

Undervalued Forgotten Opportunities: UFOs in your asset allocation by Matt Connor

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?

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 2007¹, 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 meeting².

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 returns³.

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 inception⁴, 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 yield⁵.

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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