A TECHNOLOGICAL COLD WAR?

OUR PANEL DISCUSSED CHINA'S GROWTH STORY AS IT OPENS ITS FINANCIAL MARKETS FURTHER TO FOREIGN INVESTORS, MSCI INCLUSION IN MAJOR BENCHMARK INDICES AND THE BATTLE FOR TECHNOLOGICAL SUPREMACY. CHAIRED BY **ROMIL PATEL** IN LONDON.

PANEL

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Photographs: Simon Way

***Funds Europe* – Last year saw several headwinds, including US-China trade tensions, rate hikes from the US Federal Reserve and a slowdown in China's economy. What is your investment outlook for 2019?**

Jun Li, Sagard China – Last year was tough on a number of fronts and trade tensions between the US and China was definitely one of those. Coupled with that, China's financial deleveraging hurt both private and public demand and slowed the economy. For 2019 there is still a lot of uncertainty around macro and the economy, which in turn also depend on how the US and China are going to strike an agreement.

Before leaving Shanghai, I spoke to some people on the ground and the current view is that even though China is very willing to put an offer on the table, i.e. purchasing more products from the US – agricultural products, industrial products and so on – a handful of difficult issues between China and the US remain. Those issues could potentially include things like intellectual property (IP) protection, how to lower thresholds for

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foreign investments in China and how US companies can be treated fairly in China. From a Chinese investor's perspective, what we really worry about is the impact of the economic relationship between the US and China over the longer term.

We worry about potential tensions that can lead to a slowdown of cooperation on multiple fronts, especially in technology. In biotech, we are hearing people say that new scientists are reluctant to come to China and the exchange between the top scientists has been slowing down – the impact of this on industries and companies could be long-lasting.

James Jackson, Aon – It is important not to lose sight of why investors are allocating to China. For us, it is going to be a strategic decision, something to hold for five to ten years, and certainly not something to try and time coming in and out in a single calendar year.

When you consider the depth and breadth of the A-share market, I struggle to think of reasons to avoid it entirely. Much of the long-term thesis is around consumption, healthcare, financial services and a lot of this is domestic and therefore less exposed to international trade. Look at smartphone sales in China – the vast majority are with domestic brands now, not international. There is also a big increase in domestic car brands that are being sold within China, so there are clearly still opportunities for stock-pickers to find ideas that are less exposed to global trade.

We would not preclude our managers from going there next year based purely on trade tensions.

Nidhi Mahurkar, Investec Asset Management – After a difficult 2018, the Chinese market is looking increasingly interesting relative to both the global opportunity set and to its own history. Entry value is good, and this raises the probability of outperformance on an appropriate investment horizon. At the same time, China's policy has eased both on the fiscal and monetary front. We expect the easing cycle to be a strong catalyst for China equities but would highlight that easing this time is fundamentally different from previous easing episodes. After sustained efforts trying to deflate the credit bubble and taking out shadow banking, we do not expect the liquidity taps to turn on quite as much as they did in previous cycles.

In terms of the US-China trade war, we would temper enthusiasm on rising expectations of a trade deal with the US. We expect the removal of tariffs as partial carve-outs in certain sectors. This will be a positive development, no doubt, but is unlikely to resolve broader trade friction around issues of intellectual property as well as market access and reciprocity on how US companies are treated in China.

"WHEN PEOPLE TALK ABOUT TRADE WARS, WE REALLY SEE IT AS NOISE."

Nick Samuels, Redington

We view the trade conflict as a longer-term recalibration of the relationship between the two largest economies in the world. Over time, we expect the trade conflict to serve as a natural catalyst for the Chinese economy to open up further and accelerate the rebalancing of China away from manufacturing and exports towards more consumption and services.

Jerry Wu, Polar Capital – I think trade tensions between the US and China will de-escalate – the market is telling us that. The more relevant point is the rivalry around technological supremacy between the US and China over the long term – and that is going to persist. This is the paradigm that we are going to be operating in over the next decade or two.

One of the key investment implications out of this is really the emergence of homegrown champions out of China. We have seen that with the internet, there is Alibaba and Amazon and there is Facebook and Tencent. It is going to happen in a lot of other industries, so in our portfolios, we want to be invested in the next Texas Instruments of China, the next ABB of China and the next

Medtronic of China, and that is going to happen over the next ten years. Some industries will be more difficult than others. In terms of outlook, we are cautiously optimistic. We believe 2019 is going to be a two-way market.

Nick Samuels, Redington – I was in China in September [2018] on a research trip looking for China A managers on the ground. We have since allocated or are recommending clients to allocate 10% of their equity allocation to China A, which is on top of a 20% emerging market allocation. We are very positive on the growth story in China and have opened an office in Beijing as well.

China is a strategic allocation and we are recommending our clients to take a five to ten-year view, so when people talk about trade wars, we really see it as noise and perhaps an opportunity to add at lower levels of valuation. We saw the China market fall substantially last year on worries like this and we really see that as an entry point into a long-term structural growth story.

Andrew Pease, Russell Investments – Compared to six months ago, I am a bit more constructive about China in 2019 for a couple of reasons. The US Federal Reserve (Fed) not doing three or four rate hikes in 2019 is important. Another thing is the data has been so poor in China over the last few months. Six months ago, it seemed that they were not going to do anything like the scale of the previous policy stimulus, so there is a decent chance that they are going to go in with a good monetary or fiscal stimulus from around about mid-year, which does create some cyclical upside.

Over the medium term, I am a bit more agnostic towards China because I worry about imbalances in the economy, the over-savings rate, the high debt levels, governance issues in China – particularly after the last Congress with Xi Jinping now being made effectively leader for life. There are a lot of issues in China that worry me as a longer-term investor.

"THE POLICY LANDSCAPE HAS EVOLVED POLITICALLY AND ECONOMICALLY, GIVING PRESIDENT XI A LONG RUNWAY TO PURSUE HIS AGENDA."

Nidhi Mahurkar, Investec Asset Management

***Funds Europe* – What impact has MSCI inclusion of China A-shares in its major benchmark indices had so far, and what is your outlook for Chinese equities?**

Samuels – The impact has been non-existent so far. The market was down 35% over the last 12 months. In terms of making an impact, people would have imagined a wall of money coming into China A-shares, pushing prices and valuations up, but this has clearly not happened, and the impact has been limited so far. MSCI's decision to include China in the index is certainly increasing investors' attention towards it, but the money has not really started to flow in yet. You are certainly seeing a lot more accounts opening in Hong Kong, so people can access the Stock Connect that way. People are certainly gearing up, although there have no major flows in.

We are very bullish on China equities over the long term. There is a strong top-down case which is clearly centred around the inclusion in the indices. That will continue, more and more companies are going to come to market and there will be more initial public offerings [IPOs]. That should continue to grow in the various indices as well. But the bottom-up case, the alpha case, is more interesting. It is very clear that the mentality in China is a very short-term trading-oriented way of investing. What is interesting for us is using more traditional techniques – quality investing, value investing and taking a longer-term view. The alpha potential for us is very strong within the market; 85% of the volume is pure retail investors – that is people literally trading on their phones on WeChat. What was amazing to us was seeing people hold their stocks in the same account that they would use for their bank account, so if they are going out for dinner, they could sell some shares to pay for it. There is not that profit maximisation mentality, a lot of the trading is not made on an institutional informed basis, so we believe that is ripe in the medium term for some strong alpha generation.

Mahurkar – We believe China will be a major net fund flow story as China gets to GDP weight in emerging market indices at a 100% inclusion factor. While the pathway to full inclusion by index providers will be a multi-year story, we expect this to be a continuing tailwind powering northbound flows. We believe active investors are increasingly looking to position ahead of China's phased inclusion process. Indeed, northbound flows – both active and passive – have been steadily rising since 2017. This was more than offset by China's own deleveraging and tightening liquidity in 2018, which led to a downshift in risk appetite and sentiment domestically.

In addition to the size and diversity of China's mainland market – we believe it is an attractive opportunity for alpha-seeking investors. The mainland market is the most inefficient block in global public markets that is entering the universe today. The fact that this market is richer from an alpha perspective is largely to do with it being such a retail-dominated market at over 80% of trading volume. Price discovery is not being driven by sophisticated investors here. These investors trade largely on emotions rather than on fundamentals. A disciplined and active investment approach can cut through the inefficiencies created by the behavioural biases of this investor cohort and therefore be highly effective in alpha generation. We have used this approach in a best-ideas strategy of 30-40 stocks – a first-of-its-kind strategy to invest on a pan-China basis since launch in 2014 – regardless of onshore or offshore listing.

It is also noteworthy that in January 2019, the Bloomberg Barclays Aggregate Index announced the phased inclusion of Chinese bonds with a 6% weight which will be phased in over 20 months starting in April 2019. China's market is being liberalised on a cross-asset basis, not just equity. It is the second-biggest market in the world and foreign ownership on both bonds and equities is close to 3%.

> "CAN CHINA COME UP WITH ITS OWN INTRINSIC SOURCES OF PRODUCTIVITY GROWTH? THAT WILL BE ONE OF THE FASCINATING THINGS TO WATCH."
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> *Andrew Pease, Russell Investments*

Pease – The alpha opportunities are clearly there, but the beta arguments for long-term market returns are not quite so clear. The Chinese economy is slowing, and the question is where is the earnings growth going to come from – the structural earnings growth that is going to drive that market higher? It is not expensive right now and the multiples are not particularly demanding, but going forward, the question is where is the earnings growth going to come from that is going to drive significant beta performance over the next few years?

Wu – What we expect will happen in the long term is a unified asset class called Chinese equities will be very relevant for any allocators, which explains why we went with an all-China approach for the fund. We do not care where the shares are listed, in Shanghai or in Hong Kong or in the US, we just want to capture the best ideas that are going to be able to capitalise on the structural growth opportunities in China. In the longer term, that is where the asset allocation is going to go, but the question is how long does that take?

We own about 40-50 companies in our portfolio and we want those that can deliver. For instance, we have this over-the-counter drugs company – these are the cold and flu drugs, the types of drug that can be bought from Boots. As consumers become more health-conscious, we are confident they can compound at low teens of earnings growth regardless of how the macro environment is going to be. From that large liquidity pool, there are many securities from which we can find good growth opportunities regardless of the macro environment.

Jackson – To date, MSCI inclusion has not had an impact on the performance at the index level. However, it has truly given a new string to the bow of our unconstrained emerging markets managers. A-shares are a new opportunity set, giving access to attractive areas of the market that are not available through the old MSCI China. China-A is much more consumer-focused compared to MSCI China, where historically, exposure was very much to the state-owned banks and large industrial companies.

There is a lot more discussion about China amongst ourselves and clients, whilst we are seeing managers hire more Mandarin-speaking analysts to cover the market. In most emerging markets, you can make an argument that company meetings can be done in English, but that is not the case in China – you need Mandarin language skills.

On the outlook for Chinese equities, we have discussed the size of the market and where MSCI thinks it could go. One of the interesting things about these forecasts is that they make no assumption around possible relaxation of foreign ownership limits. As China liberalises, you would expect that to increase.

From an emerging markets perspective, if we look over a seven-year period, it is not unreasonable for South Korea and Taiwan to be promoted to developed markets status, and that further increases the weight of China within emerging markets.

***Funds Europe* – How concerned you are about the impact of government regulation on stocks?**

Mahurkar – It is important to step back and look at the policy pretext of Xi Jinping's administration. The policy landscape has evolved politically and economically, giving President Xi a long runway to pursue his agenda. State-owned enterprise reform is a key plank and that generates a whole host of investments opportunities around it. The second is the tendency to intervene in the market and try and put protections in place so that there is not an overtly capitalist system where a few companies profit at the expense of the many. We saw intervention in several sectors including healthcare, gaming and education last year.

Our analysis is that there is a readjustment of risk premium that investors are going through when there is a disruption in the market. They are trying to put protections in place – be it monitoring the time that children spend on these games, the violent content in these games on the one hand, to ensuring that basic healthcare remains affordable and stays that way, and also the price of bulk formulations does not go up too much.

Intervention is something investors need to navigate, but it works both ways. As a rational investor, it is not necessarily a bad thing. For some pharmaceutical companies that we track, it accelerates the shift towards innovative speciality drugs, and there are many companies there. China remains a policy-driven market and this wrong-footed a lot of investors last year.

Wu – On the policy front, the extent of government intervention has been disappointing. State-owned enterprise reform has been a big let-down over the past few years and we have not seen much progress. We very rarely invest in state-owned enterprises. We want to see an incentive system, then organisational changes can happen, and we will pick the ones that we believe will benefit.

***Funds Europe* – Healthcare, consumption and education are becoming increasingly prevalent themes, both from an investment and social perspective in a country with a huge population. How are you incorporating these themes into your investment landscape and how big are the opportunities for participation?**

Wu – They are exactly the sectors we focus on and allocate a lot of our capital to. They currently make up about 63% of our total portfolio, and about 40% in the index. The reasons are twofold: one is these are the sectors where we are seeing a lot of structural growth, but also, we can easily find high-quality companies in these sectors. These are the companies with good brands, high barriers to entry and private enterprises with good management teams.

The social aspect also makes it very important for us to pick the longer-term structural winners. In all the Polar Capital emerging market Stars funds, the lens of sustainability is actually a very integrated part of our process. Sustainability really has become a buzzword, but for us it is something that we truly believe adds an additional analytical tool for us to gain an edge in the market.

Jackson – We are not investing on a thematic basis, but rather relying on the manager to pick best ideas from across the opportunity set. We want managers to be unconstrained and to invest where their best ideas are and not be limited by sectors or thematics. That said, it is not surprising that our managers are choosing to be much heavier within the consumption and healthcare areas of the market. Of our China A-share exposure, approximately 60% is in the domestic sectors, which is around double the benchmark.

With regards to sustainability within China – from where we sit it is very hard to grade managers. One thing we can look at is the data providers – Sustainalytics, MSCI, etc – however, a lot of the companies either do not have disclosures, or when they do, there is nearly zero correlation between scores of the data providers. Investment managers speak around weaker governance structures, related parties and poor disclosure. Yet on the other hand, you hear stories of some companies doing good things, but they are just not providing the disclosures that investors need to see.

Li – We have a slightly different view on these sectors. While these are all sectors that appear to have secular growth potential, we understand government policies could be very disruptive – especially to the development of healthcare and education. We keep asking ourselves: 'With that kind of policy headwind, do we need to switch to certain other sectors that can potentially have better growth potential?' While the demand is strong for education and healthcare, the reality is that the government is running short of funds to supply free healthcare services for everybody. If that is the reality, the earnings of a lot of drug companies are going to inevitably be hurt by price cuts. We think this is a policy overhang – it is not going to disappear. There will be another round of price cuts for

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Jun Li, Sagard China

equipment and drugs and it will last for quite some time. We are very cautious about the short-term and mid-term impact on those companies.

Inevitably we think there will be a shake-up in both in healthcare and education, leaving only the survivors of industry consolidation. We are more patient on those fronts, we are waiting for the dust to settle and want to pick the winner that can last, because during the process, a lot of weak companies may just disappear. The policy impact is very difficult to estimate and picking a winner and a loser at times like this does not really make a big difference. Hence, we are more patient – especially on those two sectors – and want to see how things go.

Mahurkar – We do not invest with a top-down thematic approach, but instead identify our ideas stock by stock, utilising a disciplined bottom-up investment process. We also place significant emphasis on assessing ESG factors, including governance and alignment with majority shareholders when conducting fundamental analysis.

Our approach identifies a mix of opportunities in both the old economy and the new economy. In policy-sensitive sectors like state-owned enterprises that certain investors shun, we own companies with an improving trajectory of returns through better capital allocation, better management incentives, environmental controls and improving disclosure. At the same time, a sizeable number of names we hold are exposed to more secular investment opportunities linked to the domestic economy – in insurance, premium brands, leisure, healthcare, but also emerging opportunities in industrial automation.

To take the healthcare sector as an example, the average Chinese person spends 32% of total out-of-pocket medical expenses on their own, so total coverage is still not adequate – there is room for growth in private healthcare with China's ageing demographics. It is the fastest-growing insurance market in the world, but the penetration of insurance premium per capita is only about 5%.

Even though the Chinese economy is slowing – a natural consequence of having emerged already as a major middle-income economy – at these growth rates, there is still sizeable room for companies to grow their footprint horizontally, vertically and geographically in the domestic market. As active investors, it is our job to drill down that opportunity set into the best 30 or 40 ideas.

***Funds Europe* – As far as the West is concerned, we are seeing variations on technology being introduced by Chinese players that are in some respects out of step with what we have seen. Are we seeing Chinese players increasingly driving innovation in technology?**

Li – You will see more innovations empowered by better infrastructure, especially the 5G technologies. The Chinese government is still very keen on pushing for 5G development, despite the fact that Huawei has been causing some concerns on a global basis. With mobile technology being pushed to 5G with the interactivity speed being significantly increased, I can imagine there are a lot more new applications and new forms of interactivities being developed.

Although I cannot pin down exactly what it is right now, with another wave of technology there will be a new wave of applications, new innovations and new companies.

Mahurkar – We are seeing a lot of innovation at scale emerging in China and not just in mobile internet and online retail penetration, where China is already the undisputed global leader. Large-scale innovation is happening in robotics, electric vehicles, 5G infrastructure, autonomous driving and biotech. China also has aspirations for self-sufficiency in semiconductors. Leading insurance companies are building a digital version of China's healthcare system through healthcare apps.

The interesting thing about China is a lot of this innovation is being driven not just by the entrepreneurial private companies, but also by the state. Typically, people tend to think of a communist party state-sponsored regime as one that stifles creativity and therefore cannot be a hub of innovation, but that is exactly what is happening. Today talent is returning to China – 250,000 people have come back in the last six years and gone into the life-sciences sector, for instance. The state is collaborating extensively with leading universities and the number of patents being filed by Chinese companies is outpacing those from the US, Japan and South Korea.

***Funds Europe* – Will we see more drivers for entrepreneurship as Chinese talent returns to China on a large scale?**

Pease – I am not negative about China by any stretch, but there is a demographic issue and long-term growth issue, and we know that the economy is slowing.

From a big-picture point of view, the question is whether China is going to avoid the middle-income trap, and can it get past that point? That will depend on whether it can come up with its own sources of productivity growth to build on top of the slowing demographic growth that it otherwise has. That is a very open question and it is encouraging to hear stories like the ones we have heard today, but the arc of the trajectory between the US and China is not supported because in many ways, we are heading towards a technological cold war, and we have seen that with challenges with a Chinese telecommunications provider. We are heading towards that tech cold war, and that will be one of the big challenges going forward. Can China come up with its own intrinsic sources of productivity growth which will allow it to escape that middle-income trap? That will be one of the fascinating things to watch over the next five to ten years.

Mahurkar – The answer to that will depend on whether they can successfully climb up that value chain. It is not going to be easy, given the current US-China engagement, but clearly as the workforce ages and investment intensity declines, the only way to get productivity up is through building an innovation and knowledge-based economy. This is the new growth model that China's policymakers wish to embrace.

Pease – The concern is they may have to go through a J-curve to get there. China can move up the value chain, but do they have a political system that can cope with the adjustment costs of structural reform? I worry that every setback sees them return to credit growth and leverage, which works in the short term but increases the longer-term vulnerabilities.

Li – Going back to governance and state-owned companies versus private companies, we do not usually generalise whether state-owned companies are less efficient and less transparent in governance. This is because while doing all the due diligence in China, we see very good state-owned companies and we see a bunch of very bad private companies with lousy governance and disclosure. Our approach is to research company by company and industry by industry.

Generally speaking, the strengths of state-owned companies are that they have a lot of technology, or they have a lot of talent and some natural advantages as the government may also sponsor them. As a result, they may have some first-mover advantages. Some companies have developed good mechanisms and incentive alignment of the managers that make them quite successful – Hikvision is one example and there are lots of others. If the reforms take off, there will be a huge uplift of productivity, especially as it such a big part of the economy. But it is a very daunting task.

Samuels – That is certainly our view and it is important to allocate to unconstrained managers rather than a themed-type approach. We have seen a number of funds – either explicitly or implicitly – just focus on the consumption themes, the growing Chinese middle-class theme. We have seen throughout history in developed markets, whether it be through the tech bubble or in emerging markets, a revaluation of structural growth quality companies up to eye-watering levels.

There will be points at which all of that future growth is priced in and you have created an opportunity somewhere else – probably in those state-owned enterprises. There are opportunities in parts of the market that people structurally do not look at, so it is important to have a broad allocation.

***Funds Europe* – What are your expectations for China's investment landscape over the next five years?**

Jackson – There is increasing demand for China-A strategies. My view is that the all-China mandate will have a bit more appeal a little bit further down the line. At the moment, clients should be looking at the types of exposure they have got within their existing portfolio, within global and emerging markets. The likelihood is that H-shares are already well-catered for, and it is the A-shares where the gap in coverage is.

We are having conversations with a number of clients around China-A exposure. Further down the track there could be an argument, as A-shares come into the index, for breaking out China and then that is when an all-China approach could be of interest for some clients, but that will not be universal. Right now, there is virtually zero product out there for emerging markets ex-China.

On a long-term view, you would also expect global and emerging market managers to more universally expand their opportunity set into China-A. It is not unreasonable to think that global managers can develop this skill set on a sufficiently long investment horizon. I have not seen the evidence thus far that local is distinctly better. It is mainly a resource issue – global and emerging market managers currently do not have the resources and Mandarin skills to cover the thousands of additional companies that A-shares present, but they will be forced to do that as A-shares come into mainstream indices more and more.

"MANAGERS DO NOT HAVE THE RESOURCES AND MANDARIN SKILLS TO COVER THE THOUSANDS OF COMPANIES THAT A-SHARES PRESENT, BUT THEY WILL BE FORCED TO DO THAT."

James Jackson, Aon

Wu – From a longer-term perspective, it makes sense to just go with the all-China approach now that market access is no longer a problem. The all-China approach is probably a simplified and unified way to allocate to China in the longer term from an allocator's perspective.