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Is Now the Time for China A-shares?

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An experienced local eye sees all the pieces falling into place for a potentially significant growth story.

As Europe and U.S. stocks felt the full squeeze of Covid-19 this spring, Chinese equities surged and, in some cases, reached record highs. The timing of the pandemic played a role – China was the first tobe hit hard by the virus, and thus the first to see it abate. With the policies currently in place – that is to say, without additional stimulus – China's

GDP is likely to grow 2% to 4% in 2020, maybe making it the fastest growing economy in the world. The growth is driven by solid companies that offer investors an opportunity to diversify their portfolios and also participate in a potentially strong growth story. II recently spoke with **Jun Li, the CIO of Power Pacific Corporation Limited, a strategic partner of Mackenzie Investments**, regarding opportunities in A-shares which she and her team in Shanghai relentlessly pursue.

What's your view on how the Covid-19 pandemic will affect China equities in the long term?

The pandemic is going to impact the global economy for all of 2020, and to what extent it does so in 2021 remains to be seen. When the U.S. and Europe have brought the pandemic under control, I think the equity market will recover. Our long-term view regarding China is that the virus is a health crisis and that it will pass like previous epidemics. In contrast to 2008, this is not a financial crisis driven by systemic failure in the banking system. Equity markets are still sound in China and globally. When an effective vaccine or a cure is developed, the global economy will recover.

Is there any silver lining among the implications of the financial disruption?

Asset prices have become more attractive. Long-term investors are using this opportunity to seek high quality assets in the U.S., Europe, and markets such as China. Post-crisis, we may see fundamental opportunities in sectors like healthcare and the technology space, where video conference and other social media tools are being used by more people and may become more ingrained. In China specifically, e-commerce, especially in food delivery, and online education could present opportunities. We will see first quarter negative GDP growth in China, and the second quarter may remain challenging, however we do not believe that the long-term trajectory has changed for China.

What was your view on China equities pre-pandemic – and will you stick to that view once things settle down?

At year end 2019, we strongly advocated an overweight of China and Asia emerging markets, and China equity, because we observed that the embedded growth is greater and the overall valuation is cheaper than in developed markets. As a result, we have a strong conviction that those EMs will outperform developed markets in the mid- to long-term, and that the China equity market should outperform other emerging markets because the strength of the Chinese economy is resilient and the core sectors are developing pretty well despite disruption from global trade conflicts.

What do you see as some of the underlying strengths of the Chinese economy looking forward?

China has a very strong labor force that is becoming better educated, and that is a key driver for future development in the technology space and advanced manufacturing sectors. In addition, we see Chinese companies investing more in R&D. Chinese healthcare companies, for example, are investing significantly more money into the development of innovative drugs, and technology companies are investing a much higher percentage of their revenue into the development of their platforms.

From a top-down point of view, China is a market with stronger growth, and from a bottom-up view companies are investing to improve productivity.

You and your team are based in Shanghai. How can that benefit foreign investors in China A-shares?

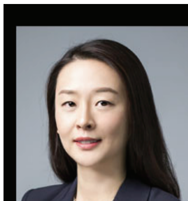
Beyond being highly skilled and experienced, our team members are all "locals" in China, so we have consistent interaction with management teams at companies we invest in or are interested in. The frequency and quality of interaction help us to understand the vision of a company's management team – and if we think they can achieve it in way that makes them worthy of investment.

Another major advantage of being local is that we conduct more primary research to form our own differentiating views on companies and sectors for the future. That kind of primary research may include channel checks – there is a very long supply chain from production to consumers in a country as big as China – consumer surveys, and talking to experts. And we can also conduct primary research by simply walking down the street to a supermarket, for example, and checking product prices to get an indication of a company's competition, its branding power, and so on.

Beyond walking into a nearby store, how is primary research executed in practice?

Last year we conducted research field trips in four different areas in China – one each quarter. This is important to forming a view because the economy is composed of so many different areas, each at a different level of development. A view from the ground regarding the different regions, cities, companies, and products and services sold in each, provides us with a holistic and realistic context for the companies that we invest in.

Being on the ground also helps us establish long-term connections with people in the industries we follow. We gain bottom-up insight from listening to their views of sectors, and that allows us to cross-check different sectors to form a more dynamic view on a key thesis that we believe in or are trying to develop.



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– Jun Li, CIO, Power Pacific Corporation Limited

Many investors allocate to China A-shares solely through indexes. Are they missing out by not participating in a more active investment process?

Yes, and they are constrained by several factors when they exclude active investing in China. One is the growth alignment of sector allocations of a certain index. The CSI 300, for example – 35.7% of the index is financial services, and industrials is about 11.3%[1]. As an investor in the index, these exposures cannot be avoided. From an active manager's point of view, however, the future of the economy and the growth of assets may not lie in the financial sector. For example, we deviated from the index by underweighting the financial sector and overweighting the sectors that we believe in, including consumer, healthcare,

[1] Source: Bloomberg, as of 3/31/20

industrials, and TMT. By being an active manager, we can select assets that represent the future and potentially higher returns for investors. There are also a lot of companies that will be winners in the future and are not part of the index. It's very difficult for ETFs to get that kind of exposure. As active managers, we can handpick the companies that are very well positioned in a niche market and show the potential to grow and surpass their current level of success – and that can generate great returns for our investors.

How do you identify what you believe to be the future winners?
We are methodical when identifying what we consider high-quality companies in China. First, we consider the industry outlook – does it show growth potential? Are there good dynamics among competitors? Does it have a high barrier to entry? A good industry dictates the success of a lot of the companies within it.

At the company level we are looking for moats within the industry – a differentiated product or service, cost leadership, consistent innovation. And we're looking to see if the business has a viable roadmap to success – can we forecast clear drivers for future growth and return for investors? We do a lot of financial due diligence in that context. We also want to invest in companies with very ambitious and capable management that is committed to good governance on behalf of smaller investors.

You mentioned good governance. How does ESG, as a whole, factor into your decision making?
Generally speaking, for us to consider a company it must be environmentally aware, socially responsible, and also treat minority shareholders fairly. We see rapid progress in the disclosures that companies make on ESG. In a market like China, we focus heavily on the G – governance. This is achieved through primary research to fully understand the companies we invest in.

There are encouraging signs of progress – all the listed companies are becoming more aware of ESG and adapting to higher market standards as disclosure policies evolve. In recent years, there has been a significant focus on the social footprint of companies and we observe a shift in mindset with better treatment of employees and bringing women into management. We recognize that ESG considerations are not static, and we seek companies that invest to improve their ESG characteristics. Showing progress is very important to us. Of course, if a company has a track record of manipulating its earnings and treating investors unfairly, we will not consider it at all.

In your mind, does China merit a separate allocation in institutional portfolios?
Yes, it's worth it for institutional investors to look at China as a separate allocation. Chinese GDP is about 16% of the global economy, and China represents about 36% of the emerging market index for MSCI – and emerging markets represent about 12% of the global equity index. If you do some quick math, China's equity weight globally is about 4.3%, so it is significantly underweight compared to its economic importance. We do see some institutional investors who want to overweight China, putting it as a separate basket containing a certain percentage of their global equity allocation, and I think a specific allocation makes a lot of sense.

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A-shares have historically been the domain of retail investors. Are you seeing more institutional players entering space, and if so, how will that affect it?
With the establishment of Stock Connect we are seeing an inflow of global capital into the China A-share market, including more institutional investors. Such foreign investment will become increasingly important and have a positive impact on the market. With more institutional participation, companies listed in A-shares will become more professional in disclosure and communication with investors. With institutional participation, the market will be less volatile, and a lot of value will be driven by good companies with a track record. The A-shares market in general is understudied, but it is the best representation of the composition of the Chinese economy. With the exception of the internet, it has the most important sectors – a lot of consumer names, technology names, including some smaller cap tech companies, and almost all the good healthcare companies – and over the past 15 years we have established a tremendous amount of knowledge about the market and the stocks that we cover.

Learn more about how China A-shares can figure into your investment strategy.

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