Market Bulletin

July 9, 2019

Keeping a LID on portfolio volatility for Asian investors

In brief

- Investing for the long term in Asian equities helps to limit extreme performance. In some cases, such as the onshore Chinese market, this may not be sufficient given the large swing in markets and narrow investor base. Additional tools are needed to generate a more consistent investment outcome.
- Investors often focus on capital gains, overlooking the role of income in lifting total returns.
- International diversification, in both equities and fixed income, has generated a more consistent return profile for Asian investors by reducing the variation in total return, with marginal sacrifice in performance. This reduces the incentive to time the market and helps investors to meet their financial objectives.

"*Investing for the long term only works in the U.S., it doesn't apply to us.*"

The quote above was from a recent client meeting in Shanghai when we recommended that investors should take a long-term view of markets, instead of trying to time the ups and downs of equities. Many Asian investors struggle to meet their financial objectives because of the high volatility in local equity markets. Some simply give up. Those that attempt to time the market often find their actions undermined by emotions and distraction from market noises.

Hence, we look into how well some of the longstanding investment principles apply in the context of Asian equities. In particular, we want to look at how "LID" works in Asia. By LID, we mean:

- Long-term investment
- Income from equity dividend
- Diversification across asset classes and geographies

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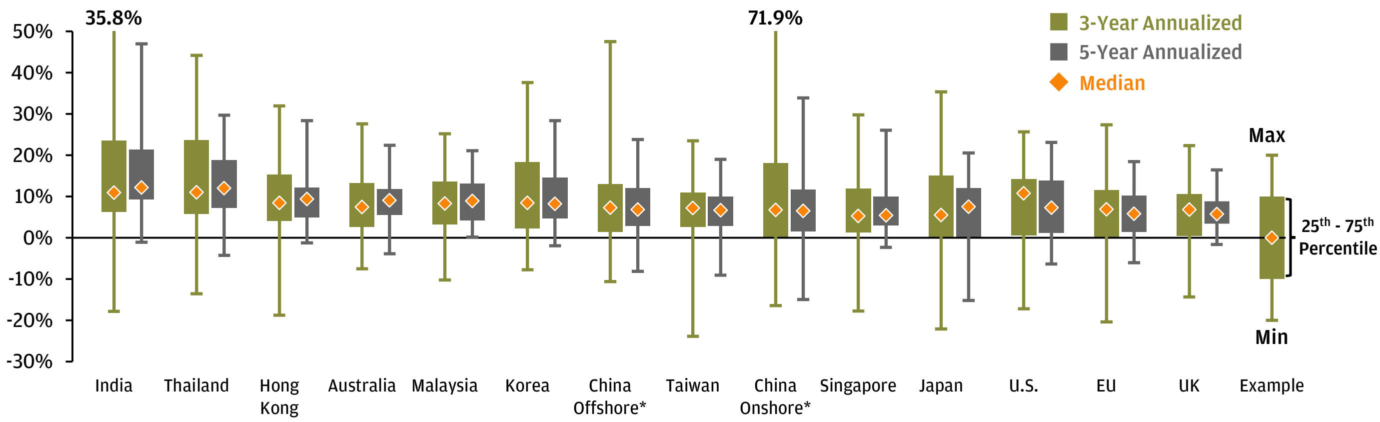
Investing for the long term narrows the range of returns

EXHIBIT 1: RANGE OF RETURNS FOR ASIAN EQUITY MARKETS

ROLLING ANNUALIZED TOTAL RETURN SINCE JAN. 2000, LOCAL CURRENCY



Source: FactSet, MSCI, J.P. Morgan Asset Management. Data are as of May 31, 2019.
*Time period analysed for China onshore and offshore equities began in Jan. 2005 due to data availability.

Long-term investment helps limit the extremes

Exhibit 1 illustrates the range of returns in major developed markets and Asian equity markets since 2000 (2005 for China onshore and offshore markets). Take Hong Kong as an example: an investor who allocated to the Hang Seng Index in any given month since 2000, and held this investment for 3 years, would have received anywhere between 32% and -19% on an annualized basis. The good news is that more than 75% of the time, an investor would have generated a positive return during this period. Increasing the investment period from 3 years to 5 years, the range of returns narrows to 28% and -1.2%, and the median return rises from 8.3% to 9.4%.

In this case, by staying invested longer in the Hong Kong equity market, the investor was able to limit downside losses while experiencing a modest pick-up in median return.

Broadening this to the rest of Asia, equity investors are able to generate more consistent returns by staying invested for longer. The range of returns over a 5-year investment is narrower than 3 years. Even at the 3-year investment tenor, with the exception of China onshore markets, investors are able to achieve a positive return more than 75% of the time. With the exception of China and Taiwan equities, the median return is also enhanced by investing for 5 years instead of 3 years.

The China onshore market is a more extreme case as it seems to benefit less from a longer investment period compared to other markets. This is partly due to its investor base being highly concentrated in retail investors, where herd mentality can exacerbate market momentum, whether it is up or down. Unlikely in more mature markets, investors with contrarian views would take an opposite position when market momentum gets too extreme.

Does this prove our skeptical Chinese investor's view? It does to the extent that a longer investment horizon in the Chinese onshore market only leads to a marginal improvement in returns. It is worth reiterating that the time horizon does improve the returns in other Asian markets with a more diversified investor base. Other tools from our investment principle toolbox can be applied to help investors generate an optimal outcome.

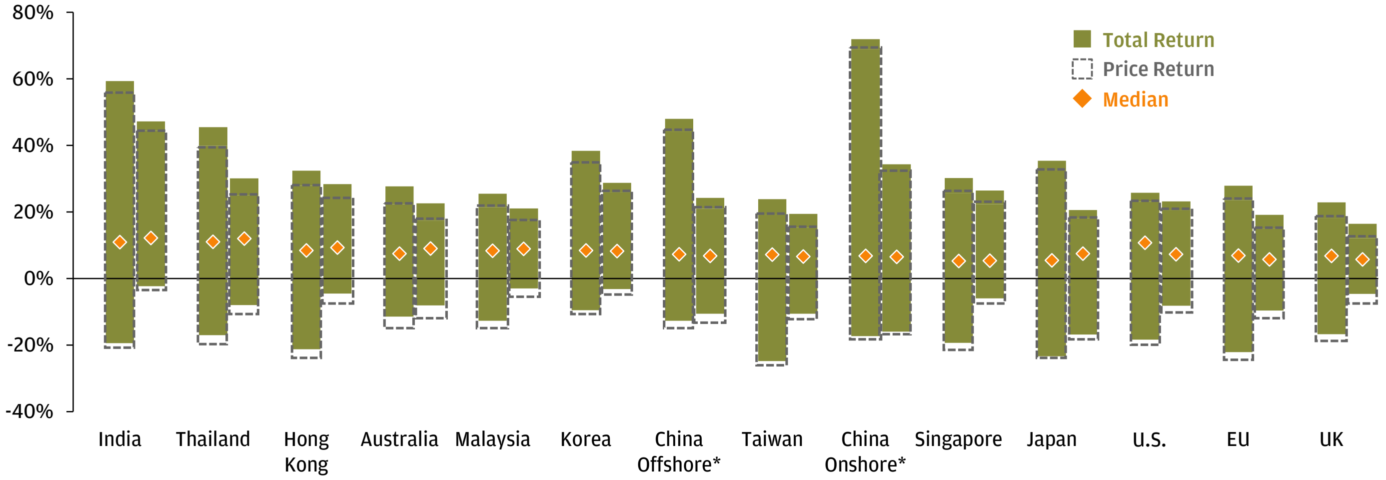
The role of dividend and income

The role of dividend and income in helping investors to achieve a better investment outcome should be intuitive. Stock dividends contribute to total return, which would enhance the upside in equity investment and offset some downside. **Exhibit 2** compares the range of total return (price and dividend in green bar) and price return (dotted bar) of these broad indices. Markets with traditionally higher dividend payout ratios, such as Australia, Singapore, Thailand and Taiwan, were able to add 4-5 percentage points to the 3- and 5-year annualized return in the best years. In the worst years, dividends reduced the downside by 2-3 percentage points. This may not seem much when the best years offer a return of 30% or higher, but this is a meaningful contribution when median returns in these markets are in mid to high single digits.

Dividends enhance returns and provide a buffer against the downside

EXHIBIT 2: DOMESTIC EQUITIES – TOTAL RETURN VS. PRICE RETURN

ROLLING ANNUALIZED RETURN SINCE JAN. 2000, 3-YEAR (LEFT) VS 5-YEAR (RIGHT), LOCAL CURRENCY



Source: FactSet, MSCI, J.P. Morgan Asset Management. Data are as of May 31, 2019.
*Time period analyzed for China onshore and offshore equities began in Jan. 2005 due to data availability.

Don't want to wait? Diversify

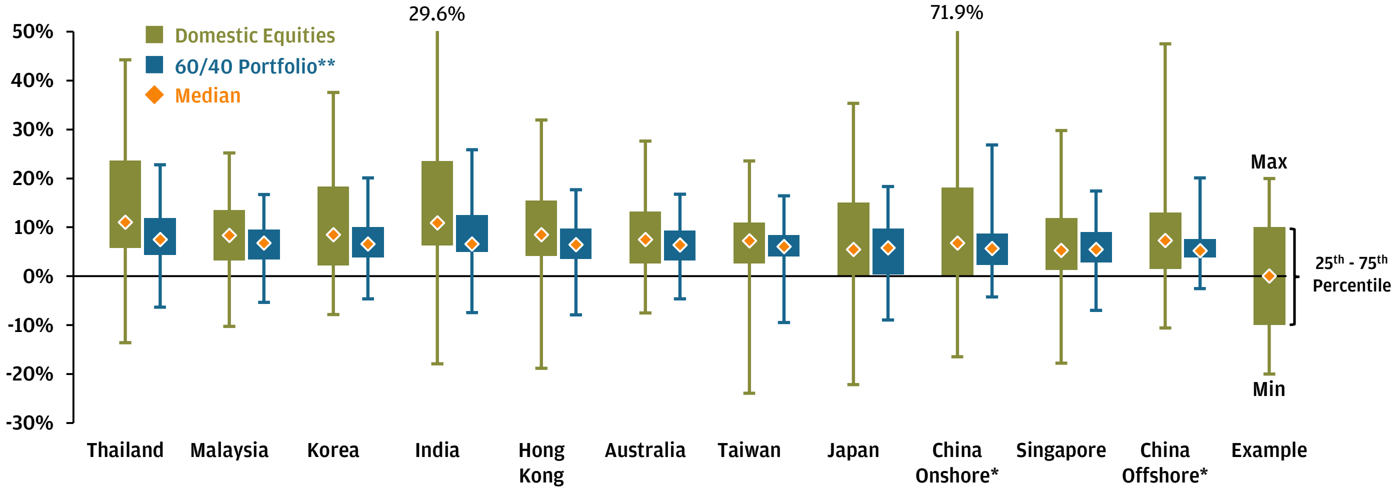
Exhibit 2 shows that by investing in only one market, it is not easy to generate a consistent investment outcome, even by staying invested for longer. Hence, there is a need for investors to consider international diversification. The chart below (**Exhibit 3**) compares the range of returns by investing in domestic equity indices for 3 years, compared with investing in a portfolio of domestic equities (30%), international equities (30%) and international fixed income (40%).

In most cases, the median return dips marginally, but the variation in return declines considerably, i.e. the risk/reward trade-off has improved. For example, for the middle 50th percentile of returns in the China onshore market, an internationally diversified approach produced a range of returns between 2.2% and 6.2%, compared to -6.1% and 18.2% for pure domestic equities. Hence, by adopting an internationally diversified portfolio, the effect is similar to staying invested in the same asset class for longer. This also means investment returns would be less dependent on market conditions at the time of entry.

Diversification continues to be key to achieving long-term investment goals

EXHIBIT 3: RANGE OF RETURN – LOCAL MARKETS VS DIVERSIFIED PORTFOLIO

3-YEAR ANNUALIZED TOTAL RETURN, LOCAL CURRENCY



Source: FactSet, MSCI, J.P. Morgan Asset Management. Data are as of May 31, 2019.
*Time period analysed for China onshore and offshore equities began in Jan. 2005 due to data availability.
**60/40 Portfolio consists of the following: 30% domestic equities of respective countries; 30% MSCI All-Country World Index; 40% Bloomberg Barclays Global Aggregate Index.

Investment implication

Most investment principles that originated from the west are still applicable to Asian investors. Long-term investing, taking advantage of income from dividends and international diversification can help investors in this region to generate a more consistent return performance in the long term and achieve their financial objectives. These principles reduce the importance in looking for an entry point to invest or exit. While some may argue this approach would sacrifice the best market returns, behavioral economics tells us that most investors attach a greater value in limiting downside than gaining extra upside potential.

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