March 2019

New opportunities in China

China has been on the world's investment radar for some time with its seemingly unstoppable GDP growth and increasingly important role in the global economy. It already ranks as the largest global economy by the IMF[1]. So why then has no-one heard of Kweichou Moutai, Songcheng and Hangzhou Hikvision?

These are shares, along with a list of over 3000 equally unfamiliar names, which up until recently have been off limits for global investors. Yet they have remained hidden, with the Chinese investment story focused rather on the demand it has created for existing global bond and equity markets through its massive Fixed Asset Investment programme[2] (1990's – 2000's). We have been more interested in the impact of China's trade with the US and its demand for steel and copper than we have on the potential to access the world's 4th largest equity market for the first time.

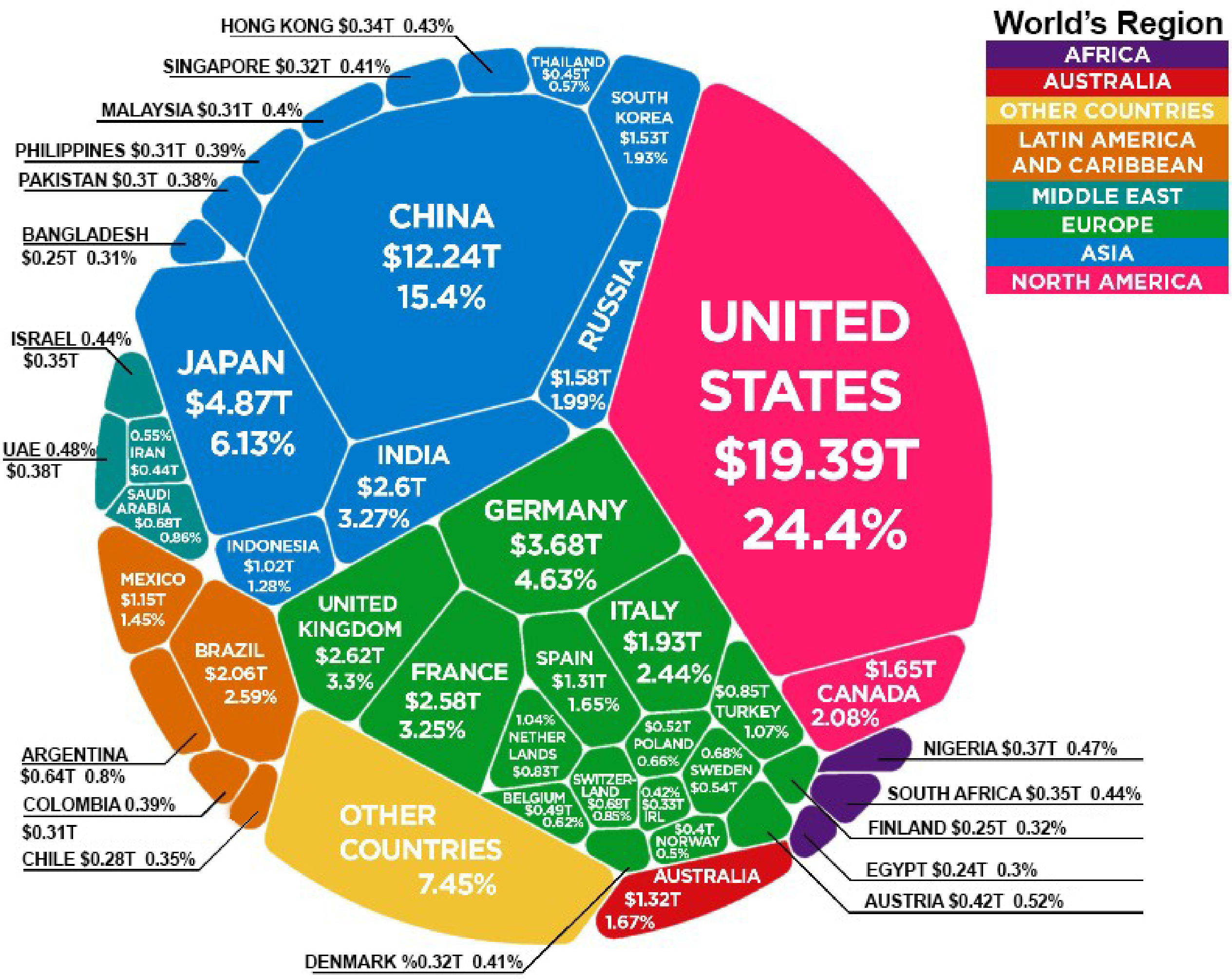


Chart 1: a significant part of China's economy has been off limits to global investors (source: Visual Capitalist, World Bank)

As part of our ongoing fund research[3], we have been evaluating the merits of considering this market opportunity for clients given that the Chinese government has set about relaxing investor access to their domestic share market.

InvestSense (Pty) Ltd
Phone: +27 10 020 6777
Email: invest@investsense.co.za
Web: www.investsense.co.za

This market (the 'A-Share' market) has been restricted from foreign investment with only 2% of the total issuance of shares held by foreign owners as at 2018. Several steps have recently been taken to slowly integrate this market with the global community, with the addition of China 'A' shares to the globally recognized MSCI indices as the most recent step. This step attracts a significant pool of investors who use these indices as their underlying basis for investment and could ultimately result in Chinese equity forming almost 50% of all Emerging Market investment opportunities.

The 'A-Share' market is a veritable case study for a finance student, with all the hallmarks of what one might call the Inefficient Market:

- Over 200 million direct Chinese investors own over 85% of the listed A-Share market.
- Institutional ownership is very low (aka the Smart Money)
- Broadly it consists of "Old China" (industrial, Mining and utility companies which benefitted from the Fixed Asset Investment programme) as well as "New China" companies which are increasingly technology and Consumer focused as the population uses its new-found wealth to improve lifestyles.
- Information access can be opaque and off-limits
- Accounting standards are frequently not adhered to, with the Big 4 audit firms covering less than 6% of companies.
- There is governance and policy risk as the roll-out of the market continues. Liquidity or access restrictions for example spook even the most hardened investment professionals.

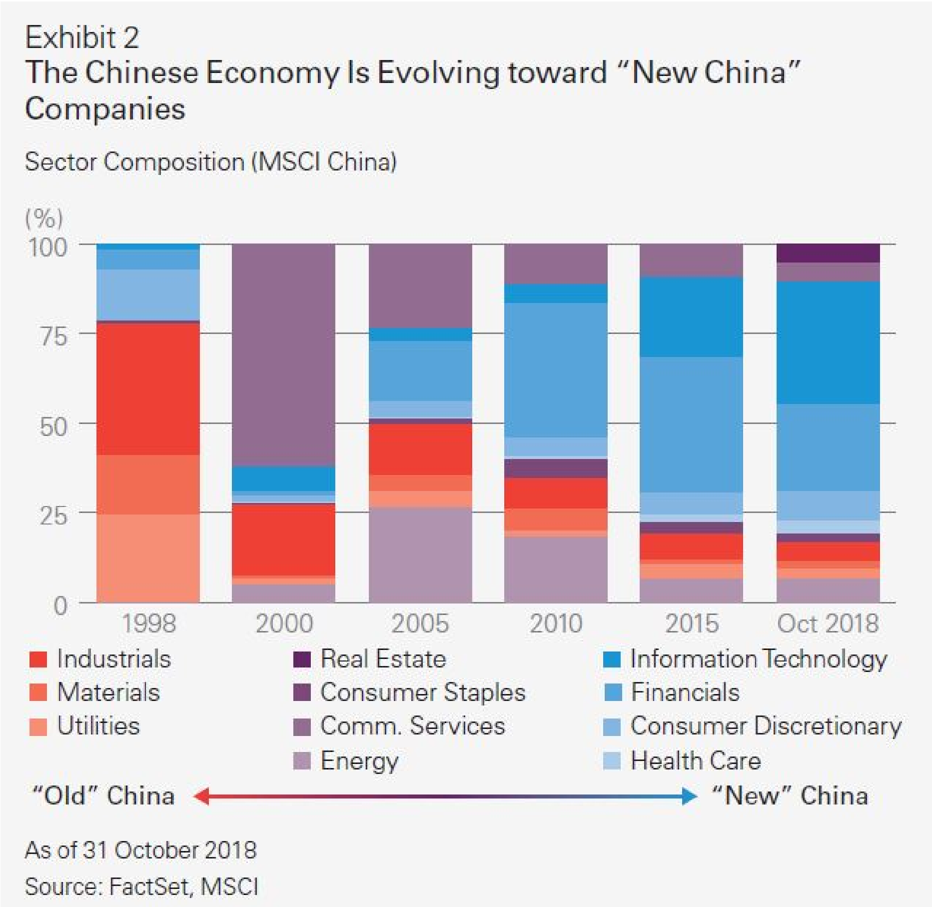
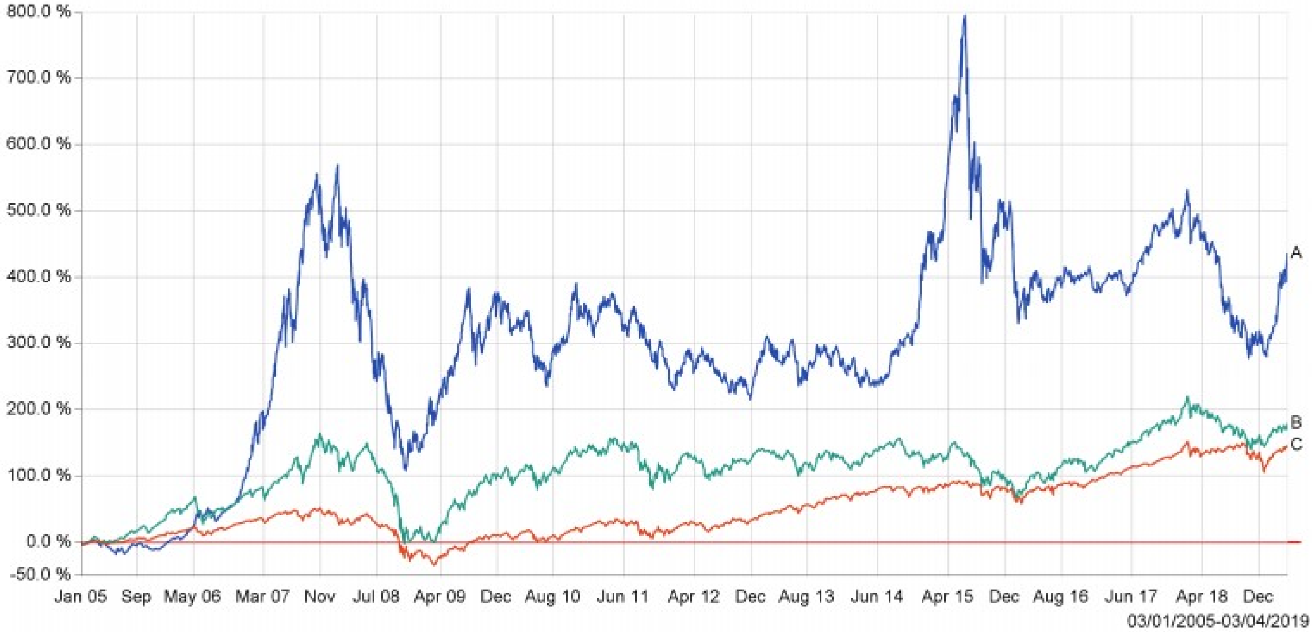


Chart 2: Domestic China moves from Old to New (source: Lazard)

InvestSense (Pty) Ltd
Phone: +27 10 020 6777
Email: invest@investsense.co.za
Web: www.investsense.co.za

It is rare these days to be presented with a large, liquid stock market where the potential for share mispricing (and therefore return opportunity) is so prevalent. This is the perfect environment for professional investors to add value. As an indication of this, many of the Old China shares have been sold down to historical low levels (mid-single digit PE ratio's for example) in lieu of the more attractive new China shares. These opportunities do not come without their risks though, as Chart 3 will attest with risk levels significantly higher than that of Developed Markets[4]. There has been a payoff though, 5% per year higher returns than other Emerging markets, and 6% per year higher than the Developed Markets since 2005.[5]



Cumulative Performance (%) Cumulative Performance as at 04/04/2019*

	Instrument	Currency	3m	6m	1y	3yrs	5yrs	03/01/2005 to 03/04/2019
A	MSCI China A Onshore TR in US	USD	40.77	22.57	-4.54	7.33	54.94	435.36
B	MSCI Emerging Markets TR in US	USD	14.10	5.09	-5.45	40.16	21.51	179.46
C	MSCI World TR in US	USD	16.25	-0.96	6.69	38.53	40.16	146.18

*excluding chart selection

Chart 3: Returns in US$ from 2005 – 2019 (Source: FE Analytics)

This transition is positive for investors continuously seeking out new investment opportunites in a world where it is increasingly difficult to avoid the same faces.

With regards to China's GDP growth path, there is mixed evidence to conclude that high levels of GDP result in high levels of equity returns to investors. However it does tend to act as a ceiling to returns over the long term, and with current levels stabilising at over 6% per year, this is double the level of the Developed Markets. The additional tailwind is the growing middle class, which can further help sustain high levels of domestic growth as the population moves towards a more consumer driven economy.

InvestSense (Pty) Ltd
Phone: +27 10 020 6777
Email: invest@investsense.co.za
Web: www.investsense.co.za

An additional challenge we need to take on is to establish which fund managers have the ability to manage portfolios consisting of China A shares. By design this is not a developed part of the fund management industry with most investor exposure to date covering the by-now-well-known Ten Cent (Naspers), Baidu and Alibaba stories. Mainland China represents a new undertaking, with new skills and expertise required. In these scenarios we would expect to see a steep learning curve and potentially some early errors – but that is the opportunity. Value and Growth managers alike should have a field day here.

Our research work on China continues as we consider the merits of this new opportunity set, the already large and increasing exposure which all investors already have to China (like it or not it is impossible to avoid), and the ability for fund managers to manage client assets effectively.

For what its worth, Kweichou Moutai sells alcohol and has a market capitalization of $50bn, Jiangsu Hengrui is in pharmaceuticals and was started in 1970, and Hangzhou Hikvision is the world's largest video surveillance manufacturer. Not that unfamiliar then.

---

[1] International Monetary Fund. In constant purchasing power terms; the US remains the largest in nominal terms, for now

[2] The Chinese government spending vast amounts on developing infrastructure

[3] Across this article we have relied on research and presentations from Schroders and Lazard.

[4] As indicated by MSCI World which is an index of the leading global developed economy stock markets

[5] Measured in US Dollars

InvestSense (Pty) Ltd
Phone: +27 10 020 6777
Email: invest@investsense.co.za
Web: www.investsense.co.za

InvestSense

March 2019

data provided by Reuters and Datastream

31 March 2019

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	8.0%	8.0%	5.0%	5.7%	6.5%	14.0%	10.8%	12.4%
FTSE/JSE SA Listed Property	ZAR	1.5%	1.5%	-5.7%	-3.8%	5.6%	12.4%	13.7%	13.5%
SA All Bond Index (ALBI)	ZAR	3.8%	3.8%	3.4%	10.1%	8.3%	8.7%	7.7%	6.9%
SA Cash Index (SteFI)	ZAR	1.7%	1.7%	7.3%	7.4%	7.0%	6.6%	0.2%	0.3%
Balanced Benchmark	ZAR	6.7%	6.7%	8.5%	6.5%	8.1%	12.8%	7.2%	7.8%
SA Inflation (1 month lag)	ZAR	0.5%	0.6%	4.1%	4.8%	5.1%	5.3%	1.4%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	12.6%	12.6%	4.6%	11.3%	7.4%	13.0%	11.0%	13.6%
Emerging Markets Equity (Datastream EM)	USD	10.0%	10.0%	-7.1%	11.1%	4.1%	9.3%	15.2%	18.7%
Global Bonds (Barclays Global Bond Index)	USD	1.7%	1.7%	-1.6%	1.0%	0.6%	2.2%	5.3%	5.7%
Global Cash	USD	0.6%	0.6%	2.5%	1.6%	1.1%	0.7%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	8.0%	8.0%	5.0%	5.7%	6.5%	14.0%	10.8%	12.4%
Global Equity (Datastream World)	ZAR	12.9%	12.9%	27.3%	10.6%	14.4%	17.8%	15.3%	14.2%
Emerging Markets Equity (Datastream EM)	ZAR	10.2%	10.2%	13.1%	10.4%	10.8%	14.0%	13.4%	13.7%
SA All Bond Index (ALBI)	ZAR	3.8%	3.8%	3.4%	10.1%	8.3%	8.7%	7.7%	6.9%
Global Bonds (Citigroup)	ZAR	2.0%	2.0%	19.8%	0.3%	7.1%	6.5%	14.2%	14.2%
COMMODITIES									
Gold (US Dollars)	USD	1.1%	1.1%	-2.1%	1.6%	0.1%	3.5%	12.8%	16.4%
Gold (Rands)	ZAR	1.4%	1.4%	19.2%	1.0%	6.6%	7.9%		
CURRENCIES									
Rand / Dollar	ZAR	-0.3%	-0.3%	-21.7%	0.7%	-6.5%	-4.3%	15.5%	15.6%
Rand / GBP Pound	ZAR	-2.6%	-2.6%	-13.1%	3.8%	-1.4%	-3.3%	16.4%	14.9%
Rand / Euro	ZAR	1.5%	1.5%	-11.1%	1.1%	-2.2%	-2.5%	14.6%	13.9%

Spot Rates		31-Mar-19	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	14.42	14.39	11.85	10.52	9.51	6.19
Rand/GBP	Rand	18.80	18.36	16.62	17.54	13.64	9.98
Rand/EUR	Rand	16.19	16.44	14.57	14.50	12.63	6.68
RATES							
Libor 6m $	US$	2.66	2.88	2.45	0.33	1.74	5.06
Repo Rate	Rand	6.75	6.75	6.50	5.50	9.50	16.51
Prime	Rand	10.25	10.25	10.00	9.00	14.00	20.00
All Bond Index Yield	Rand	9.44	9.64	8.62	8.54	10.28	NA
COMMODITIES							
Gold ($/oz)	US$	1,295.72	1,281.34	1,323.43	1,289.28	916.10	279.85
Platinum	US$	850.00	794.00	936.00	1,418.00	1,124.00	361.00
Oil (Brent Crude) $	US$	68.55	53.13	70.09	107.31	46.50	15.00
INFLATION							
SA Inflation	%	4.1	4.5	3.8	6.1	8.4	NA