Active management brings rewards in ASEAN

By Jeremy King

Why do ASEAN stock markets tend to underperform their underlying economies? In the 10 years from 2008-2017, economies of the 10-member countries of "The Association of South East Asian Nations" have averaged GDP growth of 5.1 per cent a year but their stock markets increased just 4.6 per cent a year. The answer is not straightforward, since much depends on the time period that you select, because severe volatility has hit the region from time to time.

Firstly, we should differentiate between corporate earnings growth and share price performance. Listed company earnings have grown nine per cent per annum for the last 10 years, easily outpacing the underlying five per cent GDP growth. The fact that equity indices have only gained 57 per cent in the same period is an indication of fluctuating valuations on the back of global capital flows, local liquidity, impact of foreign exchange rates on these export-driven economies and investor sentiment. Corporate earnings may themselves swing widely depending on the corporate discipline, leakage and accounting within particular companies.

Secondly, some ASEAN stock markets, such as the Philippines (although founded in 1927) are still not broadly representative of their economies and their actual free-floats may be smaller than they should be. In fact, the bulk of economic activity in ASEAN is carried out in the agriculture sector and by SMEs and partially foreign owned joint ventures that are rarely listed, but have a substantial impact on domestic banking and consumption. Key industries such as tourism in Thailand are represented only by the Airport Authority, some airlines and a handful of hotel companies, while in Singapore property companies are over-represented. Corporate governance also varies from country to country, in some cases stymieing entrepreneurialism and in others providing well-needed regulation.

Thirdly, the cyclicality of ASEAN in the past has meant that your returns would be massively skewed by the timing of your entry. The 1996-98 Asian crisis and the 2008 global financial crisis amounted to major value resets. In the future such extreme turbulence may not recur since government balance sheets are much stronger than ever before. Average government debt to GDP in Asean is 40 per cent versus 87 per cent in the UK and 108 per cent in the US. In addition, foreign exchange reserves in Asean are over US$ 1 trillion or one-third of total regional GDP versus China at US$3 trillion or 25 per cent of GDP. Similarly, total Asean debt (combined government and private) stands at a manageable 101 per cent of GDP versus 203 per cent% in Germany, 303 per cent in China and 310 per cent in the US.

In the face of all these factors, the index or basket investment approach doesn't work as well as it does in more mature markets. In the US, ETFs have been around since at least 1976 when Jack Bogle started his First Index Investment Trust. It is no secret that most fund managers in developed countries cannot beat the indices, although the likes of George Soros and Warren Buffett certainly have with different investment approaches. ETFs have been gradually introduced in Asia, but with mixed results for the reasons mentioned above.

In ASEAN, the combination of diverse cultures, imperfect economic statistics, and varied levels of corporate integrity, means that qualitative as well as quantitative inputs need to be updated on a continuing basis from a mix of formal and informal sources. Number crunching is a science whereas qualitative analysis is an art. Understanding the cultures and politics of these countries, knowing who the players are and applying one's own assumptions based on direct observation of the individual economies is vital. Contrarian timing must also be applied in order to benefit from the market cycles, and individual companies' ever fluctuating popularities.

As increasing institutionalisation and regulation worldwide risks progressively turning investment professionals into robots, only to be replaced by AI when we lose our ability to think, ASEAN stands as one of the last bastions of common-sense investing. Core ASEAN is not yet AI dominated, and not yet efficient in providing accurate information to all investors at the same time, so it likely has around ten or more years of alpha-active investing remaining, and the Mekong region at least 20 or more years.

Even then, there will still be room for alpha generation as there is in more mature markets by betting against the herd, and by making strategic value-creating investments through "hybrid" funds.

Similarly, choosing managers in this environment should also be a qualitative process, not solely a quantitative process. Managers should be favoured who have a proven track record of managing volatility and stress analysis, and be performance-led rather than simply a bureaucratic "checklist" process.

Within Asean, large banks are less dominant than in more mature developed markets, although there is sadly a steady deterioration into localized indexing, excessive investment checklist evaluation processes, and dull "plain vanilla" asset gathering.

Active in ASEAN

1) Don't buy ASEAN ETFs/Index Funds. If you must, then choose country specific ETFs so you can at least decide the asset allocation yourself reflecting your knowledge of the social, political and economic drivers of those countries;
2) Invest with independent and active managers' offshore funds, not onshore funds where process defeats performance;
3) Choose real experience over institutional branding where index enhancement is the most you can reasonably expect; and
4) Take a medium to long-term view, so you can ride out the cycles. Be contrarian and add to exposure on any major downturn (although we're not expecting one).

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