FSSA Investment Managers

Summary

Market outlook: it's the end of the world, all over again?!

Richard Jones, Director, FSSA Investment Managers

In the Asian markets, investors have gone from "anything, as long as it's China" to today's high levels of fear and disbelief, but that is typical when markets fall significantly. Speaking at the FSSA Forum 2023, Richard Jones, a director at FSSA Investment Managers, believes there are reasons for investors to be cautious – with lower demand, higher debt, de-coupling and demography being the more obvious issues. But, lower prices are usually synonymous with higher returns; and today, companies at least appear to be valued quite a lot cheaper.

Asia's "lost decade"

In Asia, there has been a "lost decade" across much of the region, with low single-digit annualised returns for the last decade (2013-2023) compared with the double-digit returns of the previous decade (2003-2013).[1] For example, China and Singapore have returned a paltry 3.9% and 1.8% annualised respectively over the last 10 years, while the Philippines and Malaysia have been negative. Only the US, Taiwan and the MSCI World (of which the US comprises half) have had higher returns in the last 10 years compared to the 10 years prior.

On a sector basis, it looks even worse. Technology, with an almost 15% annualised return for the last decade, has been the main driver of returns in Asia. Every other sector's return is much lower and considerably below the level of the prior 10 years.

Business as usual

As FSSA's long-supportive clients know, the team "don't do macro". And so, against this backdrop it is business as usual for FSSA. Such have been the tailwinds and headwinds for investors, but the team's investment process and philosophy remains driven from the bottom up and is focused on finding the region's best companies that can grow larger over time. The team looks for quality companies, which starts with the management, though the quality of the business (in terms of barriers to entry and sustainability of earnings) are also vitally important. For these attributes, they want to pay a reasonable valuation.

The outcome of FSSA's long-established (more than 30 years) investment process should result in a better-than-index outcome, over time, and a respectable long-term absolute return. The returns profile of the FSSA Asian Equity Plus strategy shows that it tends to perform better in tougher market conditions, while lagging in easier times. Indeed, the team's long track record of returns has been punctuated (and perhaps even enhanced) by the last four market crises (the Asian crisis in '97; the dot-com implosion in '00; the Global Financial Crisis in '08; and Covid in '20).

The quality of FSSA's Asian equity portfolio

Meanwhile, evaluating the FSSA Asian Equity Plus strategy as if it were a stock, the gross margin (ex-financials) for the portfolio is currently 43%. It has been remarkably stable and much higher than the equivalent for some of the indexes: the MSCI Asia Pacific ex-Japan index's gross margin is just 28%, while the gross margin for the FTSE100 and the S&P500 is 36% and 34% respectively. Operating margin for the FSSA portfolio is higher too, at 21% vs. 12% for the MSCI Asia Pacific ex-Japan index; 16% for the FTSE 100; and 13% for the S&P500.[2]

1 Source: MSCI, Bloomberg, comparing annualised returns over the 10 years to 31 July 2023 and 10 years to 31 July 2013.
2 Source: Bloomberg, as at 18 August 2023.

The FSSA Asian Equity Plus portfolio also has better corporate returns, as expressed by the return on equity (ROE). The team have often said that ROE is perhaps the best numerical indicator of potential quality. The portfolio's ROE, at 19%, is higher even than that of the S&P500. Meanwhile, the portfolio's cash-flow and cash generation is also better than the three indexes – and these higher numbers are despite the fact that Asian companies, generally, have virtually no debt.

In summary, the FSSA Asian Equity Plus portfolio has higher margins, better returns and lower leverage – all pointing to a high-quality basket of companies. From a valuations perspective, the price-to-earnings and price-to-book ratios of the portfolio are somewhat higher than the MSCI Asia Pacific ex-Japan index, but at a considerable discount to the S&P500. In Richard's view, the price vs. quality trade-off looks attractive.

Underlying company quality is similarly high

By looking at some of the portfolio companies on the same basis, there is a similar pattern. The FSSA team believes that Taiwan Semiconductor (TSMC) is still one of the world's greatest businesses, and the valuation is still not unreasonable. The long-term returns have been good, while it's hard to think of a better way to gain exposure to technology broadly. (Perhaps with ASML or ARM, but they are much more expensive.)

CSL, or Commonwealth Serum Laboratories, is another portfolio company, albeit one that may be less familiar to clients. The margin as well as the returns profile appear to be deteriorating, despite the group having historically had superior economics. CSL has had a challenging time during Covid, with its core raw material (blood from US donors) being badly impacted as America came to a halt. It is taking longer than expected to normalise, cost-wise, while they are on the cusp of commercialising a number of new products. On the other hand, the long-term returns are similarly good, while the business doesn't appear to be permanently impaired.

Wrapping up the presentation, Richard highlighted the top 10 holdings in the FSSA Asian Equity Plus strategy (TSMC and CSL are both included), the top and bottom contributors to performance over five years, and new purchases and disposals in the portfolio over the past 12 months (to 31 August 2023).

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