Episode 11: Changing Asia and implications for investment

Isaac Poole of Oreana Portfolio Advisory & Monik Kotecha of Insync discuss the following points

- Demographic and generational trends in China and Asia
- Implications for portfolio construction
- Changes in Asia over past decade and whether geographic allocation is still valid
- How to achieve exposure - directly or indirectly
- Sector specific issues
- Implications of Asian trends for global growth

Jenny Phimleut - IMAP (00:02):

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David McDonald - IMAP (00:16):

Welcome to this podcast in the IMAP Independent Thought series today, we're going to focus on a changing Asia and the implications that might have for investments for some expert thoughts on the topic I'm joined today by Monik Kotecha, the chief investment officer of Insync Fund Management and Dr. Isaac Poole, who is chief investment officer of Ariana portfolio advisory service. So welcome Monik and Isaac. Thanks for joining us. So Monik we can start with you. I know you have done some work on some of the longer term broader topics around things like demographic and generational change and what that means for Asia and markets. Would you like to perhaps give us a bit of background there?

Monik Kotecha - Insync (01:04):

Absolutely. So the demographics I've been managing money now for many years. It's interesting. The conclusions that I have been coming to are when you look at things on an annual basis, people get sort of caught up in markets and, the macro narrative, if I can call it that way, but really in the longer term and investing in equities has always been about the long term, and the longer your time horizon, the better the returns. And if you can understand that, then you become a little bit more relaxed.

Monik Kotecha - Insync (01:55):

It is tense when markets are volatile as they are like now. But the one thing that I really got to appreciate is that if you cast your mind to the longer term perspective, then you start looking at secular shifts and secular shifts actually have a profound impact on stocks, sectors, and countries. This is where demographics becomes quite important because when you look at demographic shifts, that are taking place across the world, and obviously the focus is on Asia, but it's worthwhile thinking about this on a global basis. It actually has a significant impact on the returns, even at a country level. And, an if you think about why that is, it's quite simple in some ways, if, if you think about, if you think about it's, you know, what drives market returns is earnings growth.

Monik Kotecha - Insync (02:51):

And consistent earnings growth is actually quite simple in that sense as well. You can find businesses going at a consistent level year and year out, and the share prices tend to track it. And, obviously that if you think about what drives earnings growth at an economic level, obviously there are many factors, but one is that the more people start moving into the working part of the population in their life cycle, then the spend starts to accelerate. So, you know when you graduate, that's one inflection point and then you spend increases because you're getting into your first role, and then obviously as you're going up the career ladder, your income hopefully continues to increase. So, you get another burst of spending power, and then when you get married, and you're starting a family that again provides another impetus to spending.

Monik Kotecha - Insync (03:41):

So casting our minds back over time and I used to manage European equities in the nineties. One of the things that struck me back then was that countries like Italy, for example, already aging. Rapidly aging and our observations about which markets in Europe have performed well, and which haven't, and you look at it and you go, well actually the Italian market hasn't done that well, whereas the Scandinavian markets have done a bit better, because of the demographic shifts. I think the same thing can now be observed globally. So, you know, when you look at broad regions, you take Europe, Asia, nd the United States broadly the sort of the three big regions at the moment, and you think there's a lot of focus on PEs and yields and bottom up valuations, and they are important by the way, valuations are important, but there's a reason why I believe that for example, Europe trades quite cheaply compared to the United States.

Monik Kotecha - Insync (04:48):

And that is because of the demographics. You know, if you look at Europe, the demographics in Europe places like Germany it's aging quite quickly, those countries are starting to underperform, right. And the United States is doing very well because it's performing very, very well. So if you shift now to Asia and you look at the demographic shifts that are occurring there, which is what the discussion's about today, there's a lot of focus on China, now China's obviously an enormous economy. I mean, it's got in excess of 1.4 billion people there, and that's been driving a lot of the growth, when you look at global growth, and when you look at the performance of the market, the Chinese market over the last 10 years, it actually hasn't done that well.

Monik Kotecha - Insync (05:40):

And I think the big reason, as we all know now is that China is struggling. Like Europe is in terms of aging population. You know, a lot of it was driven by the one child policy, which they implemented 30 to 40 years ago. But now you've got a situation where the working age population is now starting to decline in China. Yes. Okay. Always under pressure in China at the end of the day. Now you contrast that with India, and you know, India's been performing very, very well because there's a lot more people that are now moving into their working age populations. If you look at the average age in India, it's less than 30, it's like 27, 28 years old. If you look at China, they're almost now entering into their forties.

Monik Kotecha - Insync (06:30):

So you can see the differences, they're just the differences there. And so when you think about that spending power, that's coming through, if you've go to India, it's one thing that sort of struck me and you're walking around the energy levels are just huge. You see that with young people. It's dynamic, they want to get on with life. You know, they're very excited about their future, as we get older, we get a bit gloomier and when they are younger, they're very optimistic and you can see that being translated I think, into the economy's growth and good market performance. So that's some of the work that we've done at a very high level, and that's only at a country level.

David McDonald - IMAP (07:18):

Okay thanks...we'll get Isaac to jump in perhaps Isaac, what do you see from a portfolio construction point of view, how this sort of the demographic change and the longer term trends that Monik mentioned, would impact how you are looking at portfolios, particularly within Asia?

Dr Issac Poole - Ariana (07:38):

Yes it matters. I echo a lot of Monik’s views and thoughts are about these long term, kind of secular trends and, and demographics is clearly one of them matter for allocators like me. You know, they impact our long term assumptions. They impact our long term thoughts around growth and inflation and, neutral interest rates for those of us that think on different asset classes, it's going to impact the fundamental assumptions that we make around earnings growth and revenues, and the like, and it is an important driver of those long term assumptions that we put into our asset allocation models, but it's also going to be something that's pretty important on a more,medium term dynamic asset allocation, perspective as well.

Dr Issac Poole - Ariana (08:30):

I think that's where it's really interesting Monik’s points around the type of exposures you want to get from Asia and how you're going to get those exposures from Asia, because if you go back 10 years or 15 years ago, , there was a lot of focus on getting specific geographical exposures to get specific return drivers from those countries. And I think that's changing now. And I think it's changing in a away where people are trying hard to recognise where those revenues are coming from, what those demographic shifts mean and how you might build that into a equity sleeve of a portfolio. And I think that's where perhaps it'll be really interesting to hear from Monik how he's thinking about that you're at the coal face of that shift, right?

David McDonald - IMAP (09:31):

So you think the old idea of overweight China, underweight Europe, or something like that is perhaps not so relevant now?

Dr Issac Poole - Ariana (09:40):

I think it's challenging at the asset allocation level. It can be done if you have a really specific view that you want to implement, but, but I mean, I'm not sure that it's necessary, to get all of your Asian exposure in that, in that way. And I think global portfolios are a, a good way of, of getting that as long as you understand the drivers, the demographics and the exposures,

David McDonald - IMAP (10:03):

Monik?

Monik Kotecha - Insync (10:05):

I would agree with that. I think the world has changed significantly. Again when you go back 20, 30 years, with active allocation into Asia or Latin America, or some of these emerging markets, you could buy an broad based emerging markets fund or a broad based Asian based fund. And in the early days, that was the way to capture the growth there. And I think that that is sort of largely played out. Back then Asia broadly speaking did have a much younger demographic cohort, it was harder to differentiate between one country and back then, because they're all kind of benefiting from that.

Monik Kotecha - Insync (10:52):

But as the times moved on obviously we now starting to see changes occur between China and South Korea, on the one hand South Korea is quite developed obviously, but I'm looking at Asia where they've got a much faster Asian demographic compared to India or Vietnam, or Indonesia where you've got a much younger demographic. So I think just investing in a broad based Asian fund's a really crude way of getting exposure. And that will probably disappoint, and I think it has disappointed investors. I think you've got to be everything in life today, you've got to be a little bit more thoughtful and thinking about how do I get a much smarter way of getting exposure now? You can still get this at a country level. I believe just the demographic tailwinds alone will continue to make India look very attractive.

Monik Kotecha - Insync (11:57):

Now you've got to look at other factors like corporate governance, regulation and capital allocation like you do with anything. Such as are they sensibly managing capital and getting a good return on the capital they're investing on behalf of their shareholders? Assuming all of that's in place, then I think the way to get exposure is (certainly a global manager does look for different ways of getting it), and you can get that through looking for companies that have exposures to that growing young population, and the growing spending power. So I know that cosmetics is a good area, for example, skin care and, now Asians spend a lot of time looking after the skin …..much more so than Europeans do. Imagine the market is every south Korean lady spent an hour getting ready every morning and uses six or seven different products.

Monik Kotecha - Insync (12:53):

Those powerful European brands have a huge amount of trust in them, because of the heritage those brands have, and if you look at something Lamar which retails at 250 US dollars, you'd be amazed how many middle class women across Asia you'd be thinking they can't afford that, but that is a staple product they will have and use every day. So cosmetics is one market, and Apple is you could argue a luxury item, an aspirational item in many ways. They're not cheap phones. And yet if you think about, things like the Earpods, and the third largest market last year for Apple anywhere in the world was actually India.

Monik Kotecha - Insync (13:44):

Another area is luxury goods, if you look at stock like LVMH or Cartier, and Hermes, you will find that some of their largest markets are the Asian consumer. And every year, (even though they're increasing their prices, because obviously inflation is increasing), they manage to sell more and more products into those markets. So I think the smarter way of getting exposure is through companies, which have strong capital allocation, but they have also have a large footprint in Asia.

Monik Kotecha - Insync (14:34):

I would add is then you can actually create tilt in the portfolio if you like India or Vietnam over the long term, then what you would do is be a bit smarter about this. If you have a broad Asian fund, you're going to dilute your returns by having a more pointed exposure to India, which has got a population size that's fast approaching that of China at almost the same 1.4 billion ….it's seriously big market. Everyone's happy to invest in China specifically so why wouldn't you be as happy to invest in other countries like India and Vietnam for the same reasons?

Dr Issac Poole - Ariana (15:19):

I think that there is a lot in that for asset allocators, particularly around thinking thoughtfully, as you say, Monik, about capital flows and the footprints of big global companies. Because a lot of the companies you mentioned are obviously, global companies with footprints across Europe and US, but increasingly in Asia and driving revenue from Asia and setting up, regional headquarters around those areas, because they're tapping into the demographics, and the growth opportunities that are coming from those growing regions. It makes a lot of sense for a global portfolio to reflect that because when you break down many of the big developed market indices by revenue, a growing amount is coming out of Asia.

Dr Issac Poole - Ariana (16:13):

So of course you want some of the exposure there? What does it imply from, from your perspective of when you talk about it "tilt to a different country" are you talking about identifying local companies there and what are the risks around that? So from an asset allocator's perspective when I think about the risk and return of some of these Asian countries, they tend to be riskier with a higher standard deviation. There's more information the local companies, how do you build that into your portfolios? And is it purely bottom up idiosyncratic risk that you're looking for? What do you think about the regional kind of risks that are more top down level? Or is that something that just gets left to the, the allocator to think about?

Monik Kotecha - Insync (17:05):

I think from our perspective, it is "bottom up idiosyncratic, but there are opportunities with wonderful companies in those regions, so it is really bottom up in the way that you would be running a global portfolio, looking for all those key attributes at a bottom up level but then then finding businesses that have pointed exposure to the trends that are the secular trends that are coming through in each of those countries.

Monik Kotecha - Insync (17:55):

I think that's a good way to get exposure, because Asia is going to continue to be one of the fastest growing economies there. But there are risks associated with investing in Asia and a lot of that has to be driven from top down factors. So one of the factors is a lot of those countries do have a lot of US dollar denominated debt. So the US dollar is a significant influence on the returns you're getting from the region.

Monik Kotecha - Insync (18:43):

Right now the strengthening US dollar is a negative for the region. So you know you have got to start thinking about that when you're investing in terms of timing. As you quite rightly said, it comes with much higher volatility is a concept called ketosis in markets. And what that basically says is that the range of major outcomes is much greater in Asia. So it does come with much more volatility, for sure, India is a wonderful market, but the Indian Rupee has continue to depreciate. So bottom up, I think the returns from the stocks have been greater than the depreciation, but again you've got to think about their hedging and what are the fund managers doing in terms of hedging those specific currencies, because if you had unhedged portfolio returns, would it be a lot lower? So you can see it is actually a lot more complex, and not just saying I want Asian exposure.

David McDonald - IMAP ([19:50]):

Yes well Monik, you mentioned corporate governance as an issue. And so do you think this idea of getting exposure to Asia via some of the large multinationals that have a lot of revenue in Asia is one way of getting companies whom you can trust more, who have got better corporate governance, better, reliable financial information, rather than trying to go directly?

Monik Kotecha - Insync ([20:20]):

I absolutely do believe that that, that is a very attractive way as the reality is that most companies that are looking to grow their earnings in the coming years need to be thinking about Asia. As you said, the corporate governments is absolutely important in dealing returns, because it's all about allocation of capital and maximising the return for shareholders. If the corporate governance is very poor, then it doesn't really matter what the thematics look like at the end of the day, you're still going to end up with a poor return. So, if you were to take a simplistic view and say I'm going to keep this, and I don't want to complicate things then investing globally in that way is a smart way, and a less risky way of getting exposure to that region.

Dr Issac Poole - Ariana ([21:24]):

I wish to pick up on a point that you made Monik around US dollar strengthening and the challenge that presents especially in China, but broadly across Asia companies that have borrowed hard currency in and have the challenges of repaying that back as the US dollar goes through this almighty bull run. And if you throw on top of that rates that are moving higher in the US and oil prices that are moving higher, sort of the unholy trifecta for a lot of Asian countries from a macro perspective, and provides a lot of challenges. I think we're seeing that in parts of the market at the moment, how does that translate through to the sort of global companies ? do they get impacted by that? Maybe I'll tie it back to some comments that came through over the last few months that China was un-investible, and you know that links through to other parts of Asia being un-investible at that time, but now we fast forward a couple of weeks, and Asia's outperforming the US and outperforming global. What challenges is that providing from a bottom-up perspective? It's hard from a top-down perspective, because there's a big macro driver there, but, from bottom-up, how are you tackling that?

Monik Kotecha - Insync ([22:45]):

Well, I think we're quite fortunate because I think in a sense that because our companies are investing into those regions, they're tapping into the growth that's coming into that region without all of those macro risks that you just spoke about. At the end of the day, you know there are going to be times when Asia does well, but as I said, the problem you have is you've got to make a lot of macroeconomic cause to get that right. And you've got to look at obviously the US dollar relative interest rates, you know, what's happening in different regions. You actually got to look at global growth, as Asia is very strongly linked to global growth. So when global growth is slowing down, even though it's outperforming, which is sort of surprising me, but then I suppose, it has those moments for whatever reason what it'll do well, but with global, there's a long, strong correlation between global growth and performance of Asia.

Monik Kotecha - Insync ([23:45]):

And quite counterintuitively, for example, if the US starts to reduce interest rates, investors will become very positive about the US equity market, right? When China starts to reduce interest rates, it's actually a negative sign because it's actually telling a growth is quite weak. So it's actually counterintuitive. There's a lot of moving parts in my opinion, when you're trying to invest directly into Asia from a top down perspective. Whereas when you're looking at it from a bottom up perspective, these companies are picking up the revenue growth, and they're obviously are hedging and doing all the things they need because they've been doing for so long. So they have a treasury team in place. They're saying, okay, I'm getting my revenues from India, but the Rupee is something that continues to depreciate over time.

Monik Kotecha - Insync (24:32):

And they're probably hedging all their exposure and, managing that whole business accordingly, whereas for an asset allocator going well or, or even a fund manager to do that, it's quite a complex task and difficult to execute on, and this created a whole new layer of thinking about the risks that are involved. The way we are looking at it is to say, if you can find companies that have, growing exposure to Asia, particularly growing exposure to what I call the Gen Zers and the millennials, because they're now becoming a larger part of the global workforce. Understanding their behaviors and what they're looking is important… what is the Chinese Geno millennial looking for compared to what the Indian Geno millennial is looking for? compared to what the America one is? And there' are some similarities, and there are differences at the end of the day, but just trying to understand what it is that they're buying, what are their long term beliefs around consumption patterns and how they're different from the way that we've grown up, understanding those traits, and then saying, okay, let's find the companies that are actually selling to the millennial and gen Z zeitgeist to us. That's where the winners are going to come from.

David McDonald - IMAP (25:51):

I think one interesting topic we haven't quite touched on yet is that we talked about the demographic changes at the individual level, if you like Monik and the gen Zs and so on, but what about the country level where there is obviously changes within Asia there? You know, we've seen recently stories of Apple moving manufacturing from China to Vietnam, for instance. So do you want to just talk a little bit about what you see there at the different country levels?

Monik Kotecha - Insync (26:22):

I think two factors at play and the first one is COVID and the profound impact that had on global supply chains and logistics, and we're still paying for a big price rate because some of that is manifesting into higher inflation numbers at the moment. And hopefully over time that will bring it back down as though supply chain stuck to change and start improving. And, then the other one is the whole issue around de-globalization and the risks, particularly out of China….China is the largest exporter of intermediary goods globally, and with the much more nationalistic approach that the current Chinese government is taking on various matters has, has created challenges for companies that have set up base there and really relied extensively on one country to do all the heavy lifting for them.

Monik Kotecha - Insync (27:17):

As you know, most of Apple's iPhones and iPads and Mac IMAX and MacBook are all produced out of China, and this is a massive risk, and that's one of the most successful companies out there, and yet they've got a very high level risk from relying on one country. So they're now intimated that they're going to start looking at other countries like India, Vietnam to produce a lot more of those goods. And then you get other situations if you want to sell your products in certain countries like India, for example, Tesla, they're basically told Tesla Yes you can do that, but you need to start manufacturing in India because we're not accepting products out of China anymore. So there is a lot of reconfiguring of global supply chain and logistic patents that are going to start to take place.

Monik Kotecha - Insync (28:13):

And what that will mean is that some of the other countries like Vietnam, Thailand, and certainly India, from a consumption and a manufacturing basis want and will see technology moving there . India is obviously one of the go to places because they have some of the largest, number of people graduating from university in engineering, mathematics, and technology, plus they are sought after globally. Also in the US with the talent from there. I think it's all about identifying the countries that are going to benefit from that. And I believe those countries will be a net beneficiary, as you move out of China into some of those areas, it will be propelling the growth in each of those countries.

David McDonald - IMAP (28:57):

I think the positive thing here is we are talking about the move to other Asian countries. We don't seem to be talking a lot about moving to Africa, south America, for instance. So I guess at the top down level, it still sounds like a positive for Asia in the longer term. Look, I think we've come to the end of our time. I wish to say thank you very much to Dr Isaac Poole and Monik Kotecha for joining us today and discussing what's really a fascinating topic in the changes that are happening in Asia and what that might mean for our investments. So thank you for joining us on this IMAP Independent Thought podcast, a quick reminder that next week and the 21st of June in Brisbane, we have our “Advice in Action” Adviser conference. So please, if you're in Queensland, come along and join us for that. And we also have an Independent Thought investment conferences coming up later in the year, and you can see them on our website. Thank you.