

Sleeping dragon

Can the slower pace of Chinese economic growth diminish the appeal of Asian equities for Australian investors? **Janine Mace** reports.



After years of breakneck growth, the Chinese dragon has paused to catch its breath and the impact is reverberating around the Asian region.

Add to this the impact of nervous global investors pulling cash back to perceived safe havens every time things look dicey and you have the recipe for some fairly interesting times.

But the slower pace of Chinese economic growth has not diminished the appeal of Asian equities for many investors, and regional experts remain adamant Australian investors need to get on board.

In fact, they believe now is a great time as valuations are attractive and corporate prospects look good. They point to strong demographics, increasing middle-class affluence and solid corporate balance sheets as factors that will ensure Asian economies continue to grow despite the current hiccups.

However, even those who are convinced a major shift from West to East is occurring in global growth urge caution and emphasise the need for

Key points

- The slowdown in the Chinese economy and weak growth in developed countries resulted in a disappointing year for Asian equities, though experts continue to identify good prospects in the region.
- Lack of correlation between economic growth and share market performance is a major risk when it comes to investing in Asian equities.
- Despite the recent downturn, experts believe the long-term Asian story is still in place.
- Potential investors need to be prepared for the volatility that goes hand-in-hand with Asian share markets.

Australian advisers and clients to take a long-term view when it comes to investing in local sharemarkets.

Craig Mowll, CEO of Certitude Global Investments, is one expert who remains very upbeat about China, despite the recent economic slowdown.

"China will not give double-digit growth anymore, but I would take 7.5

per cent in the second largest economy in the world over negative growth in Europe any day," he says.

David Urquhart, portfolio manager for Fidelity's Asia Fund, agrees Asian equities are about going where economic growth is likely to be strongest.

"Where is the world's growth going to be and which assets will grow in the near future? If you want to invest in areas of good potential growth, then you need to look at Asia. Asia has the best growth prospects and valuations are attractive," he says.

Tough times for equities

Despite this optimism, the slowdown in the Chinese economy and the weak growth in developed economies means it has not been a great year for Asian companies or their equity markets.

Mowll admits it has been tough. "Asia has had a hard year and had lots of volatility."

Morningstar data shows performance to the end of August for the MSCI All Countries ex Japan Index was 0.52 per cent, compared to 4.98 per cent for the

S&P/ASX300 and 12.29 per cent for the MSCI ex Australia Index. The MSCI Emerging Markets Index turned in a disappointing performance of -2.38 per cent.

Premium China Funds Management associate director and head of distribution and operations, Jonathan Wu, agrees the performance of Asian equity markets has been disappointing.

"Most Asian equity managers have struggled – not due to low profitability of the companies they invested in – but just because the markets have been smashed left and right by the risk-off sentiment," he says.

"Asian markets often suffer from a 'last-in, first-out' mentality. When risk is off, the market gets slammed, but this is not a true reflection of the companies there."

Both continuing risk aversion and the flight to the perceived safety of developed markets have had a big impact, according to Morningstar fund research analyst, Mark Laidlaw.

"Asia had a strong start to 2012, but the increasingly negative macro picture led to declines in the second quarter,"



Craig Mowll

he says.

Wu believes this highlights there is still some way to go before the much heralded 'decoupling' of Asia from developed markets occurs. "Economies have decoupled, but sharemarkets haven't," he notes.

"Some economies such as Malaysia and Indonesia are more insular and less externally reliant, but others still face a significant impact."

The Chinese slowdown has also had an impact, explains Urquhart.

"In the past 12 months Asian equity markets have decreased about 5 per cent and a reasonable portion of this weak performance is related to the slowdown in Chinese growth and the impact on earnings expectations and growth expectations in China itself," he explains.

According to Urquhart, the worst performers over the 12-month period were the Chinese share market (which was down 10 per cent), and India (which was down 13 per cent). "The two biggest population countries struggled most in the region."

On the other hand, the best performers among regional share markets were the smaller countries, some of which turned in very strong performances.

Mowll believes the disparate performance of the various share markets highlights an important point for advisers.

"The very small markets have done well – such as Pakistan which is up 37 per cent, Thailand 21 per cent and the Philippines 27 per cent – but they make up virtually nothing in the index," he explains.

"Japan and China dominate the index. Japan represents 37 per cent of the index and the Nikkei is up 5.5 per

cent for the year, so that is a good contribution, but China has been the big negative. That is the big story for the year."

Although Korea represents 10 per cent of the index and returned 7.4 per cent, it could not compensate for the weak Chinese performance, Mowll points out.

Looking positive

Although economic growth in both China and India looks set to continue

well into the future, the recent weak share market results highlight an important risk when it comes to investing in Asian equities.

"There is not a high correlation between economic growth and share market performance," Laidlaw notes.

Aberdeen Asset Management senior investment specialist, Stuart James, agrees: "A lack of correlation between economic growth and share market performance is a trap for many people. There is a big disconnect between

Chinese economic growth and the Chinese share market performance."

In fact, China's share market is one of the worst performers over the past decade.

"You need to remember you can recognise the macro opportunity, but a portfolio is a construct of the companies within it, so it needs to be very careful in company selection," he notes.

Despite the lack of correlation

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Table 1: Morningstar performance data for Asian Equity funds to 31 August 2012

Name	Launch Date	Fee %	Net Assets \$Am	Min. Inv. \$	1 Yr %	3 Yr % pa	5 Yr % pa	10 Yr % pa
8IP Asia Pacific Partners	22-Feb-10	1.03	11.51	50,000	-42.35			
Aberdeen Asian Opportunities	20-Oct-03	1.18	397.50	20,000	8.56	6.61	1.80	
Advance Asian Shares Multi-Blend	18-May-04	2.20	3.61	1,500	-6.39	-7.60	-8.46	
Advance Asian Shares Multi-Blend W	18-May-04	1.25	4.11	50,000	-5.29	-6.63	-7.50	
AMP Capital Asian Eq Gr	10-Dec-08	0.80	0.00	10,000,000	-1.04	-2.60		
AMP Capital Asian Equity Gr A	10-Dec-08	1.10	0.66	500,000	-1.33	-2.93		
AMP Capital Asian Equity Gr H	27-Apr-09	1.40	1.59	30,000	-1.62	-3.18		
AMP FLI S2-FD Asian Share	01-Jul-10	2.30	0.36	1,500	-3.91			
AMP FLI-FD Asian Share	13-Sep-08	2.70	2.61	1,500	-4.31	-3.51		
AV Chindia Opportunities	03-Nov-06	0.80	28.73	50,000	-18.61	-6.89	-9.17	
BT Asian Share Retail	10-Jun-86	1.96	161.94	5,000	0.76	1.36	-4.44	4.88
BT Asian Share WS	22-Aug-96	1.00	197.74	25,000	1.72	2.38	-3.50	5.94
BT PPSI-BT WS Asian	17-Apr-00		1.26	5,000	1.72	2.38	-3.50	5.94
CFS FC Inv-FirstChoice Asian Share	30-Apr-07	2.30	12.01	5,000	-3.16	-0.17	-4.51	
CFS FC Inv-Platinum Asia	22-Mar-10	2.75	4.92	5,000	-2.18			
CFS FC WS Inv-Platinum Asia	22-Mar-10	1.95	6.85	5,000	-1.42			
Fidelity Asia	30-Sep-05	1.15	13.56	500,000	1.43	1.73	-5.42	
FirstChoice WS Asian Share	30-Apr-07	1.50	17.79	5,000	-2.40	0.59	-3.89	
Five Oceans Asian Share	23-Dec-87	2.25	34.18	5,000	-4.10	-2.68	-8.24	3.05
Five Oceans Wholesale Asian Share	09-Nov-94	1.15	26.80	10,000	-3.03	-1.50	-5.95	4.90
Invesco WS Asian Consumer Demand	23-May-94	1.23	8.55	20,000	-6.22	-1.47	-8.83	-0.27
Macquarie Asia New Stars No.1	27-May-10	1.20	20.03	20,000	-10.73			
Maple-Brown Abbott Asian Investment	25-Oct-02	1.03	54.00	50,000	2.38	1.98	-2.82	
OnePath OA FR IP-Platinum Asia	15-Nov-10	1.98	0.18	1,000	-2.78			
OnePath OA IP-Platinum Asia EF	16-Aug-10	2.70	0.33	1,000	-3.41			
OnePath OA IP-Platinum Asia NE	16-Aug-10	3.55	0.36	1,000	-4.16			
Perennial Asian Equity Trust	16-Jul-97	1.33	2.51	25,000	10.36	3.05	-4.06	3.75
Perennial Asian Shares Wholesale Trust	14-Jun-01	1.33	3.15	25,000	10.40	3.06	-4.07	3.75
Perpetual WFIA-Platinum Asia	10-Nov-08	2.75	16.13	2,000	-3.50	-2.31		
Platinum Asia	03-Mar-03	1.44	2,701.82	20,000	-2.40	-1.22	-1.05	
PM Capital Emerging Asia	01-Jul-08	1.40	2.20	20,000	-0.46	2.13		
Premium Asia	06-Nov-09	1.51	35.69	25,000	-3.22			
Premium Asia Income	31-Aug-11	0.98	17.19	25,000	16.29			
Regal Asian Quantitative	01-Aug-09	1.00	15.74	250,000	-1.82	2.41		
Schroder Asia Pacific	01-Apr-95	1.37	21.59	50,000	8.75	3.98	-3.20	5.77
T. Rowe Price Asia ex-Japan	18-Mar-08	1.60	155.60	500,000	4.31	4.19		
TAAM New Asia	04-Nov-05	1.00	53.99	25,000	-3.60	-3.58	-7.50	

Source: Morningstar

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Asian equities

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between economic growth and share market performance, most experts still believe the positive outlook for Asian equities makes them attractive, especially given the relentless gloom surrounding developed markets.

"In the developed markets it is a structural downturn due to the huge debt problems, but in Asia it is a cyclical downturn and driven by problems in the developed markets. Asia is a victim of developments in the development markets, but its underlying position is very attractive," James argues.

Mowll also retains a positive view. "I see Asia as one of the shining lights in an otherwise dark investment landscape. They are leading in global growth, and Australian investors need to learn more about these markets and the opportunities they offer," he urges.

This optimism seems well-founded,

as an announcement in September by the Chinese Government of several new stimulatory infrastructure projects has had a major impact.

"Since then, the small and mid-caps have rebounded strongly after being smashed earlier in the year. We have seen some increases of 10-12 per cent for some stocks," Wu notes.

The strong balance sheets of many Asian countries means they have the capacity to follow China's lead in fiscal and monetary stimulus. "Most Asian governments have room to move, so they are more likely to boost their economies than developed countries."

Attractive valuations

Despite the recent downturn, James believes the long-term Asian story is still in place.

"Valuations are looking attractive compared to the developed markets. China is slowing but is still growing at

7 per cent plus. We expect further headwinds in the Asian market for the rest of the year, but valuations are very attractive," he argues.

"Investors need to take a contrarian approach and invest now when everyone else is fearful. If you focus on the best companies and the long-term opportunities, I am bullish."

Urquhart agrees the outlook remains good, particularly for improved earnings growth.

"Growth rates are still likely to be healthy in the region and this augers well for the Asia-Pacific region, with earnings growth expected to be double digit for 2012 and 2013. We expect to see an acceleration into the 2013 calendar year," he says.

Fidelity is currently predicting earnings growth of 11 per cent in 2012 and 14 per cent in 2013.

Urquhart also sees good relative stock valuations. "At 10.9 times PE versus 12.4 times for the five-year average, valuations are looking quite attractive in the region," he says.

"The discount is very attractive, as it is currently 1.6 times book value versus 1.9 times for the five-year average. Over time, we are looking for a drift back towards average stock valuations."

The currency also makes prices attractive for local investors. "A strong Australian dollar means our overseas purchasing power is quite healthy," Urquhart notes.



David Urquhart

Return possibilities from investing in Asia are not limited just to share price growth either.

"We expect to begin to see local currencies appreciate, so there is a potential to make extra return on top of equity performance," explains James.

"In a low growth environment, there are different components in returns, so you need to capture as much as possible from different sources. Dividend yields are also increasing in Asian companies – off a low base – and this is another encouraging trend."

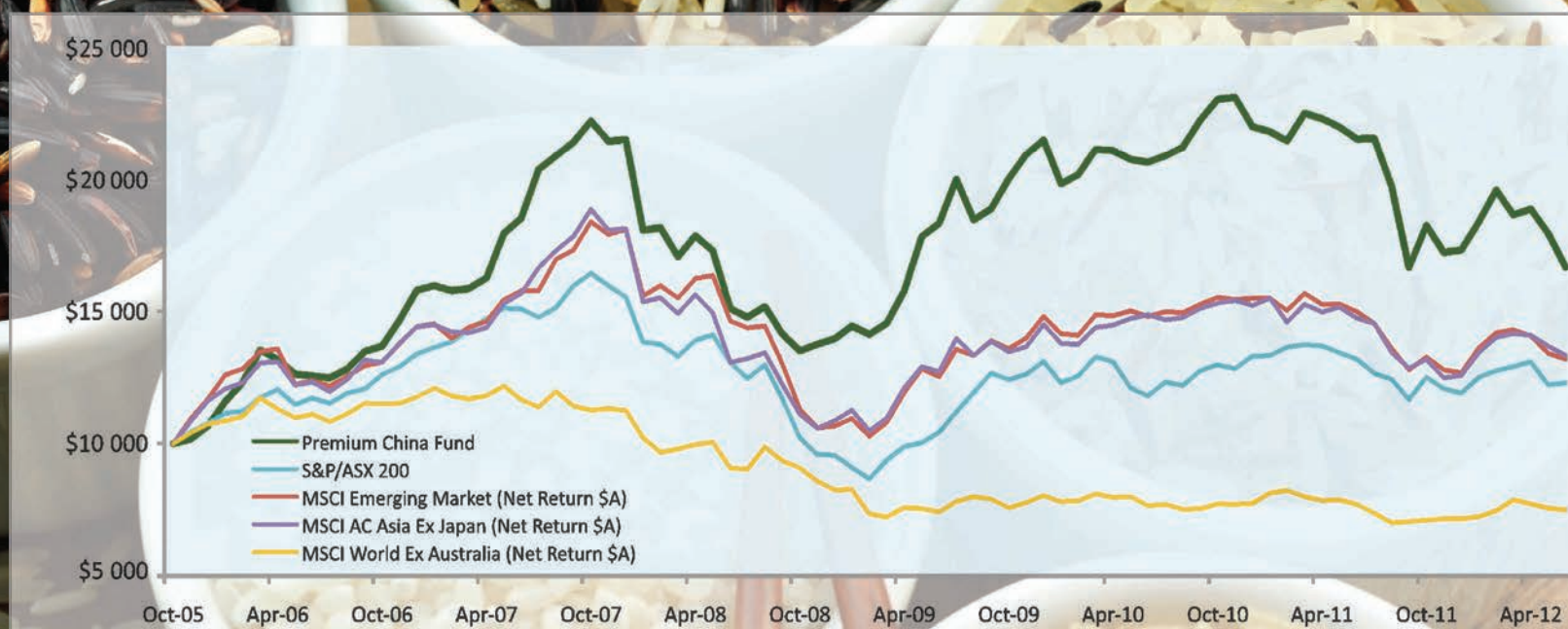
Table 2: Morningstar Asian Equity ETF performance data to 13 September 2012

Name	ASX Ticker	Net Assets \$Am	1 Yr %	3 Yr %pa
iShares FTSE China 25 (AU)	IZZ	26.08	-9.06	-10.31
iShares MSCI Hong Kong (AU)	IHK	4.91	2.72	1.12
iShares MSCI Japan (AU)	UP	22.06	-2.89	-9.10
iShares MSCI Singapore (AU)	ISG	3.50	7.70	4.61
iShares MSCI South Korea (AU)	IKO	4.52	2.83	3.49
iShares MSCI Taiwan (AU)	ITW	18.87	-2.17	-0.03
iShares S&P Asia 50 (AU)	IAA	55.19	5.45	0.80

Source: Morningstar

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Traps ahead

However, everyone acknowledges there are challenges for Asian equity markets.

"In India and China, inflation was a problem due to moves to slow their growth, but this is changing. In China, inflation is less than 4 per cent and is now within the long-term target, so it will be able to ease up on restrictive policies. However, India still has a problem with inflation, which is in high single digits at the moment," Urquhart notes.

Although acknowledging Asian growth is an attractive proposition, Laidlaw believes potential investors need to be prepared for the volatility that goes hand-in-hand with Asian share markets.

"If you get into Asian equities you must be cognisant of the risks and volatility that goes with that," he warns.

"There is not enough emphasis placed on volatility and the time needed to get back after a drop in performance."

Laidlaw points to several areas of concern. "We are starting to see medium-term headwinds and subdued performance coming through in leading indicators. Specific problems include infrastructure woes in India with black-outs, and Korea is seeing less domestic consumption."

The big countries also face a testing period politically.

"There are political challenges in India, and China is facing potential

"Asian bonds can offer 8-9 per cent yield and volatility that is less than half that of equities."

– Jonathan Wu

generational change at a time when the economy is changing, so that is a major challenge," Laidlaw explains.

The continuing political risks arising from the upcoming US election and ongoing European tensions are also influencing Asian equity markets.

"There is still a risk-on/risk-off environment and the Asian area is the first area where people pull money out if they are concerned about risk," Laidlaw says.

James agrees: "Most Asian markets are still emerging markets and relatively illiquid, so cashflows have a greater impact on prices than in other markets. Foreign investors still dominate many Asian equity markets, and that means they are at the whim of international investors."

Tackling the markets

Despite these concerns, experts believe there are good prospects in the region.

"The opportunities include the favourable demographic factors, large untapped markets and increasingly affluent local consumers. These markets took their medicine after the Asian crisis and now have low percentages of debt and a better banking system. They made the hard decisions a decade ago," Laidlaw notes.

James agrees: "Short-term sell-offs in Asia provide good opportunities to benefit from their long-term performance."

However, he believes advisers and investors need to take a selective approach and invest in carefully chosen companies, rather than just the broad Asian market. "It needs to be a more nuanced message, not just the Asian growth story generally," he warns.

Many of the best Asian companies play an essential role in producing the products consumers want to buy, James notes. "For example, Samsung makes the components

in most other manufacturers' products – such as Apple – so investing in Samsung is not necessarily a bet on its success as a competitor to Apple."

There are also attractive opportunities in buying the locally listed subsidiaries of multinationals such as Hindustan Unilever in India, he says. "You get the products and corporate governance of the parent, which gives the benefits of a multinational, but also greater exposure to the local market, which leads to greater outperformance."

Mowll believes Australian investors need to look wider than just equity markets.

"Asia is more than an equities play, it is a fixed interest and currency play as well," he says.

"Investors need to get into Asia in a dynamic way and select a manager who can dampen the volatility and manage through the inevitable cycles over the next 10-plus years. They need a very active manager who invests in all the asset classes."

Wu agrees the attractions of assets such as Asian fixed interest are often overlooked. "Asian bonds can offer 8-9 per cent yield and volatility that is less than half that of equities," he says.

"They can be very attractive for their high alpha and low volatility. A lot of European and US fund managers are seeing that opportunity and buying at the moment." **MM**



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