10 questions on strategy: China equities

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In this wide-ranging Q&A, the China equities team answers investors' key questions.

Q: What's your outlook for China and Hong Kong equities?

A: In recent months, markets have seen weakness, caused by deleveraging policies and new regulations on the asset management industry in 1H18, and the escalation of China-US trade frictions.

We see the market is going through two resetting stages: firstly, investors are resetting their over-expectations about market prospects and, secondly, valuations are being reset also. YTD some of the companies have corrected due to factors that are unrelated to fundamental growth. We feel we are closer to the end than the beginning of these resetting processes.

However, in the short-term, even though valuations have come down, it doesn't mean that the market is about to rebound immediately.

Investors need to see stronger evidence that conditions have improved to be more confident. Catalysts could include an improvement in the China/US trade relationship and appropriate policy responses by the Chinese government.

It is difficult to forecast how things will develop but our bottom-up stock selection still allows us to find good investment opportunities. Even during poor market conditions, structural opportunities may still arise.

Fundamentally, we maintain our long-term focus on new economy companies in the IT, healthcare, and consumer space, since the underlying long-term drivers for these sectors remain intact.

Q: What's your view on the US/China trade war?

A: We are paying close attention to this topic, but the negotiation path is hard to predict.

A prolonged period of uncertainty could have a negative impact on production and investment sentiments.

But we still think there's a chance for a compromise and it's a positive sign that the two sides are talking.

Ultimately, both sides will get hurt by a trade war, so we think it is in both sides' best interest to seek a solution.

At the company level, companies in the export industry with high exposure to the United States will be affected.

However, as we look at our investment strategies, we believe that our portfolios are less sensitive to the trade shock as we are focused on the domestic growth story within China and we have been tilting our portfolio toward domestic consumption-related stocks.

Q: Are you concerned about slower growth for China's economy?

A: Investors need to remember that, despite slower growth, fundamental changes are happening in China's economy, including a shift to a consumer- and services-driven economic model, that still have much longer to run.

Furthermore, China is also on a better footing today compared to a few years ago from a fundamental perspective because the quality of growth continues to improve and companies have shown solid and stable fundamental growth overall.

As such, we believe investors should focus less on GDP numbers and focus more on where to find quality companies well-positioned to benefit from the profound structural changes happening in China, and we see attractive opportunities in 'new economy' sectors like consumer, healthcare, IT, and insurance.

Q: What is your view on TAL Education given this year's volatility?

A: We maintain our positive view on China's education sector, especially the kindergarten to 12th grade (K-12) tutoring market which we believe has strong growth potential as China urbanizes.

TAL has been subject to allegations by Muddy Waters but, subsequent to the allegations, no irregularities have been discovered in the company. TAL's core business has been growing strongly during the past several years and business fundamentals remain solid. As such, we continue to have a large position in the company in our funds.

TAL is the leading player in China's K12 tutoring market and it has successfully established a national learning center network across about 30 cities.

The size of the tutoring market is approximately 50 million students, and TAL currently has around 1 million students, which means there is lots of room for expansion. TAL's learning center network is expected to expand into second- and third-tier cities and eventually cover over 100 cities in 5 years.

Although TAL's short-term forecast has been adjusted, our analysis of the company makes us believe this is only a short-term situation and we continue to have a large position in the company in our funds.

Q: What about recent weakness in Tencent?

A: Tencent has seen a lot of movement but the fundamentals and platforms of the company remain very healthy.

Tencent reported lower-than-expected (as per consensus) 2Q18 results, with total revenues up 30%, due to slowing game and payments earnings, and GAAP earnings down 2%. Non-GAAP earnings, reflecting the performance of their core business operations, were up 20%. Social network revenue grew 30% yoy and online advertising revenue grew 39%.

Tencent's online games segment was weak, as expected, mainly due to delayed monetization of survival games (PUBG) because they haven't yet received license approvals due to temporary government organizational changes/restructuring.

The company highlighted the overall healthy gamer engagement on its platform and that they will push for monetization of the PUBG games. We believe this will be resolved soon and mobile game revenue growth should pick up, also on the back of promising new games releases.

Tencent is the clear market leader in this genre with a very large and fast growing huge user base—MAU (monthly active users) of paying gaming accounts increased by 30% y-o-y.

Whilst the stock may see heightened volatility for some time given the weak market sentiment, at current price levels, we think the stock is under-valued from both a mid and long term perspectives. Given its solid growth outlook, we think the stock offers a favorable risk-reward for investors.

Q: You're overweight on healthcare. Why?

A: We've been positive on China's healthcare sector for some time now and that's because we believe the sector is still in the early stages of growth and has excellent long-term potential.

Fundamentals on the demand side look strong. For example, private spending on healthcare is increasing rapidly as incomes and demand for better living standards have grown.

Industry fundamentals are one thing but we also focus on the best quality companies in the health care sector and we are investing in industry leaders with strong competitive advantages.

R&D and innovation capacity are two factors that are becoming increasingly important as Chinese health care companies look to not only compete domestically but also globally.

While the sector may have seen some volatility recently, we invest in high-quality companies in the sector over a long period of time and we are not overly worried about the short term market volatility as long as our investment theses are intact.

Q: Any sectors you are underweight?

A: We are underweight on financials and that's mainly because large, SOE-owned banks dominate the financials weighting in the MSCI China index.

We don't see these large banking names as being as agile or having the potential to grow in the same way as private companies in 'new economy' sectors like IT, consumer and healthcare.

Within financials, we are positive on insurance firms, who we see as having strong growth potential because market penetration is still low in China compared to other developed markets.

Q: MSCI included 234 A-shares in its EM benchmark, what's the significance?

A: Index inclusion confirms the recognition of China's commitment to financial reforms and capital account opening—like the Stock Connect programs—that we feel global investors haven't fully recognized.

But while index inclusion is a significant move, the effects are more likely to be felt in the long-term rather than the short-term.

Specifically, we believe index inclusion will gradually bring more long-term institutional investors into the A-share market. That's significant because they bring different investment practices, i.e. long-term oriented and more fundamentally-driven, to the current market structure, where retail investors are dominant.

Another way index inclusion is significant is because it will help improve corporate governance and many other aspects of the A-share market because Chinese companies will have to bring their standards in line with those expected by international investors.

Q: Your cash levels look high, why?

A: On the one hand, the fund has received a lot of inflows so far this year. On the other hand, we were more cautious in investing this year, but may top up good companies if valuation becomes attractive.

Whether we deploy or not is ultimately down to ideas and opportunities. This is a bottom-up decision and not an allocation call between the market and cash.

Q: Your AUM has grown rapidly in the past 18 months, aren't you getting too large?

A: We've attracted a lot of interest from investors but we don't feel it is an issue.

Conventional wisdom might say that as a fund gets bigger then performance is impacted, but despite having a bigger fund, our performance has still been strong.

Also, don't forget that as our fund has increased, the opportunity set and the size of the market has grown as well.

The overall market cap of our investable universe has increased due to more liquidity and more companies becoming publicly traded.

Additionally, since the first Stock Connect launched in 2014, the China Opportunity fund can participate easily in the China A share market via the connect.

EMEA
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