China managers underweight to Value?

China update

In April, global markets experienced a major sell-off amid a weakening growth outlook due to heightened inflation, rising interest rates, a slowdown in China and geopolitical uncertainty.

At the same time, the US dollar and US 10-year Treasury yield climbed sharply to new recent highs.

It was against this backdrop that Chinese equities continued to decline, with the biggest risk factor being the prolonged COVID-19 lockdowns in some of the country's major cities including Shanghai. For the month, the offshore China market fared better than its A-share counterpart, with the MSCI China index returning -4.1% versus -10.2% for the MSCI China A Onshore index, reversing a trend that we saw in the previous 12 months. Hong Kong-listed Chinese companies received positive inflows from both overseas and domestic investors, as their overly cheap valuations started to gain attention.

Recent economic data for China has pointed to weakness across the board from manufacturing PMI, retail sales and employment, all sitting below seasonal trends as COVID-19 lockdowns continue to weigh on both sides of supply and demand.

There is no sign that the government will abandon the zero-COVID policy any time soon although lockdowns were easing at the time of writing this newsletter. As daily new cases fall and vaccination rates of the elderly increase, we expect further resumption of work and production in the coming weeks.

Policy easing is also coming through, with recent relaxations in the internet and property sectors, including a larger-than-expected cut in the five-year Loan Prime Rate, which is linked to the mortgage rate (15 basis points versus 5bps in the past). And there is still room to do more. At recent Politburo and State Council executive meetings, top leaders expressed concerns over the current economic hardship and urged the use of policy tools to achieve this year's growth targets. With valuations near historical lows, we are constructive in the medium to long term despite short-term volatility.

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This month we will tackle the subject of style diversification and our preferred underweight to Value relative to the index.

Underweight to Value

A common approach to manager selection is to combine fund managers with different investment styles and seek a balanced portfolio. When correctly implemented the outperformance should come from skilful stock selection as opposed to a bias toward any given investment style. A style bias, whether it is to Value or Growth, can result in returns that are driven by the market environment more than manager skill – e.g. Growth stocks do well when the economic environment is benign and underperform when economic growth stalls. Style diversification should result in more consistent performance regardless of the market environment.

At RisCura we believe in diversification across different styles and avoid any persistent bias to Value or Growth across most asset classes. However, our experience in Chinese equities is different where we have maintained an overweight to Growth and Quality at the expense of Value. This applies even where we have a large number of managers in a portfolio with very different styles including specialist Value managers. We have revisited this bias many times and often debate whether we should proactively reduce it.

Out of the negative contributors to Value, half of the tilt away from Value results from holding not enough of the cheap stocks as opposed to being overweight to the expensive stocks . Most of these cheap companies are Financials of which many are state-owned enterprises.

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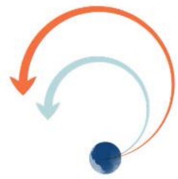
The government uses banks as a tool to manage the economy by selectively modifying lending and underwriting standards. This intervention means that many Financials are not managed for profit but have other objectives, and many active fund managers hold little or none of these companies in their portfolios. This is despite it being one of the largest sectors in the China indices. Data as at the end of December 2021 shows that 75% of managers in a universe of 172 products are underweight to the sector and the average allocation to Financials is 12.7% compared to 17.3% of the MSCI China All Shares index.

The reducing dominance of Financials in China indices

Financials were the single largest sector in China and at one point were almost a third of the entire stock market. When we started fund allocations in 2018 the sector was 28% of our benchmark. This allocation fell to approximately 17 % over just three years as many more non-financial companies have listed, and the growth of Consumer, Technology, Healthcare and Industrial companies have exceeded that of large state-owned Financials.

Whilst being underweight to Financials is the right decision on both ESG considerations and to maximise long-term return, it can be a risk to performance over shorter time periods.

Banks used to be high beta stocks during the earlier phase of China's economic growth in the 1990s and early 2000s. However, they have traded like utilities more recently after the government took assertive action against aggressive lending.



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We continuously revisit our underweight to Financials in China and the resulting underweight to Value

Therefore, they tend to outperform in falling markets such as this year or in 2018 when fears of trade wars caused extreme market pessimism. So the question is whether current circumstances call for a reduction in the underweight to Financials?

Addressing the underweight to Financials

Generally, any persistent top-down bias across a multi-manager structure makes us uncomfortable. After all the whole purpose of selecting multiple managers is to avoid a systematic bias to any one style of investing. Therefore, we continuously revisit our underweight to Financials in China and the resulting underweight to Value.

One of our peer multi-managers addresses this challenge by constantly holding a passive basket of stocks providing defensive, large cap Value exposure in their China equity portfolio. We don't think that this is the best course of action. It feels wrong to artificially address a benchmark risk that exists for very good reasons.

We have written many letters covering ESG in China and how important it is when investing in the country. Even Alliance Bernstein, a well-known value manager, exercises pragmatism in China.

Whilst it has significant Value biases across its portfolios globally it understands the importance of avoiding companies with ESG risks even if they are trading at "attractive" valuations. Because ultimately, what good is having lower risk (in terms of tracking error) optically if some real risk lies somewhere else and the portfolio cannot produce excess returns over the long term?

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Therefore, we believe that a multi-manager structure in China should exhibit a bias in favour of better quality companies even if that results in higher average valuations relative to the index – a bias which is repeated by most active managers including many Value managers.

Saying that we monitor this bias very closely.

For example, in one of our multi-manager funds, when underweight to Financials temporarily exceeded 10%, we made a tactical allocation to a passive Financials fund to bring the relative weighting to under 10%.

After searching for many years we also made an allocation to a fund manager that specialises in Chinese Financials. This was done well before the sector started to outperform the index. We wanted a manager that has the ability to take advantage of stock selection opportunities in this sector. It has been one of our strongest performing managers this year.

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To conclude, we have had a persistent underweight to Value despite allocating to a large number of fund managers with various investment styles. Much of this bias results from an underweight to Financials, most of which are State Owned Enterprises. These companies have poor governance and are not run in the full interest of their private shareholders. We monitor this position very closely but we don't believe that this benchmark risk should be eliminated given the importance of ESG in China.

The purpose of selecting multiple managers is to avoid a systematic bias toward any one style of investing. We continuously revisit our underweight to Financials in China and the resulting underweight to Value.