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Good performance not an anomaly

Markets in Asia-Pacific (excluding Japan) have produced better returns

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As the global financial crisis continued to take its toll last year, world economic output declined by 2%. Yet gross domestic product grew by 4.5% in the Asia-Pacific region, excluding Japan, bolstered by strong GDP growth in China and India.

Stock market returns reflected this economic divergence. The MSCI AC [all country] Asia ex-Japan index delivered a robust 46.5% return in 2009, outpacing all other major regional indices except emerging markets.

Based on a historical analysis (in Canadian dollars) by my firm, **Tacita Capital Inc.**, this strong performance is not an anomaly.

The annualized return of the MSCI AC Asia ex-Japan index from January 1988 through to May 2010 was 8.7%. Only the MSCI emerging markets index return of 12.2% was higher during this period.

The Asia ex-Japan index surpassed the 8.6% and 8.3% returns of the S&P/TSX composite index and the S&P 500 index, respectively, and also placed ahead of the 7.5% annualized return of the MSCI Europe index.

In contrast, the bursting of the asset bubble in Japan left the MSCI Japan index down by 1.5% annually. The key to success in investing in Asia over the past two decades was to avoid Japan.

The better return of Asia ex-Japan, however, came at a price of high volatility. The annualized standard deviation of the Asia ex-Japan index from January 1988 through May 2010 was 24.8%, the second-most volatile of all major equity asset classes and significantly in excess of the 16.5% and 14.7% standard deviations of the Canadian and U.S. markets, respectively. Only the emerging markets were slightly more volatile.

One of the contributors to this heightened volatility was the financial crisis that gripped much of Asia in 1997. Triggered by a precipitous drop in Thailand's baht, a contagion of currency devaluation swept Asia, causing a sudden rise in interest rates and sending stock markets into free fall.

Despite its geographical distance, the Asian ex-Japan market has a fairly high correlation with Canadian stocks — 0.60. The interplay of Canada's commodities with Asian manufacturing is likely the link. This compares with Canada's correlations with the U.S. (0.61) and European (0.57) markets, respectively.

Nevertheless, Asia ex-Japan can still have a diversifying effect on a Canadian portfolio. A case in point was 2007, when Asia ex-Japan was up by 19.2%, well ahead of the 3.0% and 10.5% negative returns of the U.S. and Europe, respectively.

One of the best ways to gain exposure to Asia ex-Japan is to invest in an emerging markets fund. Only two of the 10 countries in Asia ex-Japan — Hong Kong and Singapore — are not classified as emerging markets by MSCI. In fact, as of March 31, China, Korea, Taiwan and India comprised almost 50% of the holdings of iShares MSCI emerging markets index fund, which is managed by U.S.-based **BlackRock Inc.**

Some financial advisors, however, may want more direct exposure to the growth opportunities in Asia ex-Japan. **Credit Suisse** recently has forecast that the region would grow by 7.9% in 2011. China alone is expected to contribute as much to global growth as North America, Europe and Japan combined.

Advisors have a range of mutual fund options that provide exposure to Asia ex-Japan. Fidelity Far East Fund, managed by **Fidelity Investments Canada ULC**, has a solid performance record back to 1991. But, like many funds that target the Far East, its mandate is Southeast Asia and does not include India. **IE**

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