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Undervalued Forgotten Opportunities: UFOs in your asset allocation

Global Matters Weekly

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Last week the world watched on as a congressional hearing was held in the US with the goal of exploring Unidentified Flying Object (UFO) sightings and trying to establish whether alien life-forms do exist. Sightings of UFOs in the investment world, however, are less elusive - with many 'Undervalued Forgotten Opportunities' floating around an asset allocator's atmosphere.

Over the last decade or so, one would be forgiven for forgetting that an investment universe still exists outside of the S&P 500 and FAANG* stocks. Tech stocks have recently enjoyed another stint in the limelight thanks to the surge of interest in Artificial Intelligence (AI); so why look outside of what is hot right now? Diversification. Diversification is central to portfolio construction and allows investors to reduce unsystematic risk and capture other sources of return. Currently, where should an asset allocator look to diversify their portfolio?

Diversification is central to portfolio construction and allows investors to reduce unsystematic risk and capture other sources of return.

The UK market is one that embodies my commandeered definition of a 'UFO', in that it is certainly undervalued, indeed forgotten, and thus, an opportunity. The FTSE 100 currently trades at a discount to its 20-year average on a price-to-book basis and far below its peak reached in 2007[1], with valuations hampered in the UK since Brexit. The valuation gap is even more pronounced in the mid-cap space, with the FTSE 250 trading on a wider price-to-book discount versus its 20-year average than the FTSE 100 is. Our direct UK equity portfolio has a mid-cap bias and therefore fishes in the value-rich waters of the UK mid-cap universe, boasting a lower price-to-book ratio and better return on equity than the index at our Q2 asset allocation meeting.[2]

Japanese equities have been thought of as undervalued since before I was born, but after underdelivering on returns that have definitely not been 'out-of-this-world', the market has since become forgotten; investors burned by what could've been. So, what makes Japan attractive now? In recent years there has been an overhaul in corporate governance within corporate Japan due to the introduction of the Stewardship Code and Corporate Governance Code. Due to increased shareholder activism and more appropriate incentivisation, management teams are now focussing on delivering shareholder value by utilising inefficient balance sheets to boost returns through increased dividends and share buyback programmes. Morant Wright, MGIM's Japanese manager, targets companies that are trading below book value, but have inefficient balance sheets that can be utilised to provide shareholder returns.[3]

Sticking with Asia, the small-cap universe may be one that has been forgotten in the gold rush for technology stocks in recent years. Chinese mega-caps such as Alibaba and Tencent have enjoyed expensive valuations as their popularity exploded along with their western counterparts. Samarang, MGIM's Asian small-cap manager, searches for value in less-trodden ground such as Vietnam, Malaysia, and Indonesia – as well as searching for value in Japanese and Chinese small-cap stocks. Samarang have outperformed the MSCI Asia Pacific universe by over 2% per annum since inception[4], and the Asian Prosperity Fund's current portfolio seems undervalued – trading at less than its book value, despite boasting a 16% return on equity and a 4.5% dividend yield.[5]

Maybe one day humans will be able to co-invest alongside aliens on a stock market located on a galaxy far, far away. However, in the meantime, investors can seek value in the UFOs of the UK, Japanese, and Asian Small-Cap equity markets, which can be accessed through MGIM's specialist managers used throughout its multi-asset range of funds.

**Note: FAANG stocks are Facebook (now Meta), Apple, Amazon, Netflix, Google (now Alphabet).*

Sources: [1]Bloomberg Finance L.P. 3rd August 2023, [2]Momentum Global Investment Management (MGIM), MGIM Q2 Asset Allocation Meeting – UK Equity Portfolio Characteristics 15th May 2023, [3] MGIM Research, Morant Wright Research Note, July 2019, [4]Samarang Asset Management, Samarang Funds Review Presentation, June/July 2023, Page 1, [5]Samarang Asset Management, Samarang Funds Review Presentation, June/July 2023, Page 33.

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The Marketplace

- Global equities fell by 1.6% last week
- After initially putting the US on ratings watch back in May, Fitch Ratings downgraded the US from AAA to AA+ citing expected fiscal deterioration, growing debt burden and erosion of governance
- Brent crude rose by 1.5% to $86.24 per barrel
- Gold fell by 0.8% to $1942.91 per ounce

Market Focus

US

- US equities fell by 2.3% last week
- The headline Institute of Supply Management (ISM) manufacturing index fell in July coming in at 46.4 (vs. 46.9 expected)
- Weekly initial jobless claims remained at the lower levels of recent weeks at 227k (vs. 225k expected)
- Job openings came in lower than expected at +9.58 million, its lowest level since April 2021. The quits rate dropped down to 2.4%, after an unexpected increase to 2.6% in the May release
- The unemployment rate dipped to 3.5%, with labour force participation remaining unchanged at 62.6%

Europe

- European equities fell by 2.5% last week
- The unemployment rate in Germany fell to 5.6% in July from 5.7% in June, with unemployment claims decreasing by 4k (vs. a 20k increase expected). The overall Eurozone unemployment rate fell from 6.5% to 6.4%
- Euro Area economic growth for Q2 expanded 0.3% quarter-on-quarter, with Ireland (3.3% quarter-on-quarter) creating a sizeable upward distortion. In contrast, Germany recorded no growth for the quarter and Italy contracted -0.3% over Q2

UK

- UK equities fell by 1.7% last week
- The Bank of England followed the Federal Reserve and European Central Bank's lead by raising their policy rate by 25bps to 5.25% as expected. The Monetary Policy Committee retained its data-dependent approach but demonstrated confidence that tight monetary policy is now weighing on economic activity

Asia/Rest of The World

- Global emerging market equities fell 2.4% last week
- Chinese equities fell by 1.1% last week
- China's private factory activity returned to contraction for the first time since April as the Caixin manufacturing Purchasing Managers' Index (PMI) came in at 49.2 in July (vs. 50.5 in June)
- China's services activity expanded at a faster pace in July as the Caixin services PMI edged up to 54.1 (vs. 52.4 expected) from a level of 53.9, partly offsetting the drag from the soft manufacturing sector data
- Japan's unemployment rate unexpectedly dropped to 2.5% in June from 2.6% a month earlier
- The Reserve Bank of Australia kept the official interest rate unchanged at 4.1%, extending its pause in rate hikes for the second consecutive month to assess if further action is necessary to tame inflation

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Asset Class/Region	Currency	Currency returns			
		Week ending 4 Aug. 2023	Month to date	YTD 2023	12 months
Developed Market Equities					
United States	USD	-2.3%	-2.4%	17.4%	9.2%
United Kingdom	GBP	-1.7%	-1.7%	3.1%	4.7%
Continental Europe	EUR	-2.5%	-2.6%	11.8%	9.3%
Japan	JPY	-0.7%	-2.1%	22.0%	21.0%
Asia Pacific (ex Japan)	USD	-2.2%	-2.8%	5.9%	3.5%
Australia	AUD	-1.1%	-1.1%	6.3%	9.9%
Global	USD	-1.6%	-2.5%	16.0%	10.0%
Emerging markets equities					
Emerging Europe	USD	0.0%	-0.4%	23.6%	52.7%
Emerging Asia	USD	-2.1%	-2.6%	7.7%	3.8%
Emerging Latin America	USD	-3.6%	-3.8%	19.9%	26.3%
BRICs	USD	-1.4%	-2.3%	4.9%	2.9%
China	USD	-1.1%	-2.2%	2.4%	-0.5%
MENA countries	USD	-2.8%	-2.0%	4.2%	-8.5%
South Africa	USD	-6.9%	-6.6%	-0.5%	3.4%
India	USD	-1.1%	-1.6%	8.6%	8.7%
Global emerging markets	USD	-2.4%	-2.7%	8.4%	5.3%
Bonds					
US Treasuries	USD	-0.4%	-0.5%	0.9%	-4.4%
US Treasuries (inflation protected)	USD	-0.5%	-0.5%	1.5%	-5.5%
US Corporate (investment grade)	USD	-0.7%	-0.9%	2.7%	-1.9%
US High Yield	USD	-0.4%	-0.6%	6.3%	2.7%
UK Gilts	GBP	-0.6%	-0.9%	-3.7%	-18.0%
UK Corporate (investment grade)	GBP	-0.1%	-0.4%	1.0%	-8.7%
Euro Government Bonds	EUR	-0.5%	-0.5%	1.9%	-9.5%
Euro Corporate (investment grade)	EUR	-0.1%	-0.2%	2.8%	-3.8%
Euro High Yield	EUR	-0.1%	-0.2%	5.3%	3.7%
Japanese Government	JPY	-1.4%	-0.7%	0.4%	-3.1%
Australian Government	AUD	-0.4%	-0.5%	1.2%	-2.3%
Global Government Bonds	USD	-0.9%	-0.6%	0.5%	-5.4%
Global Bonds	USD	-0.8%	-0.7%	2.0%	-3.6%
Global Convertible Bonds	USD	-1.7%	-1.9%	6.6%	3.9%
Emerging Market Bonds	USD	-1.2%	-1.4%	3.7%	1.4%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 4 Aug. 2023	Month to date	YTD 2023	12 months
Property					
US Property Securities	USD	-2.1%	-2.6%	4.9%	-7.2%
Australian Property Securities	AUD	-2.6%	-2.7%	2.6%	-5.7%
Asia Property Securities	USD	-3.6%	-3.1%	-6.0%	-9.0%
Global Property Securities	USD	-2.2%	-2.5%	2.7%	-7.1%
Currencies					
Euro	USD	0.1%	0.2%	3.0%	7.8%
UK Pound Sterling	USD	-0.7%	-0.6%	5.7%	5.2%
Japanese Yen	USD	-0.7%	0.2%	-7.6%	-6.2%
Australian Dollar	USD	-0.8%	-1.8%	-3.1%	-5.2%
South African Rand	USD	-4.4%	-3.1%	-7.4%	-9.5%
Swiss Franc	USD	-0.3%	-0.2%	5.8%	9.7%
Chinese Yuan	USD	-0.3%	-0.4%	-3.8%	-5.9%
Commodities & Alternatives					
Commodities	USD	-0.7%	-0.9%	-0.5%	-0.2%
Agricultural Commodities	USD	-2.8%	-1.1%	3.2%	7.3%
Oil	USD	1.5%	0.8%	0.4%	-8.4%
Gold	USD	-0.8%	-1.4%	6.5%	8.5%
Hedge funds	USD	0.0%	0.0%	1.0%	0.9%

Source: Bloomberg. Past performance is not indicative of future returns

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