RESEARCH

Investing in Asia

8 págs 12 min.

Portfolios **Active management** Long-term **Diversification**

1. Why invest in Asia?

Investing in Asia and emerging countries is becoming a very attractive option for investors. Why is it interesting to include investment in the Asian continent in our portfolios?

First of all, the **heterogeneity**, which is enormous, needs to be put into context, so it is at least necessary to synthesise it by region, as the diversity of its constituent components is one of the foundations of the region's current and future success. Asia is extremely diverse, with differences in governance methods, economic systems, demographics, wealth and growth trajectories.

Photo: Sanghái, China. Shutterstock.

Some economies are fostering domestic demand, while others are pursuing global leadership in some of the world's most dynamic industries. For example, South Korea and Taiwan are open and technologically advanced economies in high barrier-to-entry businesses such as hardware and semiconductors that are deeply integrated into global supply chains. On the other hand, other Asian economies are benefiting from a growing service-focused economy, such as India, with its burgeoning middle class. The region also has emerging manufacturing hubs such as Vietnam and countries with a commodity bias such as Indonesia and Malaysia.

Japan, for its part, remains the world's third largest consumer market after the United States and China. Japanese companies control more than 50% of the market share in many of the technology industry's advanced components and supplies. From special glass to semiconductor manufacturing equipment to complex chemicals.

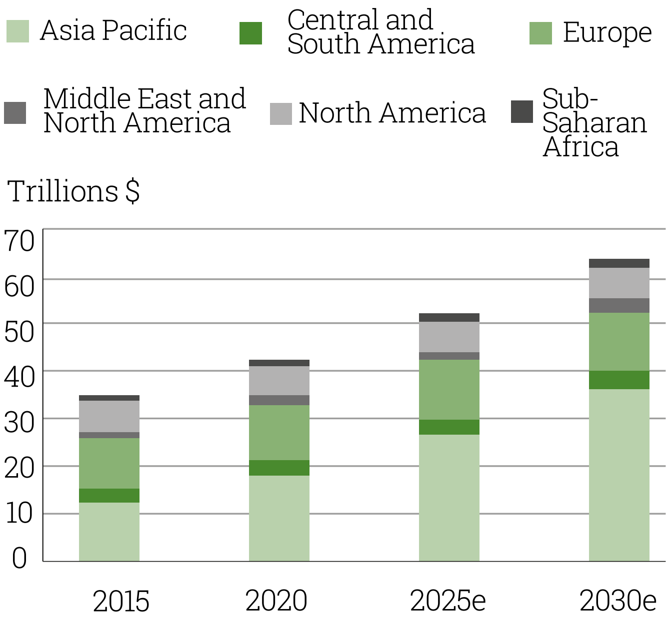
And then there is China, the dominant force in the region, very focused on the importance of its manufacturing sector, while specialising in areas where it lacked influence, fostering an economy increasingly focused on innovation and R&D, being a leader in multiple services (photovoltaic panels, electric vehicles...).

It is therefore clear that the inherent heterogeneity in Asia brings an inherent **diversity** to our investments. However, if diversity is part of Asia's investment attractiveness, so too is the region's drive to increase its **growth** and dynamism

Asia is on track to account for more than 50 per cent of global GDP sometime in the next 15-20 years. In addition to Asia's soaring consumption growth and burgeoning middle class, the region's expanding infrastructure, urbanisation, industrialisation and increased R&D spending mean that its business sector is innovating faster than ever before.

Driven by the rise of Asia's middle class and its growing purchasing power, consumer spending is a long-term growth driver for the region. To give a few examples, China's middle class is expected to exceed 1.2 billion by 2030, while India's is expected to double from 400 million in 2021 to 800 million in 2030.

Middle Class Consumption Expenditures



Source:: Brookings Institution.

Asian consumers as a whole are expected to account for half of global consumption growth over the next decade. This has important implications for incomes across multiple sectors as consumers seek to improve their lifestyles. With global economic activity picking up and Asia continuing to show comparatively higher GDP growth than other regions of the world, it is worth considering diversifying a global portfolio to include investments in Asia.

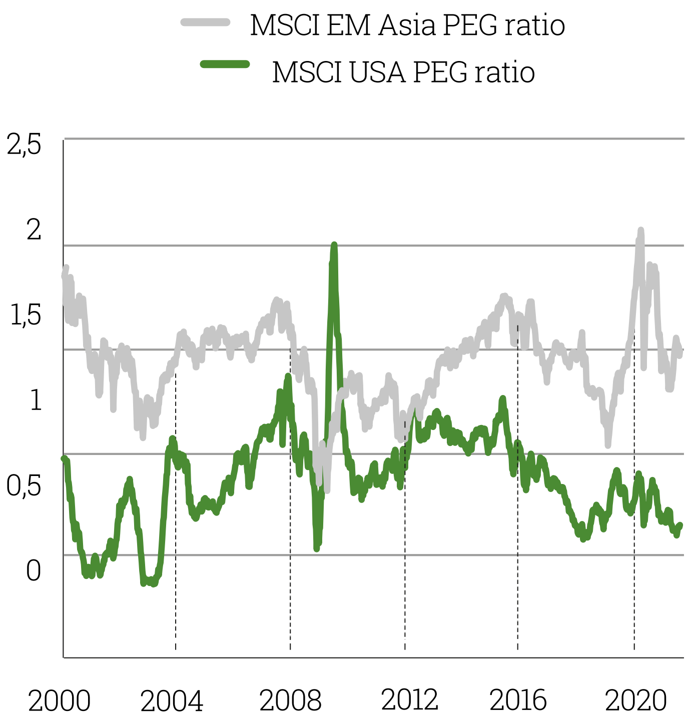
"(...) the inherent heterogeneity in Asia brings an inherent diversity to our investments"

One big difference, however, is that these markets are much less efficient from an **information point of view**. This often means that they are underweight in overall portfolios, but on the other hand can create excellent opportunities for active investors who actively exploit these pricing inefficiencies. It is also true that these groups often adhere to the same level of corporate governance and compliance as their developed market rivals, although they generally lag behind in this respect. But many companies are dual listed in developed markets, which requires them to follow more rigorous regulation. At the same time, this broadens their international investor base, which means that it is in their interest to adhere to higher standards of corporate governance. This aspect will be discussed in more detail below.

2. What are Asian equities like?

The earnings outlook for Asian equities has steadily improved, while Asian equity **valuations** continue to trade at a discount to developed markets.

Stocks' Peg Ratio: Emerging Asia vs US



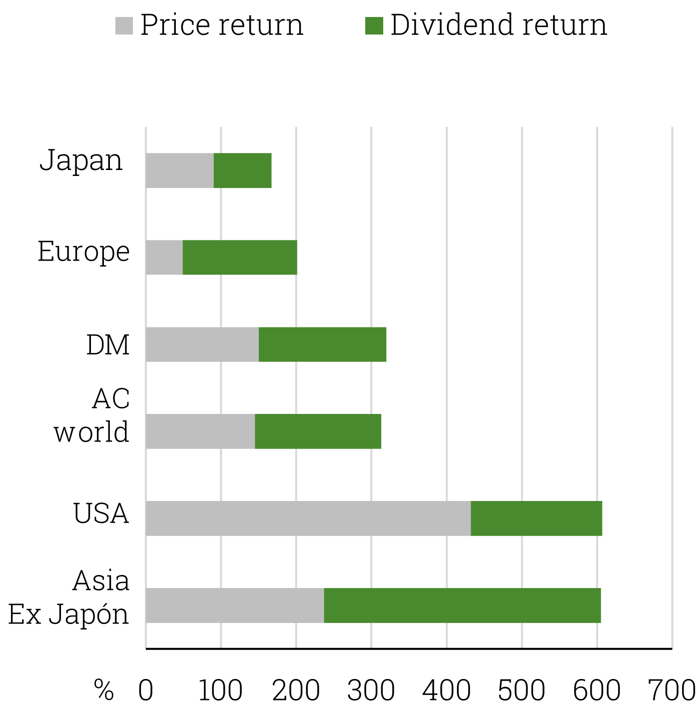
Source: Refinitv, Pictet AM.

Asian equities are a good source of income, as dividends have accounted for two thirds of long- term shareholder returns over the last decade.

Asia is home to quality companies that have strong balance sheets, generate good cash flows, are exposed to some of the best structural growth opportunities and offer an attractive dividend yield. Improved corporate governance, driven by government regulation and shareholder activism, is another factor driving this increase in dividend yields and payout ratios in recent years.

Total returns with dividends reinvested

December 2000-March 2022 (%)



Source: Credit Suisse AM, Bloomberg.

As we can see, the Asian market offers earnings growth in a global environment of low secular growth, and at attractive valuations. Additionally, the diversity and differences between the various markets result in returns of a compensatory nature, which can offer less volatility, more stable returns and potentially serve as a better diversifier.

3. Cobas AM presence in Asia

Our presence in Asia starts with our investment team.

For more than 10 years, one of our investment team members, Mingkun Chan, has been working remotely from Shanghai.

As you know, a priori we are more comfortable investing closer to home, as we believe that company culture is easier to analyse if the people in the company share values that are closer to our own.

That said, the reality is that our investment mandate is not geographically constrained in our search for investment opportunities, and we are always willing to go where we believe there is value to be found.

The importance of understanding the dynamics of the Asian continent begins long before we even consider investing in the region. In a globalised world like the one we live in, any company with a global commercial focus for its product or service will face competition from all over the world. This is where Mingkun's role begins to take on importance.

Its analytical work begins by helping us to understand the dynamics of growth in Asia. And this is important, as we have seen, Asian economies represent arguably the main engine of growth for the global economy.

According to estimates by the International Monetary Fund, world growth forecasts for Gross Domestic Product are around 3%. If we break this growth down, we find developed economies for which the expected growth is very low, at around 1%, and emerging Asian economies with expected growth at levels of around 5%.

GDP growth forecast in Asia in 2023e

Asia 5%

Source: IMF Word Economic Outlook. 2023e.

This is important. Understanding firsthand the situation of these economies is very relevant when we talk about a global portfolio like ours, given that around 2/3 of the sales of the companies that make up our International Portfolio are produced in a global framework, so exposure to the dynamics of global growth is very relevant.

Thus, the proximity we obtain through Mingkun's presence in Asia is very relevant when analysing companies that are competitors of those in which we are investors.

As he is a native speaker, his cultural affinity with the companies in the region is very strong, and this helps the rest of the team to better understand the different situations that we, as investors, may face when investing in societies so different from our own.

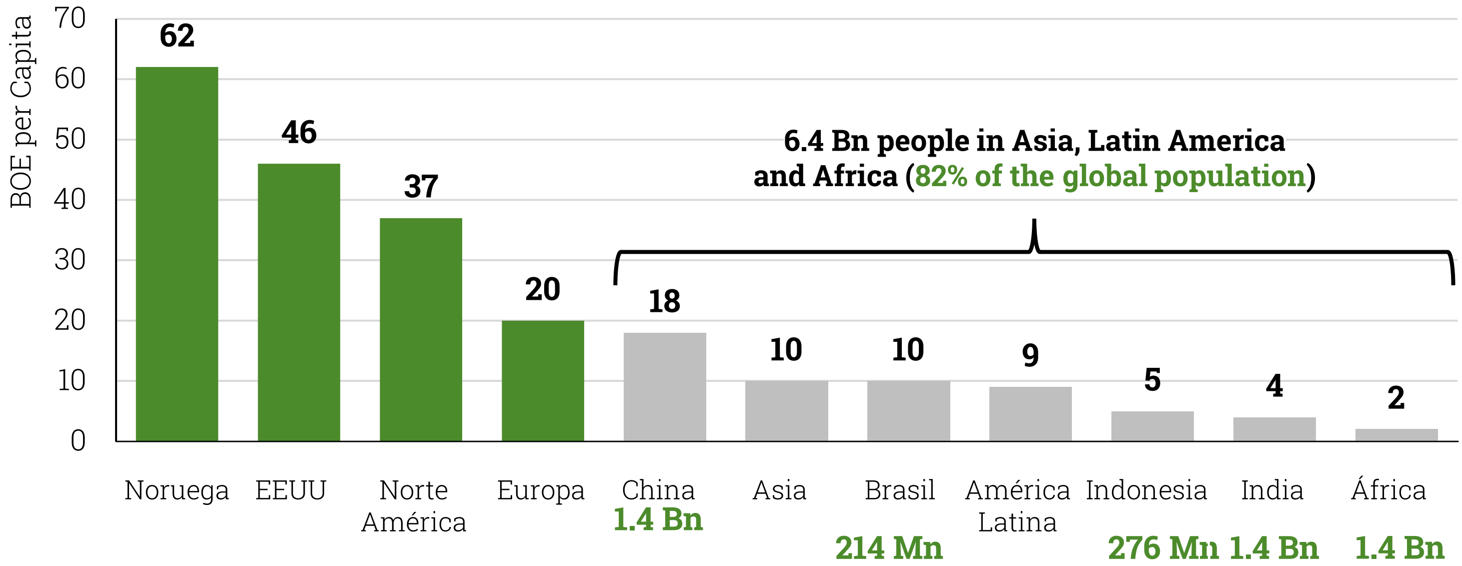
An example can be found in our energy investment thesis, which focuses on oil and gas. The basis for the general reasoning behind the thesis is on the supply side, as we consider that companies are not making the necessary investments to maintain a healthy and sufficient supply in the coming years.

On the demand side, in recent quarters the market has been debating between recession yes or recession no, and passing these forecasts on to the prices of both commodities in the form of volatility.

In our view, energy is absolutely fundamental to the development of societies and we believe that emerging markets are a very important driver of future demand.

In this respect, the size of the population in developing countries should not be overlooked, as this is where, in our opinion, a major part of future energy demand lies. And of course, Asia plays a key role:

Primary energy consumption per capita in BOE



Source: BP Statistical Review 2022, World Bank, Magni presentation at the Pareto energy conference on Sept 22nd.

After all, billions of people aspire to progress and higher levels of well-being. In this transition to development, energy plays a key role. Understanding these growth dynamics at first hand is therefore of great importance.

3. Cobas investments in Asia

However, this work does not stop here.

As of today, our International Portfolio's direct investment in listed companies in the region breaks down as follows:

Asia holdings at a glance

Company	Weight	Type of business
Samsung C&T	1,81%	Cíclico
LGE/LGC preferentes	1,46%	Cíclico
Ichikoh	1,32%	Cíclico
CKH	1,27%	Defensivo
Daiwa Industry	1,17%	Defensivo
Hyundai Motor preferentes	1,11%	Cíclico
Vtech	1,11%	Defensivo
Okamoto	1,07%	Defensivo
Johnson Electric	1,03%	Cíclico
Amorepacific preferentes	0,36%	Cíclico
TOTAL	**11,71%**	

Note: Data as of 31/03/2023

It is a relevant and diversified exposure.

We are talking about 11 companies representing around 12% of our International Portfolio.

All of them are **family-owned** or controlled by an investor group involved in the management of the business. This feature compensates to some extent for the greater geographical, and therefore cultural, distance, as what underlies here is a total alignment of interest between those responsible for management and the owners of the capital.

We are talking about quality businesses, in our opinion, with the ability to generate **returns on capital employed** of around 25% on average, which we think is very relevant. To put it in context, an average business, neither good nor bad, generates a ROCE that we can put at around 10-15%, so 25% is indicative that we are invested in very good businesses, most of them protected by barriers to entry.

Another characteristic lies in the **conservatism of their balance sheet**, another of the safety belts that compensates for the aforementioned cultural distance. In total, 9 of the 11 companies are in a net cash position, which offers a very high level of security in terms of navigating the different phases of an economic cycle.

All investments are in companies listed in South Korea or Japan. We invest mainly in South Korea and Japan (for the moment), not for geographic reasons, but because of their good corporate governance at a discount (we do this with all companies in the world). So we can argue that corporate governance in Korea and Japan has not yet been as good as in the West, so we might find some opportunities.

And the reality is that we see dynamics in both markets that lead us to believe that price/value differentials are on the right track to be corrected.

In South Korea, the number of retail investors has doubled in the last 3 years to around 14 million investors.

This means that one third of the Korean voting population is an investor in the South Korean stock market. To put this figure in context, in 2019 this figure stood at 10% of the population, so we understand that a significant shift is taking place in this regard.

What are the implications of this dynamic?

Obviously, such a change gives the government a strong incentive to reduce South Korea's discount, as it would be in the best interest of its own population.

Only a month ago, stock exchange and foreign exchange officials began making presentations to foreign investors through sessions organised by brokers. The messages we can extract were the following:

1. They will make investing in South Korea much easier, the registration process will be simple.

2. They shall protect the rights of minority shareholders.

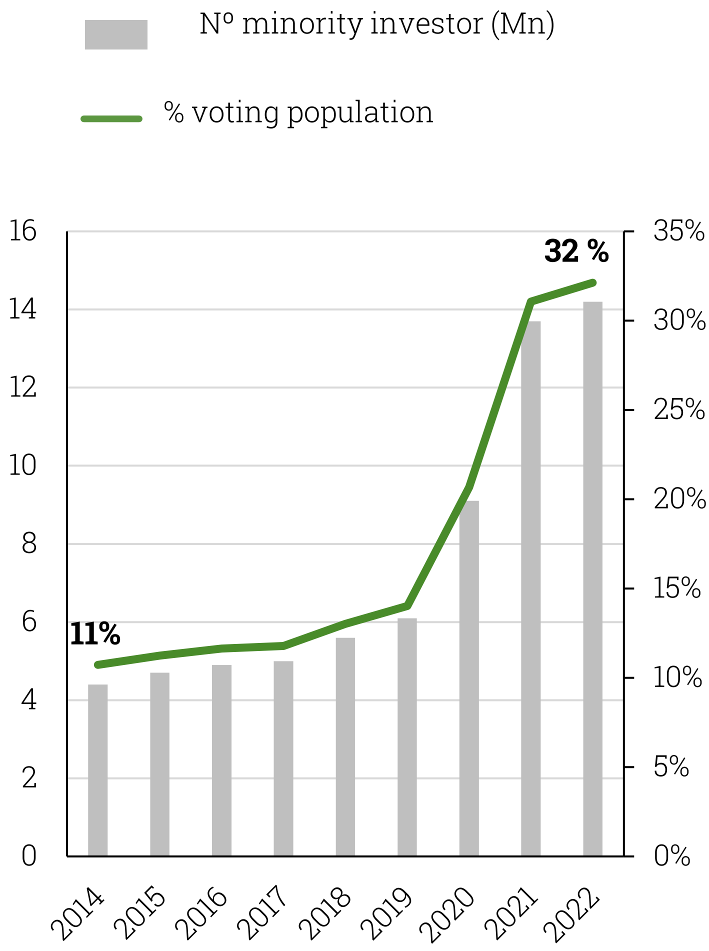
3. They will encourage Korean companies to be shareholder friendly.

These have historically been some of the reasons behind the permanent discount against their intrinsic value at which many of the country's companies have been trading for many years, as well as the discount of Asian markets relative to developed economy markets, such as the US market. Emerging Asia's equity discount to the rest of the world, as measured by price/earnings ratios, is not far from its long-term average of 10-15%.

The appreciation potential of emerging currencies offers an additional source of return for investors with portfolios denominated in other currencies, such as ours.

With this new attitude, we believe that the speed at which this valuation adjustment can take place will increase.

Korea situation: improving governance



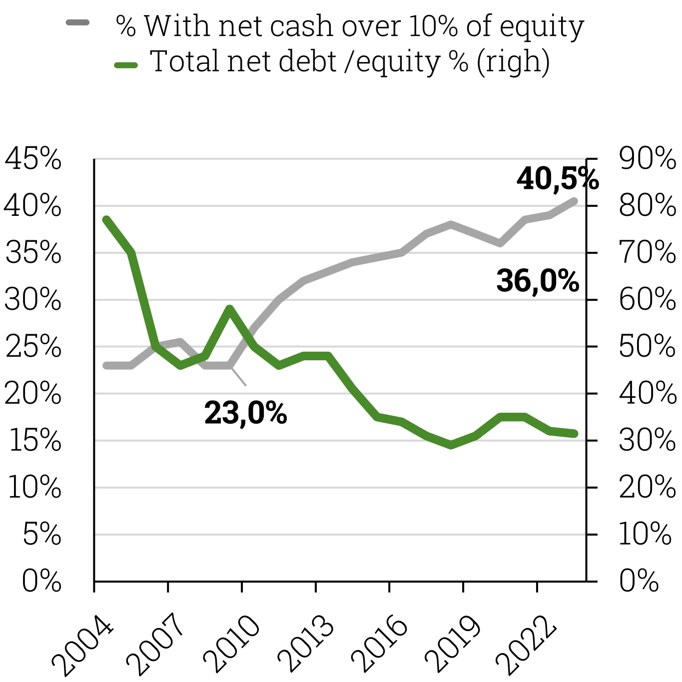
Soruce: Korea Securties Depository, IFES.

Something similar is happening in Japan.

Over the past few years, we have observed a positive trend in corporate governance and capital allocation in the Japanese market.

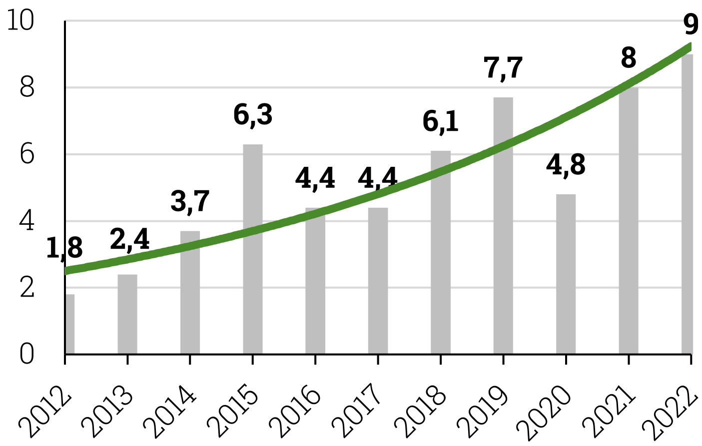
For example, the Tokyo Stock Exchange recently began sending out an annual memorandum to the approximately 3,300 companies listed on the Tokyo Stock Exchange. The purpose of the memorandum is that companies trading below book value must submit a document setting out the actions they intend to take to improve capital allocation and thereby encourage the market to adjust the wide price-to-value differentials at which many companies currently trade.

Japan situation: improving governance



Soruce: CLSA, Bloomberg.

Buybacks (Tn JPY)



Source: SMBC Nikko Securities, from Quick.

We understand that having a direct presence of our investment team on the continent, through a trusted and native person (this is important when talking about Asia) brings us many benefits, not only in relation to the companies we may be invested in from time to time.

From a more global perspective, our presence in Asia helps us to understand more deeply the growth dynamics of the world's most populous continent with the fastest GDP growth. It helps us to better understand the dynamics of competition and growth in many sectors in which, without in many cases having investments in listed companies in the region, we invest through European or American companies whose competitors in many cases are Asian companies.

In short, the direct presence in Asia offers us an added value that complements the view that our Madrid-based investment team may have on global growth trends.