RISCURA

China's Fund Industry Got Talent

China update

In December, the Chinese equity market experienced a rise followed by a pullback. However, offshore (Hong Kong) stocks still ended the month in positive territory, helping the overall indices to a positive end to the year. Benefitting from the year-end effect, dividend stocks have risen, while certain AI-related concepts still have momentum. Overall, the market remained in a consolidation phase following the rally since late September.

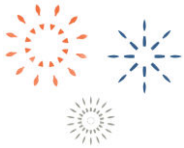
- **The MSCI China and MSCI China All Share Indices were up by 2.7% and 1.4% respectively, while the MSCI China A Onshore Index was down by 1.0%.**
- **Boosting domestic consumption and stabilising the property and equity markets remain policy priorities.**
- **Sector-wise, state-owned financials and mega internet stocks led with robust returns, while healthcare and consumer staples were the biggest laggards for the year.**

The Central Economic Work Conference (CEWC) was held in Beijing in early December, setting the tone for polices in 2025. Fiscal policy was adjusted to be "more proactive", including a higher deficit, additional ultra-long-duration government bonds, local government targeted bonds, and increased fiscal expenditure, while monetary policy shifted to be "moderately accommodative". This marks the first time in over a decade—since the 2008 financial crisis—that China has adopted more assertive and proactive macroeconomic policies. Boosting domestic consumption and stabilising the property and equity markets remain priorities.

Looking at 2024, the MSCI China, MSCI China A Onshore, and MSCI China All Shares Indices posted gains of 16.3%, 8.8%, and 13.3%, respectively. However, performance varied significantly across market capitalisations and sectors. Index gains were largely driven by large-cap stocks, supported by government funds or targeted by both local and foreign passive investments. Within the MSCI All Share Index, mega-cap stocks (market capitalisation exceeding $50 billion) surged by 33%, and large-cap stocks ($20–50 billion market capitalisation) rose by 22%. In contrast, mid-cap stocks remained nearly flat, significantly underperforming their larger peers. Sector-wise, state-owned financials (high-dividend theme), and mega internet (communication services) stocks led with robust returns, while healthcare and consumer staples were the biggest laggards.

Manager talent

The focus for this month's newsletter is on the talent within the asset management industry in China. If we were to compare asset managers in China with those in the well-established financial hubs of the UK or the USA, it is fair to say that the West still boasts a greater number of fund managers who meet all the criteria and are of institutional quality. However, we are increasingly encountering managers in China who truly impress us — some of whom are relatively young! We are holding more research meetings where we emerge full of excitement, finding that the calibre of talent matches, if not exceeds, the best asset managers in the West. Navigating the investment landscape in China is not easy. There is a unique set of challenges for fund managers — a vast investment universe, coupled with the scarcity of sell-side coverage and the ever-evolving quality of information — demanding a level of sophistication and adaptability that only the most skilled managers can provide.



Chinese equities ended the year strong despite volatile equity markets.

State-owned financials and mega internet stocks were sectors that drove robust returns in 2024.

Proactive fiscal and accommodative monetary policies are to set priorities for 2025.

Chinese fund managers have demonstrated remarkable research depth and adaptability.

Despite these challenges, the best managers we have encountered share several key attributes that set them apart:

Deep and Thorough Research

These managers usually adopt a comprehensive 360-degree approach, akin to dissecting a private company, to conduct thorough research and uncover insights into industries and individual companies. They engage in primary research, gathering first-hand information, evaluating the business model, long-term earnings potential, downside risks, ESG factors, as well as the character and capabilities of senior management. Moreover, they actively engage with a variety of stakeholders within the supply chains. This endeavour can be highly time-intensive and relies heavily on local networks and resources.

One standout example is a fund manager who made the effort to study the chemistry of Moutai (China's premier liquor brand) to understand why it can age for so long and thereafter conducted surveys with high-end consumers to understand why they are willing to pay extortionate prices to purchase vintages that go back decades.

Risk Management

The ability to effectively use investment tools, portfolio construction techniques, and risk management practices to manage risk is essential for navigating the volatile conditions frequently experienced in the Chinese market. Share prices can experience extreme volatility where they could halve overnight, sometimes for no apparent reason, at other times due to the slightest bit of negative news or external factors such as geopolitics. Take Pinduoduo as an example: it has been an incredible success story, with its share price tripling since its lows in early 2022. However, over the past three years, its share price has fluctuated significantly, halving and then doubling again. A 20% movement in the stock price over the course of a few days no longer causes headlines. When investing in a market that incurs such volatility, it's not viable to be a buy-and-hold shareholder like in the West where volatility is far lower.

The better managers have processes for managing this volatility. For instance, some long-term fundamental investors will still focus on the near-term outlook as a risk management exercise given that a poor earnings call could lead the share price to halve. In such a case they may reduce exposure to such a company from a risk management perspective.

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Use of Technology

Some managers have been early adopters of alternative and high-frequency data, such as online payment and shipment data, as well as artificial intelligence. They have fully integrated these tools into their research processes and made significant investments in developing proprietary IT systems to enhance efficiency in research and trading.

Dedication and Humility

A remarkable trait observed in many Chinese asset managers is their humility and unwavering work ethic. They often work exceptionally long hours and are deeply dedicated to their jobs, showing their passion for investing. Their commitment to continuous improvement and their drive for success set a high standard for professionalism in the industry.

Alignment of Interests

Another key factor contributing to their success is the strong alignment of interests with their investors. By having the right incentive structures and investing their own money alongside their clients, they are motivated by a shared commitment to long-term value creation. This alignment not only encourages mutual success but also reinforces a culture of integrity and partnership. For example, we are currently invested with one fund manager where nearly half of the assets under management is internal capital.

Challenges for Even the Best Managers

These talented managers have demonstrated impressive abilities to generate excess returns in the past. However, recently, even they have struggled to outperform the market. The main reason for this is their limited exposure to shares of state-owned enterprises (SOEs), which have experienced significant valuation increases due to positive sentiment, despite having weak fundamentals and questionable governance.

Most fundamental managers have opted out of this sentiment-led trend, given considerations related to ESG factors and sanctions compliance. While there are well-managed SOEs that are high-quality companies, the majority are lower-quality businesses that often prioritise interests other than those of minority shareholders. However, these companies tend to show relative resilience in bear markets due to their perceived defensive characteristics from the perspective of retail investors. Furthermore, government entities have been buying shares in these companies to prop up the overall market.

Effective risk management remains crucial in China's highly volatile market.

Chinese managers are really integrating technology well for enhanced processes.

More managers are investing their own money, ensuring aligned interests and shared long-term goals.

Most managers have opted out of the SOE trend due to ESG concerns and sanctions compliance.

Looking ahead

As shown in the graph below, China has historically been a strong alpha market, although the past two years have been challenging. We continue to favour managers who focus on investing in high-quality businesses that are trading at attractive valuations and can deliver faster and more consistent earnings growth than the overall market. We believe that the share prices of these companies will eventually reflect their fundamental strengths, helping our managers generate excess returns again.

Source: eVestment, RisCura. Simple average of excess returns of all Greater China managers in our databases.

In conclusion, we are very pleased to see the talent pool within the Chinese asset management industry is both deep and diverse with some, of world-class quality. As we navigate this complex and ever-evolving market, we remain steadfast in our commitment to identifying managers who exemplify excellence in research, risk management, technological integration, and unwavering dedication to their work and alignment with investors' interests.

Chinese asset managers' commitment to continuous improvement and drive for success set a high standard for professionalism in the industry.