# Seeking out the aces

Instead of 'buy and hold', an active approach to investing in the region may be more rewarding

**By Lim Chew Hwee**

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SINCE the global financial crisis, Asia has been struggling to revitalise its growth engine. Against the backdrop of a sluggish world economy, declining global trade growth and slumping commodity prices, many Asian countries have come to realise that the old ways of generating economic growth are no longer feasible in this post-crisis world. However, restructuring and reforms entail immediate economic pain as old methods are supplanted. Uncertainties relating to execution lead to additional risks.

Over the last three years, Asian equities' performance has been disappointing, not just in absolute terms, but also relative to developed markets. Structural issues such as declining productivity, escalating costs and rising leverage have plagued many Asian countries and hurt corporate earnings. Years of cheap money and easy credit have led to capital misallocation and fuelled mal-investments and overcapacity in many industries. These have resulted in unsatisfactory returns on capital invested and negative corporate earnings momentum.

When the US dollar began to strengthen on hints of an interest rate normalisation by the US Federal Reserve Bank, Asian equity markets saw foreign investors retreat in droves. The abundant liquidity which used to nourish Asian financial markets is evaporating.

After a shaky start to 2016, Asian equities have finally shown some signs of strength. The MSCI Asia ex-Japan Index has regained most of its losses since the January low. This performance can be largely attributed to a return of foreign funds on the back of some semblance of stability in the Chinese economy, a rebound in commodity prices and a softening US dollar, as well as the reasonable valuations Asian equities now offer.

While Asian equities currently trade around 11.9x their price/earnings multiple, which is in line with the recent five-year average, valuations are dynamic and depend heavily on the corporate earnings outlook, which continues to dim. While analysts are expecting earnings growth to be flat this year and to grow +11 per cent next year, revisions remain biased to the downside.

Ultimately, the sustainability of Asian equity performance rests on the return of supportive earnings growth. The latter in turn depends on the success of the reforms to address the underlying structural issues of falling productivity and unsustainably high leverage.

Unfortunately, such structural problems usually take years to resolve. For instance, new and more efficient manufacturing methods need time to be adopted and excess capacity will not go away overnight.

In addition, getting regional corporates to move up the value curve by developing new products and services for new markets requires time and resources. Finally, instilling discipline and embracing a market approach to capital allocation require a transformation of mindset and decisive steps to liberalise financial sectors which have traditionally been tightly controlled.

In view of the uncertainty and volatility described above, a "buy and hold" strategy may not be ideal in current circumstances. It is important to be mindful that the world's most influential equity market – the US – is trading at lofty multiples. The bull run on Wall Street is also very mature and is considered one of the longest in history. Therefore, extrapolating from the past and expecting robust investment returns in the future may be too optimistic.

Instead, an active approach to investing, especially in selective secular opportunities, may be more rewarding.

## Infrastructure development

One such example of investment opportunity is in the area of infrastructure development. According to some economists' estimates, Asia needs to spend approximately US$1 trillion every year till 2020 to meet the region's infrastructure requirements. Many regional economies need to vastly upgrade and extend their ageing physical infrastructures (including roads, airports and logistics amenities), to improve connectivity and facilitate the movement of people and goods.

More efficient and cleaner energy is also required to meet the needs of an increasingly urbanised and environmentally conscious Asian population. Therefore, companies involved in construction, logistics, clean and renewable energy could potentially benefit.

## Tourism

Another investment opportunity lies in Asian tourism. As the region's middle class grows, the propensity to travel is expected to rise. For instance, China's outbound tourists increased by 10 per cent year-on-year in 2015 alone to a record 128 million people. Top destinations included Japan, Thailand and New Zealand. Tourism-related plays in these regional countries, as well as in China, are worth examining.

Given that the penetration rate of air travel in China remains low at just 0.3 per cent (versus 0.9 per cent in Japan and 2.9 per cent in Australia), the secular trend of Asian tourism growth should remain intact over the next few years.

Finally, Asian equity markets are home to relatively attractive dividend yielding stocks compared to other regions. There are some cash-rich, Asian bluechip companies with good historical track records of paying dividends that yield more than bonds. This makes them potentially attractive long-term investment candidates, especially in the current low interest-rate environment.

In our view, the long-term fundamentals of Asia remain sound and investment opportunities abound, driven by a growing middle class whose demand for goods and services will only increase. However, before Asia's full potential can be realised, the region may need to resolve its present structural hurdles.

Only when Asian companies become more disciplined in allocating scarce resources, innovate and master new technologies and skills, will productivity improve. At that point these companies' return on equity will recover from its current level of 11 per cent, a far cry from the 16-plus per cent that such Asian companies used to attain.

Meanwhile, the journey of structural reforms remains long and arduous. It requires the determination and tenacity of the region's leadership to see it through. W

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