Asian Fixed Income

Why Asian bonds and why now?

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The premise of asset allocation is an attempt to balance risk versus reward by adjusting the percentage of each asset in an investment portfolio according to the invevstor's risk tolerance, goals and investment timeframe. Of course a choice can be made to not hold an asset yet that may not provide the balance of risk. It is for this reason why fixed income has continued to be an important asset class. Yet where does Asian Fixed Income fit it into asset allocation ? The answer to this question is (when looking at history) that Asian Fixed Income, specifically the US dollar denominated credit did not benefit from core allocations. Instead it was allocated to tactially following periods of high volatility, like 2008. Yet today the Asian Fixed Income landscape is entirely different and we believe investors should view it as a core allocation not only for Asian-based investors, but investors from outside the region.

Historically when considering Asian Fixed Income as an asset class, the primary concerns investors held were:

- Lack of diversification
- Poor credit quality
- Too much volatility
- Insufficient returns

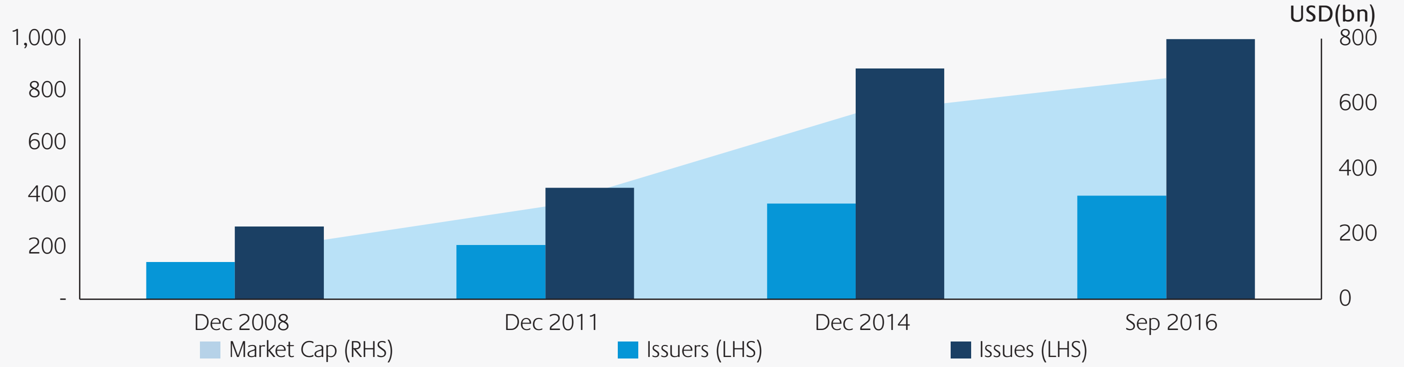
So what are these concerns and why invest in Asian Fixed Income now?

We believe we stand at a juncture where Asian Fixed Income (specifically the USD credit) should be considered a strategic allocation instead of tactical. The market is maturing and consistently produces risk-adjusted returns that compare well across other asset classes. Demand continues to grow for Asian Fixed Income yet globally, the asset class remains under allocated. There are long held concerns about allocating to Asian Fixed Income that we think are diminishing. We believe that the growth and development of the Asian Fixed Income market in recent years will continue and that these long held concerns are diminishing thanks to that growth.

Lack of diversification

Asian Fixed Income markets have experienced significant growth since 2008. By way of example, we consider the growth in a widely used Asian Fixed Income Benchmark, JP Morgan Asia Credit Index ('JACI'). Since 2008, the JACI is more than four times larger in market capitalisation. Within that, the number of issuers in the benchmark has tripled. When considering the number of issuers and that Asian Fixed Income issuers (eligible for benchmark inclusion) originate from 16 different countries, we believe this facilitates the construction of portfolios far more diversified than ever before. Today China issuers are the largest constituent of Asian Fixed Income, followed by South Korea, Hong Kong, Indonesia and India. Whilst it remains difficult to sector allocate within Asian Fixed Income (as sectors may not have as much diversity), we believe that country allocation is an effective way of constructing portfolios.

JP Morgan Asia Credit Index



Source: JP Morgan, Bank of America Merrill Lynch, Standard & Poors, Bloomberg, First State Investments as at 30 September 2016.

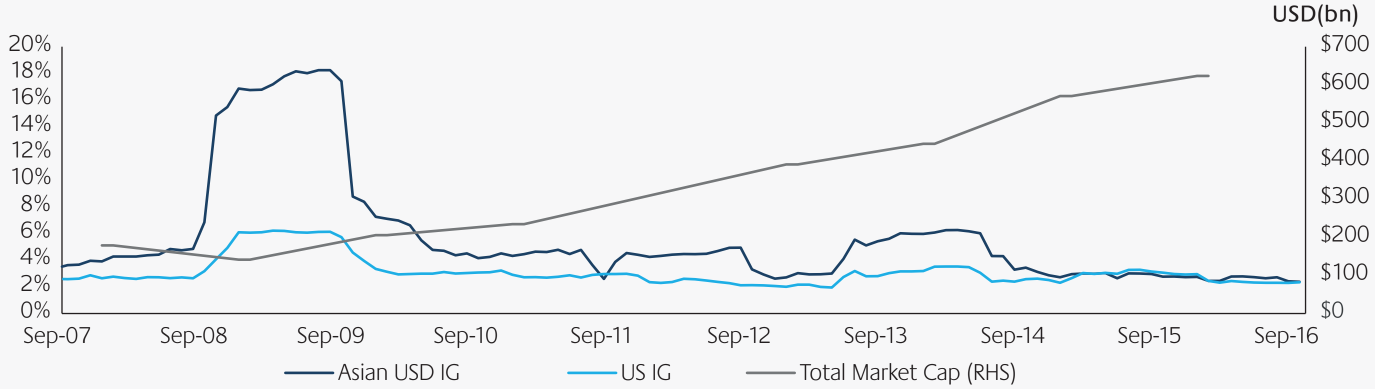
Poor credit quality

The growth in issuance has been dominated by Investment Grade corporates. In 2015 approximately 80% of issuance came from Investment Grade corporates. When considering the average credit quality of JACI, we compare it to a widely used benchmark for the US Investment Grade (namely the Barclays US Aggregate Credit Index). Today the average credit quality for the JACI is Baa1/BBB+ compared to the Barclays at A-/BBB+. We expect this trend to continue with Investment Grade issuers representing a much larger proportion of the market than High Yield, thereby supporting overall credit quality.

Too much volatility

Asian Fixed Income had historically endured volatility greater than other investment grade markets. With the growth in the market creating a deeper, more diversified market this volatility has begun to recede. However our research has pointed to an additional point that may contribute to the decreased volatility. A recent study by KPMG looked at where the Asian Fixed Income assets reside. Over the last five years the percentage of fixed income assets held within Asia has continued to grow, rather than being held in the US or Europe. We believe that this is a contributing factor to the reduction in volatility as Asian investors would be far more aware of the issues with respect Asian issuers, than foreigners. Comparing annualised 12-months rolling volatility of Asian Investment Grade to the US Investment Grade, since 2009 (i.e post-crisis) Asian Investment Grade has exhibited more volatility than the US Investment Grade. Interestingly though from the end of 2014 until today, Asian Fixed Income volatility has largely mirrored that of the US Investment Grade. We attribute this to market growth and greater participation by Asian-based investors.

Comparing volatility in Asian USD Investment Grade with US Investment Grade



Source: JP Morgan, Bloomberg, First State Investments as at 30 September 2016.

Insufficient returns

Asian Fixed Income has delivered consistent returns year-on-year. Since inception the JACI has only delivered negative returns in a calendar year twice - 2008 and 2013. However, it is important to note that the following year the returns delivered more than compensated for the years previous.

Additionally a common misconception is that Asian Fixed Income will massively underperform in a rate rising environment in the US. The JACI index was launched in September 2005, in the middle of the Federal Reserve's last rate rising cycle. That cycle was quite aggressive yet Asian Fixed Income still generated positive returns.

Asian Investment Grade credit returns and Sharpe Ratio when compared to other asset classes over the last five years are relatively favourable. We see increasing probability of more investors allocating to Asian Fixed Income in the coming years. As central banks crowd out fixed income investors globally, Asian Fixed Income will grow in importance. With higher returns than the US Investment Grade and Europe Investment Grade, and annualised volatility akin to the US Investment Grade, we believe this makes it an attractive asset class.

	5-year US Treasury	US IG	US HY	Asian USD IG	Global Equities	US Equities	EM Equities	Asia Ex-Japan Equities
Annualised Return	1.8%	3.1%	8.3%	6.1%	11.2%	16.4%	3.4%	7.2%
Annualised Volatility	2.5%	2.7%	6.2%	3.8%	12.3%	11.1%	17.3%	16.1%
Sharpe Ratio	0.7	1.1	1.3	1.6	0.9	1.5	0.2	0.4

Source: Bloomberg, First State Investments, JP Morgan, Barclays, MSCI, S&P as at 30 September 2016.

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