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Is this the year when investors consign home bias to history?

By the Nikko AM Asian Equity Team
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Home bias might be an understandable trait for investors, but in the current environment a lack of meaningful international diversification—particularly towards the Asia-Pacific region—risks leaving substantial amounts of investment returns on the table.

The home bias phenomenon represents something of a paradox

Although the benefits of international diversification of an equity portfolio are well-known, in historical terms, investors have not yet fully exploited the diversification opportunities that a global investment landscape presents. Instead, most tend to invest disproportionately more in domestic stocks than standard portfolio theory suggests would be optimal.

This home bias phenomenon represents something of a paradox in portfolio construction terms. According to the International Monetary Fund, on average, investors tend to overweight domestic stocks by nearly 40% when compared to their optimal share in the world market portfolio. This overweight in domestic stocks creates a portfolio that is less than optimally diversified, and the associated costs of home bias, both direct and indirect, are substantial. For example, European investors forgo average risk - adjusted returns of more than 1.3% per annum, which translates to annual losses of about EUR 200 billion for European investors. [1] These costs are likely to be even higher during periods of high uncertainty.

In 2023, Nikko AM published a research paper highlighting both the dangers of home bias for investors as well as setting out the benefits of international diversification. The findings suggested that by failing to explore investments further afield, by investing in emerging markets and more specifically in the Asia-Pacific region, global investors are missing out on significant potential returns.

Why Asia-Pacific?

The Asia-Pacific region is the main source of future economic growth globally. That, together with depressed stock market valuations and the potential peaking of US rate policy are some strong reasons to re-look at the region for investment. In addition, Asia Pacific is set to benefit from three investment megatrends that look likely to dominate the global economic landscape for decades to come. These megatrends are: the net

[1] Frankfurt School of Finance & Management research on behalf of Nikko AM.

zero transition, the strength of the Asia-Pacific consumer and game-changing innovations taking place in healthcare.

The net zero transition

While Asia is one of the regions facing the loudest calls to "clean up" carbon emissions, but any discussion of net zero has to consider the role played by Asia, not as part of the problem, but in driving the solution. Those vital components that will help the whole world to achieve net zero targets are being produced, utilised and exported by Asia.

For example, electric vehicle sales have caused demand to grow exponentially and Asia leads globally in battery cell and related component manufacturing. Battery storage and grid-level electricity storage relies on metals such as lithium, cobalt or nickel, and the lithium-ion battery market is expected to grow from USD 57 billion in 2020 to USD 200 billion by 2027. [2] The supply chain for all of these industries is heavily dependent on Asia, with key components currently supplied by China, South Korea and Japan. It's therefore increasingly unlikely Asia's leading manufacturers will be dislodged as economies of scale become more entrenched.

The strength of the Asia-Pacific consumer

Asia's population makes it the most significant consumer market in the world. Moreover, the healthy economic growth of many Asia-Pacific countries has increased disposable incomes. According to Euromonitor's Income and Expenditure in Asia Pacific report, total disposable income in Asia-Pacific is set to more than double in real terms over 2021-2040, faster than in any other region, but still among the lowest globally on a per capita basis. Consumers in Asia are expected to account for half of global consumption growth within the next decade.

Moreover, many Asia-Pacific countries are benefitting from the "demographic dividend" – the boost to consumption and economic productivity driven by its young and growing population. With increasing numbers of young people joining the workforce, Asia has a rich source of workers and customers. No wonder then, that McKinsey calls Asia "a USD 10 trillion consumption growth opportunity". [3]

Healthcare innovation

As the home to more than 4.5 billion people, Asia's growing and ageing population demands access to better healthcare services, as well as innovative, affordable and accessible medicines. The imperative for healthcare investment in Asia has only accelerated post-pandemic. In fact, Asia's collective response to the healthcare challenge bears strong similarities with its investment into technology dominance some 30 years ago. And while government investment and policy have played a decisive role in jumpstarting Asia's healthcare advances, Asia's private companies are dominating the healthcare landscape and taking innovation to the next level.

Extensive and relentless research and development efforts—coupled with major advances in medical technology—have resulted in new treatments and greatly improved clinical outcomes. In addition, Asia's key role in the global manufacturing supply chain of medicines, as well as the rise in demand for outsourced research, development and manufacturing services, uniquely positions the region to capitalise on global healthcare growth opportunities.

Gaining access to Asia-Pacific companies

As the Asia-Pacific region continues to grow in importance, it appears that home bias will soon prove increasingly difficult for investors in the west to justify. But gaining indirect exposure to Asia solely through either an Emerging Market or Global Equity strategy may not be the answer. Not only does it underplay the

[2] https://www. researchandmarkets.com/reports/4542929/lithium-ion-battery-market-growth-trends#:~:text=The%20market%20for%20lithium%2Dion,USD%2057%20billion%20in%202020

[3] https://www.mckinsey.com/featured-insights/future-of-asia/videos/driving-asias-10-trillion-consumption-growth-opportunity

uniquely Asian investment megatrends we've outlined, but it also risks diluting exposure to the sustainable returns on offer. Asia merits a dedicated, on-the-ground team and tailored investment approach all of its own.

From an investment standpoint, there's no good reason for investors to cut themselves off from the growth opportunity—indeed as the growth engine of the world—that Asia now represents. On current trends, by 2050, the five biggest economies in the world will be China, the US, India, Indonesia and Germany. It therefore makes sense to consider rebalancing investment portfolios to adapt accordingly and embrace the future direction of travel.

Certainly, there are risks within the Asia-Pacific region to consider, but the dangers of staying with existing home biases are likely to prove far more damaging to investor returns in the long run.

If you have any questions on this report, please contact:

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