent of the index and was one of the worst performers in the index,” James explains.

Mowll believes Australian investors

need to carefully examine the index and think about which countries are driving its performance (see chart).

“When people talk about Asia as a region, they forget the small countries such as Singapore represent less than 5 per cent of the index.”

Stock size is also important, according to Wu. “All index funds tend to consist of large cap stocks and you won’t get the same uplift in them as you will from investing in smaller stocks.”

Aberdeen believes a good approach for advisers is to have a core diversified international equities manager and then a dedicated Asia manager or emerging

market manager in a core plus satellite arrangement.

Morningstar fund research analyst, Mark Laidlaw, agrees passive investing is not appropriate in this market, but does not necessarily endorse specialist Asian funds.

“Holistically, given the inefficiencies in Asian markets, they should lend themselves to active management,” he says.

“However, you need to consider the cost side of things too, as dedicated Asian managers tend to be more expensive than diversified international equity managers. Cost is very important for the portfolio and is one issue advisers need to consider as they can’t control returns.”

Wu takes a different view and argues investors need to “value up” active management. “A low-cost solution works in developed equity markets, but active management is better in Asia.”

Although he believes cost is important, Laidlaw argues investors need to take care.

“ETFs can be a cheap and effective way to play the region, but advisers need to consider the sector exposure and biases they bring, as Asian markets have heavy concentrations of materials financials, which is something Australian investors may not need more of in their portfolio,” he notes.

Advisers need to carefully review the impact of Asian equity exposure on the rest of the portfolio and the biases and skews it introduces into the asset allocation, Laidlaw argues.

Volatility and diversification

Despite their current volatility, experts believe now could be an attractive time for investors to consider Asian stocks as a way of introducing diversification into their portfolio.

James believes this is particularly important for local investors. “The diversity of businesses in Asia is valuable – especially for Australian investors – as they tend to have a big home country bias in their portfolios.”

Mowll agrees diversification is important. “A lot of Australian investors think they are getting their Asian exposure through Australian equities, but this view is a real worry as Australian companies are likely to only be partial beneficiaries of future growth,” he says.

“Where Australia will benefit is likely to be through SMEs and you can’t buy them. Many unlisted companies will be bigger beneficiaries than large listed Australian companies.”

Many local investors are unaware of their exact exposure to the Asian growth story, according to Laidlaw. “They need to look at the underlying country and sector exposures in the existing portfolio and the index selected by the manager.” **MM**