FSSA Investment Managers

Fund Manager Q&A

Asia Pacific – Positioning for Reflation (Part 1)

June 2021

Martin Lau
Managing Partner

Martin Lau, Managing Partner, has been with the FSSA Investment Managers for more than 18 years, starting with the firm as Director, Greater China Equities in 2002. Martin is the lead manager of a number of FSSA strategies such as the FSSA Greater China Growth Strategy and FSSA Asian Equity Plus Strategy to name a few.

What are your thoughts on equities versus bonds amid rising inflationary pressure and increasing bond yields?

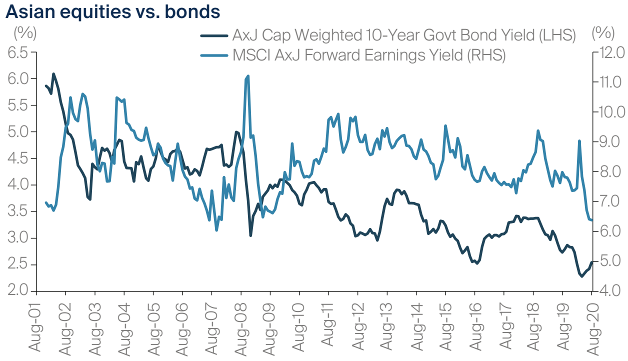
One of the things that surprised us was how much bond yields have fallen over the last few years. If we look at the black line on the top chart, which indicates Asian interest rates, it has been falling pretty much in a straight line. The US 10-year Treasury, which is the black line on the bottom chart, has been trending downwards as well.

We are no experts when it comes to inflation or bond yields, but after talking to companies that we have invested in, we can see that there is more inflationary pressure, driven by Covid, money printing and the fiscal stimulus rolled out by central banks around the world.

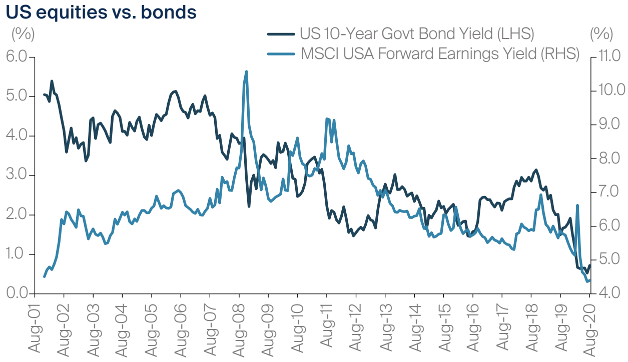
From the perspective of bond yields, even though it has bounced from the bottom, current yields are still considered very low in a historical context. If we look at the bond yields of the US 10-year Treasury, it is at 1.6% today, compared with 3% in 2018. As such, we think it is dangerous to assume that current bond yields will stay low forever. We should expect rising bond yields to cause ramifications on equity valuations.

Equities vs. bonds – "what is least expensive?"

Asian equities vs. bonds



US equities vs. bonds



Source: Bloomberg, Datastream, Factset, MSCI, Macquarie, as at 29 August 2020.

That said, we don't believe bond yields affect the fundamentals of the companies that we invest in, in terms of cash flow and profitability. However, it could affect market sentiment. Last year, investors believed that interest rates might never go up, but now investors have started to pay more attention to the potential rise in interest rates and how it could impact highly-valued stocks (such as technology companies). I see this as a healthy phenomenon, that the market is focusing on this risk.

In terms of equities versus bonds, we think equities look relatively more attractive. As of today, deposits from banks and investment grade bonds provide very low yields, if anything at all. Hence, although equities might look more expensive from a valuation perspective, from a yield perspective, we believe equities are still quite attractive compared to bonds.

In terms of our portfolio in this kind of environment, we would say it is well-positioned. We do not invest in companies that do not generate profits or cash flow, such as some of the highly-valued technology companies. They have been particularly vulnerable to a hike in long-term interest rates. Having said that, we are open to technology companies with high profitability and a good track record, such as Tencent, where we have been invested since it listed in 2004.

How do you identify high-quality companies which should be resilient during crises like Covid? How has Covid affected your investment decisions?

Every crisis provides an opportunity for investors and companies alike. As bottom-up investors, we like to observe how companies navigate through crises, as high-quality companies usually emerge from them stronger than before. For example, we look at whether they are adopting new technologies or deploying marketing dollars more wisely. We believe this tells us a lot about the company culture and the management team.

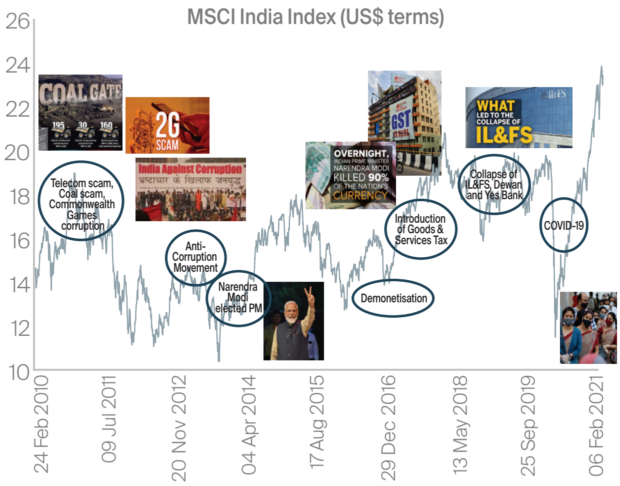
In the current climate, we are seeing a big shift in terms of consumption from offline to online, which likely won't revert to pre-pandemic levels after the pandemic is over. The challenges ahead for bricks-and-mortar retailers are clear, and as a team, we have started to turn more cautious on some of them. However, for those with higher brand equity, I think the impact would be minimal. Whether you are shopping online or offline, you are probably going to buy the same cosmetic brands, and the same household appliances or household products as before. Moving online could actually help companies save costs in the long term.

However, there is less excitement over consumption-driven companies compared to a few years ago, due to concerns about cost inflation. If you think about a tissue paper company, a shampoo company, or a snack confectionery company, with raw material costs going up, there could be increasing pressure on margins. That said, we see this as a short-term issue. If we look past the potential cost inflation and look at the improving demographics and market growth potential – particularly in some markets in Southeast Asia – there could still be opportunities for some consumer companies in the region to continue to grow.

The current situation in India is worrying. Is your investment conviction on India still intact?

India has always had issues over the past decade. About a year and a half ago, there was a housing finance crisis in India and before that, there was the demonetisation crisis. India has rarely looked as good as China from a top-down perspective. It has always run a fiscal and current account deficit, with a weak currency and unstable politics.

India has seen several disruptions over the last decade



Source: FSSA Investment Managers, BusinessToday.com, Financial Times, Outlook India, December 2020.

However, it is exactly for these reasons that we have historically found India to be an attractive market from a bottom-up perspective. It is almost the opposite of China. Because top-down has been challenging, companies need to be competitive and well-managed in order to survive. We see the current situation as an opportunity to identify high-quality companies that are able to emerge from the pandemic stronger then before, although from a social perspective, it is clearly very worrying.

One of our main investment themes in the India market — which we have had for many years and remains intact today — is the high-quality private sector Indian banks. In China, banks are 100% state-owned, whereas in India, about 70% of banks are state-owned and 30% are private. HDFC Bank, which has been one of our top 10 holdings for many years, has a market share of approximately 5% to 6%, and has been gaining market share over the years. The ratio of credit to GDP in India is about 50% or 60%, whereas in China it is around 200% or 300%, depending on your definition of credit. Hence, from a credit penetration and market growth perspective, we believe there is a huge opportunity for quality private banks in India.

Besides that, we also like Indian consumer companies — another major investment theme for us. In our view, India today is like China 10-15 years ago in terms of consumer penetration. Of course, you could argue that India might never get to where China is today, but if you look at demographics, income growth or the sheer size of the population, we believe there are good opportunities with some of these consumer companies.

As such, although one could argue that there is more macro risk in India compared to China, if we look beyond the near term and take a longer-term view, we believe there are still plenty of attractive investment opportunities in India.

How is the portfolio positioned?

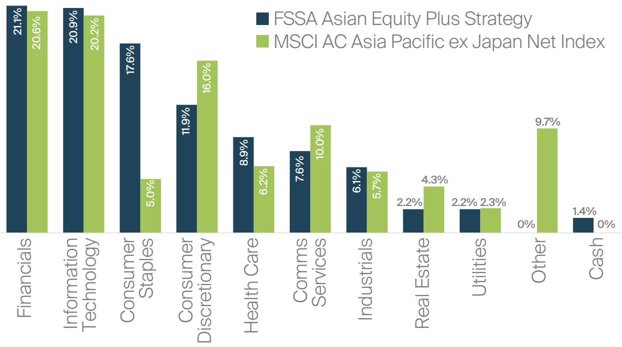
Our portfolios are reasonably balanced. We do not believe that we should position our portfolios towards a certain theme whenever that theme becomes popular.

As of today, we have approximately 21.1% allocation towards banks. Until recently, many people questioned our rationale for investing in banks due to low interest rates, but we find this overly simplistic. We have a meaningful allocation to Indian, Indonesian and Singaporean banks, all for different reasons. We believe Singaporean banks will be beneficiaries of rising rates, even though until recently people were expecting rates to fall. Also, banks such as Oversea-Chinese Banking Corporation (OCBC) have exposure to different Asian countries, including China. They have a 20% stake in Bank of Ningbo, for example. As for Indonesia, India and the Philippines, we see these markets as attractive from a credit penetration perspective.

We also have about 20.9% allocation to technology, mostly to hardware. We have stakes in Taiwan Semiconductor (TSMC) in Taiwan, Samsung Electronics in Korea and Keyence in Japan. We believe technology is a major secular trend and we do not mind holding technology companies for an extended period, especially those that are competitive and reasonably valued.

Historically, we have preferred to own consumer names. We have a high exposure to consumer companies in India and Southeast Asia because of their cash flow generation and high predictability. We do not have any exposure to energy or commodities. It is just too difficult to take a long-term view on commodity prices, or how much steel prices are going to rise and fall, or even oil prices for that matter. Historically, we have always been quite light in commodities.

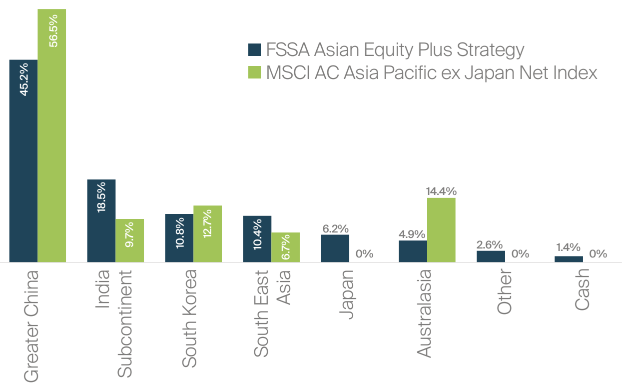
Sector breakdown
as at 31 May 2021



Source: First Sentier Investors. Numbers may not add up due to rounding.

From a geographical perspective, we have a large exposure to India at about 18.5%, and a 45.2% allocation to Greater China (including China, Taiwan and Hong Kong; or about 24% if just China). We also have a meaningful allocation to Japan (6.2%), as we like certain automation and consumer names there, and Southeast Asia (10.4%), as we believe it will continue to provide an attractive domestic consumption story in the long term, primarily because of favourable demographics — which is the opposite to China or North Asia.

Regional breakdown
as at 31 May 2021



Source: First Sentier Investors. Numbers may not add up due to rounding.

Source: Company data, as at June 2021.

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