

Which CHINA funds to buy

Many China equity funds have turned in big losses since the New Year. What are the reasons for the heightened volatility? Which funds are positioned to avoid the looming risks?

| BY KELVIN TAN |

It has been a nerve-racking start to 2016 for investors of Chinese equity unit trusts and exchange traded funds (ETFs), many of which have plummeted in recent weeks on the back of the slump in mainland Chinese stocks and Hong Kong-listed H-shares. As at Jan 12, nearly a third of the 30-plus Singapore-registered China-focused equity funds were down more than 10% for the year in Singapore dollar terms, according to fund data from Morningstar.

The unexpected weakness in the renminbi and fears of a hard landing for the deteriorating Chinese economy have triggered heavy selling of mainland Chinese stocks and H-shares of late, causing significant losses and volatility in these securities. The CSI 300 Index, which tracks 300 A-shares listed on the Shanghai and Shenzhen stock exchanges, was down 15.4% on a year-to-date basis as at Jan 13. The Hang Seng China Enterprises Index (HSCEI), the main barometer of H-shares, meanwhile, slumped more than 10% over the same period.

To be sure, the recent carnage in China's stock markets has created anxiety and fear for many investors of China-focused equity funds. But now isn't the time to dump these investments, say experts, who are advising investors to wait out the storm. To sell out now would be committing one of the investment fallacies of selling low, they point out.

Some advisers are even recommending adventurous, long-term investors who can stomach short-term volatility and have a diversified portfolio to take advantage of the current downturn by adding more money in well-run Singapore-registered China equity funds, many of which have little exposure to the precarious A-share market of China.

Bombed-out H-shares look attractive

"While the onshore Chinese equity markets have been stealing the limelight with news of circuit breakers being triggered twice recently and a depreciation of the renminbi, most of the Chinese equity funds are actually mainly invested in offshore Chinese equities, namely China H-shares," says Ho Song Hui, research manager at online fund distributor Fundsupermart.com. "It is crucial to note that China H-shares are typically accessed by professional fund managers that utilise fundamentals to invest in companies they deem attractive, unlike the onshore Chinese stock market, which tends to be dominated by retail speculators who adopt a herd mentality, speculative approach," observes Ho, who is advising his clients to continue investing in Chinese equity funds.

Local retail investors in the mainland China A-share markets seemed to have decided to sell stocks en



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masse at the beginning of 2016, observes China equities manager Charlie Awdry, co-manager of the Henderson Horizon China Fund, in a recent note. "But like most foreign investors, the vast majority of the Chinese shares we invest in are listed in Hong Kong. Shanghai- and Shenzhen-listed A-shares generally make up between 5% and 10% of our portfolios. The Hong Kong-traded shares are still subject to the same macroeconomic factors, but these H-shares tend to have more reasonable valuations, and lower volatility compared with A-shares," he says.

Given the recent selloff, Hong Kong-listed H-shares, which form the bulk of many Singapore-registered China equity funds' portfolios, have become one of the world's cheapest groups of stocks. The HSCEI, for instance, is currently trading at a multi-year low with a one-year forward price-to-earnings ratio of just 6.4 times and dividend yield of 4.6%. H-shares, trading at the bottom of their five-year valuation range, are looking "incredibly cheap", says Daryl Liew, who is head of portfolio management at boutique wealth and asset management firm Reyl Singapore.

"I expect the China stock markets to continue to be volatile this year as the Chinese government attempts to manage the gradual liberalisation of the financial sector. There are so many moving parts and I expect further policy missteps as the country continues on its development path. As such, it is entirely possible that Chinese equity markets could sell off further. But we see this as a good entry point for some China H-shares. As such, we have taken advantage of the selloff to selectively add H-shares

to some of our clients' portfolios," Liew tells *Personal Wealth*.

William Cai, who is vice-president, client adviser and portfolio manager at local financial planning firm GYC Financial Advisory, offers similar views. He points out that China-related equities including H-shares could continue to trend lower in the near term as many global investors are now concerned about a falling renminbi, and slower-than-expected growth and a potential credit crisis in the world's second largest economy. "However, from a contrarian perspective, I am excited about China as it [offers] a great value buy for the long term. China equities, especially H-shares listed in Hong Kong, are very attractively valued. From a value investor's perspective, it is shaping up to be a great opportunity. But one needs to be patient to realise the potential gains and, at the same time, stomach the volatility," says Cai.

Technical factors caused China mayhem

Craig Botham, who is emerging markets economist at fund house Schroders, notes in a report that the recent China stock market meltdown was largely due to technical factors rather than fundamentals. The expiration of a ban on the sale of shares by large stakeholders in China due on Jan 8, coupled with the China stock exchanges' circuit breaker mechanism, which would temporarily halt stock trading if the market falls 5% and suspend trading for a day if it falls 7%, were the main factors that triggered the selloff in the first week of trading this year. The desire to sell shares before trading was suspended by the circuit breaker led to more

dumping of shares by retail investors in China, he observes.

The China Securities Regulatory Commission suspended the circuit breaker on Jan 7 after admitting that the mechanism, which was designed to stop stock prices from freefalling, created a negative effect that intensified the selling of shares. "Since the suspension of the circuit breaker, and new rules restricting sales by large stakeholders past the original Jan 8 deadline, market falls have been much smaller than in the first three days of the year. We do not say this because we are bullish on the Chinese equity market, but to demonstrate that weakness there does not point to weakness in the broader economy. That is, the renewed weakness is technical, not fundamental," Botham notes.

Ho of Fundsupermart.com concurs, saying that although China's economic growth has decelerated as the nation restructures towards a more sustainable model based on domestic consumption, he has yet to see a significant deterioration in its fundamentals. "While the country pivots away from being the factory of the world as seen in declining manufacturing Purchasing Managers' Index numbers since February 2015, the services sector has not seen a monthly contraction in business activity in its Purchasing Managers' Index since the series began in 2013. With ongoing corporate reforms to reduce excess capacity in sectors that are overstocked, a property market that has appeared to have stabilised after cooling over the past few years, and a focus on tertiary industries to spur innovation and growth, China's future does not appear to be as dim as many have painted it to be," Ho points out.

Betting on new economy China stocks

For investors keen to add exposure to China equity funds, Liew of Reyl Singapore recommends they put money in actively managed funds that have significant exposure to "new economy" Chinese stocks. These include stocks in the technology, healthcare, consumer and other innovative industries. "Chinese banks and property companies, which face a myriad of problems, are of course pulling down the average. But you can find well-run companies in other sectors with strong earnings growth. China new economy companies are still doing well while old economy names are struggling," says Liew, who is cautious on China A-shares, but bullish on H-shares.

Tan Eng Teck, senior portfolio manager at the Asian equity team of Nikko Asset Management and who runs the Nikko AM China Equity Fund, tells *Personal Wealth* that over the next two to three years, the growing new economy China equity sectors such as technology, healthcare and consumer will exert more influence on the overall Chinese stock market than the old economy ones of energy, material and industrial. "That is when China [equities] will begin to outperform," he says.

Tan explains that the China economy is in the midst of a transition from a fixed asset investment-led model to a consumption-driven model, and while this transition will slow down economic growth in the short run, it will be positive for China over the longer term. "Given that the Chinese stock market comprises mostly stocks relating to the FAI model, including credit-related stocks that are highly dependent on FAI too, the impact from that perspective may be severe. Hence, China's stock market performance will be very muted. However, the consumption-led growth or New China phase is slowly making up the difference." The Nikko fund manager says his strategy is to avoid FAI-model-related stocks and to overweight counters in China's new economy sectors. "We are not bearish, although we are cognisant of the current volatility. We continue to see this as a good opportunity to pick up stocks tuned to the right direction of China."

Looking ahead, Tan is forecasting the Shanghai Stock Exchange Composite Index to range trade and the Shenzhen Stock Exchange, which has more new economy stocks, to do relatively better. H-shares, trading at a discount of almost 50% in valuation to A-shares, will provide a strong buffer against any downside, adds the portfolio manager. Tan's fund was down 10.61% in Singapore dollar terms this year as at Jan 8.

How the best China funds made money last year

| BY DANIEL SHANE |

An Internet giant, a maker of surveillance equipment and a supplier of chemicals for lithium-ion batteries were among the stocks that helped managers of China's top performing funds outgun their rivals in a year that tested the mettle of even the smartest of smart money.

Barron's Asia spoke to four of the best Chinese equity fund managers to find out what stocks gave them the edge in 2015.

UBS China Opportunity

UBS's US\$1.5 billion (\$2.2 billion) China Opportunity stock fund has yielded a total return of about 16% versus a loss of about 3% for its MSCI China benchmark. Its manager Bin Shi says the fund's philosophy has value at its heart and emphasises stock-picking and active management to deliver market-beating returns.

The fund is skewed towards consumption and services stocks, with about 20% of its holdings in high-tech names. **Tencent Holdings** makes up about 10% of the portfolio: The gaming and social media titan's stock price was up more than a third in 2015 amid a pivot to mobile and fast-growing ad sales. The fund also has a big chunk of **NetEase**, another online gaming play, whose stock soared more than 80% in 2015.

"Our fund has a wider deviation from the usual China benchmarks," Bin tells *Barron's Asia*. This is because he doesn't

see the heft of "new" Chinese industries reflected in benchmark weightings.

Stock-picking is very much the focus of Bin's fund. He says his strategy is bottom-up picks that focus on leaders in sectors like healthcare, insurance and IT. Bin admits 2015 was a "bumpy ride", but expects corporate profitability and cash flows to improve next year. "We expect the market to recover, with inevitable volatility along the way."

The fund isn't without laggards. Two of its big holdings, **Industrial and Commercial Bank of China** and **China Construction Bank**, saw their respective share prices dwindle by almost a fifth on anxieties mainland Chinese banks are under-reporting non-performing loans.

Fullerton China A Equities

Jason Zhu's Fullerton China A Equities fund favours Shanghai- and Shenzhen-listed growth-at-a-reasonable-price stocks that play on themes like healthcare, environmental protection and new energy vehicles. The fund returned about 20% in 2015 against the MSCI China A Index's gain of 6%.

"We beat the benchmark by quite a lot," Zhu tells *Barron's Asia*. "About 80% to 90% of that came from our stock selection." He takes a bottom-up approach and likes growth companies — but doesn't like paying too much for them. Zhu's approach to value is probably

more flexible than most, though. He says he's not put off paying a multiple of 30 or 40 for the right stock — high by most markets' standards — although names that trade closer to 100 times are a bit too rich for his liking.

Zhu's top holding is **Shenzhen Capchem Technology**. It makes the chemicals found in lithium-ion batteries, which are used to power electric cars and buses. Zhu says the stock is a play on environmentally focused policymaking in Beijing. Capchem's share price has powered up by more than 100% since plunging to a 2015 low in September. "We bought a lot of stock in this company during the summer's market collapse," Zhu says. "It's got very strong R&D and they provide products for top battery producers like **LG** and **Samsung**."

Jiangsu Hengrui Medicine, which researches and develops chemotherapy drugs, is another favourite. Its shares have almost doubled in value since end-2014. Zhu says Hengrui stands out for its strong R&D, management and sales capabilities in China. "This year, they've also started selling medicines in the US and European markets — which was a big surprise," he says.

Schroder China Equity Alpha Fund

Outperformance at Schroders' China A-shares fund in 2015 was driven by investments in stocks specialising in

drones and booze, among other shrewd picks. The US\$80 million fund delivered a return of over 23% this year at the time of writing, compared with the benchmark CSI 300 Index's return of 9%.

Some of the heavyweight outperformers in the portfolio were **Hangzhou Hikvision Digital Technology**, up more than 50% this year. Hikvision is the world's largest seller of video surveillance gear. Its products are used to capture nefarious acts at everything from jewellery stores to university campuses. The company has also increasingly seen its tech used in flying drones, as well as ramped up its overseas business in places like the US and the Middle East.

Another holding is **Wuliangye Yibin**, one of China's top two *baijiu* brands. Wuliangye is riding a recovery in the *baijiu* market, which was left punch-drunk by Chinese president Xi Jinping's anti-corruption crackdown. It's also streamlined its brand and focused more sharply on high-end markets. The stock is up about 30% for the year, a three-month share suspension over summer notwithstanding. Data centre company **Shanghai Wangsu Science & Technology**, which the fund has a stake in, had a supercharged year. Its stock rocketed almost 200%.

Allianz China A-shares

Wangsu Science also delivered the goods

for Allianz's onshore China fund, which returned about 17% in 2015. The US\$33 million stock fund has a bias towards industrial and new energy-type names, including **Zhengzhou Yutong Bus**, which *Barron's Asia* has been upbeat on. The company makes energy-efficient, electric buses and has been growing earnings in the double digits for the last couple of years. Yutong is also exploring taking its business overseas, with Europe being one market.

Another one of the fund's picks is **Shenzhen Inovance Technology**, whose biggest customer is Yutong. Inovance makes automation systems for cranes, elevators and other industrial applications. The company is enjoying China's policy support for new energy vehicles and is also putting its technology in electric cars and industrial robots. Its share price hasn't been on auto-pilot either: It's up more than two-thirds this year.

The fund's top holding, state-owned real estate business **Poly Real Estate Group**, has benefited from a moderate recovery in the property markets of tier-one and tier-two Chinese cities. Because of its government ties, the company gets a leg up from lower-than-average onshore borrowing costs. The possibility of lower interest rates next year could boost margins further. The stock has risen about 40% since hitting the skids over summer.

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Fund recommendations

For long-term investors, Singapore-registered China-focused equity funds currently recommended by Ho of Fundsupermart.com include the **Neuberger Berman China Equity Fund** and the **Wells Fargo China Equity Fund**, both of which were down more than 8% this year as at Jan 8.

The funds are predominantly invested in China H-shares but have the ability to invest in China A-shares, according to Ho. "Both funds have demonstrated considerable flexibility in allocating their exposure between onshore and offshore [Chinese] equities. For example, the Wells Fargo China Equity Fund trimmed its 15% exposure to the A-share market at the beginning of 2015 to below 5% by the end of June 2015 on concerns that fundamentals were being ignored before the [China stock market] melt-up in 3Q last year. The Neuberger Berman China Equity Fund had also reduced its exposure to the A-share market by end-June 2015." Ho adds that these two funds have delivered a respectable performance, while catering to different risk appetites. "The Neuberger Berman China Equity Fund has tended to be more volatile, with higher returns, given its concentrated high-conviction portfolio approach [with 30 to 50 holdings] while the Wells Fargo China Equity Fund's adoption of a 'benchmark aware' actively managed diversified portfolio [consisting of 70 to 100 stocks] has seen it demonstrate a greater degree of stability during market turmoil."

The top five holdings of the Neuberger Berman China Equity Fund are China insurer **Ping An Insurance**, bus manufacturer **Zhengzhou Yutong Bus Co**, Internet companies **Tencent Holdings** and **Netease** (American Depositary Receipt or ADR) and auto com-

pany **Brilliance China Automotive**. The top five holdings of Wells Fargo China Equity Fund are Chinese telecom giant **China Mobile**, Tencent Holdings and banks **China Construction Bank Corp**, **ICBC** and **Bank of China**. Over the past three years, Neuberger Berman China Equity Fund and Wells Fargo China Equity Fund delivered gains of 33.1% and 23.9% respectively in Singapore dollar terms as at Jan 8.

Cai of GYC Financial Advisory also likes the Neuberger Berman China Equity Fund, which has exposure to some US-listed Chinese ADRs. This fund also offers investors US dollar and Singapore dollar hedged share classes, he points out. In addition, Cai recommends First State Regional China Fund, which is managed by respected Hong Kong-based fund manager, Martin Lau. "This is a good fund, which is more diversified and has the flexibility to tap opportunities not only in Hong Kong and Shanghai, but in Singapore and Taiwan as well," says Cai.

First State Regional China Fund was down 6.34% this year in Singapore dollar terms as at Jan 8, but had delivered gains of nearly 20% over the past three years. "Most of our day-to-day work is driven by proprietary research and company meetings. We are bottom-up investors and, as a result, we pay little attention to stock market indices. Our focus, other than on valuations, has been to direct our attention to risk awareness and the financial health of companies," says Lau of First State Investments. The fund manager recently bought shares in **Luye Pharmaceuticals** and added exposure to Chinese pharmaceutical company, **Yunnan Baiyao**. Among Lau's key defensive holdings is utility firm

ENN Energy Holdings, which is one of the largest gas distributors in China. He points out that gas distribution is a reasonably stable business and should be relatively insulated from a slowdown in China's economy.

Another resilient name is **Aberdeen China Opportunities Fund**, which has no exposure to A-shares and has the lowest volatility among the Singapore-registered China-focused equity funds. During the recent selloff, the fund incurred the least losses among the 30-plus China equity funds available to retail investors in Singapore (see table). The top five holdings of Aberdeen China Opportunities Fund are **AIA Group**, **Jardine Strategic Holdings**, **MTR**, **HSBC Holdings** and **Swire Pacific**.

Without doubt, extreme volatility in China-related stocks, including H-shares listed in Hong Kong, could persist in the coming months, especially with more weakness in the renminbi against the US dollar, which would weigh down the performance of the already battered China equity funds. That's why long-term fund investors keen to take advantage of market upheaval and lower prices should consider buying into their preferred China equity unit trusts and ETFs on a systematic basis via the dollar cost averaging method, which allocates a fixed amount of investments at regular intervals such as monthly, quarterly or yearly.

"While further volatility could be expected in the short term, valuations of offshore Chinese equities are extremely undemanding today," says Ho. The multi-year-low valuations of H-shares are offering investors who have the "requisite risk appetite and patience, plenty of value in today's market", he adds. As Cai says: "Buy when there's blood in the streets." ■

YTD performance of Singapore-registered China-focused equity funds

NAME	YTD RETURN (%)	
	12/31/2015	01/08/2016
JPM China A-Share Opportunities A (acc) – RMB	-12.28	
Fullerton Lux Funds-China A Equities I USD	-11.79	
Nikko AM China Equity USD	-10.61	
db x-trackers CSI300 Index UCITS ETF 1D	-9.93	
Wells Fargo (LUX) WW China Equity A USD	-8.28	
United SSE 50 China ETF	-8.26	
Neuberger Berman China Equity USD A Acc	-8.24	
HSBC GIF Chinese Equity AD USD	-7.89	
Allianz China Equity – A – USD	-7.54	
AllianceBernstein-China Opportunity Pf A USD	-7.53	
JPMorgan China A Dis USD	-7.36	
JPMorgan Greater China A Dis USD	-7.31	
Fidelity Funds – China Consumer A-USD	-7.21	
Fidelity Funds – China Focus A-USD	-7.15	
UBS (Lux) Eq Fd – Greater China (USD) P-acc	-7.05	
PARVEST Equity China Classic Cap USD	-7.02	
db x-trackers MSCI China Index UCITS ETF (DR) 1C	-6.86	
db x-trackers FTSE China 50 UCITS ETF (DR)	-6.83	
Amundi Fds Equity Greater China – AZU (C)	-6.75	
Eastspring Investments-China Equity A	-6.72	
LionGlobal China Growth SGD	-6.72	
Deutsche China Equity A SGD	-6.67	
Pinebridge Greater China Equity A Acc USD	-6.66	
Nikko AM Shenton Greater China	-6.65	
Henderson HF China A2 USD	-6.63	
Fidelity Funds – Greater China A-USD	-6.53	
Fidelity Funds – China Opportunities A-USD	-6.49	
United Greater China Fund	-6.41	
UBS (Lux) Eq Fd – China Opportunity (USD) P-acc	-6.40	
First State Regional China SGD	-6.34	
NN (L) Greater China Eqty P Cap USD	-6.22	
Schroder ISF China Opportunities A Acc	-6.19	
Schroder China Opportunities	-6.13	
Templeton China A (acc) USD	-5.78	
Eastspring Investments-Greater China Equity A	-5.73	
Schroder ISF Greater China A Acc	-5.51	
BGF China A2 USD	-5.20	
Aberdeen China Opportunities SGD	-4.23	

Return: NAV-to-NAV or Bid-to-Bid, income re-invested, calculated in SGD.