

ARECA  
CAPITAL

# flash

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LOOK BEYOND SHORT-TERM TURBULENCE



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Dear Investors,

Looking beyond the short-term turbulence we are currently facing; our vaccination rates have been steadily increasing every day. This gives us hope that brighter days are coming. Together we will eventually achieve herd immunity and accelerate economic recovery. So, let's roll up our sleeves and get vaccinated.

In this issue of Flash, Edward and I share our insights on the equity and fixed income markets for the second half of 2021. Also, Chaw Chern talks about whether a bigger fund size is necessarily better.

Stay safe, stay healthy. Happy reading!

A handwritten signature in black ink, appearing to read 'Danny Wong'.

Danny Wong  
Chief Executive Officer  
Areca Capital Sdn Bhd

## REVIEW AND OUTLOOK

Let's start with some optimistic and encouraging numbers.

The economic engine in the country, Klang Valley which covers the major areas and states like Selangor and Kuala Lumpur, have achieved close to 100% of its adult population being vaccinated with 1 dose. Although it appears that we've been slightly slower off the mark, our vaccination rates are now among the fastest in the region - around 400,000 to 500,000 doses administered per day.

In what may seem to us as a fast-forwarded version of Charles Darwin's theory of evolution, the coronavirus has mutated rapidly with each variant more contagious and resilient towards vaccines than the last. We understand that the daily new cases reported in the country is a scary and frustrating reality check. However, as precedence shows, vaccines provide our best hope of protection against the coronavirus. The ultimate goal would be to achieve a global herd immunity. This will be crucial to hopefully turn the rampant pandemic to become endemic in time but more on vaccination later.

The world is indeed still at war with the pandemic but markets can tell a different story. Powered by a rally in US equities, the Global index is up 13.14% for the year, while the Asian index is still down by 1.37%. In Malaysia, after almost one and a half years since the first lockdown, economic and movement restrictions remain in place. For businesses and the average Malaysians, there looks to be no end to the MCOs. This has contributed to our Malaysian index sliding 8.44%.

It's been a long road in the tunnel so far, but rather than going backwards again, we do see flickers of light at the end of the tunnel. Early in the year, we made a list of risk events in the market – will there be new variants of the virus? Another resurgence in cases leading to another MCO, EMCO? Will political uncertainty take centre stage? Will global inflation turn out to be higher and longer-lived than expected, which will inadvertently force Developed Markets to turn hawkish earlier than anticipated.

The point is, that there have been many negative developments in the market that we start to wonder if many of those risks have been priced in already. At the end of the day, what separates a successful from an average investor is his/her ability to not just take stock of the existing situation but discern on what's ahead – in short, to not just move with the herd.

On our part, we try to behave like rational, long-term investors. In doing so, we believe that even if one out of the several uncertainties manages to be resolved, that should provide a floor and help support market sentiment.

However, without a crystal ball to accurately predict what's next, we will maintain our flexibility and agility in sectors and stocks selection while laying the foundation to hopefully catch the reversal in fortunes. In the meantime, we have to bide our time. As Warren Buffet says, "No matter how great the talent or effort, some things just take time. You can't produce a baby in one month by getting nine women pregnant". To this end, we will continue to manage the Fund with a strong focus in asset allocation and Barbell Strategy with exposure in both:

1. Value/Reopening – We view the path to vaccination as a brighter spot. A quarter of Malaysia's population have been inoculated while about half of our population or almost 15mil individuals have had their first dose. If we are able to sustain this frantic pace of vaccination delivery and administration, herd immunity levels are not too far off. Some projections put this around the end of Q3 or early Q4. The government's recent move to ease restrictions for fully-vaccinated individuals would help to boost economic activity too. When foot traffic returns, this eventually bodes well to a host of businesses. We term these as the economic reopening plays and consists of the banks and consumer sectors. As prices fell, we have been prudently taking position in the names that we like. On concerns of the political front, we believe that Malaysians are no strangers to the political noises and uncertainties abound anyway – but we try to avoid ones that have their fortunes tied to this.





2. Growth – On the other hand, we continue to be positive in the prospects of our exporters; players in the technology and industrial space that tap on the technology secular trends and recovering global growth. Our view is generally aligned with the largest OSAT, ASE's pyramid conceptual concept. It illustrates the relationship between innovation and total semiconductor volume. Imagine that innovation is at the tip of the pyramid. The pyramid becomes taller as innovation becomes more pervasive. This means the base, width and total volume of the pyramid will need to increase proportionally in order to support a taller pyramid. In essence, the semiconductor ecosystem resembles the concept – to support any innovation, a proportional increase of systems and infrastructures are required, which in turn, will drive the demand of semiconductor at all levels. Hence, aside from sudden increase of Covid-led demand that caught the industry off guard, we are also witnessing accelerating demand driven by innovations in 5G, Artificial Intelligence, Internet of Things, Electric Vehicles and many more. While the semiconductor industry has the incentive to build additional capacity to accommodate for short term demand, they are also preparing themselves for the future increase in demand driven by the new paradigm shift.



*Source: From various compilations. Global index as represented by the MSCI AC World; Asian index as represented by the MSCI AC Asia ex Japan. Returns are recorded US Dollars, as of 31st July 2021. Article written on 8th August 2021.*

In China and more specifically the Chinese Big Tech stocks, near term outlook remains cloudy with the country's regulatory campaign on Big Tech. Companies like Alibaba, Tencent, JD.com and Meituan have lost close to half their value. However, let us quickly add that regulatory interventions are not uncommon for the country and the industry players. In 2018, new gaming regulations designed to prevent addiction among China's youth led to Tencent losing almost half of its value. Looking back, long-term investors with the stock would have been substantially well rewarded – Tencent rebounded from its low of HKD260 to several times its current value now.

No doubt, the industry will be impacted in the short term as the government looks to bring disorderly expansion under control, implement anti-monopolistic practices and stay true to its socialistic form – including driving down skyrocketing tutoring costs for children and introducing gaming restrictions for minors. In what are deemed as harsh measures, in the long run, the market will develop in a healthier and more inclusive direction.

We remain positive on the world's 2nd largest economy and one of the ways to take advantage of China's growth was to participate on the consumption and technology theme. These are still valid now. Growing disposable income, personal savings and consumption expenditure from a 1.4bil population and the global mega technology trend and development e.g., 5G, Internet of Things (IoT) and Electric Vehicle (EV), will allow the right companies to deliver revenue and earnings growth which drives room for re-rating in the future. We strongly believe that despite the current uncertainties, the major trends, proven business models and winners do not go away overnight. We will patiently monitor and may average further on weakness for mid-term (2-3 years) prospects.

# FIXED INCOME MARKET REVIEW & OUTLOOK

BY EDWARD ISKANDAR TOH



The year began euphorically as vaccines were administered at a ramped-up pace. The scale and breadth of inoculation gained momentum in the United Kingdom and United States with large venues utilized to accommodate the race to herd immunity. It was easy to get carried away after almost a year being held hostage at home by an unseen enemy. We latched onto any glimmer of hint of a return to what life used to be.

Economic data even began to show support to the notion of a quick return to growth. Q1 and Q2 GDP grew at 6.3% and 6.5% in the US. Signs of tight labour began to emerge with US unemployment touching a 14-month low of 5.8% in May this year. Some may label this as structural unemployment due to human relocation resulting from the pandemic. Many were forced to leave cities to return to hometowns as part of adjusting to loss of jobs and income. As lockdowns were eased, retail outlets began to reopen and the rush to fill jobs contributed to double digit wage rises throughout the months in the second quarter. Broad based inflation accelerated to 4.2%, 5% and 5.4% for April through June months; highest since August 2008. Key indicator to the Federal Reserve is Personal Consumption Expenditure (PCE) inflation which also recorded higher levels of 0.5% month-on-month in June and 4.0% against the same month last year. Of course, low base effects are largely to blame for all annual data; it is thus essential to monitor the Federal Reserves' consideration of how much of these rises have long-term effects on inflationary data.

In the second quarter, the world was jolted back to reality with the humbling emergence of a mutated strain of the virus identified as the delta variant. The war against Covid-19 was far from over. First discovered in India in April, this version is more transmissible and deadlier. Daily cases hit 100,000 and quickly surged to over 400,000 by the end of the same month before tapering off mid-May in this second most populous country. Thankfully, data showed later that most vaccines administered globally are effective against this latest variant.

Currently, Malaysia appears to be in the midst of a fourth wave with the highest recorded number of infected (up till mid-year) at the end of May at 2021. Authorities are hemmed in needing to balance between health and wealth. Having to re-impose a nationwide full lockdown from early June, it is estimated that the nation loses up to RM1 billion a day or a reduction of 1% to 1.5% in GDP growth for the year. The compromise in allowing some industries to open reduces this daily loss to half but it is adversely reflected in the steep rise in covid cases.

Pushing for 'herd immunity' is the only way to bring us back to how we lived. The US and UK (apart from Israel) led the way with full vaccination for 46% and 49% (as at end June) of their respective population before gradually reopening their economies. The world was more than excited to witness sporting events like the deferred football championship; Euros 2020 and Wimbledon with large crowds indicating that we are close to returning to normalcy. The timely significant rise in the rate of vaccination in Malaysia in recent weeks gives hope that we can 'flatten the curve' soon.

The question now is will herd immunity contain this latest threat in the delta variant? If it does, our road to recovery and a semblance of normalcy will seem clearer again. Inflation will likely gather pace and if unthreatening as the Federal Reserve reminds that they will remain patient to accepting that much of the initial inflation surge is due to low base effects, they will leave rates unchanged till next year. However, it is a matter of time before talk of scaling back the bond purchase program that was introduced to support the extremely and unusually but necessarily low interest rates environment reignites chatter. Taper tantrums will resurface.

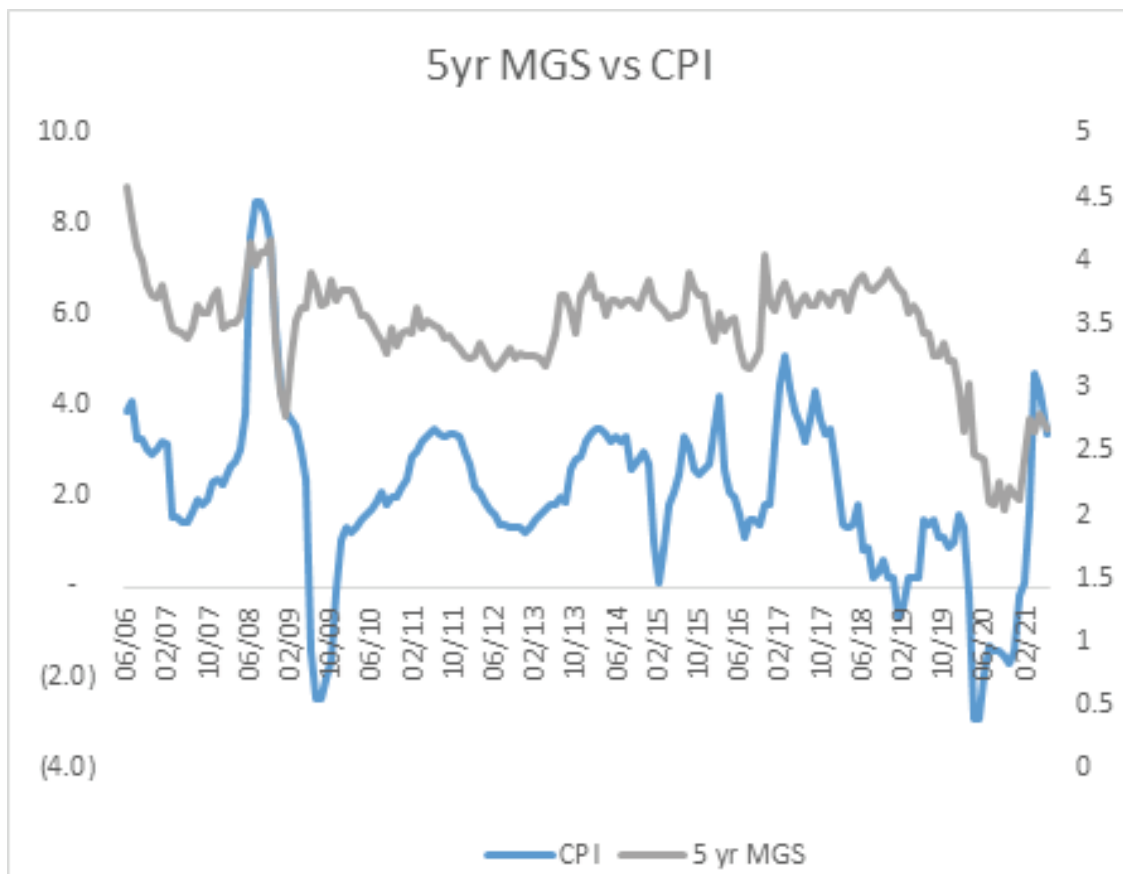
The performance of bonds globally is tied closely to the expectation of interest rates directions, which are inversely correlated to the economic pace of a country which is now dependent on how well the virus is contained.

So, the rise in yields to almost pre-pandemic levels in benchmark US Treasuries earlier in the year mirrored the exuberance towards lifting of restrictions and the expected economic recovery. This rise was checked in the second quarter when the delta variant began to impose and cause doubt to this recovery when the number of infected began to rise again.

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# FIXED INCOME MARKET REVIEW & OUTLOOK (CONT'D)

How do we deal with rising rates then? While we celebrate the return of the growth cycle, bond investors have a few options to mitigate and benefit from this.



The updated chart above plots Malaysian inflation (measured by Consumer Price Index) against 5 years Malaysian Government Securities (MGS) (benchmark with the deepest liquidity) for the last 15 years. It is visibly in sync while its correlation measure is a credible 0.44. As noted before, a declining inflation may encourage lower Government bond yields and likewise; a rising inflation may instigate yields to rise regardless of whether policy rates change.

It is natural to instinctively shorten or reduce portfolio durations to shelter against sensitivity to volatility of bond prices affected by rising yields as one of the first steps many bond fund managers would do, as we have. A return to growth also means that credit standing of some companies will also improve with a better economic atmosphere. Picking the right issuers while balancing against duration is another strategy we will apply going forward.

At Areca, we also work with issuers to invest in where we have enhanced security and other features for the benefit of our investors. In addition, our team continues to initiate solutions that appeal to various needs. An example is one of our latest funds which we are hoping to introduce soon where we offer a stable acceptable level of return to suit investors that seek fixed income returns over a 3 to 5 year period without being subject to the volatility of bond valuation resulting from interest rates movement.

We believe that economic activity will pick up in the second half of 2021 as the rate of vaccinations gain momentum. We believe Bank Negara Malaysia will likely hold back raising rates for as long as possible so that growth can be entrenched and sustainable. Our path to recovery is indeed in our hands; provided we can retain political stability, a much sought-after virtue by foreign investors.

Meantime, we will maintain a short duration strategy to ride through the next phase in the interest rates cycle.

# FUND SIZE – IS BIGGER NECESSARILY BETTER?



WRITTEN BY:

WONG CHAW CHERN SENIOR MANAGER, PRIVATE INVESTMENT

It's the time of the year again and Sam plans to invest his bonus. Finding 2 funds that have passed his checklist of good consistent track record, credible fund management company, low expenses, he moves on to the next criteria – fund size. This is where the similarities end; one has a much bigger fund size than the other.

Sam is at a loss. Would bigger funds project a more reliable image? Putting yourself in Sam's shoes, what would you have done? Here are a few considerations that we suggest you to look out for when scrutinizing fund sizes:

## Fund Strategy

First, consider the size of the fund relative to its mandate or strategy. A fund specializing in small cap stocks should be correspondingly small but enough to achieve adequate diversification across at least 20 – 25 stocks. Preferably, the fund size should not get too large. Imagine a RM1bil fund trying to establish a 5% weight into a small cap stock. Although it only means a RM50mil position from the fund's perspective, consider the amount relative to the market capitalization of the stock itself. The RM50mil will be equivalent to a substantial 25% stake in a small cap stock with market capitalization of RM200mil. Not only would the fund manager have problems buying that much into the stock, eventually he would have problems getting out of it as well.

That being said, would a larger fund size be more fitting for a fund that buys into large caps? It could be due to a specialist mandate or the fund could be restricted in doing that because of its burgeoning size, but here's some food for thought. There is a likelihood that the fund's return could resemble the returns of the index. After all, it will not be easy for a large cap stock to achieve double digit returns. So, in other words, you could potentially be paying an alpha price for a beta performance.

## Operating Costs

At the same time, a fund that has too little in terms of fund size may potentially face higher Management Expense Ratio or MER. These consist of the costs stemming from the various fees charged: brokerage, audit, trustees, research etc. A larger fund would be able to achieve better economies of scale and spread out the costs. That is why funds which are persistently too small to be viable are more likely to be eventually liquidated or shut down.

## Sudden Increase/Decrease in Size

If possible, check out the size of the particular fund several months or even a year before. If there are any big increases or decreases in size, that should pop up as a warning sign. Contrary to the belief that more money is better, a sudden or rapid inflow of money can cause a few problems.

Here's a scenario of what could possibly happen. A fund is awarded for a series of good performance and the next thing you know; everybody starts pouring money into that fund. Behind the scenes, the fund manager may not be able to invest the fresh funds straight away hence most of it will be sitting in cash. On the other hand, if the fund made its name specializing in quick and agile decisions in small or mid cap stocks, the massive inflow of funds could neutralize its advantage. Performance may eventually suffer.

Sudden decreases in fund size should also be a red flag. There could be reasons happening behind the scenes that you are not aware of; such as a departure of the fund manager or other uncertainties that are causing investors to yank money away from the fund.

## Conclusions

In our opinion, a fund size of between RM20million to RM30million for a local equity fund would be considered small. An ideal size for a local equity fund to have adequate diversification, liquidity and cost efficiency could be anywhere between RM20million to RM300million. Smaller sized funds are generally thought to be nimbler and more agile than their larger peers.

Before you invest, always conduct your homework. There can be more ways to judge a fund other than its performance chart or table. Fund sizes are one of the areas that you should keep an eye out for, as we have shown above.

However, let us highlight that there will be exceptions to the rule. A smaller fund may be able to justify a higher MER by producing higher than average returns, or a fund manager could be adept at managing significantly more money than the investing style would suggest.

# STAY THE COURSE

A key ingredient to ride through the wave of volatility is concentrating on the long-term results rather than the bumps along the way. Persevering can be tough, but it can also create opportunities.



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