FULLERTON FUND MANAGEMENT

FULLERTON INSIGHTS

March 2019

China A-shares: Active is as Active Does

China A-shares have been on a tear since the turn of the year, on the back of hopes for a US-Sino trade deal and the Chinese government's latest stimulus measures. As local retail investors return to their trading home ground, foreign investors are also reconsidering their exposure to China A-shares given MSCI's latest decision to increase the weight of A-shares in the MSCI indices. In this note, we revisit the notion of active management in China A-shares, in light of recent developments, and share some of our thoughts on the market.

Dinah Washington won a Grammy Award for Best R&B Performance in 1959 with the song "What A Difference A Day Makes". Fast forward to recent days and one could wonder the same about the onshore China equity market, albeit in a somewhat different context: what a difference two months make.

Having spent 2018 languishing in the red, with more than 30% losses (USD terms) for the year, China A-shares have since rebounded by more than 25% (USD terms) YTD, as at the end of February 2019[1]. What gives?

Thunderstruck

Tighter regulations from local authorities with an impetus to deleverage, a slowdown in infrastructure investment and property sector moderation were among some of the sources of growth headwinds plaguing the world's second largest economy in 2018. A drop in auto sales in the latter part of the year also led to questions about the outlook for domestic consumption in China and consequential implications for the broader economy[2].

As if the grind brought about by the aforementioned domestic developments was not enough, the looming spectre of a US-China trade standoff started to take its toll on investor sentiment. This eventually proved to be the proverbial straw that broke the camel's back, as subsequent tit-for-tat trade tariffs and policy measures came to the fore, impacting both economies and in the process causing ripple effects throughout the global economy. Emerging market contagion fears on the back of the plunge in the Turkish lira in the middle of the year, accompanied by a plunging RMB that reached a level of 6.9348 versus the dollar in August[3], did little to assuage concerns.

Concerns? What concerns?

Animal spirits have since awoken and 2018 now seems like a distant memory.

The decision taken by the US and China in December 2018 to come to a tentative truce, manifested via the postponement of further tariff hikes and the resumption of trade negotiations, provided the market with some much needed breathing space. Progress made thus far since the turn of the year between both parties, with increasing anticipation for a trade deal, has fuelled the upward move in equity markets. While surging stock prices appear to have discounted much of this latest development, we believe there is still upside if tariffs imposed in 2018 are reversed and non-tariff issues are resolved.

On the domestic front, monetary policy easing measures by the local authorities have stepped up, with broad-based Reserve Requirement Ratio (RRR) cuts boosting interbank liquidity, coupled with the introduction of a quarterly targeted medium-term lending facility. Fiscal policy has also taken on a proactive stance in a bid to stabilise growth by boosting domestic demand, with additional support for infrastructure spending announced at the annual National People's Congress providing more buoyancy.

[1] With reference to the MSCI China A Onshore Index.

[2] According to data sourced from CEIC, China's Private Consumption accounted for 39.1% of Nominal GDP in 2017, up from 35.6% in 2010.

[3] Source: Bloomberg. Note: the RMB fell to its lowest at 6.9757 versus the dollar in October 2018.

The China Securities Regulatory Commission (CSRC) has relaxed restrictions on private funds trading, which has in turn boosted market confidence and ignited investor interest. Additionally, the huge growth in Total Social Financing in January also points to loose monetary policy. Financial conditions have improved and China A-shares have taken notice.

Another recent external boost to onshore China equities has been MSCI's announcement on 1 March 2019 to increase the weight of A-shares in the MSCI indices, by increasing the inclusion factor from 5% to 20%, following an extensive global consultation with foreign institutional investors.

Various commentators suggest that the aforementioned index changes may induce some US$70-100 billion of inflows into the A-share market by November 2019[4]. Having had a positive Stock Connect experience, coupled with the successful implementation of the initial 5% inclusion of China A-shares by MSCI, foreign institutional investors are now more willing to increase their exposure to onshore China equities.

Separating the wheat from the chaff

While there are more than 3,500 China securities listed on the Shanghai and Shenzhen stock exchanges, the move by MSCI will eventually result in 253 large and 168 mid-cap China A-shares becoming components of MSCI indices[5]. An application of simple arithmetic tells us that there are thus still more than 3,000 stocks which remain "unrepresented" to investors, especially those who are primarily benchmark-driven when making asset allocation decisions.

The advent of index inclusion has been touted as a means of increasing foreign investor participation in the China A-shares market. According to a UBS report, citing data from the People's Bank of China, foreign investors accounted for 2.4%/6.7% of the total / free-float market cap of the onshore equity market at the end of 2018, up from 0.8%/2.3% in November 2015[6]. Additionally, the report also goes on to state that foreign investors as a group have surpassed insurers as the largest holders of China A-shares, and with the help of the MSCI weight increase, may start to give domestic mutual funds a run for their money soon.

Hence, with China A-shares still being the primary domain of domestic retail investors, it is not surprising that the onshore China equity market is often characterised by under-researched companies and short-term retail buying and selling. However, what such conditions do in turn is create opportunities for active managers who are willing to put in the necessary effort to conduct comprehensive due diligence, in the search for existing and potential leaders in key structural growth sectors, which are either unrepresented or under-represented in the various commonly tracked indices.

With foreign investors poised to play a bigger role in China A-shares, this can only mean that listed companies in China will increasingly come under the lens and naturally be scrutinised with a fine tooth comb – the need for disclosure and governance standards to be brought on par with acceptable international standards will only gather pace. All things considered, this bodes well for corporate quality, which is a key trait that cannot be overlooked when it comes to investing in an emerging market like China.

It is thus easy to see why the case for active management in China remains very much alive. The harvest of under researched, undiscovered companies still available for the early investor to pick from is rich, while the ability to separate good quality companies from the poor ones, the winners from the losers, will certainly provide the diligent investor with an edge over less thorough, less discerning investors over the longer term.

Show me the numbers

But what does the data show? Can adopting an active approach to investing in China A-shares unlock the presence of alpha in the onshore equity market?

In a commentary released in April 2018 by Fund Selector Asia, with reference made to a ranking of best- and worst- performing mutual funds and ETFs

[4] Source: Fullerton
[5] Source: MSCI
[6] UBS, China Equity Strategy, *MSCI's decision to make foreign investors a larger force in A shares*, 1 March 2019.

available for sale to Hong Kong and/or Singapore investors at the end of 1Q2018, an observation was made that actively-managed funds dominated the top of the list, while the bottom comprised largely ETFs[7].

A data scan[8] of actively managed China A-share strategies in Mercer's Global Investment Manager Database (GIMD) shows that the median manager generated 8.6% in excess returns in 2018[9]. While upper quartile managers in this survey generated at least 11.0% in excess returns for the year, what is perhaps worth noting, is that even lower quartile managers were able to generate up to 5.9% in excess returns in 2018[10].

Over longer five-year and 10-year periods, the median manager has generated 9.4% and 4.7% in excess returns in USD, before fees, respectively.

Mercer Investment Survey of China A Managers: Excess Returns (%) vs MSCI China A in $US (before fees), as at end-Dec 2018[11]

Group Statistics	1 yr	3 yrs	5 yrs	10 yrs
Upper Quartile	11.0	15.9	11.3	7.9
Median	8.6	13.0	9.4	4.7
Lower Quartile	5.9	9.4	6.6	4.3

Note: This output should be read in conjunction with, and is subject to, MercerInsight MPA™: Important notices and Third-party data attributions. Past performance is not necessarily indicative of future returns.
See www.mercerinsight.com/importantnotices.aspx for details. © 2019 Mercer LLC. All rights reserved.

And don't forget the volatility

The aforementioned observations appear to suggest that there is indeed alpha to be obtained from investing in what is still a very much emerging, inefficient universe of China A-share equities.

But the case for active management in China A-shares is better appreciated if one were to also consider the volatility that accompanies investing in this space. Here, it is worth noting that a buy-and-hold strategy tracking the MSCI China A Onshore Net Index (USD) would have exhibited an annualised volatility of 26.7% (USD) and experienced a maximum drawdown of 52.1% (USD), for the 10-year period ending December 2018[12].

While the above numbers may lack context on their own, it would perhaps help to see how the average active China A manager did over the same period. Looking once again at GIMD data, the median China A manager had a lower annualised volatility of 24.8% (USD) and a maximum drawdown of 37.9% (USD) over the 10-year period ending December 2018[13], not to mention also possessing a 0.7 Information Ratio[14].

Therefore, when volatility is also taken into consideration, it follows that mere outsized returns are not the holy grail when it comes to investing in China A-shares. To this end, for investors wishing to obtain exposure to this market, the priority ought really to be

[7] Zembrowski, Piotr, *China equity: A case for active management?*, 12 April 2018. Fund Selector Asia is an investment news and analysis site dedicated to Asian fund selectors.

[8] Based on data obtained from Mercer's Global Investment Management Database. Note that this is not an official Mercer universe release and should be considered in conjunction with and subject to MercerInsight MPA™:Important notices and Third-party data attributions.

[9] Versus the MSCI China A Index. Past performance is not necessarily indicative of future returns.

[10] All excess returns discussed here are in USD, before fees.

[11] This is not an official Mercer universe release. Data in excess of one year is annualised.

[12] The 10-year period ending December 2018 comprises a fair balance of up (e.g. post GFC, 2017) and down (e.g. mid-2015, the start of 2016, 2018) markets and so can be viewed to be an apt representation of the kind of volatility one can expect to be exposed to when investing in China A-shares.

[13] Based on data obtained from Mercer's Global Investment Management Database. Note that this is not an official Mercer universe release and should be considered in conjunction with and subject to MercerInsight MPA™:Important notices and Third-party data attributions.

[14] The book *Active Portfolio Management*, by Richard C. Grinold and Ronald N. Kahn, is commonly cited by academia in the discussion of the Information Ratio (IR). The IR, which is a risk-reward benchmark that is often used to quantify the performance of an investment, specifically the effectiveness of a fund manager, has been described as being analogous to a normal bell-shaped curve with value of zero as the mean of the distribution. As such, it follows that an IR greater than zero shows a manager which has performed in the top 50% of the population and vice versa. To this end, it is worth noting that taking the lead from Grinold and Kahn, an IR of 0.5 is widely viewed, by both academia and practitioners as being reasonable and/or good, while an IR of 1.0 is deemed to be exceptional.

placed on *risk-adjusted returns* and accordingly, the search for managers who are able to demonstrate a superior, consistent ability of navigating the volatile and momentum-driven nature of China A-shares, across a market cycle.

More than 12 years ago

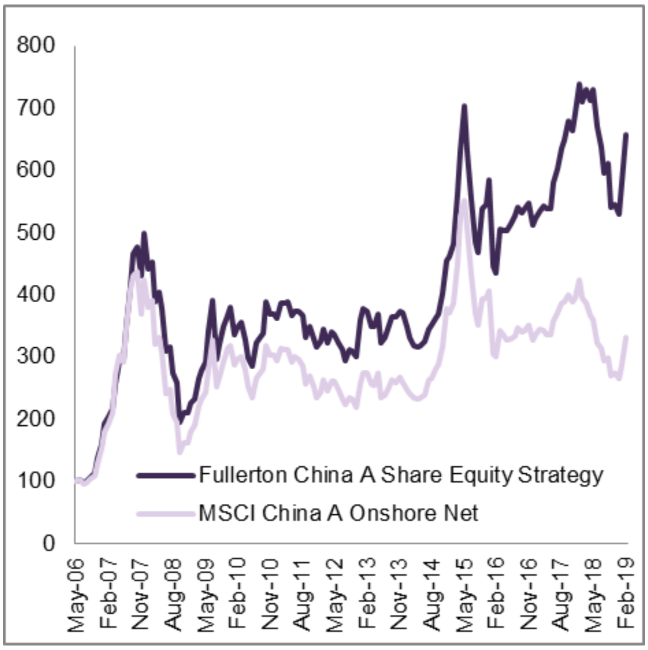
There are many ways to implement an active management strategy when investing in equities. Fullerton's approach to active management is via bottom-up driven stock selection, with a focus on fundamentals, and constructing portfolios with highest conviction ideas.

Notwithstanding an edge in bottom-up stock selection, we recognise that when it comes to investing in an emerging market like China, there is significant value in understanding any investment implications which can arise from macro-oriented factors such as state policy, social and demographic trends, corporate structure and local government interests. To this end, Fullerton's onshore research presence in Shanghai, China, plays a key role in our early discovery of growth sectors and companies to invest in, across China's economic value chain.

Fullerton began investing in China A-shares more than 12 years ago in May 2006 and opened our first foreign representative office in China in 2007. In September 2017, we obtained a private fund management license from the Asset Management Association of China.

With more than 10 years of experience managing Chinese equities, we have been offering a wide range of investment solutions for clients with varying needs for Chinese equity exposure.

Growth of $100, May 2006 – February 2019: Fullerton China A Share Equity Strategy versus MSCI China A Index (in USD)[15]



Looking ahead

The year-to-date rally in China A-shares has been led by strong liquidity, propelled by the evident shift of focus by Chinese Leadership towards economic growth and financial stability. When presiding over a group study session of the CPC Central Committee Political Bureau on 22 February 2019, President Xi Jinping emphasised the importance of a strong capital market and its role in better supporting the real economy. We see this being an affirmative signal of support for the Chinese equity market. To this end, we believe a "slow bull" market is in line with the government's desire for sustainable capital market development, but caution of the possibility of regulatory intervention should the market rally get out of hand[16].

The Chinese economy is likely to bottom out in the coming quarter and small-mid cap companies could potentially experience more upside than the blue

[15] Data used for the Fullerton China A Share Equity Strategy is that of the Fullerton China A Shares Equity Composite. Source: Fullerton, February 2019. Past performance is not necessarily indicative of future returns.

[16] China's securities officials have warned of an increase in shadow margin debt and they have started asking brokerages to monitor abnormal trades.

chips. As such, rather than risk getting caught up in the current reverie sweeping China A-shares, we find it prudent adhering to our fundamentals-centred investment philosophy while keeping a close eye on macro developments. Key exposures in our portfolio revolve around the consumer, financials and IT sectors, building on themes such as structural shifts in domestic consumption patterns, local government spending, and evolving IT needs, among others.

We believe opportunities for active stock picking will abound following the release of 1Q19 corporate earnings results. In the interim, we intend to continue scouring the China A-share universe actively for companies which not only meet our investment criteria but also possess more visible earnings forecasts. After all, active is as active does.

Disclaimer: This publication is prepared by Fullerton Fund Management Company Ltd (UEN: 200312672W) ("Fullerton") and is for your information only. The information contained herein has been obtained from sources believed to be reliable but has not been independently verified, although Fullerton believes it to be fair and not misleading. It is not for general circulation and no recommendation is being made to purchase or sell any securities whether referred herein or otherwise. This is not the basis for any contract to deal in any security or instrument, or for Fullerton or its affiliates to enter into or arrange any type of transaction. Any investments made are not obligations of, deposits in, or guaranteed by Fullerton.

Investments have risks and you may lose your principal investment. The value of the investments and any accruing income may fall or rise. Any past performance, prediction or forecast is not indicative of future or likely performance. The contents herein may be amended without notice. Fullerton, its affiliates and their directors and employees, do not accept any liability from the use of this publication.