



Time to broaden the palate

How investors can spice up diversification with attractive risk-adjusted returns.

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If diversification is the only free lunch in investing, UK investors are ordering from a rather limited menu. The latest figures from The Investment Association show three-quarters of equity portfolios are allocated to the US, UK and Europe, leaving under 15% for Asia.

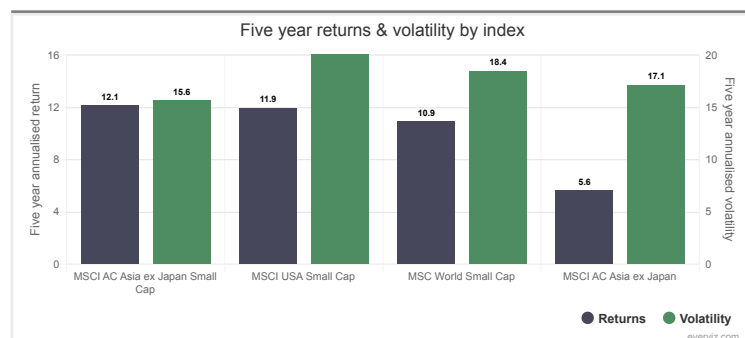
Asia's growth story is well appreciated but worth a brief recap: the region has contributed 70% of global GDP growth over the past decade and now surpasses the collective GDP of the rest of the world. That's certainly a striking contrast to current portfolio allocations.

Asia's equity universe also dwarfs other regions, with over 20,000 listed companies, more than Europe, Japan, the US and the UK combined, according to the World Federation of Exchanges.

But true diversification goes beyond geography, extending across market cap, sectors and styles. Investors looking for exposure to Asia often gravitate to the perceived safety of large-caps yet the numbers reveal a different story.

As shown below, the MSCI AC Asia ex Japan Small Cap Index has delivered more than double the five-year return of its large- and mid-cap counterpart but, interestingly, with lower volatility along the way. What's more, it also outperformed both the MSCI World and MSCI USA small-cap indices in both returns and volatility.

Fig.1: Asian Small-Caps Offer Attractive Risk-Adjusted Returns



Source: MSCI factsheets (as at 31/07/2025).

Past performance is not a reliable indicator of future results.

Turning to sector and style, large-cap Asia ex Japan indices are dominated by a handful of mega-cap, technology-led regional names that are often affected by market momentum. In contrast, smaller caps offer a broader and more balanced spread across both countries and sectors (such as healthcare, industrials and

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materials) and are an under-researched universe of opportunities.

As a result, to a discipline-driven bottom-up stock picker, Asian small-caps have offered a compelling mix of attractive returns, lower volatility and diversification across geography, size and style.

Breaking down barriers

Asia is one of the most diverse and dynamic investment regions in the world but also among the most complex. Regulatory frameworks, accounting standards and cultural practices vary widely between markets while company disclosures can be inconsistent. Many smaller companies receive little or no sell-side coverage, meaning that valuations can lag behind fundamentals.

This can create a rich source of alpha for active managers with well-resourced teams that can navigate local nuances, verify information through first-hand engagement and develop a deep and multi-faceted understanding of the long-term prospects of companies.



Active management can also be nimble in adapting to shifting market and style cycles, trim exposure when valuations become stretched and allocate capital to companies with the most attractive long-term risk-adjusted potential.

While many Asian equity funds focus on large-caps, **Fidelity Asian Values (FAS)** looks to unearth the most compelling opportunities in the under-researched and inefficient small-cap universe. Managers Nitin Bajaj and Ajinkya Dhavale have a collective experience of almost 40 years and are supported by Fidelity's extensive on-the-ground resources.

The Asia Pacific team comprises more than 40 analysts across the region, including dedicated small-cap specialists, with the potential for further cross-pollination with Fidelity's global and sector research teams.

This allows the managers to build a 360-degree view of a business, engaging not only with the company itself, but also with customers, suppliers and competitors, and drawing on years of accumulated research to evaluate each investment thesis.

Getting more bang for your buck

The managers hold a portfolio of around 100 to 200 stocks, balancing diversification with conviction in their best ideas. Stock selection follows a disciplined, contrarian philosophy, seeking "good people, good businesses and a good price."

Nitin and Ajinkya look for high-quality management teams with the capability and integrity to deliver sustainable value creation; in other words, building long-term competitive advantages rather than chasing short-term share price gains. Regular engagement with management teams provides clear insight into strategic direction, governance, culture and resilience through economic cycles.

"Good businesses" combine dependable cash flows, solid balance sheets and strong returns on equity with durable competitive advantages such as pricing power, market leadership or valuable intangible assets.

For example, FAS has invested in automotive retailers benefiting from China's expanding "car parc" of drivers and steady cash flows from after-sales services rather than 'flavour-of-the-month' Chinese EV manufacturers.

The trust's focus on valuation creates a margin of safety, targeting quality companies priced below their long-term potential. This contrarian approach focuses on companies

currently out of favour, perhaps due to an industry downturn or short-term earnings weakness, and avoids those lifted purely by market momentum.

As a result, the managers have avoided some of the more expensive opportunities in Taiwan and India, and maintained a meaningful exposure to China, Indonesia and Korea. The trust's overweight to China reflects the managers' views on its long-term competitive advantages created by its high-quality physical and intellectual capital, as well as the opportunity to capitalise on attractive valuations.

Another key advantage of active management is the ability to manage downside risk for investors, which the managers define as absolute loss of capital rather than relative underperformance against the benchmark. As value investors, the managers will tend to be early entrants but will trim positions when momentum drives excessive valuations.

By way of example, FAS invested in Sudarshan Chemicals, an Indian pigment manufacturer, in 2022. While industry headwinds weighed on valuations, the company's market leadership and financial strength enabled it to weather the downturn. However, when momentum drove up Indian small-cap valuations in 2024, the managers exited their position due to concerns about the valuation premium relative to the company's growth prospects.

The managers' stock-picking expertise is evident in the trust's five-year share price total return of 87%, well ahead of the index's 67% (as at 30/06/2025). Notably, FAS has delivered positive share price returns in nine of the past 10 financial years, which is a testament to the management of downside risk for investors.

Looking ahead, Asian smaller-caps continue to combine attractive valuations with strong fundamentals. Over the past 30 years, Asian small-cap value equities have outpaced both growth and value large-cap indices but currently trade at their widest discount to growth in five years.

Perhaps it's time for UK investors to add a bit of spice to the diversification menu...?

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