Reaping big rewards in Asian small caps

16 June 2021

Grace Yan, a Senior Portfolio Manager and a member of the Nikko AM Asian Equity Team, talks about the underlying reasons behind her recent success in winning Citywire Asia's Best Fund Manager award and her passion about uncovering hidden gems in the Asian small-cap equity arena.

At the recent Citywire Asia Awards 2021, you won the Best Fund Manager award in the Equity – Asia Pacific Small & Medium Companies category. Share with us your thoughts about winning the award.

This award is a testimony of all our hard work in the area of Asian small-cap investing. I am delighted and proud to have won the award, and I would like to thank the Asian Equity team for supporting and contributing to the success of the Asia small-cap strategy. On the whole, there are plenty of overlooked Asia small-cap companies out there and many of which have valuations that are attractive. The large opportunity set in the regional small-cap universe also offers active investors like us to have a wider scope to select stocks from the bottom up, sniff out the potential small-cap winners and avoid the losers. I hope this achievement will help to increase awareness about our funds.

Senior Portfolio Manager Grace Yan recently won the Best Fund Manager award in the category Equity – Asia Pacific Small & Medium Companies at the Citywire Asia Awards 2021.
Source: Nikko AM

> **I hope this award serves as support to other female fund managers at Nikko AM and inspires the other female analysts to become fund managers.**

In addition, I hope this award serves as support to other female fund managers at Nikko AM and inspires the other female analysts to become fund managers. I always take inspiration from a famous quote from American aviation pioneer Amelia Earhart, who was the first female aviator to fly solo across the Atlantic Ocean. She said: "The most difficult thing is the decision to act, the rest is merely tenacity. The fears are paper tigers. You can do anything you decide to do. You can act to change and control your life; and the procedure, the process is its own reward."

When and how did you get interested in regional small-cap investing?

My interest in Asian small- and medium-cap stocks actually began at the start of my career back in 2008. Back then, I was with Deutsche Asset Management, where I covered small- and mid-cap stocks in South Korea, Taiwan and Singapore for about five-and-half years as an equity analyst and assistant fund manager. It has always been an area that I've been interested in and passionate about. To me, small-cap investing is akin to searching for acorns which can grow into big trees. Nimble, fast growing and at an early stage of development, small-cap companies have the ability to seize market opportunities at a quick pace, generate exceptional earnings growth and internally compound capital faster than their big-cap peers. Many successful small companies have shown the ability to take on larger companies with niche and huge addressable markets. Speaking as an active fund manager, I think Asian small-cap investing encapsulates the true essence of active equity investing, where stock selection truly adds value. Small-cap investing is about finding the winners of tomorrow and that drives my passion in the Asian small-cap arena, where many opportunities exist due to prevalence of information gap and mispricing.

Tell us about the investment philosophy and process of the Nikko AM Asian small-cap strategy.

With a long track record plus decent long-term performance (versus both benchmark and peers), our distinct style of active small-cap investing has continued to add value and generate alpha for our investors over the years. In short, our small-cap strategy is a bottom-up stock strategy which you can think of as a "best ideas strategy". What makes us unique is in the way we choose stocks and craft our portfolio, which consists mainly of our best stock ideas.

Essentially, we look for stocks that can deliver either sustainable returns and/or fundamental change. Examples of sustainable returns are high return on equity (ROE) or consistent earnings growth. Examples of fundamental change are new management, change in strategy and/or policy change. We then overlay that with an environment, social and governance (ESG) lens. Particularly in Asia due to the diverse markets in the region, we believe that focusing on these areas are key to delivering alpha. This is especially important for small caps as a lot of companies don't have ESG ratings on public sources, so our analysts have to do the analysis and engagement themselves.

In terms of our investment process, we will first seek out promising and under-researched Asian small-cap stocks via our proprietary idea generation process. To garner more insights, we go to industry conferences, make company calls with management teams and conduct visits of small-cap companies in the region. After a thorough analysis of the companies' financial statements, we will weed out the weaker players and focus our attention on those with strong balance sheets, sustainable earnings and positive fundamental changes in the lead up to portfolio construction.

During the portfolio construction phase, weights of individual stocks will be determined by our level of conviction in these counters. The stronger our conviction is in a particular small-cap stock, the higher will be its weighting in our portfolio. Country and sector overweights and underweights in our portfolios (relative to the benchmark) are not based on any macroeconomic factors but predicated on our conviction levels and where we find the best investment ideas. We will reduce exposure or sell out of stocks when their fundamentals or ESG ratings deteriorate. We are benchmark agnostic and many of the stocks in our funds are non-benchmark counters.

Is it a challenge to find small-cap companies in Asia with a good ESG profile?

The reason why we incorporate ESG into our research process and philosophy to ensure the companies we invest in do care about the community and corporate governance at large. Although smaller companies in Asia are perceived to have poor ESG policies and practices, that is not always true. Given our extensive research insights and on-the-ground knowledge in Asia, we are still able to find small-cap companies with excellent ESG practises.

An example of a small-cap name that ranks highly in terms of ESG and corporate social responsibility (CSR) is Sunjuice Holdings, which is a Taiwanese mid-stream producer of concentrated fruit juices, fruit pulps and fruit-flavoured powder with operations in China. Sunjuice engages in sustainable farming, leasing land in China and engaging locals to work in its pesticide-free fruit farms. Without the use of pesticides, the company has to allocate other resources to control pests and weeds. The chairman's philosophy is that in order to grow quality fruits, the company needs to first take care of the environment. Focusing on sustainable production, Sunjuice also treats the industrial water generated during the production process and uses it to make organic fertilizer. The company engages in energy saving techniques in its factories and offices, and carries out recycling and reusing of production waste materials to maximise usage and prevent wastage. What's more, Sunjuice is an advocate of gender equality, regularly disclosing remuneration policies and salary information between male and female employees. It also provides enhanced maternity benefits for female employees who give birth to twins. All in all, there is a very good corporate culture at Sunjuice, which is a stock among our top holdings.

What are the other competitive advantages of your team in the Asian small-cap arena?

The ability to speak the local languages of the Asian markets that we cover do give us an edge in the Asian small-cap space, where management teams have the tendency to communicate in the native tongues of their respective countries. For example, many of the top executives of small companies in China do not speak English. The only way to communicate with them is through Mandarin. Having fund managers and analysts in our team who are multilingual gives us a competitive advantage in this aspect. Furthermore, communicating using local languages with smaller companies also helps us to build rapport with the management teams of these firms as well as enable us to understand the nuances of individual markets.

2020 was indeed a daunting year for many investors due to fallout from the COVID-19 pandemic. What did you learn when the market was volatile last year?

2020 was indeed a humbling experience where we faced great uncertainty not only in the financial markets but in our daily lives as well. A main learning point for me was to remain anchored to our core beliefs that sustainable returns and /or fundamental change can drive core returns. While the external environment can lead to big swings, constantly challenging our conviction, we need to have the courage to hold on to the holdings that we have strong conviction in and have the humility to learn from our mistakes when we are wrong. After all, we are students of the markets and there remains much to learn.

Investing in companies that demonstrate good ESG during the coronavirus pandemic gave us a unique experience and an additional sense of purpose. As stewards of capital, it is especially touching for me to see our invested companies giving back to the community and supporting their employees and stakeholders during this unprecedented crisis. One of our holdings JNBY Group, which is a fashion company from China, for instance was committed to pay their staff a full salary despite its stores being shut when lockdown measures were in placed last year. It also allowed distributors to return part of the inventory and bought COVID-19 insurance for its staff. Another example would be Taiwanese laser vision equipment and technical services company called Universal Vision Biotechnology Company; it provided free LASIK surgeries to about 100 medical workers in Hubei and also offered discounts of up to 30-50% for refractive surgeries for about 500 medical staff. Over 2,000 people participated in the corporate initiatives of this company. These gestures of kindness from our invested companies actually brought about a new purpose, meaning and experience to our jobs as fund managers.

Nonetheless, the Small Cap Asia (ex-Japan) Equity Strategy managed to deliver gains of more than 80% in US dollar terms in 2020, outpacing the benchmark more than threefold. How did you manage to achieve such a feat and which of your holdings did well last year?

After the steep slump in first quarter of 2020 due to uncertainties brought about by COVID-19, many of our stock holdings made a strong comeback in the following three quarters to finish the year with double-digit gains. In fact,

Any references to particular securities are for illustrative purposes only and are as at the date of publication of this publication. This is not a recommendation in relation to any named securities and no warranty or guarantee is provided.

many of the stocks in our Asian small-cap portfolios have net cash positions in their balance sheets. These are companies that have a cash surplus after paying all their debt obligations. During the severe market downturn in March 2020, our funds still managed to outperform the benchmark because of the solid balance sheets of our holdings. I would highlight a few of our top performers of last year.

South Korea's Studio Dragon, the leading drama producer, did well in 2020, owing to key blockbusters by the company including *Crash Landing on You* and *The King: Eternal Monarch*. The company benefits from the rise in demand for content globally and has the largest intellectual property library in South Korea with more than 160 titles. With companies such as Netflix, Apple, Disney, Viu and Iqiyi all going global, over-the-top streaming providers are now focusing on exclusive and original content. In 2020, the company reached a new milestone with *Sweet Home*, a Netflix original drama and the first South Korean show to reach the most watched list in the US, breaking the traditional barrier that Korean dramas are only watched in Asia.

In India, Voltas Limited was a key contributor to performance as well. Voltas is a leading player in residential air conditioners in India. The company is well positioned to benefit from the growth in white goods in India with rising incomes. Policies have also been supportive for the company with the government trying to push for domestic production, banning imports of air conditioners with refrigerants. Voltas is expected to benefit as market consolidation takes place.

While we did well in many instances, there were hard decisions that we had to undertake in 2020. In Indonesia, PT Selemat Sempura Tbk, which is an automotive component manufacturer, continued to underperform due to the tough operating environment. Coupled with the lockdown in Indonesia, its earnings fell. We had originally expected that the company to benefit from the growth in heavy duty trucks but that didn't flow through. In Hong Kong, we exited our position in Tang Palace, which is a restaurant operator. Due to the pandemic, its operations were affected as stores were closed, and the company suffered from loss in earnings. Despite the attractive valuations, we took a view that its earnings recovery will be delayed, and we will revisit it in due time.

Lastly, what is your near-term outlook for Asian small caps?

Small-cap companies in Asia continue to look attractive in terms of valuations. Their earnings growth is also estimated to be strong in 2021, supported by a low base as well as the economic recovery. Our strongest conviction ideas by sector remains the consumer sector, where we see quality growth in selected stocks. In particular, there is a focus on companies which display positive fundamental change that are undervalued. We continue to be focused on the core fundamentals of companies, constructing the portfolio from a bottom-up perspective, while staying cognisant of macroeconomic risks.

Any references to particular securities are for illustrative purposes only and are as at the date of publication of this publication. This is not a recommendation in relation to any named securities and no warranty or guarantee is provided.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.

Republic of Korea: This document is being provided for general information purposes only, and shall not, and under no circumstances is, to be construed as, an offering of financial investment products or services. Nikko AM is not making any representation with respect to the eligibility of any person to acquire any financial investment product or service. The offering and sale of any financial investment product is subject to the applicable regulations of the Republic of Korea. Any interests in a fund or collective investment scheme shall be sold after such fund is registered under the private placement registration regime in accordance with the applicable regulations of the Republic of Korea, and the offering of such registered fund shall be conducted only through a locally licensed distributor.