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Value investing in Asia

Portfolio manager Soeren Addicks discusses value investing in an Asian context, including the case for value-based approaches, the power of adding select dividend-growing and quality stocks, and his personal valuation framework.

DOES VALUE INVESTING WORK IN ASIA?

Yes, value investing works well in both Japan and in Asia ex-Japan. Some may be surprised by this – while Japan tends to be known as a value market, the opportunity for value in Asia ex-Japan is often underestimated. Yet the evidence is persuasive: if we measure stocks that are most attractive and most unattractive on three prominent valuation measures, price-earnings (P/E), price-book (P/B) and dividend yields (DY), we can see how it pays to hold stocks that have lower P/Es, lower P/Bs and higher dividend yields, especially a combination of the three, and this holds true in both Japan and Asia ex-Japan.

Long-term performance of valuation factors in Asian markets

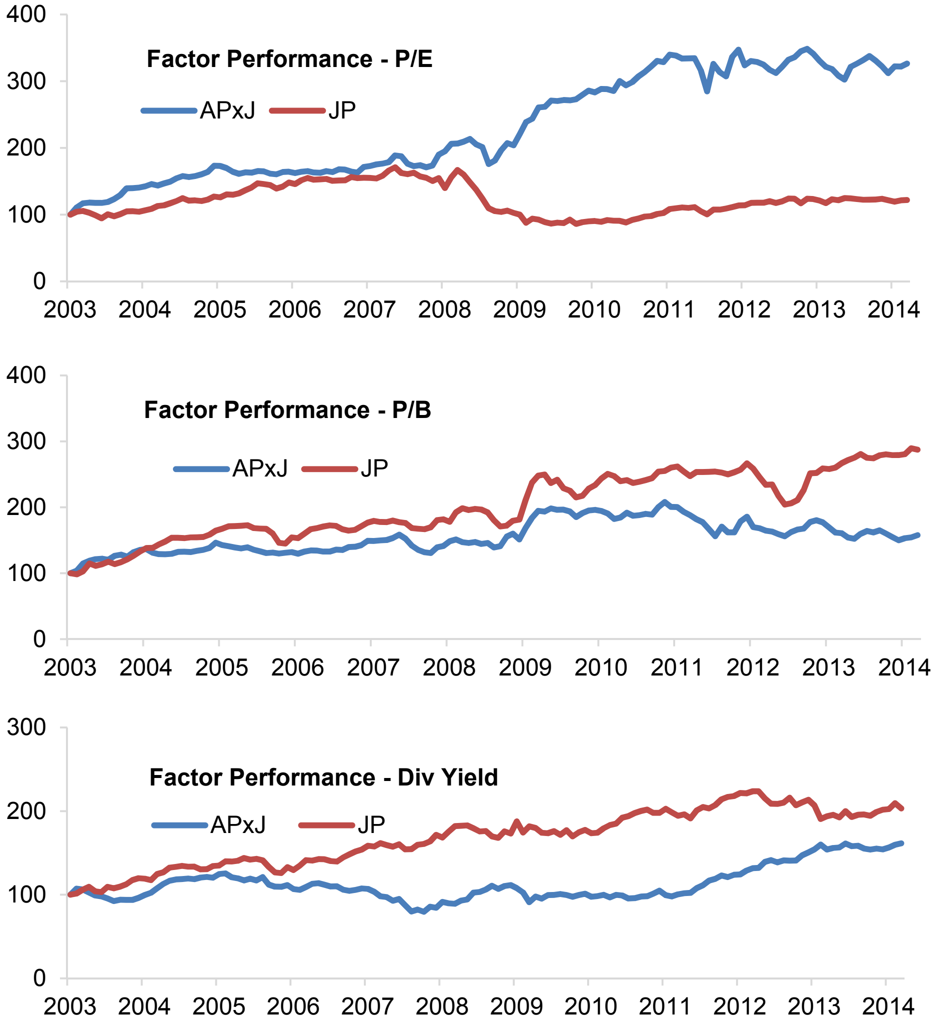

Chart 1. Source: Fidelity, Macquarie custom product group. Methodology: long-short spread of best vs. worst quintile, equal-weighted, rebalanced monthly, 12-month forward PE, PBR, dividend yield, indices MSCI Asia Pacific ex-Japan and MSCI Japan, June 2014.

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ARE CURRENT CONDITIONS FAVOURABLE FOR VALUE INVESTORS?

Yes, I would argue that now is a good time to consider a value approach to investing in both regions. Firstly, if you look at the past, then it's clear that periods of underperformance in value strategies do not last – so it makes sense to 'buy the dips'. Looking at Asia ex-Japan, since 2013, it is clear that a value approach, measured for example by an average of the P/E, P/B and DY factors hasn't worked so well as investors in mainland China, for example, have tended to favour more richly valued internet stocks over state-owned companies and banks that now look historically cheap, but may have a lot of non-performing loan issues to deal with. Based on past patterns of the underperformance of cheap stocks being followed by outperformance, I would argue that now is a good time to pursue a value approach in Asia.

In Japan too, the environment is favourable in my view. The following chart shows an example of what I would call the 'scarcity of value' in Japan. In short, when the red line is low, the forward performance of low P/B stocks (the blue line) tends to be high and we are close to such a point now.

"Now is a good time to consider a value approach in both Japan and Asia ex-Japan."

Value is relatively 'scarce' in Japan – good timing for the outperformance of value

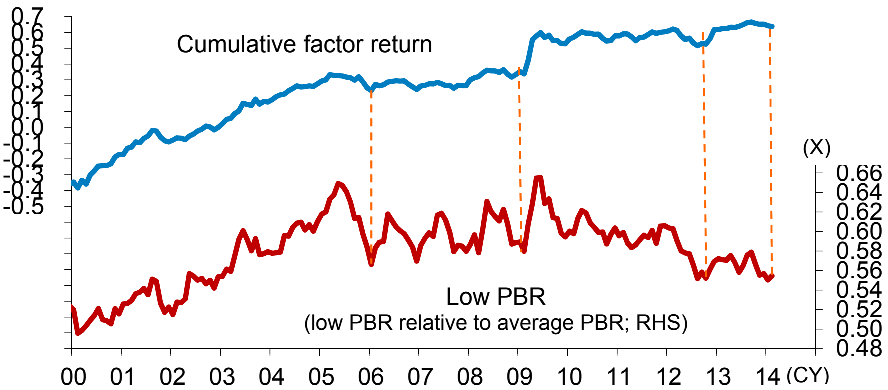

Chart 2. Source: MUMSS Notes: Universe consists of TOPIX 500 stocks; cumulative factor return is the cumulative difference between the monthly return of low-P/B stocks (the 20% with the lowest P/Bs as of the end of each month) and the average return for the five groups since end-2002 (does not take sector classifications into account); relative P/B is the low-P/B stocks' average P/B divided by the average of the five groups, June 2014.

WHAT ARE THE KEY ADVANTAGES OF A VALUE APPROACH?

There are three considerations that stand out. Firstly, what value investing ultimately amounts to in my mind is a great path to **downside protection**. Why is that so important? Because investment returns are geometric, i.e., single outcomes are multiplied with each other, something that we humans often underestimate because we tend to think arithmetically in terms of adding and subtracting. You may have read about the Kelly criterion or the popular book 'Fortune's formula: the untold story of the scientific betting system that beat the casinos and Wall Street' by William Poundstone, which draws heavily on Kelly's work; in my view, the essence of these works is largely a solid appreciation of downside protection.

If tasked with delivering performance relative to benchmarks and peer groups, logically downside protection is typically relative rather than absolute. This makes things a bit more complicated: I spend a lot of time looking at valuations relative to an investable universe, but I also want to consider the intrinsic valuation of a company. A simple way of appreciating downside protection is to recognise that when unexpected events occur, the positive events contribute normally, while the negative ones are buffered by downside protection. Over time, this is really beneficial for long-term performance.

Secondly, **valuations tend to move before fundamentals**. Therefore, if you wish to buy close to a bottom or sell close to the peak of a stock, you need to have a very keen eye on valuations, especially asset-based valuations such as P/B. The following chart (overleaf) shows Japan's largest stock by market capitalisation, Toyota. The blue line is Toyota's return on equity (ROE), a core measure of fundamental business health that peaked in late 2007 and troughed in late 2009. Yet the stock peaked significantly earlier, with the P/B (grey line) in late 2006, a year before the peak in ROE. Similarly, around the bottom, Toyota's P/B troughed in late 2008, about a year before fundamentals troughed.

"Valuations move before fundamentals, so they point towards the best times to buy or sell."

Valuations moving before fundamentals: the Toyota example

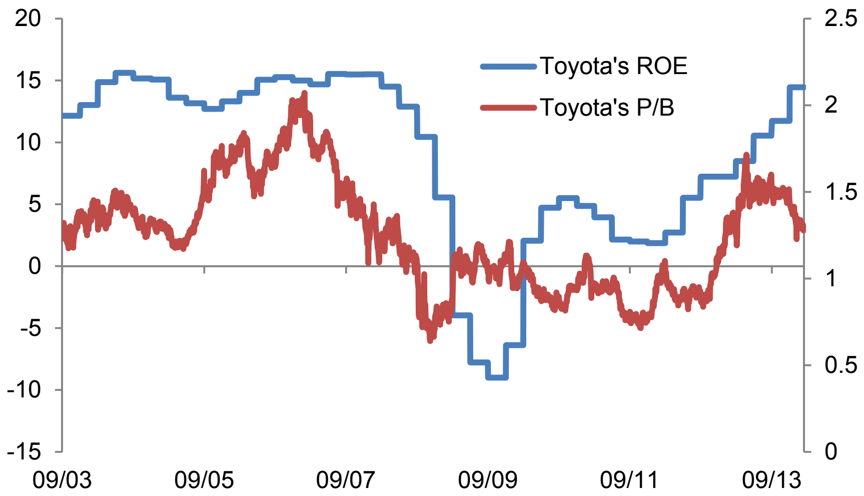

Chart 3. Source: Bloomberg, June 2014.

In other words, what this example shows is that in order to buy the right stock, one needs to make the right judgement on valuations, in this case, P/B. You cannot 'wait for fundamentals' because valuations often move well in advance.

Thirdly, a value approach typically means owning companies with great dividend streams (now or in the future or both). A wealth of evidence shows that investing in companies with **higher than average dividend yields, especially steadily growing ones, is a successful strategy**.[1] Some of the reasons for this should be obvious: dividends are cash returns and they instil discipline in management. However, what makes dividend yields especially important as a value factor is their low correlation with the other two key valuation factors of low P/Bs and low P/Es.

Cheap P/B stocks can underperform for a while and so can cheap P/E stocks, but high-dividend-yield stocks are much less likely to underperform at the same time. Low P/B stocks in some market environments for example, start to correlate with high beta stocks; in other words, if you are not careful and blindly buy low P/B stocks, you can inadvertently end up with a portfolio that is very high beta (i.e. highly exposed to market risk). High-dividend-yield stocks tend to not have that problem. In short, we can summarise like this: high dividend yields are attractive not only by their own virtue, but also because they are less correlated to other value measures and less correlated to market beta.

CAN YOU ELABORATE FURTHER ON THE IMPORTANCE OF DIVIDENDS?

Within dividend investing, there are lots of important finer details. I find again and again that investing in companies with **growing dividends** is a more successful strategy relative to investing in stocks that happen to have some of the highest dividend yields. Understanding how dividends are supported by current cash flows and how they can be supported in the future is a key part of my process.

"One key pillar of my approach to value investing is the positioning towards future dividend income."

I try hard to avoid those stocks where the dividend is at risk for whatever reason, while balancing this with earning attractive dividend levels today and paying income to investors. I also tend to view total shareholder returns as the sum of dividends and share buybacks since they ultimately come from the same source – the business, namely the company's cash flows and balance sheet.

Emphasising the importance of dividend growth in my approach, I typically hold stocks that offer steadily growing dividends over extended time periods. Today, for example, I own 46 such stocks in my Japan Dividend discipline. The following chart (overleaf) shows how those 46 companies have grown their dividends over the past 10 years.

Remarkably, since 2000, not one of these companies has cut their dividend, not even in the global financial crisis. This is especially notable if you consider that during the 2008-2009 financial crisis, total dividends paid out in Japan dropped by over 26%. The average increase in dividend per share of my 46 companies has been 661% since 2000.

Average dividend per share of 46 ‘dividend growers’ in the portfolio

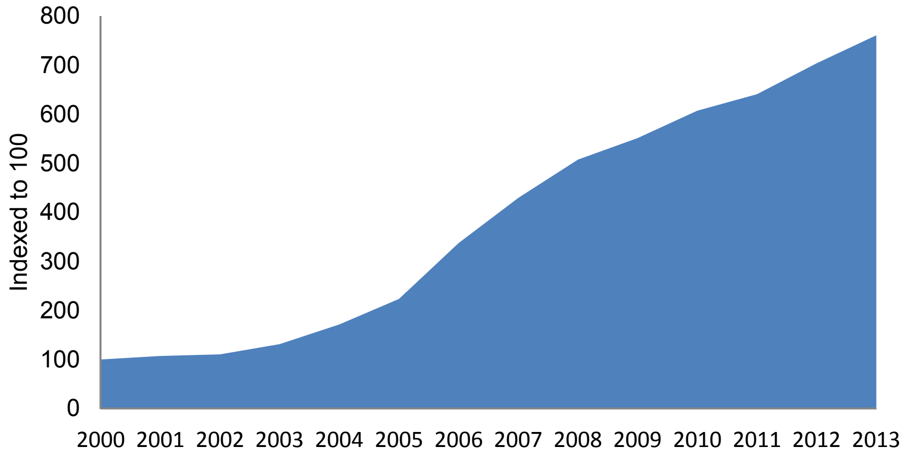

Chart 4. Source: Fidelity, Bloomberg, June 2014.

Capturing a stock that has a high dividend yield today and goes on to deliver great capital gains on top of that is very rare, because the market must have really overlooked something to start with, but it does happen sometimes. In Japan, for example, Japan Tobacco was in this position in 2009 and the telecom carrier KDDI in 2010. They were both remarkable in that they started with high dividend yields and went on to deliver great capital gains thereafter.

There is also an interesting point to note here in relation to the difference between Asia ex-Japan compared to Japan. If we look at five-year weighted averages, then the 33% dividend payout ratio in Japan is not that different from the 31% in Asia ex-Japan, but the share buyback-per-income ratio is 9.5% in Japan against 1.7% in Asia ex-Japan, leading to a 42% comprehensive pay-out in Japan versus 32% in Asia ex-Japan. As Asia ex-Japan matures, I suspect a similar trend may start there with rising buybacks, making the forecasting of this variable increasingly important in this market over time.

ARE THERE ANY FEATURES OF YOUR APPROACH TO VALUE INVESTING THAT ARE DIFFERENT FROM THE NORM?

The first thing to mention would be that for me valuations come right at the beginning of the investment process. I don’t look at stocks and then check how expensive or cheap they are. I do it the other way around – I first look at valuations, because valuations move before fundamentals and because they give me a sense of the odds for the future performance of a stock. I tend to visualise a ‘value landscape’ in which essentially nameless stocks are moving around in. In this value landscape, I only become interested in the name and the nature of a stock once it stands out as interesting purely based on its valuation characteristics.

Secondly, where I feel my approach differs is that instead of measuring one stock by its P/E, another by its P/B or EV/EBITDA and another by its dividend yield or free-cash-flow yield or something else, I prefer to look at all these aspects at the same time. As mentioned, the three most important factors in my framework, because I have found them to work best over long term, are P/B, P/E and dividend yields.

Thirdly, I think it’s important to compare both where a stock stands today versus all the other stocks today, and compared to its own history. I like to combine these two standpoints into one in order to get a fuller perspective. Regarding a stock’s own history, I think it’s possible to learn a lot if you study how it has behaved at its extremes or during times when the entire market has been at extremes, such as during the recent financial crisis period.

The best way to sum up the valuation landscape through which I tend to view the whole investment universe is in a 3D framework that features my three most important valuation measures: P/B, P/E and DY. I populate this 3D space with the average six-month returns for every stock in the viable universe, based on past combinations of the three factors over the last 10 years. By denoting the positive average returns in green and negative average returns periods in red, I can create a heatmap that provides a remarkably complete historical valuation perspective for any market or any stock. This then helps me to determine the odds of outperformance based on past patterns.

“It is important to compare both where a stock stands versus other stocks today, and compared to its own history.”

The use of such a 3D value framework also has many other benefits – I can see how any stock has performed in terms of its price over time and compare this to how it has moved in the 3D space. In addition, I can add in my own forecasts for variables such as future earnings, future dividends etc. and then use this to project where I think the stock will be in the future.

"The 'Addicks chart' shows the essence of how I think about stocks"

Valuations in 3D – the 'Addicks chart'

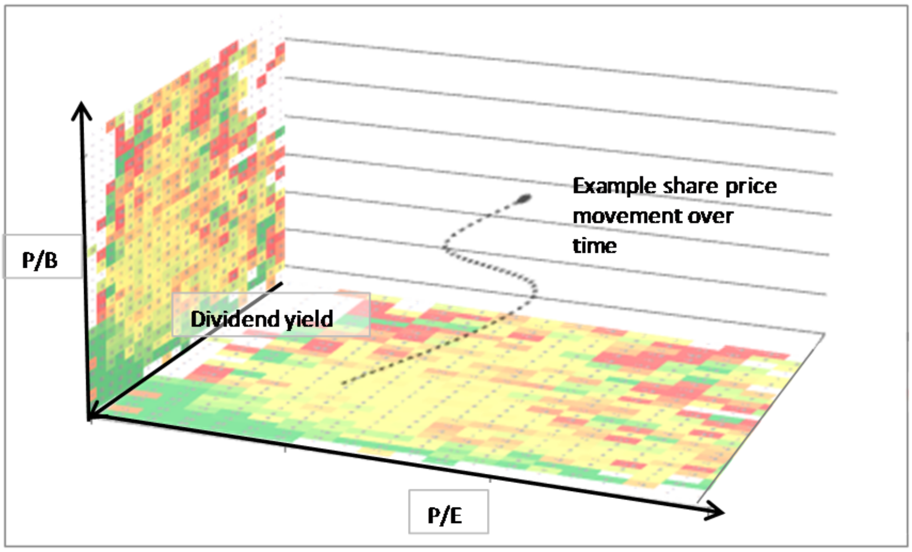

Chart 5. Source: Soeren Addicks, May 2014.

In the following charts, we can examine more details. While it is difficult to project a 3D view properly onto a 2D plane such as paper, it is nonetheless possible to take a look from different sides – so for example, either from the P/B-P/E side, the P/E-DY side or the D/Y-P/B side. This approach can be especially useful for comparing and understanding different regional markets, such as Japan or Asia ex-Japan.

P/E vs P/B – Asia ex-Japan

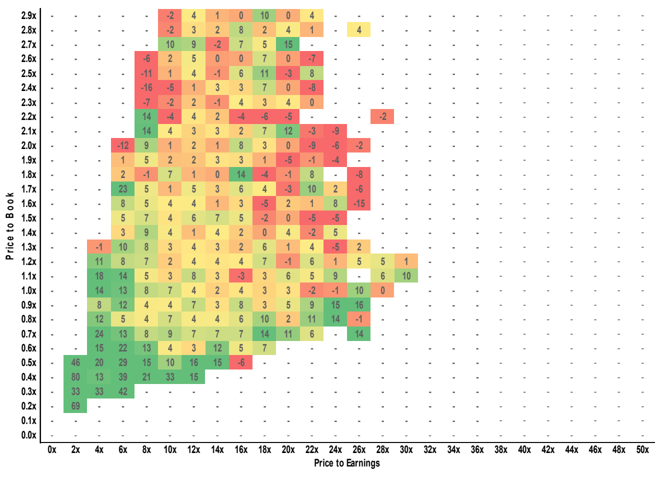

Chart 6. Source: Macquarie custom products, May 2014.

P/E vs P/B – Japan

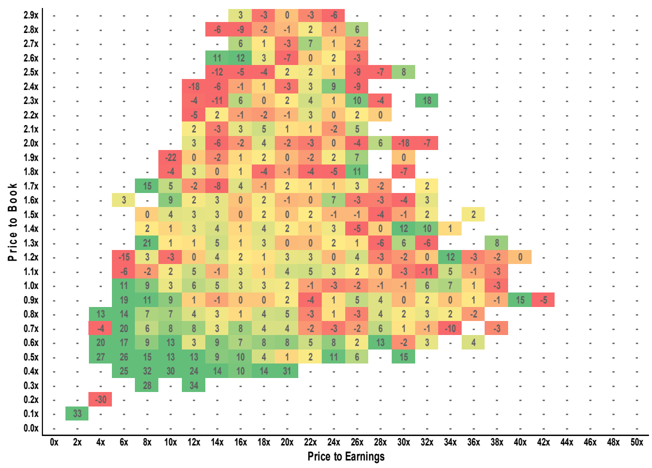

Chart 7. Source: Macquarie custom products, May 2014.

The charts above for Japan and Asia ex-Japan can immediately help us to draw some remarkably strong conclusions based on past patterns. Firstly, owning low P/B and low P/E stocks works in Asia – this combination dramatically improves the odds of positive performance (i.e., the bottom left corner is substantially green). And this is true for both the Asian and Japanese markets as represented by the MSCI Asia Pacific ex-Japan and Topix 500 indices respectively. The other quite specific message we get from this is that in both Japan or across Asia ex-Japan, if you pay less than 0.5 price-to-book for a stock, your chances of solid forward performance are very good.

An important feature of the P/E vs P/B perspective is that this also enables a view of ROE, since this is equivalent to P/B divided by P/E. For example, a 10% ROE stock can be anywhere on the straight line that passes through the two points (P/B=1.0; P/E=10) and (P/B=2.0; P/E=20), but nowhere else. Often I have stocks with similar

"Owning low P/B and low P/E stocks works for the Japanese market."

ROE, for example I could have two stocks with an ROE of 10% – the 3D value framework helps me assess whether it's likely to be worthwhile owning the stock with higher valuation multiples based on my own outlook for future ROE.

Similarly, I can look at a stock's ROE history and how that has caused it to move through my 3D valuation framework. In the case of cyclical stocks, it is often pretty clear where peak and trough ROEs may lie and what the market has paid at those junctures in the past. I can thus force myself to be very disciplined about buying or selling objectively without getting too drawn into great sounding fundamentals near the peak or awful sounding ones near the trough.

Dividend yield vs P/B – Asia ex-Japan

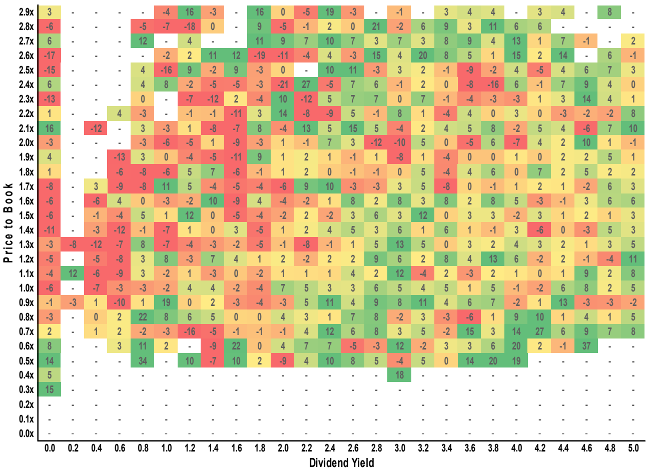

Chart 8. Source: Macquarie custom products, May 2014.

Dividend yield vs P/B – Japan

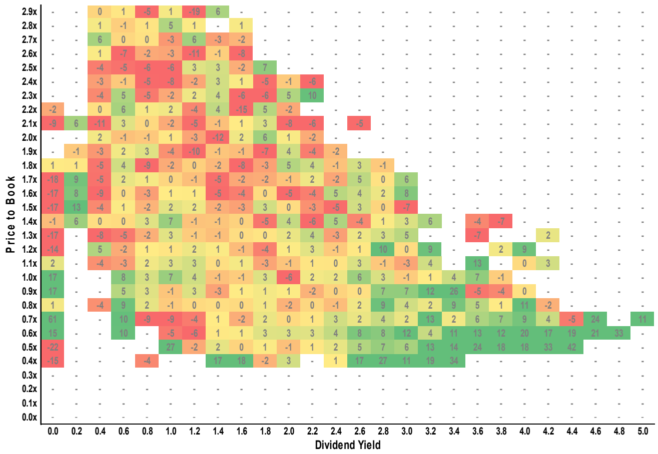

Chart 9. Source: Macquarie custom products, May 2014.

Having taken a look in the 3D chart for Japan and Asia ex-Japan from the P/E-P/B side, it can also be instructive to look at the same markets from the P/B-DY perspective as depicted in the two charts above. With the colour-coding, we can easily see that owning stocks with a high dividend yield and low P/B puts you in a favourable situation in Japan as indicated by the dominance of green on the lower right-hand side of the chart. In the case of Asia ex-Japan, we can also see that the high dividend/low P/B stocks improve the chances of success, but unlike in Japan, there are also a lot more high-dividend/high-P/B companies that generate positive returns. My key takeaway from this is that while going up the dividend scale tends to be helpful in both Japan and Asia ex-Japan, lower P/Bs alone do not improve the prospects in the case of Asia ex-Japan, while P/B is not as good at putting the odds in your favour as in Japan, an interesting takeaway in itself.

"Markets in Asia ex-Japan and Japan are not identical, but I can apply my framework to both."

CAN YOU GIVE A SPECIFIC STOCK EXAMPLE IN YOUR FRAMEWORK?

In Japan, the example of Sony is quite instructive; it was a stock I had never owned before and it had underperformed for a long time. So much so that by late 2012, Sony shares began to look like a compelling opportunity in my valuation framework, so I started buying them. The following is one of my 3D charts from the P/B-P/E side for Sony, with the trail of Sony's valuations over time marked on as a dotted line.

Sony example

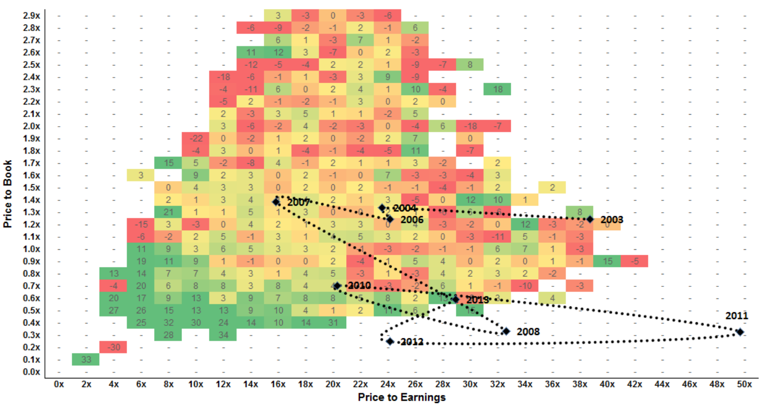

Chart 10. Source: Macquarie custom products, May 2014;

It is clear to see that in the best of times in 2007, Sony was priced at a P/B of 1.5 and a P/E of 16x earnings implying an almost 10% ROE. However, four years of losses from 2009-2012 due to its weak electronics business caused a derating that brought the implied ROE to its lowest level in 10 years in 2011 (far bottom-right chart), one year before the last and biggest losses of 2012. Still with equity being destroyed, I decided to wait a little longer. However, Sony became especially interesting in late 2012 when the stock not only entered the favourable absolute odds area (green zone), but importantly was deviating too far clockwise from the ROE recovery path that was on the horizon. In other words, the ROE recovery that was likely to come from a non-recurrence of losses could have merited higher multiples, but the market was pricing it far too cheaply (too far towards the lower left in the chart).

In late 2012, Sony's stock bottomed at 790 yen. I bought Sony shares between November 2012 and February 2013 at prices as low as 801 yen. I was later selling them between May and August 2013 for prices between 1,951 and 2,221 yen per share. The regular price charts for Sony and Sony versus the Topix Index are shown below. The charts show that the relative outperformance of Sony over that time period was almost 100% (almost tripled in absolute terms), which I think is remarkable because we are looking at one of Japan's largest companies rather than a small cap.

Sony stock price

Chart 11. Source: Macquarie custom products, May 2014.

Sony relative to Topix Index

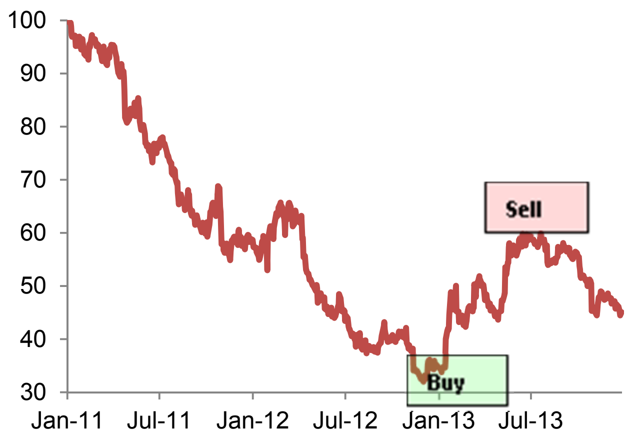

Chart 12. Source: Macquarie custom products, May 2014.

IN WHICH CASES DO YOU TEND TO OWN STOCKS FOR A LONG TIME?

First of all, it is worth noting that the price and what it says about all the valuation factors outlined is always the most important factor in my approach. Nonetheless, given this, what is often observed is that apart from stable dividend growth companies, the other types of stocks which I tend to hold for longer periods are those where 'quality' and value overlap. By 'quality', (to keep the argument simple) I mean high ROE companies. More specifically, we can think of where quality companies and where value companies are located by referring again to the charts, this time from the P/B-P/E side.

"Apart from stable dividend-growth companies, the other type of stocks which I tend to hold for longer periods are those where 'quality' and value overlap."

How value and quality can overlap

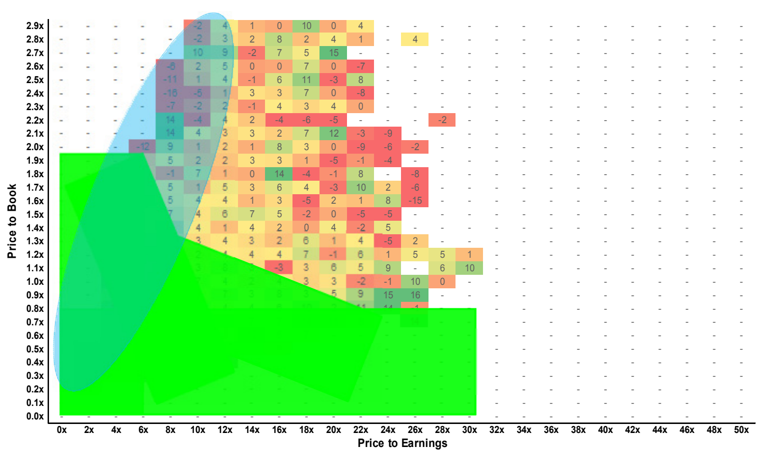

Chart 13. Source: Soeren Addicks, May 2014.

In the chart on the previous page, I have highlighted in green the area of value stocks: those that are cheap in terms of the combination of P/B and P/E factors. The light blue oval area marks the area of quality stocks, where ROEs are high. As you can see, there is an overlapping area, value and quality are excluding each other, the stocks I tend to own for a long time, apart from dividend growers, tend to be those that are in this overlap area between value and quality.

SUMMARY

At its core, value investing is about delivering performance from changes in valuations, while quality investing is about delivering performance from changes/accretions of fundamentals through high ROEs over longer periods of time. Added selectively, quality augments my core value approach well and as the chart on the previous page shows, value and quality approaches can often overlap.

REFERENCES

[1] 'Triumph of the Optimists', Dimson, Marsh and Staunton, February 2002.

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