# Asian small caps attractively valued

## Manulife Asset Management's Linda Csellak, Head of Asia Pacific Equities, discusses the outlook for the Manulife Global Fund - Asian Small Cap Equity Fund (AA) after a year of volatility in regional markets. The Fund was recently named 'Best in Class' at Benchmark's Fund of the Year awards 2013[1].

### Q1. Can you comment on the performance of the Manulife Global Fund - Asian Small Cap Equity Fund and explain some of the key factors that make this Fund "Best in Class"?

The Manulife Global Fund – Asian Small Cap Equity Fund (the Fund) has shown consistently strong performance over the long term, having delivered cumulative returns of 16.3% over the past year, 40.2% over the past three years and 267.9% over the past five years. In these periods it has outperformed the benchmark MSCI AC Asia Pacific ex-Japan Small Cap index by 12.5, 45.6 and 118.4 percentage points, respectively[2]. This outperformance and the Fund's recognition as "Best in Class" can be attributed to its investment strategy of carefully selecting individual securities with high profitability that are selling at relatively low valuations – the Fund's price to earnings (P/E) ratio has historically been below that of the benchmark while its earnings per share (EPS) has historically been above.

### Q2. What is your outlook for Asian small-cap equities and how is the Fund positioned to generate positive returns in 2014?

While some Asian small-cap equities re-rated during 2013, we see the potential to generate further positive returns in the segment during 2014. In our view, the key is to be highly stock selective and to seek attractive valuation alongside high EPS growth. The Fund is currently positioned with a forward P/E of just 13.2x alongside forward EPS growth of 41.2% – almost double that of the benchmark, which is trading at 16.7x forward P/E with forward EPS growth of 23.4%. We generally continue to prefer North Asia to Southeast Asia and are more exposed to cyclical holdings than defensives. We believe that this positions the Fund well as we are reaching a point in the economic cycle which should favour companies that are geared to a growth environment – small cap valuations are lower in North Asia and constituent economies are more geared to export demand and should benefit from continued pick up in global trade flows.

[1] BENCHMARK Fund of the Year Awards 2013 recognises Manulife Global Fund - Asian Small Cap Equity Fund AA as 'Best in Class' in the Asia ex Japan Equity category.

[2] All Fund and benchmark performance data is presented in US dollar terms on a net asset value (NAV) basis with dividends reinvested. Manulife Asset Management took over management of the portfolio on 1 April 2010. Past performance is not indicative of future results. Source: Manulife Asset Management, Factset; 31 December 2013.

### Q3. Are there any markets or sectors that you are particularly bullish on?[3]

We are particularly bullish on South Korean small caps, which are attractively valued at 11.3x forward P/E despite forward EPS growth of 45.5%[4]. While our exposure to the market underperformed during 2013, with several of our holdings losing substantial ground due to a combination of external factors such as tax law changes and rebalancing by fund managers, we now find ourselves well positioned with a slate of promising value stocks with structural growth potential. We are also positive on the Hong Kong market, where small caps are trading at 11.8x forward P/E alongside forward EPS growth of 37.3%[4].

In addition, we are beginning to see value emerge in selective Southeast Asian small cap names after an extended period of volatility in 2013. Thailand is a good example, as the current political unrest has created what we consider to be some attractive buying opportunities.

Some sectors we are bullish on include information technology, where we are significantly overweight on the strength of LED general lighting and servers, and consumer discretionary, which continues to benefit from rising domestic consumption across Asia. We find better upside than financials and real estate and are significantly underweight in these sectors.

### Q4. Can you share an example of a top-ten holding that has contributed particularly strongly to the portfolio over the past year? Do you continue to see value in this holding?

One of the Fund's top holdings is a Hong Kong-based provider of standard and custom-designed monochrome LCD screens for automotive. At first glance there appears little to get excited about as this is a mature market that generates slim margins. However, the company generates an operating margin in excess of 20% and its generally conservative management recognises that automotive LCD screen use continues to grow and is quietly reaping the benefits of market share growth as competitors exit the market. Despite having appreciated more than 150% during 2013, we see further upside potential as the shares are trading at a still-attractive 7.5x forward P/E[5] and its significant exposure to Europe should prove beneficial as the European auto market continues to recover.

### Q5. Can you explain how you select stocks to add to the Fund?

We consider many factors when deciding to buy or sell a Fund holding. We look for companies with sustainable growth, ample cash flow and trustworthy management teams. We also like companies that are well positioned in their respective industries and have a strong competitive advantage. And pricing – and mispricing – is the key, as we are looking for undervalued stocks. We actively screen for stocks that are trading at a P/E ratio that is half the earnings per share (EPS) growth rate (ie, a P/E to growth ratio of 0.5x or below) as we wish to secure sufficient upside and not overpay for growth. Our ideal holding is a stock which undergoes a significant re-rating over time. Once the stock becomes a more highly valued mid-to-large cap stock, we can take profit and reinvest in a less recognized and less expensive company which can possibly provide a higher risk-adjusted return.

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[3] Information about the portfolio's holdings, asset allocation, or sector diversification is historical and is not an indication of future portfolio composition, which will vary. It does not constitute any recommendation to buy, sell or invest in the sectors.
[4] Manulife Asset Management, Bloomberg, 31 December 2013.
[5] Manulife Asset Management, Bloomberg, 31 December 2013.

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### Q6. What are the key risk factors that influence the Fund and how do you address these risk factors.

One of the key risk factors influencing the fund is the potential for further outflows from Asian markets as the US Federal Reserve continues its Quantitative Easing (QE) taper. While we believe that the potential impact of the taper itself is already largely priced into markets, the speed at which interest rates rise is an important factor to consider and the taper is a key influencer of this trend. While periods of future volatility are possible, the impact should be manageable as long as further tapering is implemented at a gradual pace alongside continued economic recovery in the US and interest rates do not spike suddenly. Within the portfolio we believe that our bias to North Asia helps insulate us from the potential impact of further tapering and/or rate hikes as the region was relatively resilient during the mid-2013 sell off, with some investors even treating North Asian markets as safe havens of sorts.

That being said, our bottom-up stock selection process focuses on fundamentals and our goal is to select small cap names with the potential to outperform regardless of the market cycle and macro trends. In line with this, we focus on alpha generation rather than beta and incorporate equities that are driven by company or industry specific factors and are thus relatively less correlated with the wider market. We target lower volatility than that of the benchmark by striving to enter positions at low valuations and by trimming holdings that become overvalued relative to the market.