Asian equities are back on track

Volatility management could be key for investors

Asian equities (MSCI AC Asia Pacific ex Japan) started 2019 in strong fashion after being blighted by investors last year. However, the indiscriminate selling created opportunities that investors are gradually recognizing. Going forward, positive internal characteristics (attractive valuations and growing dividends) and improved external conditions (the fed, the US dollar, trade), have the potential to put Asian equities back on track.

Attractive valuations and growing dividends

When compared to their global counterparts, Asian equities are low hanging fruit. From a 10-year price to book perspective, Asian equities are heavily discounted against developed markets (DM, MSCI Developed World Index). That is in spite of growing sales, rising earnings and less debt. When you add growing dividends to the picture, the valuation differential between Asian equities and DM equities could be more perception driven than based on facts.

Chart 1: Asian equities are more than one standard deviation cheaper than DM equities.

Price to Book spread between DM equities and Asian equities

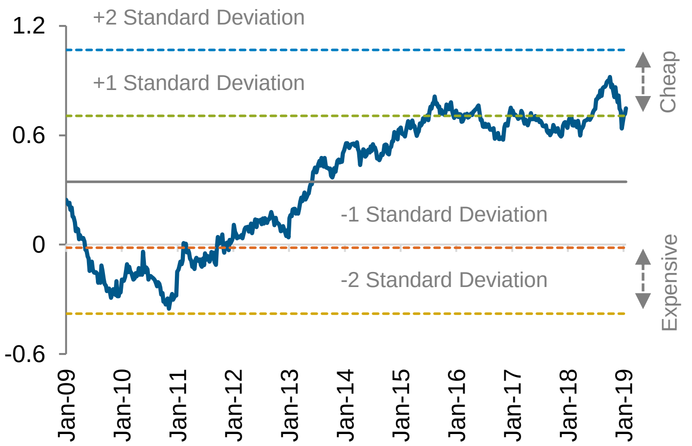
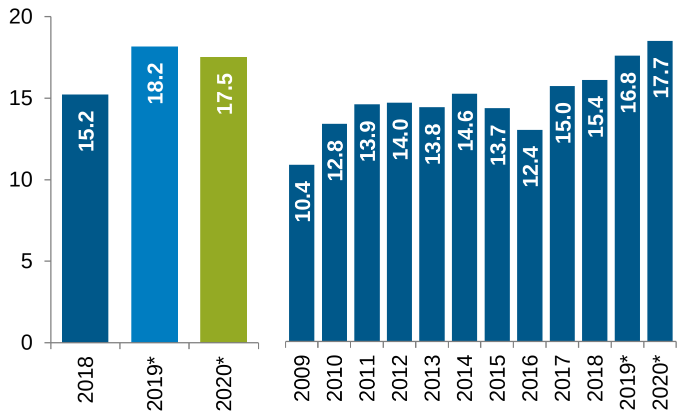


Chart 2: Asian equity dividends are at a premium to DM equities and growing.

Dividend Yield Premium between Asian equities and DM equities (%)

12 Months Dividends Per Share (USD)



Sources: Charts 1, 2. Bloomberg, MSCI. Data as at 18 January 2019. *2019 and 2020 data are Bloomberg estimates.

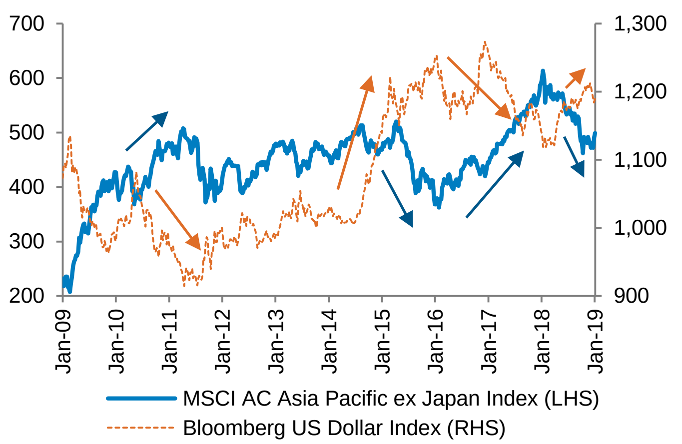
Fed contemplation and a cooling US dollar

After raising rates four times in 2018, volatility in financial markets has the fed recently expressing the willingness to take a more patient stance on raising rates.

In addition, after an extended run up against emerging market currencies, the US dollar seems to be consolidating at current levels. Weighing on the dollar are mixed signals surrounding the US economy, the increasing attractiveness of non USD denominated assets and burgeoning US government debt.

Typically, a strong USD sours the appetite for Asian assets as a firmer greenback raises the cost of inputs and increases the debt burden of Asian government and corporates.

Chart 3: A weaker US dollar bodes well for Asian equities.



Sources Chart 3. Bloomberg, MSCI. Data as at 18 January 2019.

Source: Legg Mason, 22 January 2019.

Managing the risks

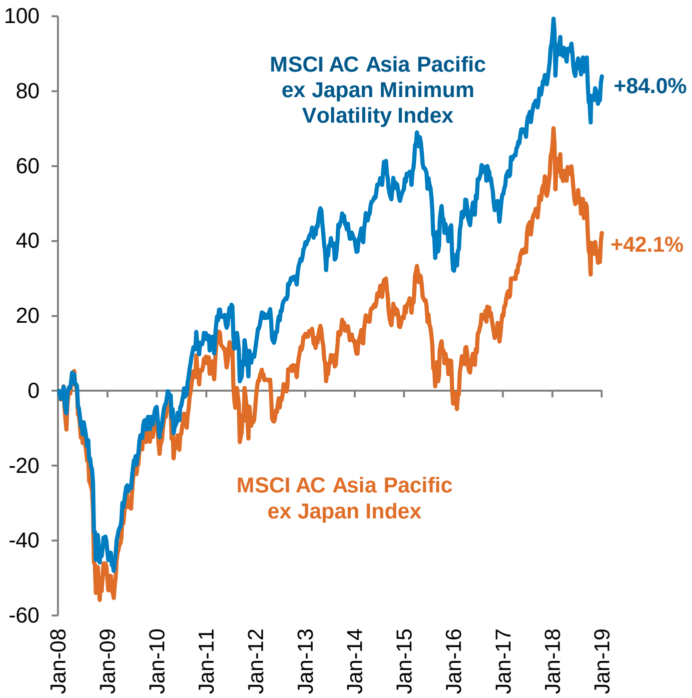
While the conditions for Asian equities to flourish are clear, the experience of 2018 suggests that a measured approach to Asian equities can be a sensible option.

Note in the table below that since 2008, an Asian managed volatility strategy (MSCI AC Asia Pacific ex Japan Minimum Volatility Index) beat the plain Asian equity strategy (MSCI AC Asia Pacific ex Japan Index) 8 out of the last 11 years **(green rows)** while gaining alongside over 3 years **(grey rows)**

The outperformance of a managed volatility strategy illustrates convincingly that investors can benefit more over the long term by losing less over the short term. (Mathematically, larger drawdowns are more difficult to recover from, losses should be mitigated to facilitate a quicker recovery of the portfolio[1])

Chart 4: There are cumulative and annual performance benefits of a managed volatility strategy

Rebased returns (%)



	MSCI AC Asia Pacific ex Japan Minimum Volatility Index	MSCI AC Asia Pacific ex Japan Index
2018	-4.8	-13.7
2017	27.4	37.3
2016	2.9	7.1
2015	-5.3	-9.1
2014	7.0	3.1
2013	6.1	3.7
2012	24.8	22.6
2011	-5.2	-15.4
2010	22.5	18.4
2009	56.6	73.7
2008	-43.0	-51.6

Conclusion

The case for Asian equities is compelling. Attractive valuations and improved market conditions could potentially reignite this asset class. However, for investors conscious about the relative risk that investing into Asia demands, engaging a strategy that curtails short term volatility, could very well indeed be a judicious move for the long term.

END

Source: Legg Mason, 22 January 2019. 1Amy Lubas, Kiersten Engel, September 2017. NDR White Paper – Minimizing Drawdowns Helps Long-Term Returns.

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