A shift in momentum?

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Asia ex-Japan Equity
February 2025

Federated Hermes Limited

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The apparently unstoppable growth of passive assets – via exchange traded funds (ETFs) – presents a considerable challenge to active contrarian fund managers (like us). In this letter, we discuss how this powerful dynamic favours momentum stocks and how the outperformance of such stocks might run out of road.

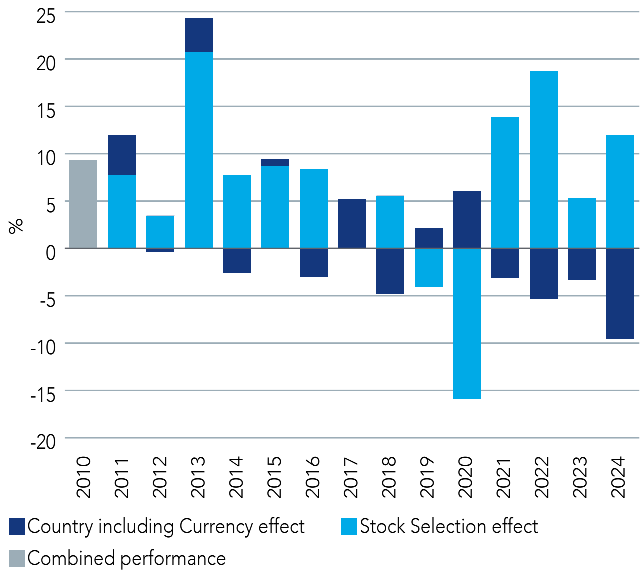
- In both developed and emerging markets, passive inflows have been consistently positive, and the trend appears to be accelerating. By design, stocks selected by active managers are 'pounced upon' by cash-flush passive investors driving the price of these popular stocks up further.
- However, we believe that the market's heavy tilt towards momentum investing – led by ETFs – is leading to divergences between price and value that, for many stocks, has become untenable.
- At some point, the valuations of most overstretched momentum stocks will fall – as they are aggressively sold by active investors at a faster rate than they are being bought by the follow-on passive investor base. In this letter, we consider how the momentum trade might unravel.

Since inception on 1 January 2010, the Strategy has returned a cumulative 291% versus its passive benchmark[1] index return of 101%[2].

Nonetheless, 2024 was somewhat frustrating. Our strong stock selection in many countries (adding 12% of relative performance) was mostly undone by being overweight underperforming countries and underweight outperforming countries (detracting 10%). As a result, our performance over the year was only slightly ahead of our benchmark's 11% return[3].

Indeed, being wrongly positioned in various countries has been a feature of our Strategy in each of the last four years.

Figure 1: Asia ex-Japan Equity Strategy (stock selection within countries vs. country allocation)
Annual performance relative to benchmark (%)



Source. Federated Hermes as at 31 December 2024. Inception date 1 January 2010. Benchmark is the MSCI Asia ex Japan All Country IMI Net Return Index (Bloomberg ticker MIMUAAJN). Returns calculated geometrically, gross of fees, in US dollars. Adding currency allocation, country allocation and stock selection will not exactly equal total relative performance in any year due to the geometric calculation methodology. Note 1 and 2: Attribution breakdown not available for the full 2010 calendar year. Note 3: This shows the total geometric relative return for the Strategy since inception.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Past performance is not a reliable indicator of future results.

[1] The benchmark is the MSCI AC Asia ex-Japan IMI Net.
[2] Source: Federated Hermes, Northern Trust as at 31 December 2024. Returns are net of fees of 0.75% per annum and in US dollars.
[3] Returns calculated geometrically in US dollars. Adding currency allocation, country allocation and stock selection will not exactly equal total relative performance due to the geometric calculation methodology.

In 2024, it was the turn of our biggest overweight, South Korea – which disappointingly fell 19%, lagging all other Asian markets – to take the shine off our fortunes.

There is an irony here because South Korea – with exceptionally cheap stocks and viable changes to shareholder rights on the horizon – was the market we held up most hope for. We still do.

During the year we pushed hard for reforms to South Korea's corporate governance laws, and we remain optimistic these reforms will happen.

We are hopeful that 2025 will be the year where South Korea's capital market stars align – when it's extremely cheap valuations meet positive governance reform.

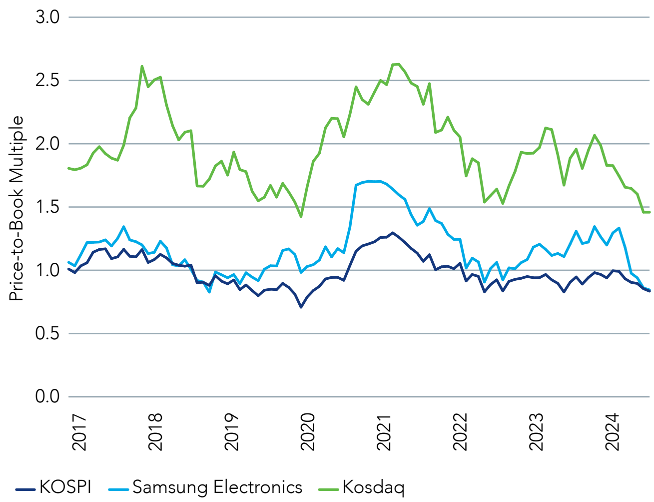
It's likely that President Yoon Suk Yeol – who was elected in 2022 on a five-year term – will be impeached and forced to stand down following his spectacularly ill-judged declaration of martial law in December. As a result, an early presidential election will need to take place.

In our opinion, the opposition Democratic Party of Korea – led by Lee Jae-myung – has a high chance of winning the presidency. It already holds a majority in the National Assembly. This outcome hastens the likelihood that viable corporate governance reforms will be implemented.

The party has promised to introduce various laws that establish a company's fiduciary duty to its shareholders and mandate the equal treatment of minority and majority investors alike.

We have covered the thorny issue of the 'Korea discount' – and the endemic mistreatment of minority shareholders in the country – in our previous report (Asia ex-Japan Equity: Letter to Investors | Federated Hermes Limited). The paper was widely circulated in South Korea and has been cited as helping to advance the conversation among regulators and lawmakers about how to tackle the problem.

Figure 2: Low valuations remain on offer in South Korea – despite the positive changes that may be on the horizon



Source. Bloomberg as at 31 December 2024. **Past performance is not a reliable indicator of future results.**

The challenge facing active

All in all, the Strategy's performance in 2024 was ok. But it's safe to say we did not end the year in fits of ecstasy. Of course, *many* active fund managers were unhappy in 2024. Indeed, many active fund managers are *generally* unhappy.

The market backdrop over the last few years has seen many leading active funds fall into a period of underperformance. It's not fun to those it happens to.

One might imagine older active fund managers, as they approach retirement, looking back on their life's work wistfully, as they realise a passive fund tracking a benchmark has handily outperformed them. 'What was the point of all that?', they might ask themselves.

Even those few active fund managers who do manage to beat their benchmark over the long term – as we have – and can look back at their careers with some satisfaction might not have enjoyed the journey.

Psychologists wax lyrical about how humans experience negative emotions associated with losses more acutely than positive feelings associated with gains.

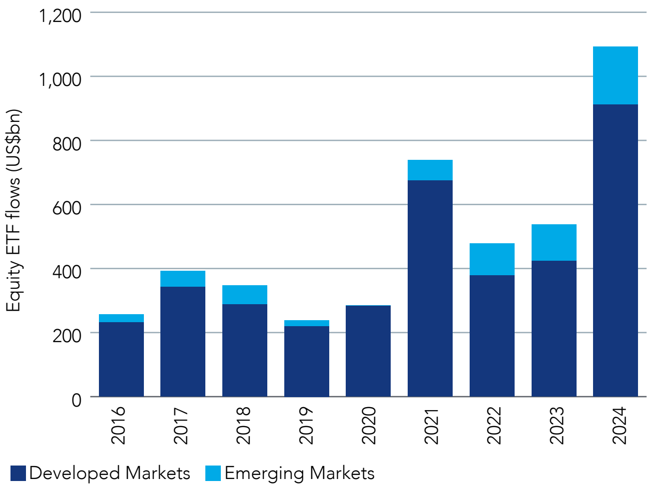
And even the best active managers will have experienced almost as many bad stretches as good ones. The few managers that do experience positive long-term relative performance, understand it does not run in a straight line. Even the legendary Warren Buffett had negative relative returns in: 1967, 1970, 1972, 1974, 1975, 1984, 1986, 1987, 1990, 1996, 1999, 2001, 2003, 2004, 2005, 2009, 2011, 2015, 2019, 2020 and 2023[4].

For fund managers who choose to adopt a contrarian or value-based approach to investing, the journey is inevitably harder still. They are routinely forced to watch as 'investor darling' stocks that they don't own rise, while the out-of-favour stocks that they do own fall.

They are destined to endure long periods where their local barber's stock picks sharply outperform their own. And when the market has a blowout day, rising (say) 4%, their stocks will often rise 3% or less, blunting their own happiness as others pop champagne corks. While their picks might only fall 7% when the market slumps 9%, no one is in the mood to celebrate a significant capital loss. There are not many songs of joy that include the phrase 'it could have been worse…'.

At the present time, the apparently unstoppable growth of passive assets – via exchange traded funds (ETFs) – can cause a contrarian manager to experience brutally long and sharp periods of underperformance because passives' outperformance has been driven by the herdlike market momentum trade; the very opposite of contrarianism.

Figure 3: Passive inflows – positive with accelerating momentum?



Source: Bloomberg as at 31 December 2024. ETF flows may include some actively-managed ETFs. **Past performance is not a reliable indicator of future results.**

In both developed and emerging markets – and in sharp contrast to the experience of active managers – passive inflows have been consistently positive, and the trend appears to be accelerating.

The impact of the growth of passive investing on stock prices is not straightforward. After all, the largest ETFs simply buy broad indices. They are – by design – buying stocks at their existing or 'natural' weightings.

Such strategies, surely, do not inherently favour one stock over another? However, consider the following illustration:

Imagine that a benchmark existed comprised of only two stocks – 'Boring' and 'Winner' – and on day one, each was trading at US$50 per share.

A passive index fund investing US$100 at the end of day one would buy one share of each. Now assume that active investors on day two decide that Winner is actually worth US$100 a share and bid it up to double its day one price.
At the end of day two, a passive investor would place an order seeking to invest two thirds of day two's US$100 in Winner (US$67) and one third in Boring (US$33).

[4] Source: Berkshire Hathaway Annual Report 2023, pp 17.

So the stocks that do well (because active managers bid them up) benefit from an *additional* relative inflow from passive investors. The active manager might do the work of identifying 'Winner' and initially buying the stock, but the follow-up investment is provided by a throng of well-capitalised passive managers.

It is of course possible that the passive flows will push the price of Winner up to US$115 and active managers, assessing the stock has run too far, will sell it back down a little (say to US$110). But, even so, at the end of day three, the passive investors will again be allocating more than two thirds of that day's capital to 'Winner' providing an additional boost to its relative stock price. And the higher the proportion of new flows that are passive, the greater the impact of such flows on popular stocks will be.

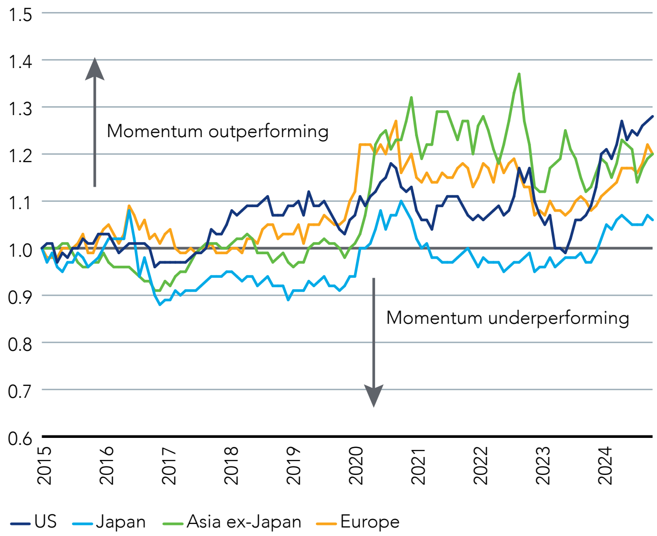
This is momentum. Winning stocks deservedly benefit from an active managers' initial assessment – and then then again from passive inflows because of the relatively high dollar allocation to the winners. As a result, stocks enjoying a run, enjoy a steeper, longer run. And even if they fall back, the higher incremental flows still benefit these stocks relative to the proportion invested by the earlier passive flows (even on day two).

As active managers take an interest in a stock; these stocks are 'pounced upon' by cash-flush passive investors.

And while investors who chose passive over active might be in a self-congratulatory mood, as their 'fund picks' benefit from this dynamic, the more thoughtful investors might lament the fact that they may have missed a trick (aside from investing in our Strategy, or course). As opposed to investing in a 'vanilla' benchmark-following ETF… they should have been in a *momentum*[5] product.

In every major region, passive momentum indices have beaten their vanilla[6] counterparts over the last decade. This margin has been particularly pronounced in the United States (28%).

Figure 4: Momentum/vanilla benchmark performance in all regions over the last decade



Interpretation of chart: The chart divides the performance of each region's momentum benchmark over the performance of the equivalent vanilla benchmark. If the value of the time series exceeds one it means that momentum is outperforming vanilla.

Source. Bloomberg, MSCI. Standard benchmarks tickers were the net US dollar benchmarks, MIMUAAJN for Asia ex-Japan, NDDUJN for Japan, SPTR500N for the US and SXXT for Europe. Momentum tickers were the net USD Momentum benchmarks M1ASJMOM for Asia ex-Japan, M4JPMMT for Japan, SP500MUN for the US and MAEUMMT for Europe. **Past performance does not guarantee future performance.**

A 2021 paper, by academics Xavier Gabaix and Ralph Koijen, outlines the 'inelastic markets' hypothesis. They argue that – contrary to the efficient market hypothesis[7] – every US$1 flowing into the market pushes up aggregate prices by US$5. Moreover, (and surprisingly to me) the effect on prices is more pronounced the larger the stock – because the greater the market capitalisation of a stock is – the higher the daily value traded *when expressed as a percentage of that market cap*[8].

[5] Momentum is a style factor which seeks increased exposure to companies that are outperforming and decreased exposure to companies that are underperforming.

[6] A vanilla ETF is an exchange-traded fund that tracks a specific index (such as the S&P 500, the Hang Seng Index or the Nikkei 225).

[7] The efficient market hypothesis holds that stock prices at all times reflect the best estimate of the present value of future cash flows. It implies that temporary fluctuations in prices caused by large flows quickly self-correct so that the price again reflects such present value.

[8] Reference: Gabaix X, Koijen RSJ, *In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis, June 2021.* Available at https://www.nber.org/system/files/working_papers/w28967/w28967.pdf.

Unstoppable momentum?

What could change this powerful – apparently self-reinforcing – dynamic that drives the outperformance of momentum stocks?

On the face of it, it would seem to require passive flows to turn negative, or for active (contrarian) inflows to exceed passive inflows.

But this seems unlikely. Firstly, passive equity inflows have been positive for almost every month over the last decade; while active funds have generally experienced net outflows. Secondly, there are few remaining contrarian active fund managers.

Does this analysis mean that the market backdrop will remain supportive of passive investing (and the momentum trade in general)?

Yes. Until, of course, it isn't.

A singular focus on inflows and outflows fails to take into account that the market's heavy tilt towards momentum investing will eventually lead to divergences between price and value that become untenable.

This price-value gulf will be particularly apparent if momentum stocks are also growth stocks – which often already have optimistic expectations baked into stock prices.

At some point, the valuations of the most overstretched momentum stocks will fall – as they are aggressively sold by active investors at a faster rate than they are being bought by the passive investor base.

> **At some point, the valuations of the most overstretched momentum stocks will fall – as they are aggressively sold by active investors at a faster rate than they are being bought by the passive investor base.**

It is, of course, hard to tell when that point will be. Not all valuations of the largest benchmark names are stretched (We own sizable positions in Asian giants Taiwan Semiconductor Manufacturing Company [TSMC] and Tencent, for example).

However, to cite other examples around the world: iPhone maker, Apple, trades at 36 times forward earnings with expected revenue growth of 5%; German software behemoth, SAP, trades at 50 times forward earnings with expected revenue growth of 10%; and Japanese apparel giant, Fast Retailing, trades at 42 times forward earnings with expected revenue growth of 9%[9].

Momentum has, in our view, already led to some stocks becoming far too pricy.

Other anecdotal evidence abounds: TSMC, which we own, has a US-listed American depositary receipt (ADR) which trades at a premium of some 25% to the local line[10] (versus pre-2024 levels of well below 10%).

> **Momentum has, in our view, already led to some stocks becoming far too pricy.**

The sheer magnitude of this premium points to a market distortion that could be a result of passive inflows into the US line, which are unmindful of, unperturbed by or uninterested in the fact that an identical security is available in the local Taiwanese market at such a significant discount.

A guide to how the momentum trade might unravel can be seen in the performance of Danish multinational Novo Nordisk – maker of Wegovy weight loss drug – at the end of last year.

On 20 December, Novo Nordisk announced the Phase III results of the clinical trial of experimental obesity drug CagriSema. The results were successful with patients experiencing 22.7% weight loss (vs. 2.7% weight loss by the placebo group).

However, the market was expecting the results to show a weight loss ratio of greater than 25%. And the stock plunged over that day by as much as 27%[11]. It now trades on a less exuberant price-to-earnings multiple of 28 times, even as the stock continues to benefit from daily passive inflows into this large benchmark name.

As the father of value investing, Benjamin Graham, memorably put it: over the long term, the market is a finely-calibrated weighing machine. We believe it remains so. And while the rules that govern the market's voting machine – the short- and medium-term drivers – have been distorted by the rise of passives, eventually every stock will need to cast a lonely figure on the scale – with no thumbs around.

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The opinions expressed in this report represent the views of Jonathan Pines, Lead Portfolio Manager, Asia ex-Japan Equity and the Federated Hermes Asia-ex Japan Equity team.

[9] Source: Bloomberg for valuation data and consensus estimates for revenue growth. As at 31 December 2024.
[10] As at 2 January 2025.
[11] Source: Bloomberg.

Rolling year performance (%)

	31/12/23 to 31/12/24	31/12/22 to 31/12/23	31/12/21 to 31/12/22	31/12/20 to 31/12/21	31/12/19 to 31/12/20
Strategy	12.11	10.01	-10.05	7.85	11.91

Source: Federated Hermes as at 31 December 2024. Composite inception date: 1 January 2010. Returns are in USD gross of fees. The information shown is supplemental to the GIPS® compliant composite report provided in the Appendix. **Past performance is not a reliable indicator of future results.**

Schedule of Rates of Return and Statistics

Composite: **Federated Hermes Emerging Markets Asia IMI Equity**
Index: **MSCI AC Asia ex Japan IMI (net)**
Periods Ending: **31 Dec 24**

	Returns (%)		
	Composite Gross Return	Benchmark	Composite Net Return
Q4 24	-7.86	-7.56	-8.04
1 Year	12.11	11.16	11.07
3 Years (Annlzd)	3.52	-1.24	2.44
5 Years (Annlzd)	6.01	3.38	4.88
10 Years (Annlzd)	7.63	4.66	6.47
15 Years (Annlzd)	10.54	4.76	9.51
Jan-10 – Dec-24 (Annlzd)^^	10.54	4.76	9.51

	Annualised Returns (%)								
	Composite Gross Return	Composite Net Return	Benchmark Return	*Composite 3-Yr Std Dev	*Benchmark 3-Yr Std Dev	Number of Portfolios	**Dispersion	Composite Assets (mil)	Firm Assets (bil)
2015	1.41	0.29	-8.35	14.14	13.00	5	N/A	2,066.3	28.0
2016	8.25	7.06	4.21	14.91	14.62	5	N/A	2,944.3	28.9
2017	45.74	44.13	40.54	15.23	14.66	5	4.52	4,807.8	34.5
2018	-14.45	-15.39	-14.93	15.02	14.43	7	0.34	4,391.7	32.0
2019	13.88	12.62	16.91	15.00	14.36	7	2.15	4,338.3	40.2
2020	11.91	10.68	25.13	19.52	18.81	6	0.98	3,220.7	585.7
2021	7.85	6.67	-2.05	17.86	17.16	7	0.45	3,713.0	634.2
2022	-10.05	-11.04	-19.76	20.94	20.52	7	0.54	3,738.5	627.4
2023	10.01	8.80	8.01	18.22	18.11	8	1.41	4,956.3	720.0
2024	12.11	11.07	11.16	19.38	18.68	6	0.87	3,797.1	792.2

^^ Represents composite inception period. See below for additional notes to the schedule of rates of return and statistics.
* Represents the 3-year annualized standard deviation for both the gross composite and the index returns. Statistic is used to measure the volatility of composite returns.
** Standard deviation is calculated using gross returns. Standard deviation is not applicable (N/A) for any period if fewer than five accounts are in the composite for that period. (See footnote 5)

The composite includes all discretionary portfolios following the Emerging Markets Asia Equity strategy run by the Federated Hermes Asia ex Japan Equity team (London Office) and has an inception date of 1 January 2010. The objective of the strategy is to achieve long-term capital appreciation. From February 2016, the investment process evolved to allow the use of partial hedging where allowed by the investment mandate. The benchmark is the MSCI AC Asia ex Japan IMI (net) Index, which is designed to measure the equity market performance of developing and emerging market countries in Asia excluding Japan and covers all investable market capitalization securities. Prior to December 2012 the benchmark was the MSCI Emerging Asia IMI Index. The benchmark is market-cap weighted and rebalanced on a quarterly basis. The return is calculated on a total return basis net of withholding tax. This composite was created in March 2010. Federated Hermes claims compliance with the Global Investment Performance Standards ("GIPS®") and has prepared and presented this report in compliance with the GIPS® standards. Federated Hermes has been independently verified for the period of January 1, 1992, through September 30, 2024. The verification report is available upon request. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. Since inception the management fee schedule for this strategy was 1% per annum for the first USD 25mln, 0.90% per annum for the next USD 50mln, 0.88% per annum for the next USD 25mln, 0.86% per annum for the next USD 50mln, 0.82% per annum for the next USD 50mln and 0.73% per annum thereafter. As of 1 January 2014, the management fee schedule for this strategy was 0.75% per annum. As of 1 November 2014, the management fee schedule for this strategy is 1.10% per annum. As of 1 July 2024, the management fee schedule for this strategy was 0.75% per annum. Gross of fees returns have been calculated gross of management/custodial fees and net of reclaimable withholding taxes, but after all trading commissions.

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