



### Analyst

Liang Shibin

+6565311516

liangsb@phillip.com.sg

## Asia Pacific ex Japan Small Caps – Growth & Value

### Executive Summary

**Outperformance during Recovery Phase** – Small caps tend to outperform during economic recovery, attributed to the factor of “nimbleness” in their operations.

**Compelling Asian Growth Into Near Future** – Asia’s leadership of the global economic recovery looks unabated at the moment, supported by exports and private domestic demand.

**Valuation is Attractive from the PEG ratio perspective** – Asia Pacific ex Japan small caps are trading at a forward P/E of 15.3 while an expected earnings growth of 17.2 percent at the moment. PEG ratio at 0.89.

### Introduction – Resounding Performance of Asian Small Caps to Persist

In its simplest form, small caps refer to stocks with a relatively small market capitalization. Depending on varying exchanges’ definition, small caps can be broadly defined as group of companies with an individual market capitalization below US\$2 billion. We are positive on the outlook of Asia-Pacific ex Japan small caps heading into the next few quarters.

Firstly, historical data will point to that small caps are more likely to outperform the broad market in times of recovery. Secondly, the growth and economic momentum in the Asia continent are likely to retain pace as the growth disparity between the West and East persists, which will be a further boost to the growth rate of the continent’s small caps. Lastly, we favour the small caps from a valuation basis. In particular, the Asia-Pacific ex Japan small caps are currently trading at a low Price/Earnings To Growth ratio of under 1 and a dividend yield above 3 percent.

### Risks associated with Small Caps

The implication of investing in small caps stocks may be associated with the higher level of risk involved (i.e. have higher stock price volatility) than the corresponding large caps. This can be attributed to the less than consistent earnings, lower liquidity, general uncertainty about the product lineup etc., which made up the general underlying characteristics of small caps. As such, given the higher stock price volatility and greater uncertainty involved, market participants assume a higher level of risk and would thus, demand a premium when investing in small caps. From that angle, small caps should outperform their large cap counterparts over time based on an absolute return (unadjusted for risk) point of view.

Several studies suggested that small caps tend to outperform their large cap counterparts following a recession. Small caps, as represented by the Russell 2000 Index, had outperformed large cap stocks over the most recent five U.S. recessions except the 5-year period associated with the 1981-82 recession and the 1-year period associated with the 2008-09 recession. This can be explained by the tendency for small caps to exhibit a higher beta risk than the large caps.



### Why Small Caps? – Outperformance during Recovery Phase

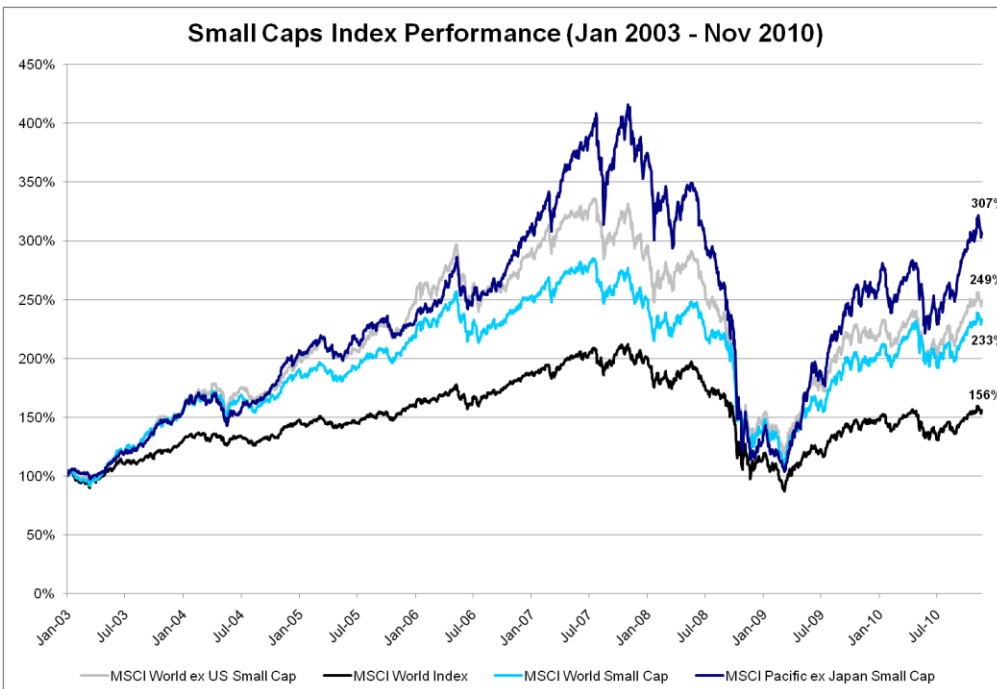
Since 1 Jan 2003, global equities had endured many ups and downs. From Chart 1 below, the MSCI World Small Cap Index soared as much as 280 percent while the MSCI World Index gained 200 percent over the same 7 years period. The MSCI World ex United States Small Cap and MSCI Pacific-ex Japan Small Cap index displayed similar same pattern. Both indices outpaced the large-cap MSCI World Index by more than 10 percent (annualised) during the same period.

Part of the reason for the above outperformance can be attributed to the factor of “nimbleness”. Small and mid-sized companies are generally better able to quickly add to their work forces and ramp up production in anticipation of an improvement in the economy. In short, because of their nimbleness in operations and working capital investments, smaller companies tend to benefit more quickly from economic rebounds.

The second reason can be explained using the concept of valuation arbitrage. Broadly speaking, small caps are assumed to be under-researched (little known to many investors) and under-owned (lack of institutional ownership). As a result, there is a tendency for the stock price to be trading lower than the intrinsic value, in other words, undervalued. In short, valuation arbitrage is more likely to occur in the case of small caps as compared to the large caps.

Lastly, smaller companies tend to get a performance boost when merger and acquisition activity increases, which is common toward the end of a recession when valuations become more attractive and larger companies look for ways to grow their businesses.

### Chart 1: Small Caps Tend to Outperform Big Caps in Recovery



*The Asia Pacific ex Japan Small Caps was the best performing group over the past 7 years period, gaining more than 300 percent.*

Source: Bloomberg, as of 22 Nov 2010



### Why Asia Pacific ex Japan? – Compelling Growth Into Near Future

**Table 1: IMF Estimates on Asian Real GDP Growth**

	2009	2010 (Projected)	2011 (Projected)
<b>Industrial Asia</b>	-4.1	2.9	1.9
Japan	-5.2	2.8	1.5
<b>Emerging Asia</b>	5.8	9.4	8.1
<b>NIEs</b>	-0.9	7.8	4.5
Hong Kong	-2.8	6.0	4.7
South Korea	0.2	6.1	4.5
Singapore	-1.3	15.0	4.5
Taiwan Province of China	-1.9	9.3	4.4
China	9.1	10.5	9.6
India	5.7	9.7	8.4
<b>ASEAN-5</b>	1.7	6.6	5.4
Indonesia	4.5	6.0	6.2
Malaysia	-1.7	6.7	5.3
Philippines	1.1	7.0	4.5
Thailand	-2.2	7.5	4.0
Vietnam	5.3	6.5	6.8
<b>Emerging Asia excl. China</b>	2.5	8.2	6.4
<b>Emerging Asia excl. China &amp; India</b>	0.4	7.2	4.9
<b>Asia</b>	3.6	8.0	6.8

Source: IMF Regional Economic Outlook, as of Oct 2010

From a global perspective, we may be in the middle of a long-term wealth shift from Europe and North America into the Asian continent. Rising Asian wealth is likely to continue to drive substantial GDP growth in the region and lead to higher disposable income for Asian consumers. From Table 1 above, Asian countries (ex Japan) are expected to enjoy near double digit growth for the year itself while the Western counterparties continue to struggle with high unemployment and fiscal deficits. Unless any significant economic restructuring or rebalancing took place, this growth disparity between the West and East will be likely to persist for the foreseeable future.

Asia's leadership of the global economic recovery looks unabated at the moment. The fundamental economic momentum across the region had been spurred mainly by exports and private domestic demand. Asian exports had been boosted by the global and domestic inventory cycles. We observed that by August 2010, overall Asian exports were at about pre-crisis levels, though still about 10 percent below pre-crisis trends. Private domestic demand has also continued to grow strongly. In particular, private fixed investment has strengthened in many regional economies, on the back of higher capacity utilization and relatively low capital costs.

We acknowledge that growth rate is likely to moderate going into 2011 as many governments in the Asian region are expected to continue making policy conditions less accommodative at a gradual pace. For instance, China increased the domestic bank reserve ratio by another 50 basis points as recent as 19 Nov 2010, adding to the previous 250 basis points hike since the start of Q3 2009. Nevertheless, Asia's situation is a positive one and its policymakers have managed effectively the balance of macroeconomic risks, so far so good.

*Asian countries, excluding Japan, are likely to generate high single digit growth in 2011, according to IMF estimates.*



### Valuation is Attractive from the PEG ratio perspective

From a valuation perspective, we also favour the small caps at the moment. As displayed in Table 2 below, the small caps are trading at a higher P/E ratio as compared to the big caps. However, the P/E ratio in this case does not take into account the high earnings growth rate for small caps, which is an important fundamental aspect when analyzing companies in the high growth phase.

The price-to-earnings-growth (PEG) ratio is primarily a growth investing metric that measures the P/E ratio in relation to the growth rate the company will experience in the future. In other words, the PEG ratio will provide the relationship between the P/E ratio and earnings growth after adjusting the P/E ratio for the earnings growth rate. This will tell a much more complete story than the P/E on its own. As a guide, the lower the PEG ratio, the more attractive is the stock price.

We observed that the PEG ratio for the World ex US Small Caps and Asia Pacific ex Japan Small Caps are under 1.0. A PEG ratio of under 1.0 is sometimes said to represent a beneficiary trade-off between the values of cost and the values of growth. It indicates that the index is undervalued given the expected growth ratio. The MSCI Asia Pacific ex Japan Small Cap is trading with a forward P/E of 15.3 while analysts expect an earnings growth of 17.2 percent at the moment. In this case, the value of growth (17.2) outweighs the value of cost (15.3).

In conclusion, it is increasingly unlikely that we will experience a broad based equity rally heading into the year 2011. Prudent value investing may be key moving forward. Investors, if play it right on the Asia Pacific ex Japan small caps universe, can profit from the fastest growth Asian market in the world.

**Table 2: Valuation Ratios of Small Caps against Major Indices**

	Singapore Equities	United States S&P 500	MSCI World	MSCI World Small Caps	MSCI World ex US Small Caps	MSCI Pacific ex Japan Small Caps
Forward P/E	15.68	14.07	13.68	19.13	16.69	15.25
2010 Earnings Growth Estimate	9.88	11.41	13.38	17.43	24.87	17.19
Price-to-Sales	1.52	1.28	1.08	0.75	0.59	1.38
Price-to-Book Value	1.77	2.13	1.79	1.50	1.23	1.56
Current Dividend Yield	2.60	1.93	2.45	1.75	2.31	3.19
PEG Ratio	1.59	1.23	1.02	1.10	0.67	0.89

*Based on the PEG ratio, the we are favoring the Asia Pacific ex Japan Small Caps against other sectors.*

Source: Bloomberg, as of 22 Nov 2010



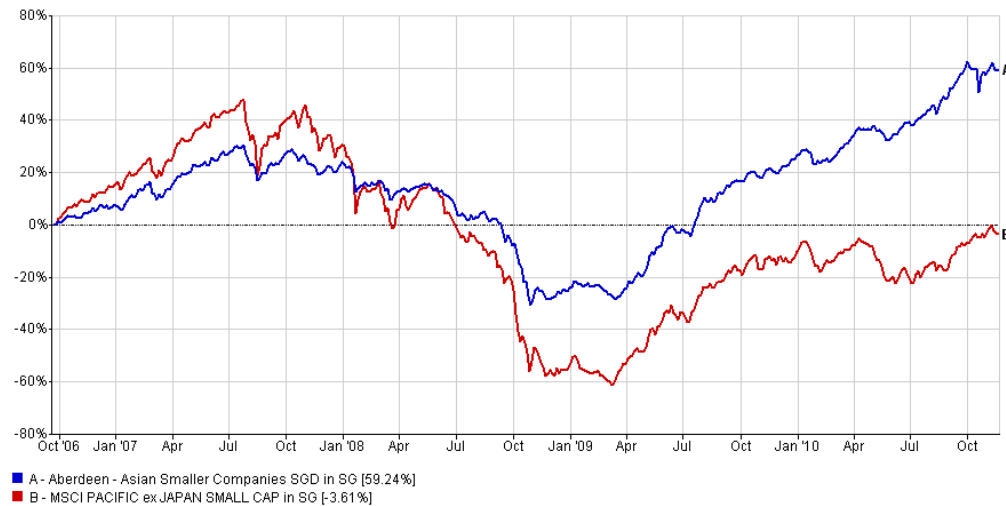
### Fund in Focus – Aberdeen Asian Smaller Companies Fund

The Aberdeen Asian Smaller Companies Fund is mainly exposed to Asia Pacific ex Japan companies with a market capitalisation of under US\$2.5 billion. The fund is benchmarked against the MSCI Asia Pacific ex Japan Small Cap China Index and the fund had outperformed its benchmark by more than 62 percent since inception in 2006 (See Chart 2 below). As compared with its peers, it is ranked first based on its 1-Year (32.1 percent) and 3-Year returns (10.2 percent annualised). On a risk adjusted basis, its Sharpe ratio stood at 2.07 and 0.41 over the 1-Year and 3-Year period.

In terms of investment approach, fundamental company analysis will be the centre of the investment process and the investment team applies a standard set of quality filters to all companies. Fund takes on a long-term focus and look for companies that will create profits over time while ignoring 'market noise', hence the fund has a low portfolio turnover. At the same time, the investment team focus on collective wisdom and not the cultivation of 'star managers'.

In terms of risk, this fund has a below average volatility level as compared to its peers. The standard deviation on a 1-Year and 3-Year basis for the peer funds is at 17.7 percent and 28.0 percent respectively. The 1-Year standard deviation for the fund is currently at 14.0 percent and its 3-Year at 22.6 percent. In terms of maximum drawdown, fund's drawdown is at 7.3 percent while its peer average is closer to 15.0 percent.

### Chart 2: Fund performance against benchmark (Since Inception)



*Aberdeen Asian Smaller Companies fund has outperformed its benchmark by more than 60 percent since inception.*

Source: Financial Express, as of 22 Nov 2010



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