A China Retrospective

China in November

In October, Chinese equities regained some ground amid easing regulatory concerns over the internet sector and increasing efforts by the government to address the Evergrande debt crisis and sporadic power shortages.

At a recent Politburo meeting, President Xi Jinping called for sound development of the digital economy and a balance between regulation and promotion of the tech sector. For the month, the MSCI China and MSCI China A Onshore indices were up 3.2% and 2.2% respectively. Among the sectors, TMT, autos, electrical equipment and clean energy performed well, while commodities, real estate and healthcare detracted the most.

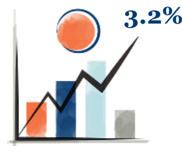
A-share companies have recently been reporting their third-quarter earnings. If we ignore Financials and Oil, A-share companies saw a 13% growth in profits compared to the same quarter in 2019 (pre-COVID-19) although the growth rate has decelerated over the more recent quarters. At the macro level, China's official PMI came in lower than expected. The consumption and service sectors also remained sluggish, as China continues to pursue a "zero-Covid" policy with strict lockdowns and controls. Policymakers have taken a prudent approach to fine-tune policies to contain systemic risks, like relaxing restrictions in the property sector, but we have yet to see any broad-based easing measures. There are growing expectations of policy reflation soon.

Over the last three years, our multi-manager strategy has experienced both severe bull and bear markets, has navigated fears and the impact of trade wars, a global pandemic, regulatory scrutiny and subsequent market recoveries.

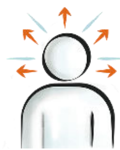
During each of these phases, the benchmark fell by as much as 10%. There were several learnings along the way that we wanted to share with you this month. Some were expected whilst others were not.

1. Never underestimate the benefits of diversification in China

Our approach has been guided by allocating to a wide range of underlying managers – usually more than ten. This may seem high but given the significant size of the stock market and lack of readily available information we found that:



MSCI China and MSCI China A Onshore indices were up 3.2% and 2.2%, respectively.



2021

Overlap between our managers has reduced during 2021 reinforcing the benefits of diversification.

- the best managers are specialised and highly-concentrated, often investing the majority of their portfolio in a few sectors or a handful of stocks; and
- managers were complementary to each other and added value in diverse ways without cancelling out each other's convictions. In developed markets this is often a risk – managers having offsetting views and thereby negating each other's positions – such that the client receives an expensive benchmark-like performance. This is not the case in China. The market is sufficiently large, data is scarce and managers that we work with have found non-overlapping and non-cancelling opportunities in different sectors.

A diversified multi-manager portfolio is therefore able to deliver high outperformance but at low tracking error, yielding an excellent information ratio and with a good chance of outperforming most single fund managers. Our experience with underlying fund managers is that they did indeed nearly all contribute, but did so at different times - delivering returns when others were struggling and vice versa, thereby maintaining the consistency of returns.

2. Taking advantage of irrational markets

Whilst all our fund managers have different areas of specialisation by style and sector, they all have one thing in common: taking advantage of irrational markets.

Approach to fine-tune policies to contain systemic risks, like relaxing restrictions in the property sector, but we have yet to see any broad-based easing measures.

The Chinese stock market is full of inefficiencies whether driven by retail investors in mainland China or when foreigners sell indiscriminately over market concerns. This happens every three to five years creating attractive buying opportunities – many argue that we are currently going through a phase like this.

Interestingly, whilst all our fund managers are actively looking for these opportunities, they are buying different stocks in different sectors. In fact, we have notcied that the overlap between a typical specialist managers and his/her peers has reduced during 2021 reinforcing the benefits of diversification. The stock market is so large that there is plenty to choose from.

Good fund managers are often not market-timers and with hindsight often enter a little earlier than the market bottom. This means that relative returns can be lacklustre during irrational markets as fund managers position themselves for the future. However, if previous market dislocations are any guide to the future, then we should expect a period of strong outperformance in the coming quarters.

3. Benefits of appointing specialised fund managers

At RisCura, we believe that both local fund managers that specialise in China and good global fund managers that have a holistic perspective can deliver outperformance in the long-run. Our observations of the managers we work with have borne this out: local fund managers have frequently found unique insights that have helped to avoid the "land mines" (individual companies or sectors that suffer disproportionately due to corporate events or external shocks) and thereafter found investment opportunities in a continuously evolving landscape. These investment managers have benefitted from access to their local networks, observed the pressure points in the economy and identified emerging risks such as regulation.

▼30%

China tech indices have fallen by over 30% from their peak this year.

The standard deviation of market returns in China is not that different to the US or other developed markets over the last three years.

Examples include the increasingly competitive landscape in e-commerce and recognising that the regulator is serious about clamping down on after-school education companies. When the drivers of returns change in China they do so dramatically with significant consequences to share prices. After years of consistent outperformance, the China tech indices have fallen by over 30% from their peak this year.

In the last three years, while the market environment and opportunity set in China has been changing, the local managers were more focused on irrationally-priced stocks whether it was the smartphone supply chain during fears of trade wars or the semi-conductor industry benefitting from import substitution.

They were also early to identify fast-growing new companies as well as old economy stocks that were moving from the cheapest in the world to best in the world whether it be in medical devices, electric components or heavy machinery. Local managers typically identified these trends well before their global peers.

4. Volatility is the norm in China

The standard deviation of market returns in China is not that different to the US or other developed markets over the last three years. Much of this can be attributed to shared global movements since the pandemic broke out last year, tracking the incidence, government policies and vaccines. However, high volatility in China has been a feature over a longer period. It is more common to see big down months followed by swift recoveries in this market.

Interestingly, whilst all our fund managers are actively looking for these opportunities, they are buying different stocks in different sectors.

Whilst this creates opportunities for the active investors it is critical to be a patient investor and not to sell at market bottoms.

Manager outperformance is also volatile, hence the need to understand the drivers of returns for each manager and diversify accordingly. Managers that have had the strongest returns over the previous three years can have the worst returns over subsequent years if their style turns out of favour. Furthermore, we have also come across less-skilled managers that delivered eye-watering returns over shorter time periods because they held the stocks that were in favour at the time. Unfortunately for them, they are caught out when things get tough like they have this year.

5. The importance of a disciplined investment process

In volatile markets, we have learnt that it is even more important to maintain a disciplined investment process. Maintaining the required diversification by both sectors and styles, rebalancing, working with fund managers to minimise cash and closely monitoring the managers have all helped considerably. It is also helpful to maintain broad sector exposure even where opportunities may initially be limited. For example, Financials is a large sector in the onshore market, but it includes many poorer quality companies that generally do not qualify as desirable investments. Nevertheless, a well-constructed portfolio would have some exposure here to ensure it has no blind spots.

Manager outperformance is also volatile, hence the need to understand the drivers of returns for each manager and diversify accordingly.

Ensuring a disciplined process has also required continuous engagement with fund managers on aspects of their back-office functions and Environmental, Social and Governance factors.

A common question for a manager researcher is whether one could have acted earlier when redeeming an underperforming manager?

With hindsight here are inevitably points where one could have acted differently but at the time it is always a fine balance between giving trusted fund managers the benefit of doubt and deciding to move on.

Here, too, a disciplined process is essential. Opportunity-sets change, managers lose their edge through complacency, staff turnover or macroeconomic developments. The role of the manager researcher is to assess and respond to these changes. It is the ultimate challenge for a manager researcher!

We thank our clients for putting their trust in us. Our objective remains to deliver a stable outperformance across diverse market environments by trying to find the most suitable, most skilled managers to allocate capital to.

The role of the manager researcher is to assess and respond to these changes. It is the ultimate challenge for a manager researcher!