



From the desk of Alex Duffy

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Throughout my career, I've been asked a multitude of questions by investors about the developing world. With more than 25 markets in my universe, the focus can rapidly shift from one area to another, with certain topics clearly a greater priority for some clients versus others. However, very often certain themes do emerge that are common to many clients across the board.

In broad terms China is a perennial, but what's captured the attention of many investors in recent times has been the announcement by MSCI to continue to increase the weighting of the China A Share market in 2019 in the MSCI Emerging Markets Index.

For those less familiar with the importance of the A Share market, I would simply introduce this market by highlighting that it was traditionally the 'playground' of the domestic investor, and indeed it remains dominated by those investors today. It's tipped the interest of many because of the sheer scale of the market – 1,918 companies¹ and, by market cap, it is the third-largest stock market in the world, behind the US and Japan.

The recent decision by MSCI represents a further step forward for mainland China, with A Shares first featuring in the index in 2018. The latest move will result in China A Shares representing an estimated 3.3% of the global EM index. Whilst the decision is no surprise, the timeline for the upscaling the weighting (which is being conducted on a phased basis) is quicker than most would have anticipated.

Whilst this represents a milestone for many, my index agnostic approach, coupled with the benefits of a research team which have long scoured this universe for good opportunities, means that I am less inclined to see this as a pivotal moment. China A Shares have featured amongst portfolio holdings since 2015.

I don't turn the portfolio frequently, but I have adapted the exposure to this market over the course of time – with that decision-making process hinging firmly on my framework for assessing the opportunities and risks.

I chose to invest the portfolio considerably in unloved and unfashionable China A Share stocks during H2 2015 when it was clear that the market was ignoring good quality absolute return companies at highly attractive absolute valuations. Typically, these businesses manufacture everyday essential products such as cookware and home appliances, and grow their cash flows at healthy yet

moderate rates compared to the more fashionable and racy technology and healthcare sectors. For this reason, they were ignored by the largely momentum-focused domestic investor base.

The portfolio benefitted substantially through 2016 and 2017 by holding such companies, as the market came to appreciate the true intrinsic value of their market positions and consistency of return profiles. In fact, whilst during this period many investors focused primarily on the strength of the China Internet giants such as Tencent and Alibaba, our A Shareholdings also posted particularly strong gains through the period, contributing significantly to performance.

As we headed into 2018, I was becoming more concerned about the elevated valuation multiples that these stocks were trading on, following a period of strong revenue and profit growth due to economic recovery. As a result, I reduced the absolute exposure to such names to better reflect the risk-adjusted return profile that the stocks were offering at that point of time. This led to names such as home appliance manufacturer Midea going from a position size of c. 300bps to c. 170bps of the portfolio in Q1. Other names saw a similar reduction in position size. The key point to mention here is that these remain attractive companies with strong market positions that I want to hold for the long term. However, it is also important to remain aware of the risk-adjusted return profile one can expect from a particular business given the valuation starting point – hence the reduction in overall position size. As 2018 progressed, the market bore the brunt of Chinese investors' concerns about the state of the domestic economy and escalating trade tensions with the US (an evolution that accelerated in H2 2018), providing me with the opportunity to add selectively back into the best quality business towards the end of 2018.

During recent periods, the portfolio exposure to A Shares has headed towards 10%, with the aggregate weight of these stocks certainly placing the portfolio head and shoulders above many of my industry peers. I would argue that the on-the-ground coverage and the experience we've

1 Reflects the number of A Share listings on the Shanghai Index and on the Shenzhen Index, and excludes ChiNext. SME Board listings are not included given the manager's market cap focus (SME = small- and medium-sized enterprises). Data at 28 February 2019.

garnered through our dedicated internal research teams means that we are better placed than most to understand both the opportunities and risks.

Whilst the position size of a given business within the portfolio may evolve as the market provides opportunities, the investment process through which stocks are assessed remains constant. Stocks continue to be diligently assessed versus the five key criteria of governance, balance sheet strength, return profile, reinvestment opportunity and valuation. There are periods when valuation levels compress in the volatile China A Share market, which can in turn provide opportunities for me to increase my exposure; thereby, in the longer term I remain more cautiously optimistic than outright bullish on this particular portion of the asset class.

So, what underlies my reservations? The Chinese authorities are clearly opening this market to an international investor base; however, we should remain mindful that the Chinese capital account has remained closed for a protracted period of time before gradually opening. Whilst trending in the right direction, it's by no means certain to me that we are moving to full fungibility, and that we won't see a slowing or reversal should economic or political purposes require. This raises questions for me about currency convertibility in times of stress – something I believe all investors should be mindful of.

Furthermore, whilst we've built a dialogue with management teams, we still can't claim to have known these companies for extended periods relative to other companies operating in other markets in our universe. The true incentives of management teams and objectives of other stakeholders in the businesses in which we invest remain to be seen in many instances. Therefore, I maintain my view that it is best to take a cautious, pragmatic approach to investing within the China A share market, with a keen focus on the true absolute risks that we are embracing as we deploy our clients' capital within this undoubtedly large, potentially rewarding yet undoubtedly challenging area of the investment universe.

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