MACKENZIE Investments

SAGARD CHINA

The case for Chinese public equity

September 2019

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Executive summary

1. China's economic influence on the world is returning to its former prominence over a 200-year cycle

For the next decade or longer, China is poised to be the top contributor to global GDP growth by a large margin

World's top-10 economies: 1820-2030 | % share of total world nominal GDP

1820		1970		2016		2030E	
China	**28.0%**	U.S.	38.8%	U.S.	22.9%	**China**	**18.5%**
India	16.0%	Germany	7.8%	**China**	**14.8%**	U.S.	16.5%
France	5.4%	Japan	7.6%	Japan	6.5%	India	12.0%
U.K.	5.2%	France	5.4%	Germany	4.6%	Brazil	4.8%
Prussia	4.9%	U.K.	4.7%	U.K.	3.5%	Indonesia	3.5%
Japan	3.1%	Italy	4.1%	France	3.3%	Japan	3.1%
Austria	1.9%	**China**	**3.3%**	India	3.0%	Mexico	3.0%
Spain	1.9%	Canada	3.2%	Italy	2.4%	Russia	2.7%
U.S.	1.8%	India	2.2%	Brazil	2.4%	U.K.	2.3%
Russia	1.7%	Brazil	1.5%	Canada	2.0%	Germany	2.3%

Source: Angus Madison, World Economic Forum 2018

2. Supported by an increasingly high-tech, consumer-based economic powerhouse, China's public equity market is now second only to the U.S. in terms of market capitalization.

Just like its economy, China's onshore public equity market has become too big and too attractive to ignore

3. Highly liquid and offering low correlation with other capital markets – including in emerging markets – China A-shares present investors with a unique opportunity to improve their portfolio efficiency.

Still dominated by retail investors, we believe China's onshore public equity market gives institutional investors the potential to generate significant alpha

Global investors should take a fresh look at China. In our view, near-term issues are dwarfed by China's long-term rise and the potential for mutual gain in worldwide growth, trade and technology.

Investing in China’s stock market

Foundations

Through its scale, liquidity and ease of access, China’s compelling stock market has caught the attention of investors worldwide. Similar to its buoyant economy, China’s stock market is becoming increasingly modern, reliable and professional. Furthermore, upgrading and institutionalizing the investment market is a central government priority (broader foreign access; greater focus on institutional pension market; new heads of securities, insurance and banking regulators).

Scale

Chinese onshore stock markets began as an experiment in 1990 with the reopening of the Shanghai Stock Exchange (SHSE) and establishment of the Shenzhen Stock Exchange (SZSE). China has now grown into the world’s second-largest public equity market. China A-shares are the stocks of companies based in mainland China that trade on the SHSE and SZSE. They comprise most of the stocks listed on these two exchanges. Historically, only mainland citizens could trade A-shares. However, since 2003, select foreign institutions have been able to trade these shares through the Qualified Foreign Institutional Investor (QFII) system.

Liquidity

The Chinese stock market is highly liquid. The stock turnover ratio of China A-shares is among the highest in the world, allowing investors to buy and sell shares easily and at decent price spreads. In 2017, the Shanghai and Shenzhen stock exchanges saw US$30 billion and US$48 billion, respectively, in daily turnover. When compared to the size of the exchanges’ market value, this makes the Chinese stock markets among the world’s most liquid.

Access

Shanghai-Hong Kong Stock Connect – which allows investors in each market to trade shares on the other market using their local brokers and clearing houses – has opened the door wide, and financial liberalization is set to continue as regulators have long advocated for an increase in institutional investor participation to help dampen market volatility.

While China’s market continues to be retail-led and volatile, corporate governance standards have improved and regulators are implementing clearer, more effective rule frameworks.

4,905

Listed companies in China – vs. 3,600 in the U.S[1].

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China's stock market represents 14% of the global market[2] – roughly in line with its share of world GDP. This includes a US$6 trillion domestic market and US$3 trillion traded offshore in the U.S., Hong Kong and Singapore.[3]

[1] As at March 31, 2018. Chinese stock market composition data from: Wind

[2] As at March 31, 2018. Source: MSCI

[3] American Century Investments®

Strong beta

China's resurgence was paved by a reliance on exports, but this is no longer the case. Today, it has become one of the world's most innovative economies, increasingly service-oriented and driven by growing domestic consumption.

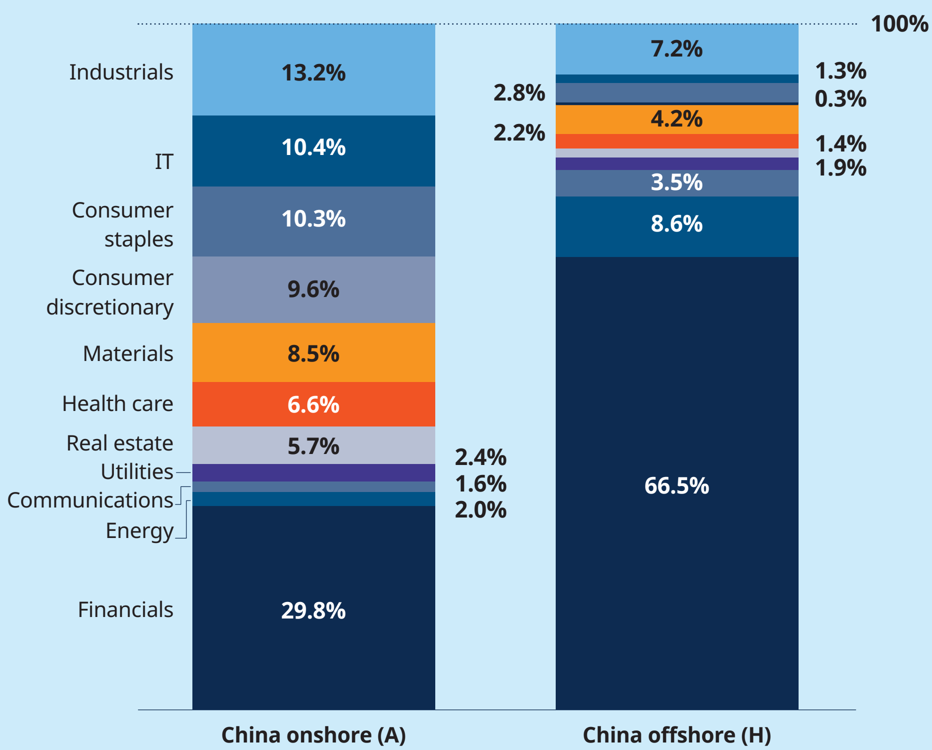
China is focused on transitioning into a stable, consumption-based economy. This transition requires robust markets, credible institutions, rules-based oversight and a more complete financial liberalization.

For the next decade or longer, China is poised to be the top contributor to global GDP growth by a large margin

Accessing China's onshore public markets allows investors to benefit from the strength of China's massive economy. More sector diverse than Chinese offshore markets, and no longer dominated by State Owned Enterprises (SOEs), China's onshore market offers a broader and truer representation of the economy.

China also has the world's largest middle class population, with 109 million adults (compared to 92 million in the U.S.). It is projected to expand rapidly, at 20% compound annual growth between 2010 and 2020 [1], which is the fastest rate in the world after India. A robust middle class traditionally drives increased economic growth.

China onshore vs. offshore sector composition (Q1 2019)[2]



[1] Source: https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html
[2] MSCI China H Index (USD); MSCI China A Index. Q1 2019

With the rise of the middle class, industries like health care, insurance/wealth management and consumer staples will greatly benefit from robust economic growth. Companies within the services sector of the economy also appear likely to grow strongly.

China's economy continues to upgrade and is poised to be an innovator on the global scale. The new focus will be a service-centric, innovation-ready economy. Increased spending on research and development – notably in technology, pharmaceuticals and energy – and the rising number of patents filled clearly indicate that this immense transformation is underway.

Strong economic fundamentals × **Solid companies** = **Excellent beta opportunity**

Strong economic fundamentals

China's stock market is backed by a US$12.2 trillion consumer-led economy

Solid companies

The market contains some great companies with phenomenal moats and business models driving earnings growth and ROIC

Excellent beta opportunity

China's stock market is set to achieve long-term sustainable growth

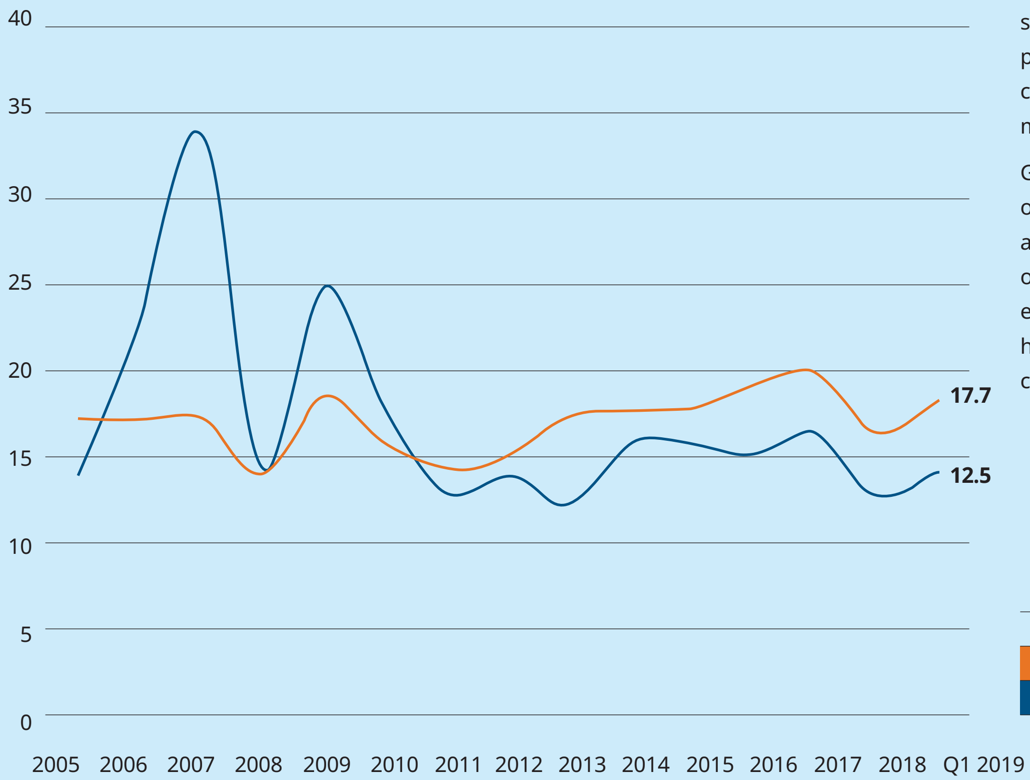
High alpha potential

Trading in the onshore market is still dominated by 140 million retail investors. These account for over 80% (vs. 20% in the West) of a typical day's trading volume. Most retail investors are self-directed or invest through managers with a notable momentum style. This leads to great companies being regularly misvalued, which allows shrewd investors to buy growth potential at a meaningful discount.

While China A-shares have not kept pace with more developed markets since the 2008 financial crisis, their prospects for significant earnings growth, given the positive underlying macroeconomic trends, have led to attractive valuations on a relative basis for investors seeking long-term alpha.

Despite robust growth, valuation metrics are relatively low in Chinese markets – presenting alpha capture opportunities for serious investors

Average price to earnings ratio



Source: Bloomberg. As of March 31, 2019.

The low valuations relative to long-term sustainable earnings-per-share growth present significant potential for alpha generation, which can be optimized through active management.

Given the size and growth potential of China's onshore stock markets and their lack of correlation with other economies or asset classes, exposure to Chinese public equity can help create an efficient portfolio with compelling risk-return characteristics.

	P/E	EPS Growth
CSI300	12.5	12.9
S&P500	17.7	8.8

Low correlation and superior portfolio efficiency

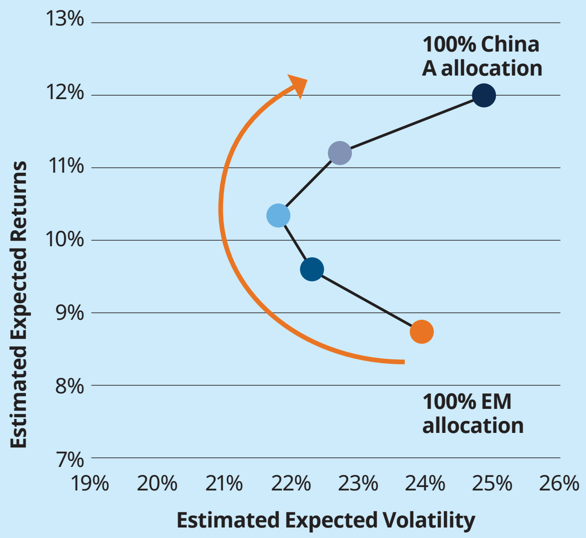
We believe an efficiently constructed portfolio should include Chinese public equity, which accounts for almost 14% of the global equity market. Since China's onshore stock market is highly uncorrelated with other stock markets and offers high alpha potential compared to other markets, it presents investors with significant new opportunities to achieve above-average returns while adding low-correlation, liquid assets to portfolios in mainland China.

Mainland China markets exhibit low correlation with other equity markets

	MSCI World	MSCI ACWI	S&P500	MSCI EM	Hong Kong	MSCI China A
MSCI World	**1.00**					
MSCI ACWI	1.00	**1.00**				
S&P500	0.97	0.95	**1.00**			
MSCI EM	0.84	0.88	0.76	**1.00**		
Hong Kong	0.77	0.80	0.68	0.90	**1.00**	
MSCI China A	0.40	0.41	0.38	0.46	0.56	**1.00**

Source: Bloomberg; based on last 10-year data. As of March 31, 2019.

Benefits of adding China A-shares to an emerging markets (EM) portfolio



Assumptions

MSCI Emerging Markets

Expected volatility: 24%

Expected returns: 8.75%

MSCI China A Onshore

Expected volatility: 25%

Expected returns: 12%

Allocations

- 75% EM | 25% China A
- 50% EM | 50% China A
- 25% EM | 75% China A

As the allocation to China A increases, the estimated expected volatility decreases and the estimated expected returns increase, given the uncorrelated nature of China's mainland markets. At a certain point, the portfolio becomes too concentrated in China-A shares, creating a portfolio that is 100% allocated to China A-shares more volatile than a 100% emerging markets portfolio.

Source: Bloomberg

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Overview

Sagard China, owned by the Power Corporation of Canada[1] (“Power Corporation”), manages Power's investment portfolio in China, primarily in China's public equity market including China A share and H share as well as China ADR.

Sagard China’s operations in China were established in 2005 to invest on behalf of Power Corporation in China’s public equity markets using a Qualified Foreign Institutional Investor (“QFII”) license. Power Corporation was among the first to achieve a QFII license to invest in China's A share market in 2004:

- The first Canadian institution to be granted a QFII license in China.
- One of the first non-bank/insurance/brokerage institutions to be granted a QFII license China.

Since its inception in 2004, Sagard China has successfully grown its public equity investment activities in China. Currently Sagard China has approximately $500 million AUM[2] in its public equity portfolio of China A, H shares and ADRs. Sagard China strives to build a premium investment platform in China by attracting industry's best talents and achieve superior performance.

Sagard China, collectively as a team, has over 50 years investment and portfolio management experience. The company believes their team is the most critical asset to their business and is their single most important competitive advantage. The team received their MBA or other graduate degree from global and China's top tier universities. Many of them are CFA charter holders or CFA candidates. Their prior experience ranges from finance, industrial, pharmaceutical, consumer, transportation, TMT to management and strategy consulting.

Investment strategy

Sagard China implements a long term, fundamentals-based strategy focused on China’s public equity markets.

- They invest in businesses that share this long-term orientation.
- They seek out firms that are helping to lead society to a cleaner, healthier, better living future for China.
- They believe that business which delivers on this promise in a financially responsible and socially sustainable way, will as a result also provide an excellent return on capital.

Sagard China’s edge is its private-equity approach to public markets investing: long term investment horizon, concentrated portfolio, forensic due diligence, and emphasis on responsible corporate citizenship and good governance.

[1] Sagard China is composed of an investment manager, Power Pacific Investment Management Inc. (PPIM), a Canadian corporation that has registered with securities regulators in Ontario and Quebec in Canada as a portfolio manager and investment fund manager; and Power Pacific Corporation Limited (“PPCL”). Both PPIM and PPCL are wholly owned subsidiaries of Power Corporation of Canada (“Power”).

[2] Proprietary portfolio.

Conclusion

1.

Fundamentally sound market conditions in support of beta

China's stock market is supported by solid macroeconomic fundamentals, 40 years in the making. Those fundamentals give China's stock market strong and sustainable long-term growth prospects.

Active equity has good opportunities for the next 20 years in China A-shares

2.

Attractive alpha generation prospects

China's highly volatile and momentum-based onshore market offers clear opportunities for active management to generate attractive alpha

3.

China A: One of the keys to an efficient portfolio

The attractive expected returns of China A-shares, along with their relatively uncorrelated behaviour with the rest of the world, make investing in China onshore a persuasive argument for enhanced portfolio management efficiency.

4.

Growth for investors prepared to seize the opportunity

Today, A-shares open the door for global investors to capture China's new "quality growth" story. Investors who are best positioned to capitalize on this growth will be experienced, flexible and strongly rooted in Chinese fundamentals.

Contact us to learn more about Sagard China.

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