ADVERTISEMENT FEATURE

NOMURA

A NEW TECH BUBBLE IN ASIA EX-JAPAN MARKET?

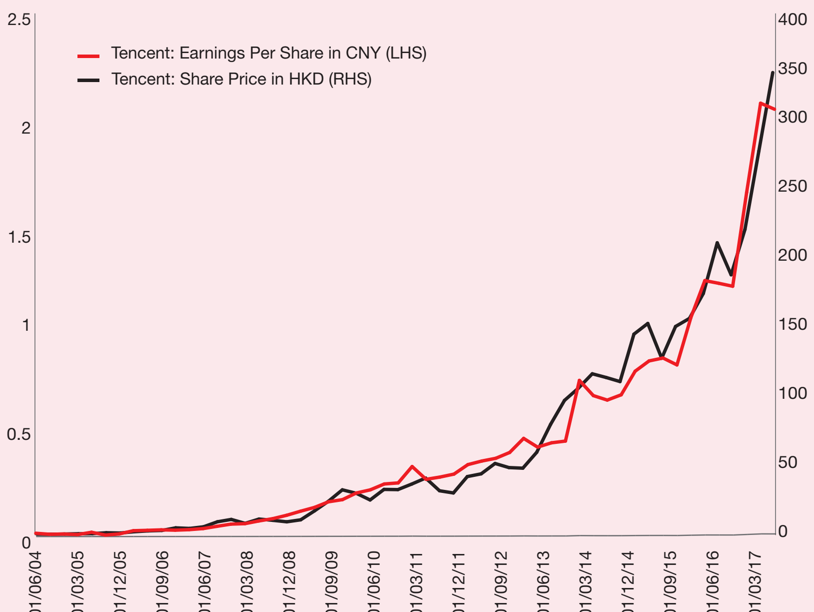
The Asia ex-Japan equity market had a spectacular year in 2017 with the strongest performance seen in the technology and internet sectors. MSCI's All Countries Asia ex-Japan technology sector surged 59.1% in US dollar terms, outperforming the broader index by 20.4%. In terms of its importance, the sector's weight in the index further increased to 31.8% at end of 2017, with each of the four largest index names a technology company: Tencent, Samsung, Alibaba and Taiwan Semiconductor. With the sector attracting more and more attention and interest, given the stellar performance and heavy weight, one question has also been raised - is there now a new technology bubble in Asian market?

STRONG PERFORMANCE MAINLY DRIVEN BY EARNINGS GROWTH

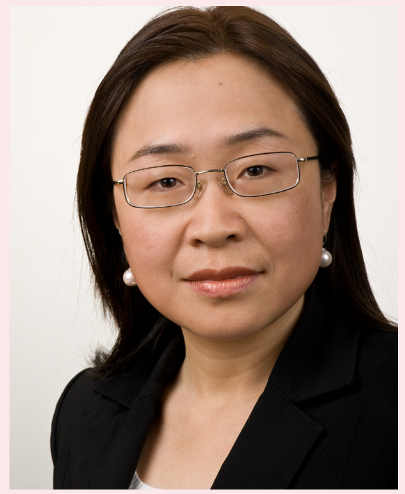
Last year's robust performance of the technology and internet sectors was driven mainly by earnings growth. For example, the South Korean market saw the highest earnings growth and the biggest earnings revisions in the region in 2017, driven by leading blue-chips including Samsung and SK Hynix. Both benefitted from the favourable cyclical environment in the memory chip market and enjoyed explosive earnings growth in 2017. China's internet sector, led by Tencent and Alibaba also delivered strong earnings growth of about 55% with companies consistently beating expectations.

The Chinese internet sector has been in a strong secular development for several years. Benefiting from the massive expansion of eCommerce, internet social communication, internet gaming, ePayment and eFinance in China, the sector has achieved remarkably high growth. As a leading internet giant, Tencent has been a key overweight in Nomura's Asia ex Japan High Conviction Fund since inception in September 2013. From a top-down view, we are convinced this growth trend can continue. More importantly, from a bottom-up stand point, Tencent has continuously expanded its business rapidly and consistently delivered high earnings growth, less impacted by the macro-economic cycle in China than many of its peers. This combination of positive sector outlook and specific fundamental strength at company level convinced us to hold Tencent as a key overweight.

We have retained conviction in Tencent, even through periodical share price corrections. For example, after Trump's presidential victory in November 2016 Tencent experienced profit-taking pressure after a run of strong performance. We felt the market jitters (partly caused by Trump's anti-globalisation, populist rhetoric) did not reflect the continued strong growth prospects of Tencent and retained our position, fully benefitting from the subsequent rise throughout 2017.



Source: Bloomberg and Nomura Asset Management, as of 30.09.2017. Q4 2017 results are not released at time of writing.



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This robustness in the face of market fluctuations is a function of Nomura's sell discipline. We will not reduce or sell a stock on short term market sentiment fluctuations. Only a fundamental deterioration or a change in relative valuation will cause a reduction or selling of our holding

RELATIVE VALUATION MATTERS

After the extraordinary returns seen in 2017, valuations in the China internet sector appear high on first inspection. However, we focus on valuation relative to fundamentals – we see a stock as attractively valued if it delivers market-level growth with cheaper-than-market valuation, or if it enjoys greater-than market growth for market-level valuation.

In the case of Tencent, the valuation (PE 37.7x 2018 estimated earnings) is higher than that of the MSCI AC Asia ex Japan Index (PE 13x 2018 estimated earnings). However, Tencent enjoys a much higher expected growth of 30% for 2018 compared to the index average of approximately 11%. Furthermore, Tencent's strong track record and relatively low volatility (thanks to low dependence on the economic cycle) also help to justify its valuation premium. Therefore, in our estimation, Tencent still enjoys an attractive relative valuation.

> 'We do not hold stocks we do not like, and we only invest in the stocks in which we have highest conviction'

By contrast, we hold different views of two sub-sectors: internet and technology hardware. Whilst the internet sub-sector enjoys strong secular growth with less sensitivity to the macro-economic cycle, the hardware sector experiences much higher cyclical volatility due to the product cycle. For example, Samsung and SK Hynix have benefitted from the strong upturn in the memory chip market in 2017 and have achieved explosive earnings growth. However, the cycle is now nearing its peak with early signs of slowing demand as well as accelerating supply, the sharp appreciation of the Korean Won also adds a headwind to these companies' export competitiveness. Although valuations of these two names are much lower than market average, their attractiveness to us has decreased as we see their growth profile decelerating in 2018. For this reason, we reduced our previous overweight to SK Hynix in late 2017.

STOCK PICKING REMAINS KEY

It is worth highlighting how important stock picking remains in this region (and for our strategy). The right sector does not mean the right individual stock.

Although China's internet sector as a whole achieved stellar performance in 2017, the performance of individual stocks diverged significantly. In 2017, the spectacular sector performance attracted a wave of IPOs of internet-related companies and lots of investor attention, but most post-IPO share price performance has been disappointing given the high initial valuations.

Qudian is an example of this; a leading online consumer loan "FinTech" company and a particularly sought-after IPO in October last year. We avoided Qudian's IPO and have not purchased the stock since. Although we see growth potential in the online consumer loan business in China, we were concerned about regulatory risk and the sustainability of Qudian's high growth. It comes as no surprise to us that Qudian already fell 41% from its IPO price to year end, facing strengthened regulatory pressure from the central bank on its main cash loan business since November.

Our strategy is straightforward: we do not hold stocks we do not like, and we only invest in the stocks in which we have highest conviction. We take a minimum 1% overweight in any stock entering our portfolio, which ensures discipline and conviction in our investment process.

SUMMARY

In a nutshell, despite the strong run in 2017 we still see value in the internet sector given the strong secular growth perspective. However, we think it is reasonable to have a healthy share price correction in the short term. The technology hardware sector faces increasing risk of a slowdown in the semiconductor cycle and the appreciation of the Korean Won – and we have reduced overweights to these companies. Stock picking remains key in the Asia ex-Japan markets – Nomura's high conviction strategy invests only in those stocks exhibiting attractive valuations relative to their fundamentals, enabling us to target sustainable excess returns with controlled risk.

ABOUT NOMURA ASSET MANAGEMENT

The Nomura Asset Management Group is a leading global investment manager. Headquartered in Tokyo, Nomura has additional investment offices based across the world including London, Singapore, Malaysia, Hong Kong, Shanghai, Taipei, Frankfurt and New York. With a global workforce of over 1,200 employees it has been operating in Europe for over 30 years.
Today Nomura Asset Management provides its clients with a wide range of innovative investment strategies including global, regional and single country Asian equities, high yield bonds, alternative investments and global fixed income strategies.

NOMURA ASIA EX-JAPAN HIGH CONVICTION EQUITY FUND

Nomura's fund offers investors a concentrated, unconstrained approach to investing in Asia and aims to deliver high excess returns. The Singapore based fund manager constructs a portfolio of 30-35 stocks that allows Nomura to express their 'best stock ideas' in Asia whilst still permitting prudent protection and diversification against unexpected downside risk.
A disciplined, bottom-up approach is adopted emphasising fundamental analysis and draws on Nomura's considerable research infrastructure based across the region.