RISCURA

December 2021: China Newsletter

2021 in review

China in December

As China enters the Year of the Tiger, we look at how fund managers navigated a challenging 2021.

In the last month of 2021, investor sentiment remained weak in the China offshore market while the A-share market was range-bound. The US Securities and Exchange Commission (SEC) finalised rules on delisting depository receipts (ADRs) of companies that fail auditing requirements in the next three years.

While these actions were well-telegraphed in advance and will be mitigated by the dual-listing mechanism, the market still reacted strongly to it. For December, the MSCI China index was down 3.2% and the MSCI China A Onshore index was up 0.7%.

A challenging year for fund managers

2021 was an eventful year for Chinese equities. First, we saw a sharp reversal of a long-term uptrend of large consumer companies like Alibaba and Tencent, precipitated by the state deciding to place a higher priority on social stability and common prosperity objectives. This prompted a wave of regulations impacting sectors from education and e-commerce to Macau gaming. New measures changed the growth prospects of companies in these sectors, resulting in significant share price corrections. In the last quarter of 2021, volatility returned as the property sector succumbed to stringent policies to curb speculation. This led to widespread negative sentiment among foreign investors with few areas of respite.

Offshore listed companies in Hong Kong and US ADRs fell indiscriminately. By contrast, onshore China A shares delivered stronger returns on the back of many sectors doing well, especially those that are linked to the green economy and the domestication of supply chains.

For Chinese fund managers, 2021 was a challenging year. A peer group of 112 Greater China and All China products delivered a median return of -13.4% versus the MSCI China All Shares return of -12.8%. For onshore-focused China A share managers a peer group of 54 products delivered +0.3% versus the MSCI China A Onshore return of +4.2%. In a normal year we would expect a majority of managers to outperform which wasn't the case in 2021. It is also worth noting that the year saw an unusually high dispersion of returns (the range between best and worst), with the 95th percentile manager being 7.4% and the 5th percentile being –23.9% for the Greater China and All China peer group.

For Chinese fund managers, 2021 was a challenging year

Some consumer stock-focused managers saw drawdowns of up to 50% in 2021

Despite a difficult backdrop, it was possible for diversified funds to deliver outperformance especially if they had larger exposure to China A equities. Examples of outperforming underlying managers were those who drastically rebalanced their portfolios away from consumer and technology at the beginning of the year and others, who are more sensitive to valuation and were already underweight these sectors. These were likely to more than offset the underperformance from managers who struggled over the year as we discuss below.

We will now look at how different groups of managers performed in 2021.

Group 1: Buy and hold owners of Consumer stocks

This cohort experienced the biggest reversal of fortunes in 2021.

Some experienced potentially career-destroying drawdowns of up to 50% after they had delivered incredible returns over the previous three to five years.

They were previously beneficiaries of large consumer brands such as Tencent, Alibaba, TAL, Haidilao and Moutai which had grown significantly as consumption increased in China and government incentives to help grow the digital economy. These large blue-chip stocks also benefitted from the positive sentiment from both global and local investors.

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There were many fund managers that had posted eye-watering returns up to the end of 2020 and yet RisCura struggled to build conviction in their investment skills. It all changed for them in 2021 as these sectors went out of favour.

Many, if not most of these fund managers, were investors with developed market training where they were taught to be patient investors in the best companies. This strategy only works if the manager is right about their thesis. However, in China not only is the market less efficient, but company fundamentals can change over short periods. Last year was the perfect example of this. Many fund managers missed the intensifying competition in e-commerce and that many well-known brands were profiteering from unsustainable practices where the government's patience was running out.

The performing managers in these cohorts saw the risks that these companies were facing and dramatically reduced their exposures. There were very few of these.

Group 2: Nimble growth managers

Many experienced investors in Chinese equities have come to realise that investing in China has some major differences to developed markets:

- It is a less efficient market – share prices can significantly depart from fundamentals and can reach extreme valuations.
- Competition, regulation and consumer habits are fast-changing and can have a dramatic impact on the fundamentals of even the market leaders.
- The investment opportunity set is vast so there are always opportunities to upgrade the portfolio.

0% - 20%

One growth fund manager's allocations to Tencent and Moutai varied between 0%-20% over the last three years

This group also consider themselves long-term investors but the allocation to a company at any point of time is a function of opportunity cost, risk factors and valuation; i.e. they will trade in and out of the same name according to prevailing conditions.

We have one fund manager whose allocations to Tencent and Moutai have varied between 0% to 20% over the last three years and added significant value by doing this.

Most managers in this group also had large allocations to consumer companies at the beginning of 2021 but some managed to reduce and rotate into other sectors resulting in a high dispersion within this segment:

- We had several fund managers that aggressively cut their exposure to consumer and internet stocks in Q1 as the high valuations felt unjustified whereas the risks were rising. Our strongest performing manager's timing was almost perfect.
- Some fund managers were a bit late to cut their exposures to companies affected by regulation but they were able to minimise the damage caused and gains in other parts of their portfolios allowed them to deliver a respectable overall performance.
- Others were victims of the indiscriminate market sell-off. Whilst these managers were not invested in companies that were directly exposed to adverse regulation or the property sector, their bias to cyclical companies detracted from returns.
- The best performing managers in this space had correctly identified the potential demand for products and services required to transition to a greener economy and built sizable positions in the supply chain.

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Group 3: Value managers

On the back of a general rotation into value stocks, many managers focused on this area outperformed in 2021. These managers avoided the hyped sectors that derated over the year and had little or no exposure to the sectors that were impacted by regulation.

However, it was not an easy year for them either. Their exposure to "cheap" financials and property stocks did not perform amidst an economic slowdown and were further hurt as the "Evergrande crisis" emerged towards the end of the year.

Finally, a value manager cannot resist a bargain — but what constitutes a bargain is seldom clear. Some started to build positions in affected sectors such as e-commerce far too early. We are seeing value managers across the world enticed by the current valuations of companies like Alibaba after their tremendous fall from glory.

Group 4: The pragmatic managers

Some of 2021's best-performing fund managers were those with a pragmatic investment style – they look for good quality growth companies but are far more sensitive to valuation.

2021's best-performing fund managers were those with a pragmatic investment style

They generally don't participate in any hype or theme, had a tough year in 2020 as they missed the growth rally and didn't have a lot of exposure to the 2021 trendy themes of 2021 either. However, reasonable annual returns over time can result in attractive overall results when other groups are experiencing large swings in fortunes.

Finally, diversified products, often using quantitative strategies, delivered alpha as a function of being exposed across multiple investment styles, not too different to our approach.

Conclusion

Last year was a tough year for many fund managers in China.

Our diversification across multiple styles allowed us to capture gains where they were available and to outperform the benchmark index.

Whilst we don't have a bias to any specific style, a theme that runs through our manager slate is that these fund managers understand that investing in China has its nuances that must be appreciated in order to succeed.

RisCura wishes you and your family a healthy and prosperous Year of the Tiger.

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