Crossbow Partners
Experience & Discipline

Honk Kong Trip Report

A Stock Picker's World Amid A Positive Economic Outlook

November 20 - 21, 2017

Executive Summary

Deregulation creates plenty of new opportunities in China, Hong Kong, India, and Japan (such as the Connect stock trades; the opening of the domestic bond market in China; the introduction of single stock futures in India; or the focus on shareholder value in Japan, etc.)

Dispersion in Asian stocks is on average about 1'000 bps higher than in developed markets and MiFID II will further reduce research coverage of small and mid caps, favouring active managers with stock picking skills

The current market environment in China is very conducive for stock pickers, as dispersion is high, industries are consolidating and the economy is reflating, while national champions are being created

Environmental protection is a top priority of the Chinese government and has shifted the focus from growth to environmental concerns and capacity rationalization, promising a better structural balance in various sectors and leading to a reflationary momentum in the economy

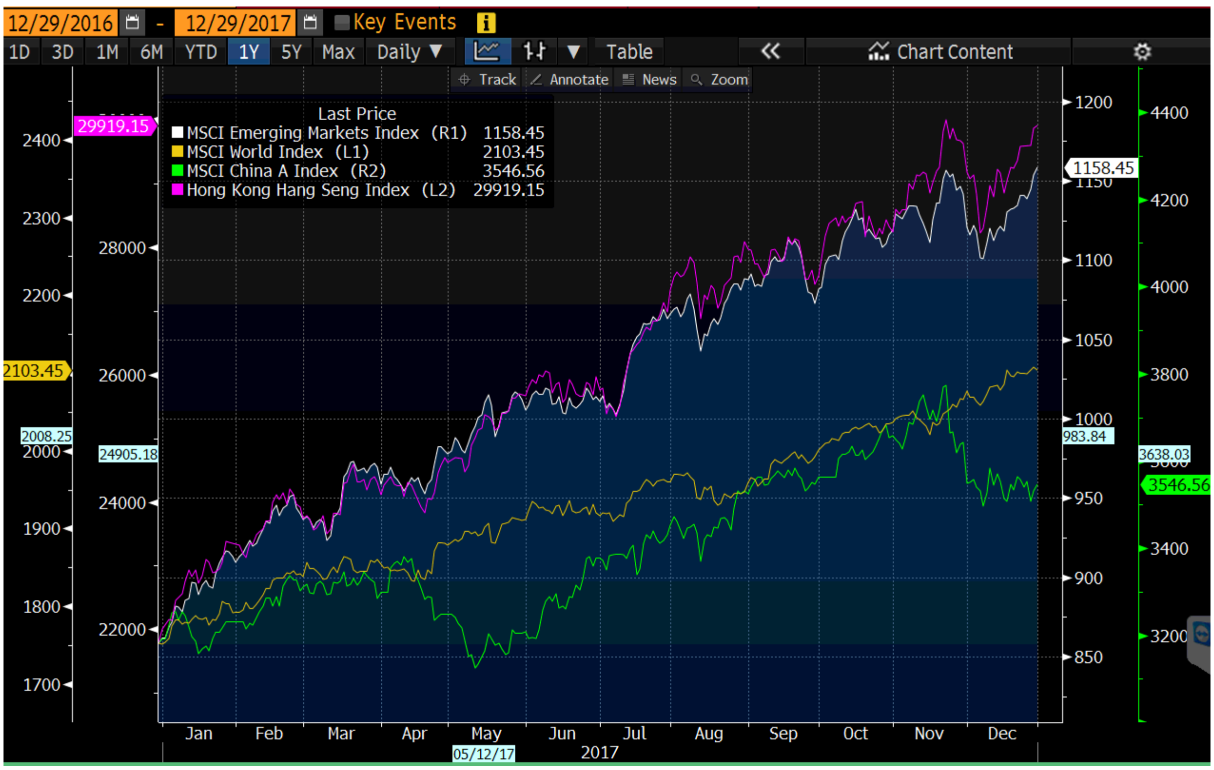
Despite the recent equity market rally Chinese stocks still offer decent upside return over the medium term, as market's equity premium continues to be high by historical standards and markets have not yet fully factored in the potential fruits from structural reforms and the trend to better capital discipline and usage

China is now opening up the domestic bond markets to foreign investors who will, initially, primarily target high quality bonds and, possibly, "fallen angels", but not yet high yield bonds as long as liquidity does not improve and regular defaults do not create forced sellers and dislocations

Investing in China

1. Emerging Markets Equity After the Rally

2017 turned out to be the best performing year for emerging markets equity since 2009. The MSCI Emerging Markets Index delivered an annual return of 37.5% and outperformed the MSCI World by 14.4%. The market rally was both remarkable and surprising because in 2016 most market pundits had predicted that emerging market equities were to suffer from substantial headwinds in 2017, such as a China slowdown and oil worries, a higher USD, rising interest rates in the US and potential trade frictions due to Donald Trump's protectionist promises. Yet the nature of the recent rally is just as noteworthy, as it was almost entirely driven by corporate earnings growth and very little by multiple expansion.



Source: Bloomberg, January 5, 2018

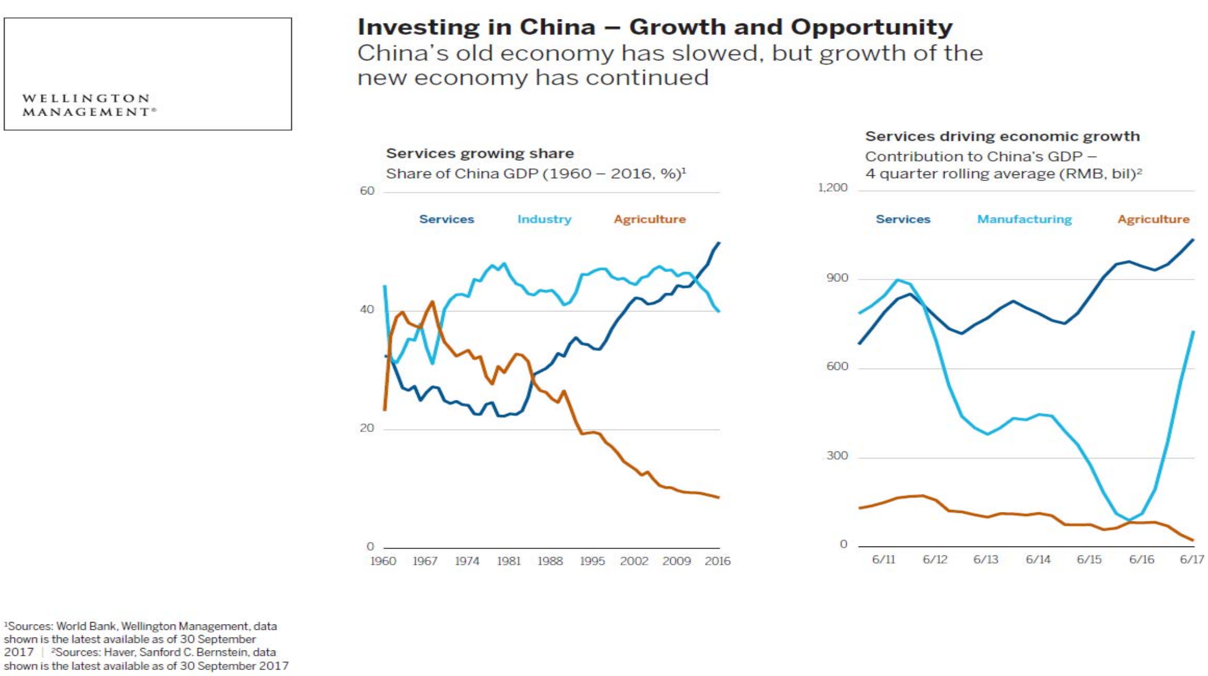
Basically, this bodes well for emerging markets equity in the current year, as valuations are still reasonable against the backdrop of synchronised global growth, still modestly accommodative central bank monetary policies and improving economic fundamentals. Earnings in emerging markets equity rebounded by about 30% in 2017, capping a multi-year long recession. Current earnings expectations for 2018 are around 14% and appear to be well supported by global growth, better capital discipline and earnings momentum, while the MSCI Emerging Markets Index was valued around 12x P/E at the end of 2017 – more or less in line with the long run valuation average. Thus, earnings growth seems to be well supported and could pave the way for another decent - albeit more modest - year of returns for emerging markets equity.

The main risk to this scenario originates from the action of the central banks in the developed world when they start the process of unwinding their quantitative easing programmes. Markets will depend on their skills that the process of deleveraging their balance sheets will not lead to unintended consequences and trigger a stock market dislocation. In the U.S. the impact of the tax reform and the U.S. mid-term elections could also lead to short-term market volatility. As the outcome of the U.S. tax reform on the economy supports both investor sentiment and corporate profitability, it is expected to have, on average, a positive impact on stock markets and should entail elevated corporate activity (M&A) and financial engineering, but it can also lead to sector rotation, heightened factor risk and repatriation of untaxed corporate profits of US firms.

In emerging markets, concerns over China's ability to achieve its growth targets while managing the complex transition of its economy and its potential "debt and real estate bubbles" will periodically resurface and hurt investor sentiment. But for now, investors appear to have come to the conclusion that China's fortunes have dramatically improved, as a "soft landing" has largely been achieved, the key problems have been addressed, and the market's long-term growth prospects look exciting. Even though reservations about the Middle Kingdom's economy still abound and international investors are underweight in China, a China "blow-up" is not considered imminent. And while the risk of geopolitical unrest in Asia (North Korea) and in the Middle East complement the increasingly long wall of worries that international investors now face, markets take these risks in their stride so far.

2. China

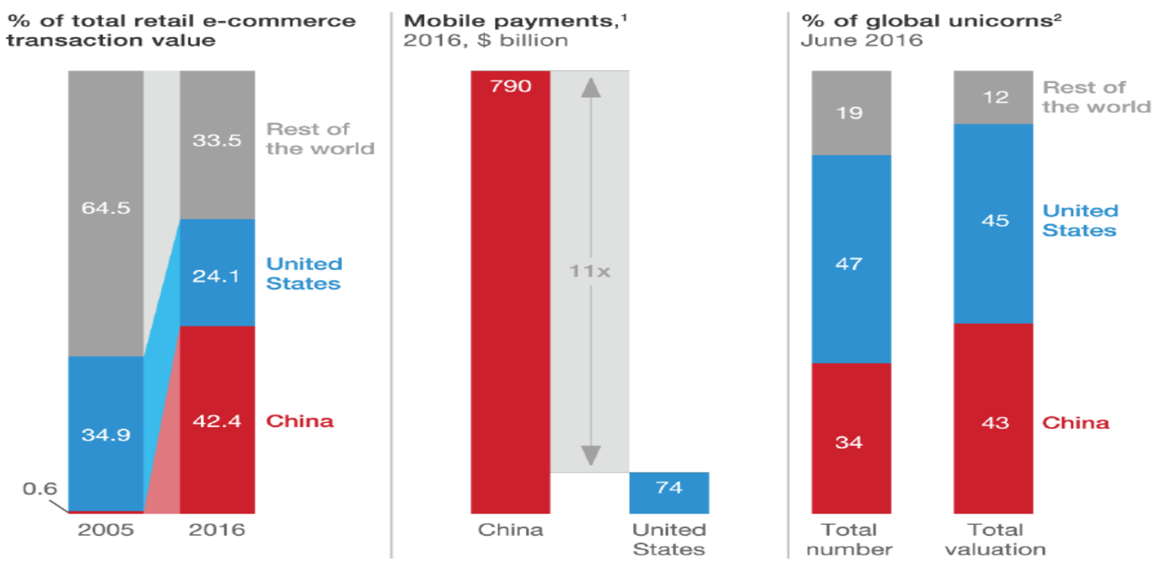
China enters 2018 with robust economic growth momentum, but most investors expect to see a controlled slowdown, as credit-financed investments in polluting industries are being curbed and the shift from manufacturing to services continues. Policy makers are aware of the acute stresses in the system, such as the regional disparities, demographics (an aging population; one child policy), declining heavy-industry sectors, property bubbles, growth in debt levels, and severe environmental pollution. The government has successfully initiated supply-side reforms in primary industries (such as steel, cement, chemicals, and coal) by curbing oversupply and creating national champions, and thereby also addressing capital allocation to heavy polluters. More effective regulation of output volumes, of days of production, of pollution output, and of capital investments will reduce output and spur further consolidation.



Source: Investing in China, Wellington Management, 2017

McKinsey predicted in a recent paper that China's overseas investments will resume its upward trajectory in 2018. In line with its "Made in China 2025" proposal, China seeks to foster innovation in manufacturing and to strategically invest in relevant sectors ranging from computers, aviation/tourism, and automotive to wealth management, education, and healthcare. The other focus is on internet-enabled businesses, such as artificial intelligence (AI) and the Internet of Things (IoT).
At home, the success of China's tech giants is increasingly used by the government to tighten control. All online payments will now have to pass through a central government-run clearing house. As a result, the government can now see who is transferring money to whom. These popular online payments prompt some forecasters to predict that cash will become obsolete in China by 2020, while financial flows are then even easier to monitor than today. Requiring real-name usage for any activity on the internet allows similar oversight of online behaviour. That some of these internet players have been allowed to become highly popular asset managers and key payment providers has only added to investor excitement, as growth opportunities remain attractive, even though regulators have recently moved to tighten regulation and to restrict opportunities for regulatory arbitrage.

China's digital economy is a story of commercial success and investor excitement.



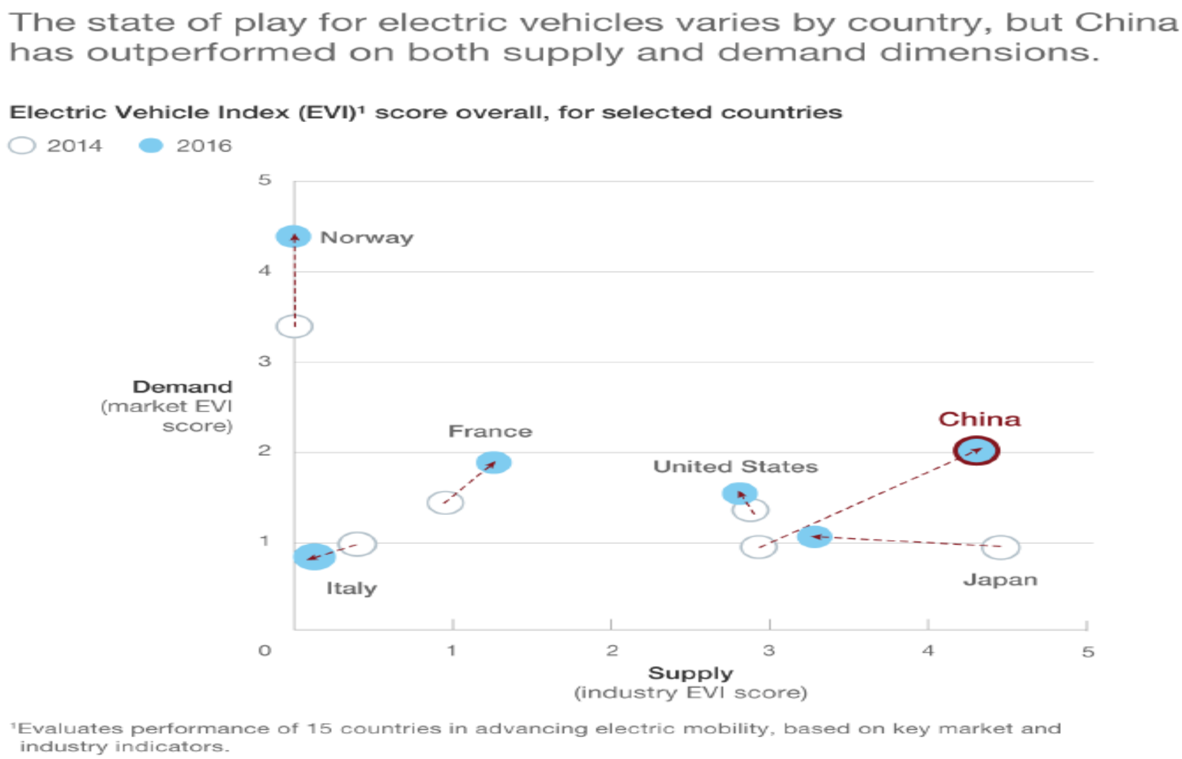
1Refers to third-party payments conducted through mobile transactions. For China, mobile payments exclude bank or UnionPay credit card transactions, digital wealth management, and digital finance. For the United States, payments are in-person payments on mobile between buyers and sellers, and remote payments on mobile devices.
2Defined as a privately held startup valued at over $1 billion.
Source: PitchBook; Dealogic; eMarketer; iResearch; TechCrunch Crunchbase Unicorn Leaderboard; McKinsey Global Institute analysis

McKinsey&Company

Source: What can we expect in China in 2018?, McKinsey, December 2017

The international footprint of China's tech companies is coming under scrutiny and notably the Trump administration is pushing back on Chinese investments in fin-, med-, and edtech and AI companies. As U.S. approval for M&A and investments in strategic industries is more difficult to obtain, many Chinese firms will turn their attention to other countries such Israel, Scandinavia and the UK.

McKinsey believes that a number of industries could reach key tipping points in 2018. A noteworthy example is the automotive sector: Regulations require OEMs to dramatically increase sales of electric cars and near-electric vehicles every year for the next several years. These goals are fully in line with the government's ambition to dominate the global electric vehicle market by 2030. The regulations promote both the share of new energy vehicles sold (vs. traditional combustion engine cars) and the fuel efficiency of the vehicles produced.



Source: What can we expect in China in 2018?, McKinsey& Co, December 2017

As McKinsey also pointed out, more than USD 50 bn in subsidies will be awarded to the industry by 2020, while the two leading Chinese battery producers are aggressively hiring overseas talents to enhance their development capabilities. Power-grid companies have already installed nearly 200'000 charging stations and Shenzhen has switched all their busses to electric, with taxis being next. Other big cities are expected to follow suit.

Pharmaceutical is another industry where a key tipping point could be reached. In 2017, more than 35 new drug launches were approved by the China Food and Drug Administration (after 5 in 2016). More drugs approved, more drugs in the market, more patient access through online services, and more funds from private equity and venture capital will continue to drive the sector. In biotech, Chinese companies now have more than 800 molecules in the development pipeline and are aggressively licensing in and out of China, while also stepping up M&A activity abroad. In addition, tech stalwarts such as Baidu and Tencent and insurance giant Ping An are all launching AI and big data-based innovations to create better patient outcomes, while Bristol–Myers Squibb launched China's first outcomes-based insurance regime. That healthcare in general is attractive is also confirmed by consumer spending trends. With modest inflation and real disposable incomes rising 8% nationwide, consumers have ample funds to save or spend. Consumer spending is forecast to grow in high single digits in 2018, underpinned by strong consumer confidence. Spending will notably grow on health-related areas such as healthier foods, exercise activities, and medical expenses.

And, last but not least, technology remains a hot topic for investors and politicians alike. The Hong Kong based newspaper "South China Morning Post" reported in November 2017 that China has "recruited" Baidu, Alibaba, Tencent, and IFlyTek as first members of the artificial intelligence “national team”. The Ministry of Science and Technology has identified these four companies as national champions in artificial intelligence and as partners in an ambitious strategy to accelerate the country towards global technology leadership.

The Ministry confirmed that the four companies would leverage their respective strengths to build “open innovation platforms” in four different fields. Baidu’s focus will be on autonomous driving; the cloud computing division of Alibaba is tasked with a project called “city brains”, a set of AI solutions to improve urban life, including smart transport; Tencent will focus on computer vision for medical diagnosis; while Shenzhen-listed iFlyTek, a dominant player in voice recognition, will specialize in voice intelligence.

A strategy consultant at Roland Berger added that the “launch of the platforms indicates the development of AI has been upgraded and pushed ahead at a national level”. And he pointed out that the government’s blessing could give Baidu a leg-up when it came to cooperating with carmakers on self-driving vehicles, and provide Tencent with wider access to hospital data.

3. Investing in China

Investing in Chinese stocks is no longer a no brainer. After the eye-watering gains made by the Chinese tech stocks in 2017, investors are facing the issue whether to keep betting on the country’s new economy – which requires paying expensive prices by historical standards – or move out of the very crowded trades and revert to businesses from less loved sectors (i.e. financials, industrials, etc.).

One school of thought claims that the best way to invest in Chinese equities is simply piggybacking on official government policy, but not necessarily only on state-owned enterprises, as they come with considerable ESG challenges. And while the likes of Alibaba and Tencent are private companies on paper, they often have a symbiotic relationship with the Chinese authorities: As national champions they benefit from implicit, or at least tacit, state support. And in turn they help the government in its attempt to better control its citizens through the data emanating from the digital offerings these firms provide.

One of our value managers believes that the investment focus must more than ever be on quality companies that drive industry consolidation and adhere to capital discipline, deleveraging and free cash flow generation, as consumers upgrade along the value chain. The biggest opportunity for them are firms that heavily invest in R&D and technological upgrade.

Chinese companies are increasingly going global, as they are no longer low-value added OEMs, but become a critical part of the global supply chain. Hardware is replaced by software and, critically important and supported by government, by AI capability. Lenovo is a leader in cost competitiveness, while more and more companies act as Medea (Kuka) and Haier (GE Appliances) that recently bought Western top technology.

Whatever your answer to these questions is, the Chinese stock markets are difficult to navigate – starting with the language issues and ending with governance criteria and outright fraud that are always looming on the horizon. Clearly, the market is still less efficient and is therefore more driven by stock-specific factors than markets in the developed world.

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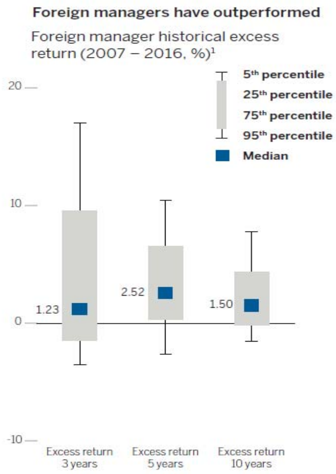
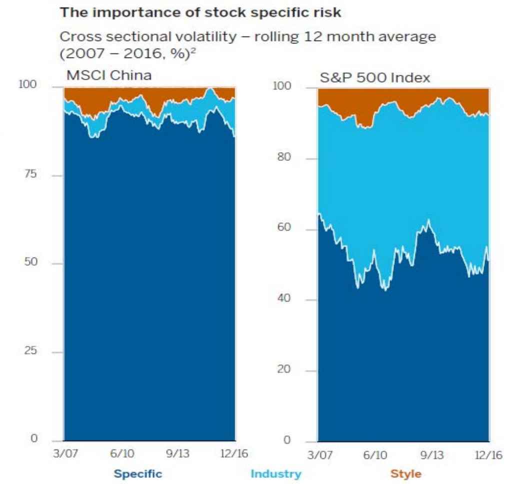
Investing in China – Market Structure

China is a less efficient market driven by stock-specific factors





[1]Source: eVestment. Based on analysis of the 39 products that compose eVestment's "Overseas China Equity" universe | [2]Sources: MSCI, Barra, FactSet. From 31 December 1997 to 31 December 2016 | Data is that of a third party. While data is believed to be reliable, no assurance is being provided as to its accuracy or completeness. The peer group comparison represents the percentile rankings, which are based on gross of fee returns and reflect where those returns fall within the indicated eVestment universe. The Overseas China Equity universe is defined by eVestment as foreign institutional managers of local Chinese equities. The expected benchmark for this universe would include MSCI China. Constituent observations are as of 31 December 2016. Updated annually.

Source: Investing in China, Wellington Management, 2017

With strong earnings growth (ca. 15% to 20% in 2018 for MSCI China) and decent valuations (ca. 14x P/E 2019 for MSCI China), Chinese stocks remain a fertile hunting ground for active managers that can rely on extensive research capabilities on the ground and possess the stock picking skills to identify the winners from the losers. And, what is more, as a complex and yet still inefficient market with low historical correlations to global equity indices, China's markets offer a robust diversification potential for global investors. And that is the allure - and still one of the best reasons - to invest in China now.

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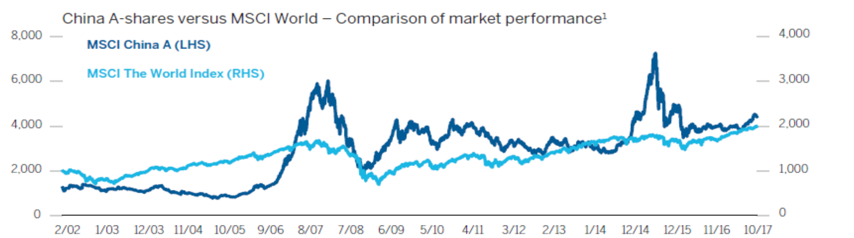
Investing In China – Market Structure

An inefficient market with low historical correlations to global equity
Incorporating domestic equities increases potential diversification



Comparison of historical ten-year annualised volatility:
MSCI China A-shares: 30.3%
MSCI World: 16.4%

A-shares' low correlation with global equities indicates potential diversification[2]

10 years ended September 2017	MSCI China A	MSCI China	MSCI World	MSCI Emerging Markets	MSCI AC Asia Pacific ex Japan	MSCI Frontier Markets	MSCI USA	MSCI Japan	MSCI Europe
MSCI China A	1.00								
MSCI China	0.77	1.00							
MSCI The World Index	0.46	0.80	1.00						
MSCI Emerging Markets	0.54	0.91	0.86	1.00					
MSCI AC Asia Pacific ex Japan	0.58	0.93	0.88	0.99	1.00				
MSCI Frontier Markets	0.27	0.65	0.92	0.72	0.74	1.00			
MSCI USA	0.43	0.74	0.99	0.80	0.82	0.92	1.00		
MSCI Japan	0.53	0.74	0.90	0.70	0.74	0.84	0.88	1.00	
MSCI Europe	0.44	0.79	0.98	0.85	0.88	0.90	0.93	0.87	1.00

[1]Sources: MSCI, Factset, Wellington Management | [2]Sources: FactSet, Wellington Management, gross returns | **PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE.** Gross performance results are net of commissions and other direct expenses, but before (gross of) advisory fees, custody charges, withholding taxes, and other indirect expenses, and include reinvestment of dividends and other earnings. If all expenses were reflected, the performance shown would be lower. Actual fees will vary depending on, among other things, the applicable fee schedule and account size. For example, if US$100,000 was invested and experienced a 10% annual return compounded monthly for ten years, its ending value, without giving effect to the deduction of advisory fees, would be US$270,704 with an annualized compounded return of 10.47%. If an advisory fee of 0.95% of average net assets per year were deducted monthly for the ten-year period, the annualized compounded return would be 9.43% and the ending dollar value would be US$246,355. Information regarding the firm's advisory fees is available upon request. | Data is as of 2 October 2017

Source: Investing in China, Wellington Management, 2017