China equities update

China equities have grown as an investment asset class, but what explains this year's performance and what's the outlook? Read the write-up from our exclusive webinar

Key takeaways

- Given market exuberance over the past 12-18 months, valuations in some industries in the Chinese equity market currently look stretched.
- In our view, we do not believe that many of the names involved in this rally are convincing long-term opportunities.
- Regulatory changes and the rumors and uncertainty around potential changes have impacted market performance – namely in the Private Tutoring industry – and we have adjusted our strategies' portfolios accordingly.
- The team's tried-and-tested process remains unchanged, and we have recently strengthened the team by adding two senior analysts in the China equities team covering the healthcare and industrials sectors.
- We believe that the long-term fundamental trends driving China's growth remain intact with a wealth of attractive investment opportunities that the active manager can explore for the benefit of clients.

Geoffrey Wong, Head of Emerging Markets and Asia Pacific Equities

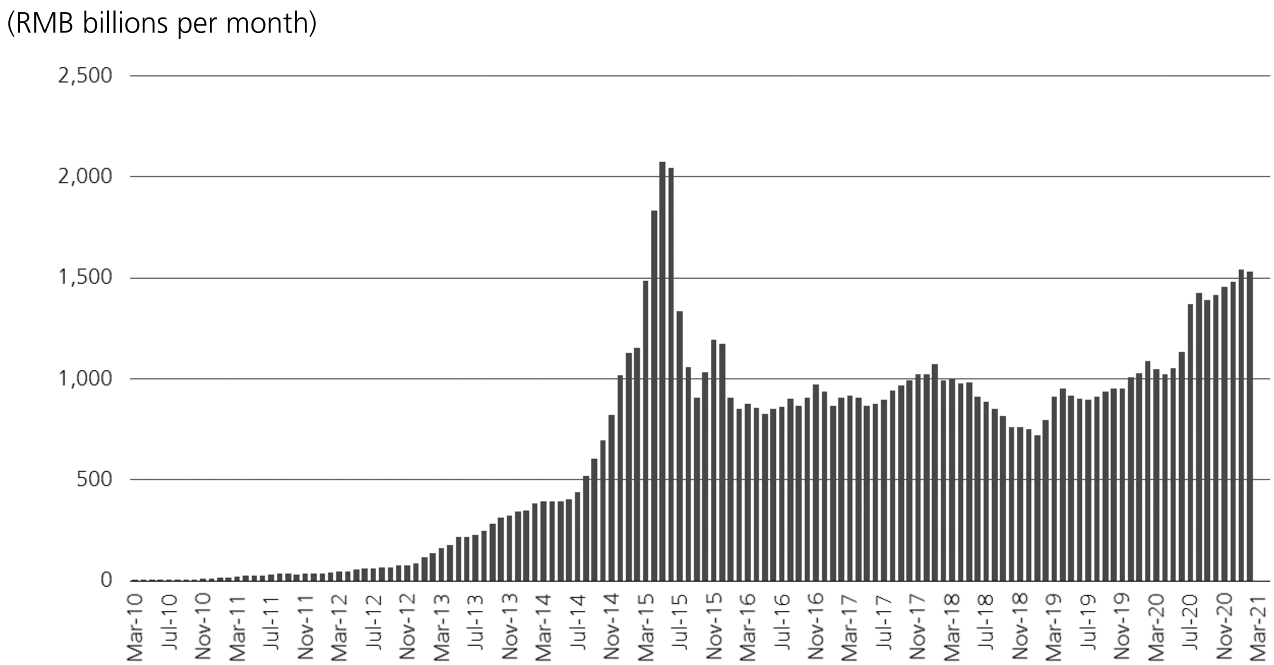
Liquidity is fueling a lot of what is going on in the China equity markets.

Around the world we are seeing many retail investors enter markets.

Retail money tends to favor a certain kind of stock - namely, the kinds of companies hitting the front pages of the local papers, such as electric vehicle (EV) firms in China.

Furthermore, margin financing is a major factor behind the heavy flows of capital into the market.

China margin financing, Mar 2010 – Mar 2021



Source: Wind, Jefferies as of 10 March 2021.

Note: This information should not be considered as a recommendation to purchase or sell any security

Margin financing fueled a bubble in China's equity markets in 2015, and we are in a similar kind of situation now, with growth stocks being pushed to extreme highs.

If we look at the spread between growth and value stocks in the China equity markets, growth stocks are trading at premiums not seen since the dotcom bubble in 1999 and early 2000.

While we have seen a small correction in 2Q2021, there's a long way to go before we hit normalized valuations.

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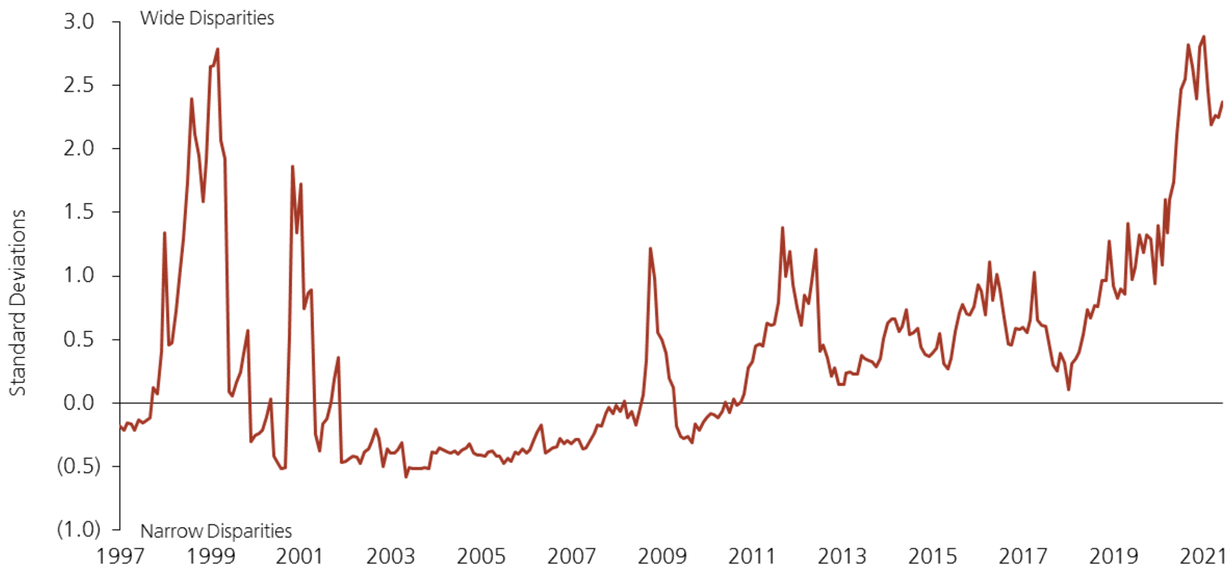
China valuation spreads

The top quintile compared to the region, avg 1997 to Jun 2021



Source: Empirical Research Partners Analysis. Data as of June 2021.

Which sectors have been most impacted?

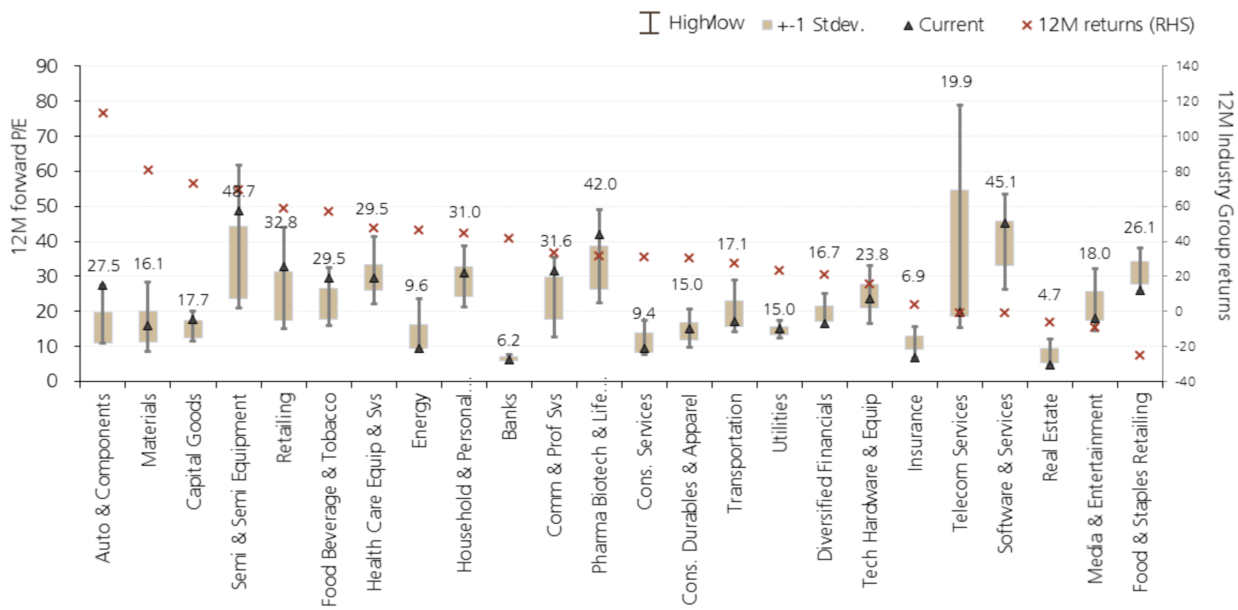
The Auto and Components sector has delivered the highest return over the past 12 months - however, this strong performance misses an important sector dynamic.

Within the Auto sector, EV stocks have tripled or more over the past 12 months.

One of China's leading EV companies currently has a market capitalization that is about the same as BMW, despite making only one-tenth as many cars

MSCI China A – industry group performance & valuations

Past 12 months industry group returns and valuations



Source: Goldman Sachs Research, Factset. Data as of June 2021. Note: 5 years historical data used for the P/E calculation

We are optimistic on the long-term outlook for the EV sector, but we feel that valuations aren't supported by fundamentals.

Many players are entering the EV business in China, with new players coming in regularly due to low entry barriers. For example, you now have property companies attempting to make EVs.

We see similar conditions in other sectors as well.

When we look at the materials sector, companies exposed to copper have also experienced high returns and elevated valuations recently.

Within the healthcare sector we see similar trends with biotechnology companies, while good quality pharmaceutical companies have fallen behind.

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By comparison, we are holding good quality companies with double-digit earnings growth who we believe will deliver good returns in the long run.

Over the long run, our strategies have outperformed the index by factor of three.

I would like to focus on 2015 when we saw a similar bubble situation where the market went up and down quite sharply.

In comparison, our strategy also went up sharply, but it came down by much less than the market. After 2015, the market went nowhere for between three to four years, but our portfolio did very well.

Wealth index (%), Mar 1, 2007-Jun 31, 2021

Source: UBS Global Composite System Quarterly update, June 30, 2021. Performance figures are of the Composite. Inception date is 31 March 2007. The Wealth Index reflects the cumulative result of geometrically linking the period returns since inception.
Performance figures are gross of fees.
Past performance is not indicative of future results

So, despite there being some overvalued sectors within the market, we feel that by avoiding short-term stories and focusing on opportunities with high-quality companies we believe we can deliver positive returns for investors over the long term.

The price you sometimes pay for maintaining a focus on long-term performance is that is that you will occasionally experience a period of underperformance because the market is looking at something else, such as glamorous stocks with high short-term growth.

China's long-term outlook

Investors need to look at the risks and opportunities when investing in China.

Starting with the risks, there is no doubt that US/China frictions are going to be with us for the foreseeable future. This situation will produce both losers and winners. Winners could be local companies in China who grow market share at the expense of foreign companies, for example.

Additionally, China's regulatory environment is getting stricter. Regulatory pressure is something we can learn to adjust to, and it may be possible to identify winners from new rules and regulations.

Finally, many popular industries in China, like EVs, biotechnology, and copper, currently seem exceedingly overvalued, which presents an obvious risk. That's one reason not to be indexed, because you are going to be investing in overvalued companies at their peak.

We believe that the risks, however, are outweighed by the opportunities.

China's stock market is already the second largest in the world and is fast catching up with the US. Just as a global investor would not want to be out of the US, we believe the same holds true for the China stock market.

If we look at the number of IPOs in both China and Hong Kong, China has overwhelmingly the most in the world, and that means a strong pipeline of investible opportunities.

China continues to offer a big opportunity for active management. It is still an emerging market with inefficiencies such as we are seeing right now. But as an emerging country China also has tremendous trends.

I look at China and it reminds me of South Korea and Taiwan in the 1970s and Japan in the 1960s.

Like those countries, China is industrializing. If we go back to the 1950s the biggest car and electronics companies were American but they have been overtaken by Japanese players in the 1980s subsequently by Taiwanese and Korean players in the 1990s and 2000s.

We are beginning to see these early global leaders in China. Who would want to miss out on what is an exciting stage of China's development?

China spends more on R&D than any other country in the world and it files the most patents in the world. China’s growing strength in innovation looks likely to soon rival the US and we believe this will offer many attractive investment opportunities.

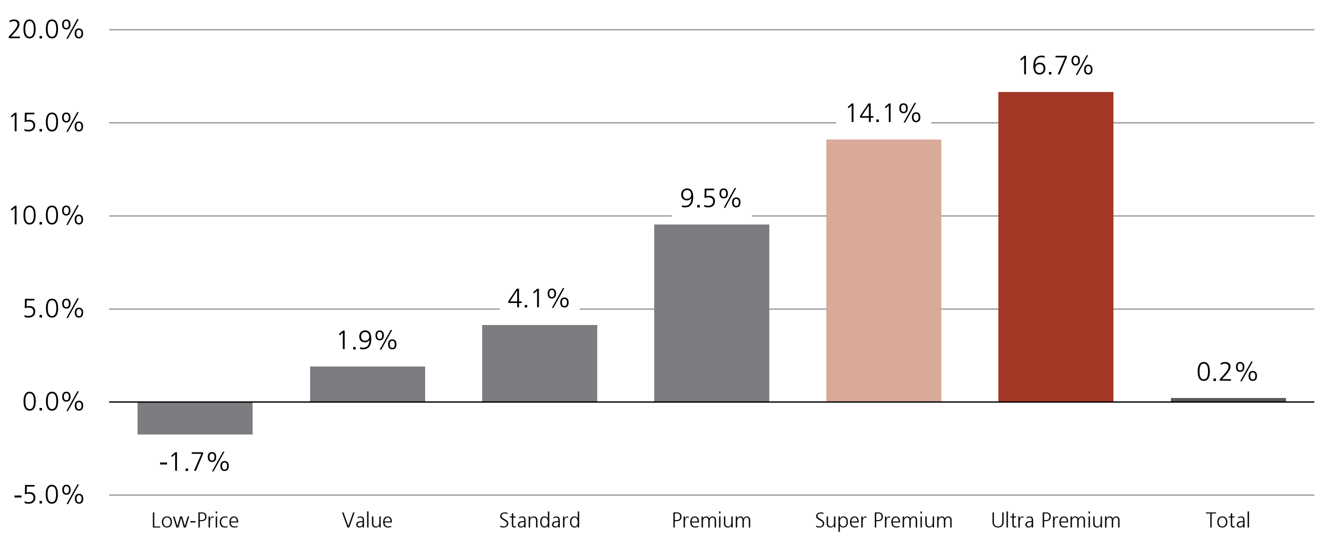
Denise Cheung, Analyst & Investment Specialist, China Equities Team

We see a number of exciting long-run trends that we believe offer opportunities in the China equities space.

First, growth in discretionary consumption and premiumization in the Chinese domestic market is set to benefit Chinese retailers and producers, especially those marketing premium and local products.

As disposable income increases, consumers are pursuing higher quality lifestyles and we see this driving growth in consumer categories like athletic apparel & footwear, high-end liquor, and toothpastes with ingredients from traditional Chinese medicine.

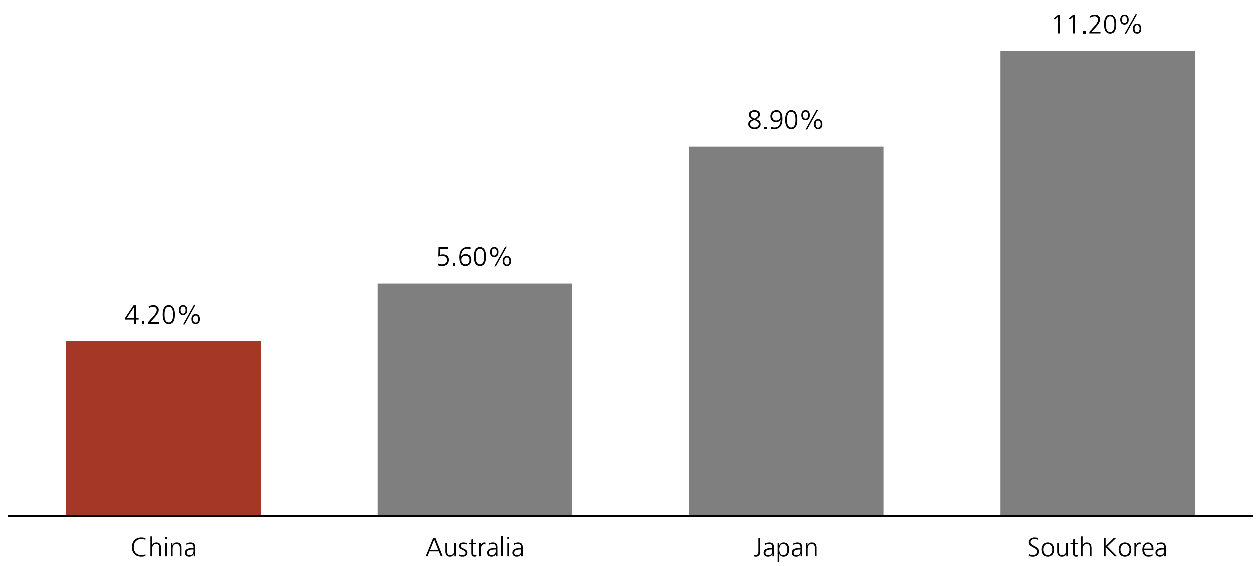
CAGR of sales volume growth of Baiju (Chinese liquor), 2018-2023(E)



Source: IWSR, NBS, Canback, Bernstein analysis & estimates, updated September 2019

Second, the challenge of China's aging population can turn into a golden opportunity for investors, as this powerful demographic trend will spur significant demand for insurance services, asset management services, and healthcare.

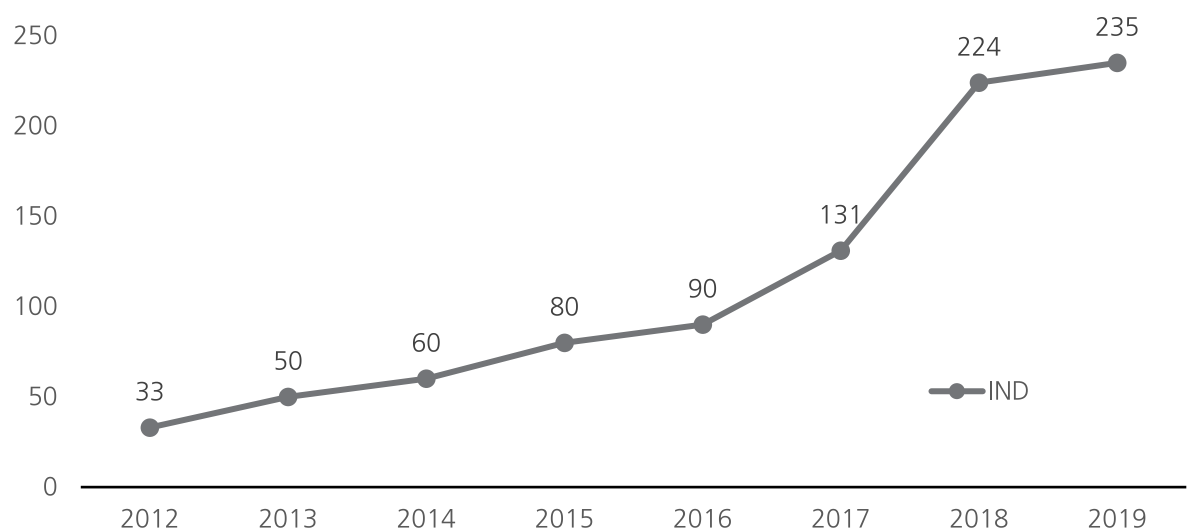
Gross written insurance premiums as % of GDP, 2018



Source: Ernst & Young, Asia-Pacific Insurance Outlook, 2020

Finally, the Chinese healthcare sector is undergoing some structural changes that we believe will reward investors capable of identifying winners and losers in this space, both in terms of production and distribution of healthcare products and services. Internet healthcare is also a key theme, spurred by an offline-to-online shift in consumption of healthcare services and products.

Number of Investigational New Drugs in China



Source: Citi Research, CDE, July 2021

Q&A

1 Have regulations and your cash position impacted performance over the past year?

GW: Regulations have influenced performance, particularly in the Internet and Education sectors.

In the Education sector, for example, the government has made this a very strong focus of regulation.

New rules and restrictions have come in very heavily and I think good companies are going to find it hard to grow as they have in the past.

Cash is something that has been relatively high in our China strategies.

This is due in large part to the high volatility of the market where individual stocks can fall a lot in a given day.

Our portfolio manager feels it is advantageous to have some cash on hand at any given time to be able to pick up stocks when their valuations dip.

Performance analysis also shows that the effect of cash on a portfolio is fairly neutral over the long-term.

2 What changes have you made to either the portfolio, people, or the process?

GW: Our portfolio will always evolve because we have to react to stock price movements and when opportunities present themselves.

However, we haven't made major changes to either the portfolio or the process. We remain consistent in our philosophy and our focus on long-term earnings.

We have made enhancements to the team. We have recently onboarded a top-ranked healthcare analyst, and we have also added a similarly well-regarded analyst to lead our coverage of the industrial space. We will soon have another healthcare analyst join the team, who will be based in our Shanghai office.

3 Regarding Education services, what have you specifically done about your strategy with the sector?

GW: Although we like the management quality of the companies we have been researching, there are tremendous headwinds for China's Education sector.

Education is a hot topic in China and the government wishes to be seen to take very strong action. In many provinces now, after-school tuition and new school openings are being highly restricted, so growth rates will have to be sharply adjusted down.

As such, we feel that good companies will have a hard time justifying the valuations we have seen in the past, so we have reduced our exposure to this sector. If the attitude to regulation in this sector changes, we can change our mind, but for the time being we feel our investments can be deployed elsewhere.

4 What is your view on the outlook for Chinese Internet giants against the backdrop of increasing regulation?

GW: We believe that some of the Internet giants will prosper in the long run, albeit under a stricter regulatory regime.

We are particularly focused on Internet companies with a good competitive position, good technology and a strong business model

In the short run, we expect continued uncertainty because the authorities are still formulating their regulations, but we don't believe there is an intention to crush the Internet industry.

We still believe that stock picking among the well positioned players has the potential to pay off in the long run. There will be winners as well as losers, and this is where active management will come into play.

5 Is the team looking at the energy transition team at all and, if so, where do you see opportunities currently?

GW: We are looking at it extremely closely.

Overall valuations are high, so we have to be extremely careful. There could, however, be opportunities in select niches.

Take solar panels for example. The solar panel sector has very low barriers to entry and raw materials can be easily sourced. We believe that to invest in the solar sector you need to look into niche parts of the supply chain, for example, mid-cap companies making obscure components.

The same applies to EVs. We hold some of the battery makers in our broader portfolios. We are looking carefully at other parts of the supply chain, for example essential components for EVs that most people won’t have heard of.

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