Asia ex-Japan smaller companies

Attractive risk-adjusted return potential

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HSBC Global Asset Management

Asia ex-Japan smaller companies
Potential for attractive risk-adjusted returns

Asset class overview
An attractive opportunity set

The Asia ex-Japan small-capitalization universe is composed of a dynamic and diversified set of smaller companies in Asia. Relative to the US and European small-cap markets, the Asia ex-Japan small-cap universe is a considerably deeper, yet demonstrably less efficient market with lower levels of sell side coverage and more limited information flow. This provides active managers fertile ground for delivering alpha. Investing in Asia ex-Japan small-caps offers unique access to niche business models and get greater exposure to companies benefiting from growing domestic consumption in Asia. While volatility is higher relative to the large-cap space, risk-adjusted returns for small-caps in Asia have proven to be more attractive over time. In our view, investors should consider an allocation to Asia ex-Japan small-caps within a broader equity portfolio.

A few basics

The Asia ex-Japan small-cap universe includes companies listed in markets such as China, India, Hong Kong, Korea, Taiwan, Thailand, Singapore, Malaysia, Indonesia, and the Philippines. There is no single definition of what constitutes a small-cap in the region. While market capitalization boundaries (e.g., less than $2 billion, or less than $5 billion) may often be quoted, in practice, a smaller company is a relative concept and may be different in different markets. For example, a company with a $5 billion market cap may be considered a small-cap stock in the Hong Kong market, while in the Indonesian market it may be considered a mid-cap stock.

The number of listed smaller companies in the region totals more than 7,000. The MSCI AC Asia ex-Japan Small Cap Index—the most widely followed benchmark for small-caps in Asia—includes over 1,700 stocks. MSCI has taken the approach of classifying companies in the bottom 14% of market cap in each of the constituent index countries as small-caps, subject to minimum liquidity and free-float requirements.

Large-caps and small-caps in Asia
Key differences

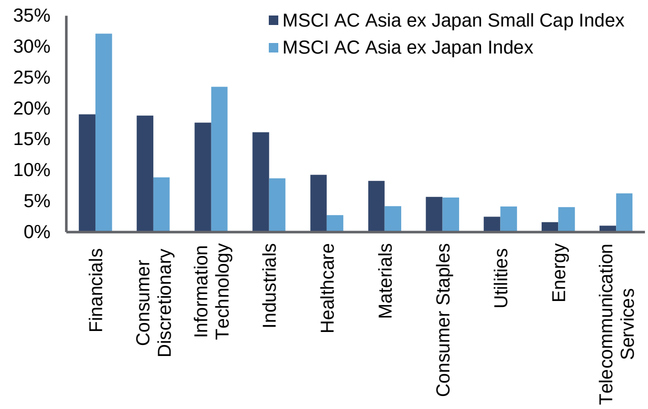
Exposure to higher-growth sectors

When comparing large- and small-cap indices in Asia ex-Japan, one of the key differences lies in the significant weighting of financials relative to other sectors in the large- and mid-cap index. This reflects the dominance of banks, insurance companies and real estate companies in the large-cap space. In contrast, the index for smaller companies has a more balanced representation of stocks across sectors. The two sectors with the largest weightings (financials and consumer discretionary) represent less than 40% of the small-cap index, while for large-caps, the two largest sectors (financials and technology) represent over 55% of the index. (See Exhibit 1.)

Perhaps more importantly, the sector exposures also highlight that the small-cap segment has greater exposure to 'new economy' stocks in Asia—companies in sectors that are benefiting from rising domestic consumption and/or that are associated with innovation. Specifically, we would highlight the higher exposure to consumer sectors (consumer discretionary, in particular), industrials (primarily domestic names), healthcare, and to technology (a relatively large weighting, although a lower percentage versus the large-cap segment). At the same time, small-caps show less exposure to 'old economy' sectors such as telecom and utilities. (See Exhibit 2a.)

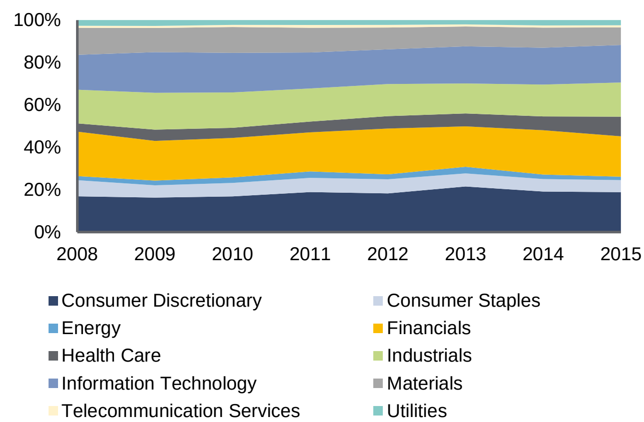
Looking at sector exposures over time, the small-cap index reveals that the healthcare and technology sector weightings have become more prominent over the past few years. While we see a similar trend in the large-cap space, this has been somewhat overshadowed by the rising dominance of financials in the index. (See Exhibit 2b.)

Exhibit 1: Asian large-cap vs. small-cap sector exposures



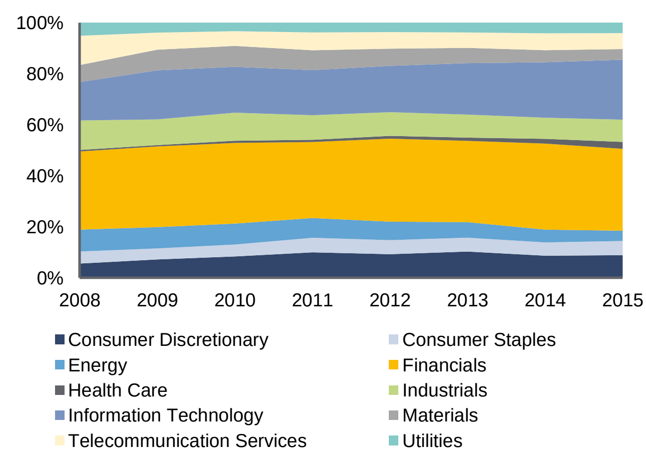
Source: HSBC Global Asset Management, data as of December 31, 2015.

Exhibit 2a: Sector exposures over time: MSCI AC Asia ex-Japan Small Cap Index



Source: HSBC Global Asset Management, as of December 31, 2015

Exhibit 2b: Sector exposures over time: MSCI AC Asia ex-Japan Index



Source: HSBC Global Asset Management, as of December 31, 2015

Large-caps and small-caps in Asia
Key differences *(cont'd)*

'Pure players' and niche business models

With a more balanced sector exposure in the Asian small-cap segment, investors can access a broader set of companies. The small-cap universe offers exposure to companies in specialized industries that are simply not available in the larger-cap universe. An example is the auto sector in Asia, where large-caps are represented mainly by auto equipment manufacturers and auto assemblers, while small-caps are represented primarily by auto parts manufacturers that provide more niche or high tech components. Similarly, in the technology sector many large-cap names represent assemblers, while small-cap players are often niche parts suppliers.

One benefit of investing in smaller company niche businesses in Asia is that they often represent 'pure plays' in a particular market and have less complex business models. While these companies may be more exposed to specific (and potentially negative) trends, they often benefit from the management's sharp focus on the core business and on finding ways to innovate to stay competitive. In addition, smaller companies in Asia often have a better alignment between management and shareholder interests because the management team tends to have higher levels of ownership. With more 'skin in the game,' smaller company management teams may have more incentive to deliver strong performance and returns.

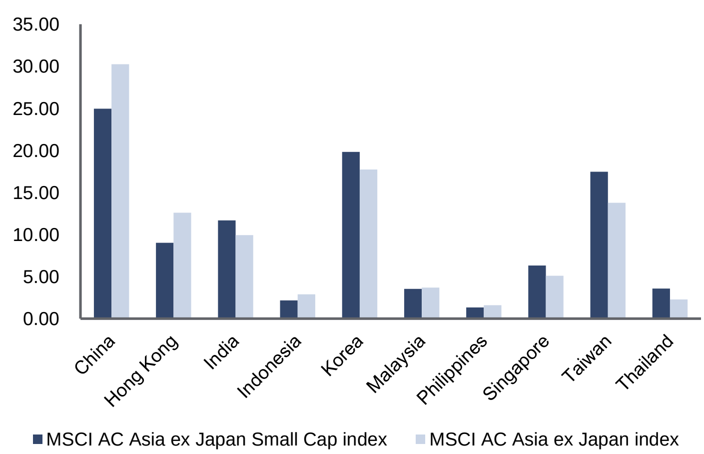
Diversified exposure, high active share[1] portfolios

The Asia ex-Japan small-cap universe not only offers a better diversification profile from a sector perspective, but it is also better diversified on a single stock basis. Specifically, the top 10 stocks in the MSCI AC Asia ex-Japan Index comprise around 23% of the market cap of the index, while the top 10 names in the MSCI AC Asia ex-Japan Small Cap Index represent just 3% of the index market cap.

As a result, smaller-cap funds investing in Asia ex-Japan generally have a much higher active share(1) relative to their reference benchmarks than larger-cap funds. It also means that smaller-cap fund managers can generally be more benchmark agnostic than larger-cap managers, who are often forced to own mega-cap stocks in order to avoid excessive benchmark risk. Given the sheer size of the small-cap universe (and specifically, the MSCI Asia ex-Japan Small Cap Index with over 1,700 names), a smaller-cap portfolio generally can only reflect a manager's highest conviction ideas.

Looking at the country composition, the small-cap index is quite similar to that of large-cap, with China, Korea and Taiwan having the three largest weightings in the index, and the Philippines, Indonesia and Malaysia, the three smallest weightings. (See Exhibit 3.) China's index weighting has been increasing due to the growth of its market and new listings. China became the largest market weighting in the small-cap index in 2014, with relative weightings in Singapore and Malaysia decreasing respectively.

Exhibit 3: Asian large-cap versus small-cap country exposures



Source: MSCI, Bloomberg as of December 2015

[1] Active share is a measure of the percentage of stock holdings in a portfolio that differs from the benchmark index

Core strengths of Asia ex-Japan small-cap stocks
Risk-adjusted returns and stock-picking

The potential for stronger risk-adjusted returns

While we have highlighted the diversification benefits for investing in small-caps in the Asia ex-Japan region, ultimately the question is whether small-caps provide better returns for investors over the long-term. In assessing returns, it is important to consider the risks that are being taken to achieve those returns. For the most part, small-caps are more volatile than large-caps due to a number of factors including lower levels of liquidity and, more specifically, potentially higher earnings variability from niche businesses where earnings swings may be large relative to companies that manage multi-line or multi-industry businesses.

However, while the volatility of the small-cap universe has historically been higher than for large-caps, investors have been well compensated for taking on the higher volatility, with small-caps delivering better risk-adjusted returns. Looking at returns from January 2001 to October 2015 using the MSCI AC Asia ex-Japan Indices as proxies for each market, we find that small-caps have outperformed the broader market by 1.8% on an annualized basis over the past 15 years. (See Exhibit 4.) Adjusting for volatility, small-caps have also delivered stronger risk-adjusted returns over this period than the broader market, with a Sharpe ratio of 0.44 versus 0.38 for large-caps.

Exhibit 4: Volatility of returns

31 Jan 2001 – 31 Oct 2015	Cumulative Return	Annualized Return	Annualized Std Deviation	Shape Ratio (1 mo. Libor = risk free)
MSCI AC Asia ex-Japan small-cap USD Net	297.9%	9.8%	24.2%	**0.44**
MSCI AC Asia ex-Japan USD Net	210.4%	8.0%	21.7%	**0.38**

Source: MSCI, HSBC Global Asset Management as of October 2015. Past performance is no guarantee of future results.

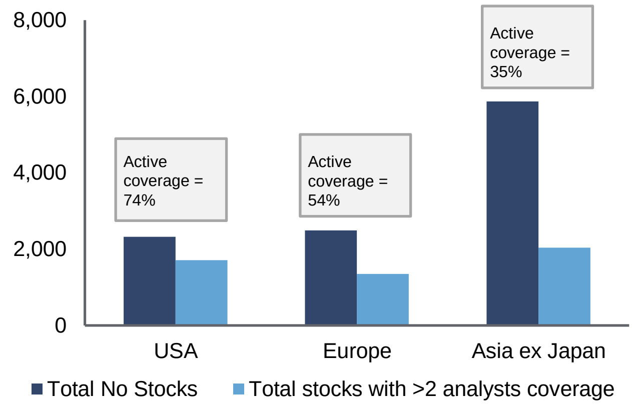
An attractive playing field for stock pickers

With 7,000+ stocks in the universe and 1,700+ stocks in the index alone, we believe Asian small-caps provide fertile ground for active management and alpha generation. The lower levels of liquidity in small-cap names often result in wider bid-ask spreads and higher share price volatility. This ‘excess volatility’ also implies that small-cap stocks tend to undershoot and overshoot their fair value, thereby offering investors opportunities to 1) buy stocks at lower values and 2) increase the likelihood of delivering excess returns as stock prices revert to levels that are closer to fair value.

The Asian small-cap market is relatively inefficient compared with developed small-cap markets because of its relatively thin sell side coverage. (See Exhibit 5.) It is also under-researched, with only 35% of the roughly 2,000 companies in the investible universe (those with market caps the a range between $100 million-$2 billion) receiving coverage by three or more sell side analysts. In other words, 65% of this small cap space has only 0-2 sell side analysts covering the stock. The main reason for the relatively thin coverage of the smaller-cap segment is the sheer size of the universe as well as underinvestment by sell side firms (where coverage of small-caps can be less profitable).

The 35% sell side coverage figure for Asian small-caps compares with 54% for European small-caps and 74% for US small-caps. Thinner coverage means that information on a company may be disseminated less frequently, while earnings revisions may be irregular or imprecise. This backdrop provides opportunities for well-resourced buy side investment teams to obtain a distinct information advantage.

Exhibit 5: Active coverage of small-caps by region



Source: Macquarie, as of April 2015

Core strengths of Asia ex-Japan small-cap stocks
Risk-adjusted returns and stock-picking (cont'd)

Attractive valuations

In terms of valuation, Asia ex-Japan small-caps look inexpensive compared to US and European small-caps. Using leading market indices as proxies, at the end of December 2015, Asia ex-Japan small caps were trading at materially cheaper levels on both a price/book and a price/earnings basis, despite expectations for better earnings growth going forward. Importantly, the strong valuation and profitability credentials are being offered with relative low average debt to equity. In terms of fundamentals, Asia ex-Japan seems dislocated from global valuation levels and appears relatively under bought.

Exhibit 6: Valuation comparison

	MSCI AC Asia ex-Japan Small Cap	MSCI Europe Small Cap	Russell 2000
Price to book	1.3x	1.9x	2.1x
Price to earnings (CY 2015 Est)	16.8x	20.0x	30.0x
Return on Equity (CY 2015 Est)	12.8%	8.5%	8.5%
Debt/Equity	80.3%	106.0%	107.2%

Source: Bloomberg, data as at December 2015

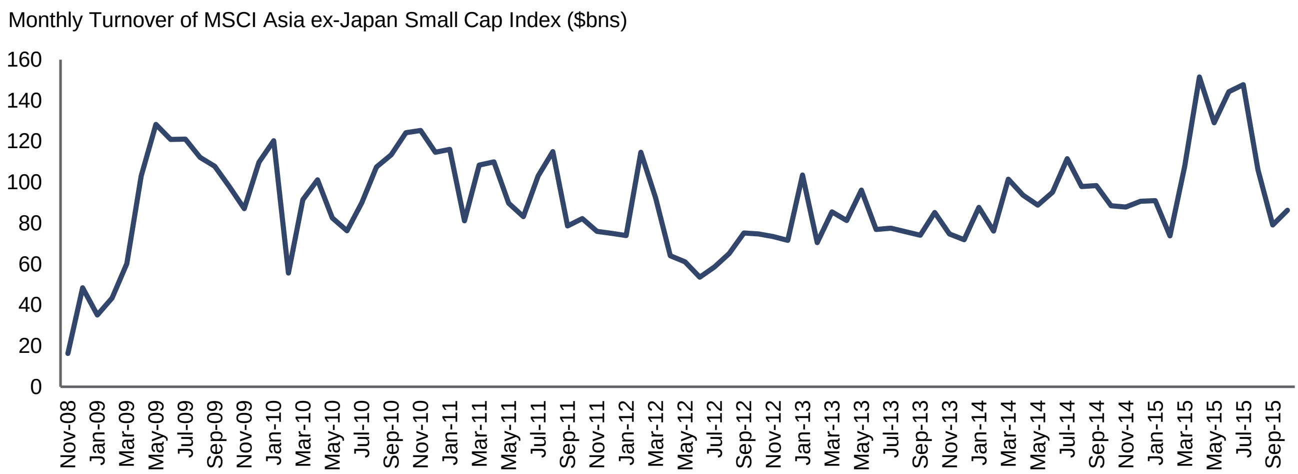
Risks of investing in small-caps
Company-specific risk and liquidity risk

The key risk for Asian small-caps is company-specific risk. As noted previously, sell side coverage of small-caps is very thin in Asia and requires that small-cap fund managers have robust investment processes and are properly resourced to perform their own due diligence on companies. Beyond stock-specific risk, small-cap investors should also be mindful of a stock's liquidity.

Liquidity describes the degree to which a stock can be quickly bought or sold in the market without affecting the stock's price. Small-cap stock liquidity can be highly sensitive to changing risk appetites. Improving liquidity, which is often the result of increased broker coverage of stocks or increasing investor appetite for equities generally, can provide re-rating potential for small-caps and serve as a tail wind to performance. At the same time the 'drying up' of liquidity, which can be driven by a 'risk off' environment, can have the opposite effect.

Exhibit 7 shows the monthly turnover of the MSCI Asia ex-Japan Small Cap Index constituents (in aggregate) and the extent of its variability. Monthly liquidity peaked at $152 billion of turnover in April 2015 only to decline to $79 billion in September 2015. As part of a robust risk framework, screens may be used to better manage liquidity risk in a portfolio such as through minimum daily turnover (typically $1 million average daily turnover), or minimum market cap (i.e., $100 million). Assessment of liquidity is critical when selecting small-cap stocks and building portfolios. The attractiveness of a stock with significant upside potential in terms of fundamentals should be balanced by an assessment of the stock's average liquidity when determining the weighting of the idea in a portfolio, or whether to include the stock into the portfolio at all.

Exhibit 7: MSCI Asia ex-Japan Small Cap Index monthly turnover



Source: MSCI, Bloomberg data as of October 2015

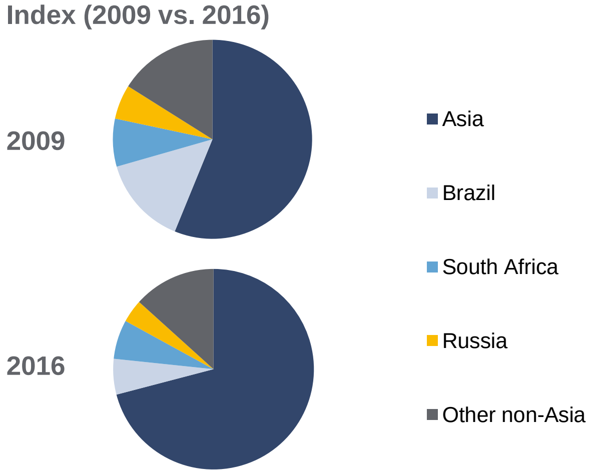
Further considerations on small-caps
Asia ex-Japan within a broader EM universe

Asia now dominates emerging markets

At the end of February 2016, companies in Asia ex-Japan made up 71% of the MSCI Emerging Markets Small Cap Index. (See Exhibit 8.) This has increased from 56% seven years ago (March 2009), driven by the growth of China and Korea as a share of the index, but also the steep decline of South Africa and Brazil, both of which were reduced by more than half over the period. It is likely that Asia will continue to dominate emerging markets equities, particularly if China continues to open its share market to foreign investors. China A-shares, those listed in Shanghai and Shenzhen, are a large and liquid universe of stocks that will see the weighting in the index rise even higher once they go mainstream.

While there is clearly significant overlap between the two indices, a key differentiator of the MSCI Asia ex-Japan Index is the inclusion of Hong Kong and Singapore. These markets are considered developed markets by MSCI and hence, not included in the MSCI EM Small Cap Index. However, many Hong Kong small-caps provide exposure to China, while Singapore's small-caps provide an effective way to play the attractive demographics and improving prosperity of the ASEAN region. As such, inclusion of Hong Kong and Singapore in a small-cap portfolio provides additional investment opportunities for investors looking to play niche businesses in developing economies. At the same time, the Hong Kong and Singapore markets help to lower the overall risk profile of the Asia ex-Japan universe compared to the MSCI EM Index, especially given the high exposure of the latter to commodity-linked markets such as Brazil, Russia and South Africa.

Exhibit 8: Share of Asia in the MSCI EM Small Cap Index (2009 vs. 2016)



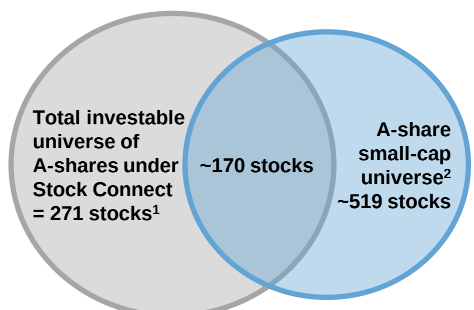
Source: Bloomberg, HSBC Global Asset Management as of March 2016

The China A-share market

For growth in the small-cap universe in Asia ex-Japan, the key market to watch is China. Given ongoing efforts by the Chinese government to open their capital markets, international investors will increasingly be able to participate in the Chinese onshore equity (and bond) markets, including the small-cap stock universe.

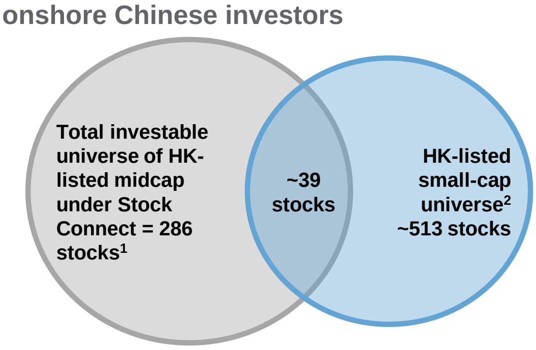
China launched the Shanghai-Hong Kong Stock Connect in November 2014, which allows foreign investors to trade in a range of onshore stocks (A-shares) via the Hong Kong Stock Exchange. (See Exhibits 9a & 9b). At the same time, onshore investors in China are allowed to invest in the offshore HK equity market via the Shanghai Stock Exchange. The program is currently limited to mainly large and mid-cap stocks in both directions. In the future, however, it is likely that the stock connect program will be expanded to include smaller companies and also stocks on the Shenzhen Stock Exchange (Shenzhen-HK Stock Connect)—which has a higher proportion of small-caps than the Shanghai Stock Exchange.

Exhibit 9a: Small-cap A-shares available to international offshore investors



Note:
1. SSE 180 + SSE 380 + A-H Dual listed stocks. 2. Stocks with market cap less than or equal to $2bn and daily turnover of $1m

Exhibit 9b: Small-cap HK shares available to onshore Chinese investors



Note:
1. Hang Seng Midcap Index stocks. 2. Stocks with market cap less than or equal to $2 billion and daily turnover of $1 million
Source for both exhibits: CLSA, data as of April 2015. For illustrative purpose only

Further considerations on small-caps

Asia ex-Japan within a broader EM universe *(cont'd)*

Such an expansion will have two key impacts over the longer term:

1) additional buyers (more liquidity) of Hong Kong-listed small-caps from onshore Chinese investors, and 2) an enlarged universe of smaller companies in Asia ex-Japan as China A-share small-caps become available to offshore investors. Index providers such as FTSE and MSCI are currently determining whether to include China A-shares into mainstream indices, which should also drive liquidity higher. However, index inclusion will be dependent on the pace of market reform.

Another marginal driver of liquidity for the region as a whole is the Mutual Recognition of Funds (MRF) initiative announced in May 2015 which will allow the passporting of mutual funds between Hong Kong and China (for funds domiciled in their respective markets). While subject to eligibility criteria such as a minimum age of a fund, the initiative will be an important channel of liquidity flow over the long term from mainland Chinese retail investors to offshore markets, including Asia ex-Japan.

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The **MSCI AC (All Country) Asia ex Japan Index** is a free float-adjusted market capitalization weighted index that is designed to measure the large- and mid-cap equity market performance of Asian countries, excluding Japan.

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