The Chinese Equity Market Paradox

The Challenge of Translating China's Economic Growth Into Portfolio Returns

June 2020

MarketGrader
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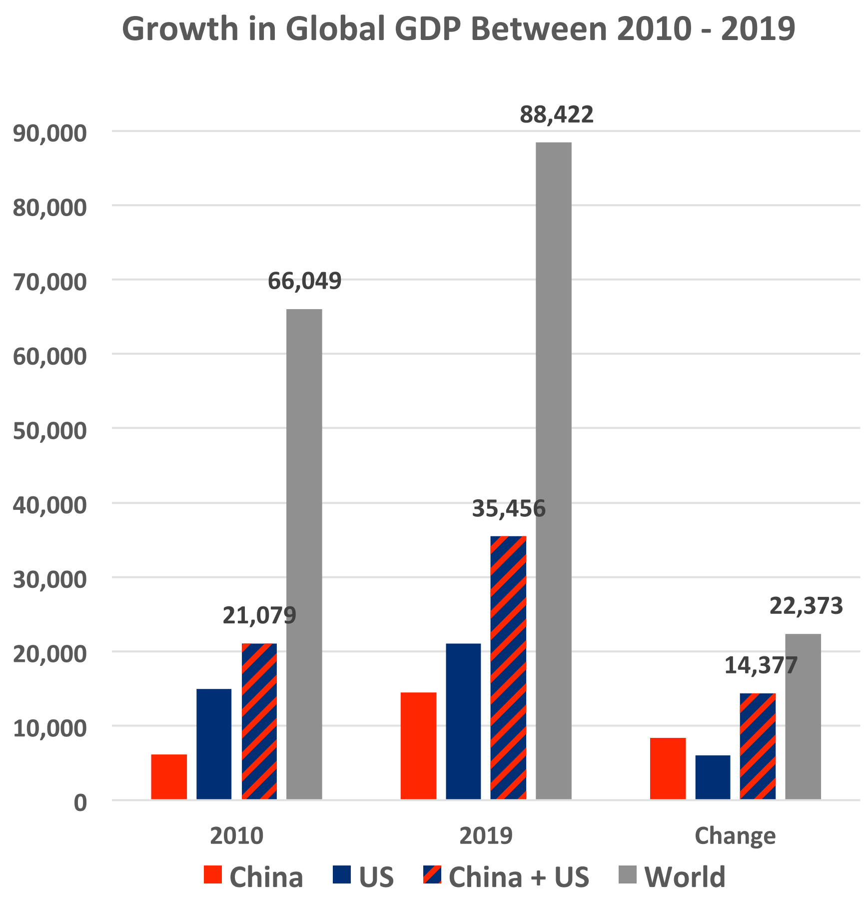
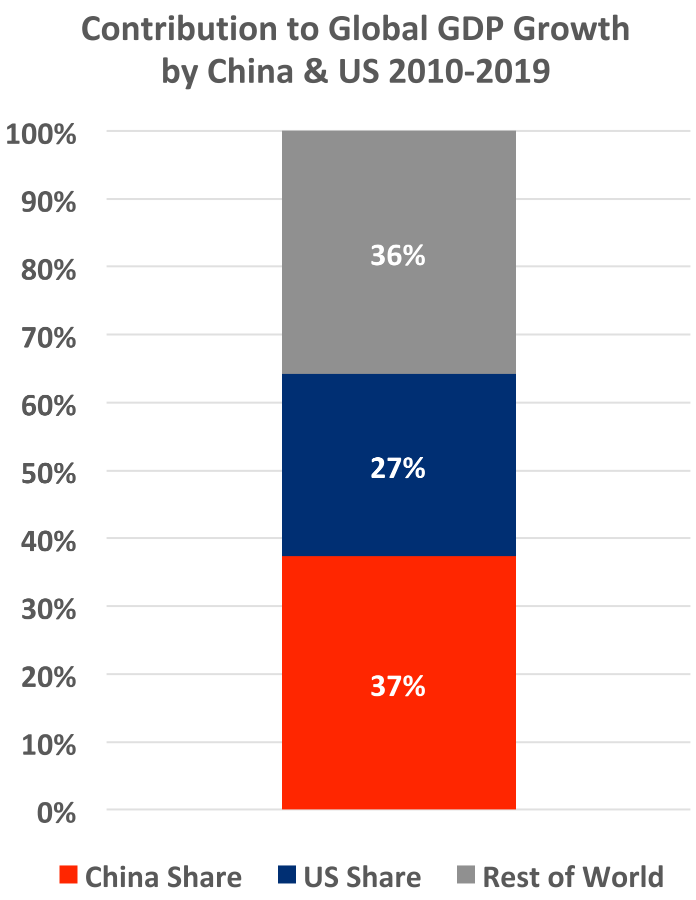
While China and the U.S. Account for 40% of Global GDP, they Contributed 64% of Global Economic Growth in the Last Decade





Gross Domestic Product (GDP) in billions of USD. Sources: World Bank (2010 GDP); International Monetary Fund (2019 GDP estimates).

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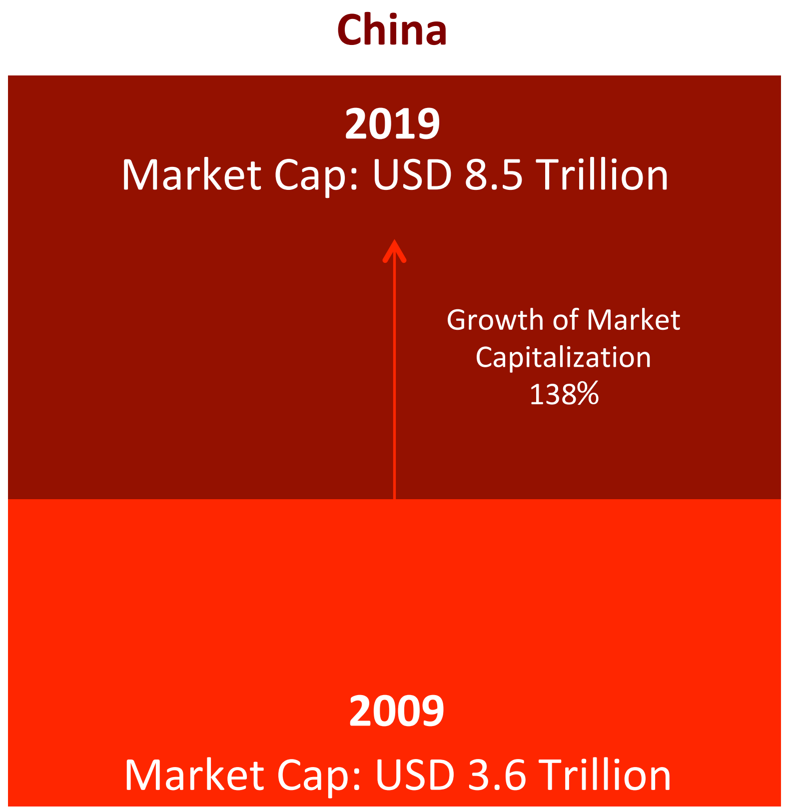
Investors that Bet on a U.S. Rebound After the Global Financial Crisis (2007-2009) Were Handsomely Rewarded

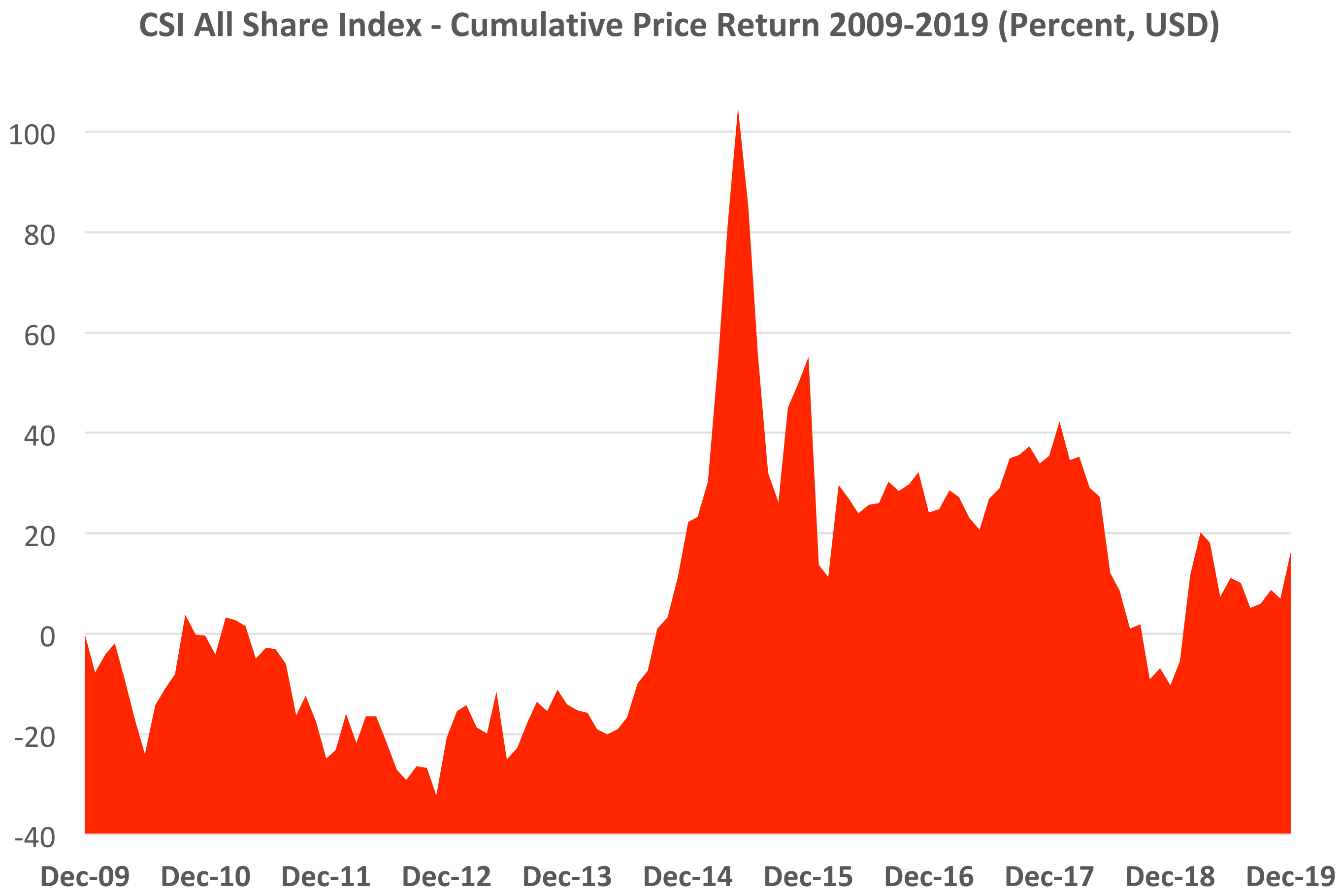
USA

Russell 3000 Index - Cumulative Price Return 2009-2019 (Percent, USD)

Source: MarketGrader Research (market cap), Bloomberg (index returns)

However, Investors that Bet on Chinese Equities Were Bitterly Disappointed We Call this the ‘Chinese Equity Market Paradox’





Source: MarketGrader Research (market cap), Bloomberg (index returns)

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The Chinese Equity Market Paradox: While the Country's Economy More than Doubled in a Decade, the Benchmark Couldn't Even Keep Up with Inflation

	United States				China			
	Real GDP Growth	Total Market Capitalization of Equity Market in USD at End of Year	Growth of Total Market Capitalization	Russell 3K Price Return (in USD)	Real GDP Growth	Total Market Capitalization of Equity Market in USD at End of Year	Growth of Total Market Capitalization	CSI China All Shares Price Return (in USD)
2009	-2.5%	15,077,285,740,000	30.1%	25.5%	9.4%	3,573,152,460,000	100.9%	106.4%
2010	2.6%	17,283,451,680,000	14.6%	14.8%	10.6%	4,027,840,300,000	12.7%	-0.3%
2011	1.6%	15,640,707,040,000	-9.5%	-0.9%	9.6%	3,412,108,290,000	-15.3%	-24.7%
2012	2.2%	18,668,333,210,000	19.4%	12.3%	7.9%	3,697,376,040,000	8.4%	8.0%
2013	1.8%	24,034,853,520,000	28.7%	30.9%	7.8%	3,949,143,490,000	6.8%	8.4%
2014	2.5%	26,330,589,190,000	9.6%	10.5%	7.3%	6,004,947,670,000	52.1%	42.2%
2015	2.9%	25,067,539,600,000	-4.8%	-1.5%	6.9%	8,188,019,320,000	36.4%	26.8%
2016	1.6%	27,352,200,720,000	9.1%	10.4%	6.7%	7,320,738,379,789	-10.6%	-20.0%
2017	2.2%	32,120,702,650,000	17.4%	17.9%	6.8%	8,711,267,220,000	19.0%	8.3%
2018	2.9%	30,436,313,050,000	-5.2%	-7.8%	6.6%	6,324,879,760,000	-27.4%	-34.7%
2019	2.3%	36,329,851,880,000	19.4%	28.5%	6.0%	8,515,504,380,000	34.6%	30.5%
Cumulative Growth	21.8%		141%	180.7%	108%		138%	17.1%
Annualized Growth (10 Yrs.)	2.3%		9.2%	10.9%	7.6%		9.1%	1.6%

Sources: International Monetary Fund (GDP), World Federation of Exchanges (Market Capitalization), Bloomberg (Index Returns)

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This Presentation Seeks to Answer 2 Questions

1. What explains the significant divergence between the growth of China's economy and the performance of its equity market?

2. Can a clear understanding of this 'paradox' be incorporated into an investment strategy that is better suited to harness China's remarkable economic growth?

Brief Chronology of How China's Reforms Led to the Privatization of State Assets and the Creation of its Equity Market

1976:	Mao Zedong dies; end of Cultural Revolution
Late 1970s:	Millions of Chinese farmers and peasants begin to quietly break free from farm 'collectives' and, instead, produce their own crops, selling surplus in neighboring cities (eventually embraced by the state)
1978:	Government unveils 'Open Door Policy,' allowing foreign investment into China for the first time in almost four decades
Mid 1980s:	Small scale privatizations begin in China
1990:	Shanghai Stock Exchange reopens, and Shenzhen Stock Exchange is founded
1992:	Privatizations accelerate as SOE sector reports heavy losses

Privatizations with 'Chinese Characteristics'

As China opened up, it desperately needed to become competitive globally in order to catch up with the rest of the world, after decades of disastrous economic policies, and thereby raise its citizens' living standards.

Privatizing its woeful State-Owned Enterprises offered two solutions at once:

1. Easiest and quickest way to attract Foreign Direct Investment (FDI).

2. With Foreign Direct Investment came managerial know-how in order to make its SOEs competitive.

How China managed the privatization of its State-Owned Enterprises explains, in large part, the behavior of the country's equity market to this day.

Privatizations with ‘Chinese Characteristics’

As China’s privatization program began in earnest in the early 1990s, the Chinese government was determined to avoid the disastrous privatizations carried out in Russia and the former Soviet republics.

China’s privatization program differentiated it from Russia’s in two significant ways:

1. Chinese State made the key objective of its privatization program to preserve the State’s majority ownership of newly privatized SOEs.

2. State Owned Enterprises would continue to play a central role in executing not only the State’s industrial policy but its social policies as well.

China's Privatizations: Selling State Assets Without Giving Up Control

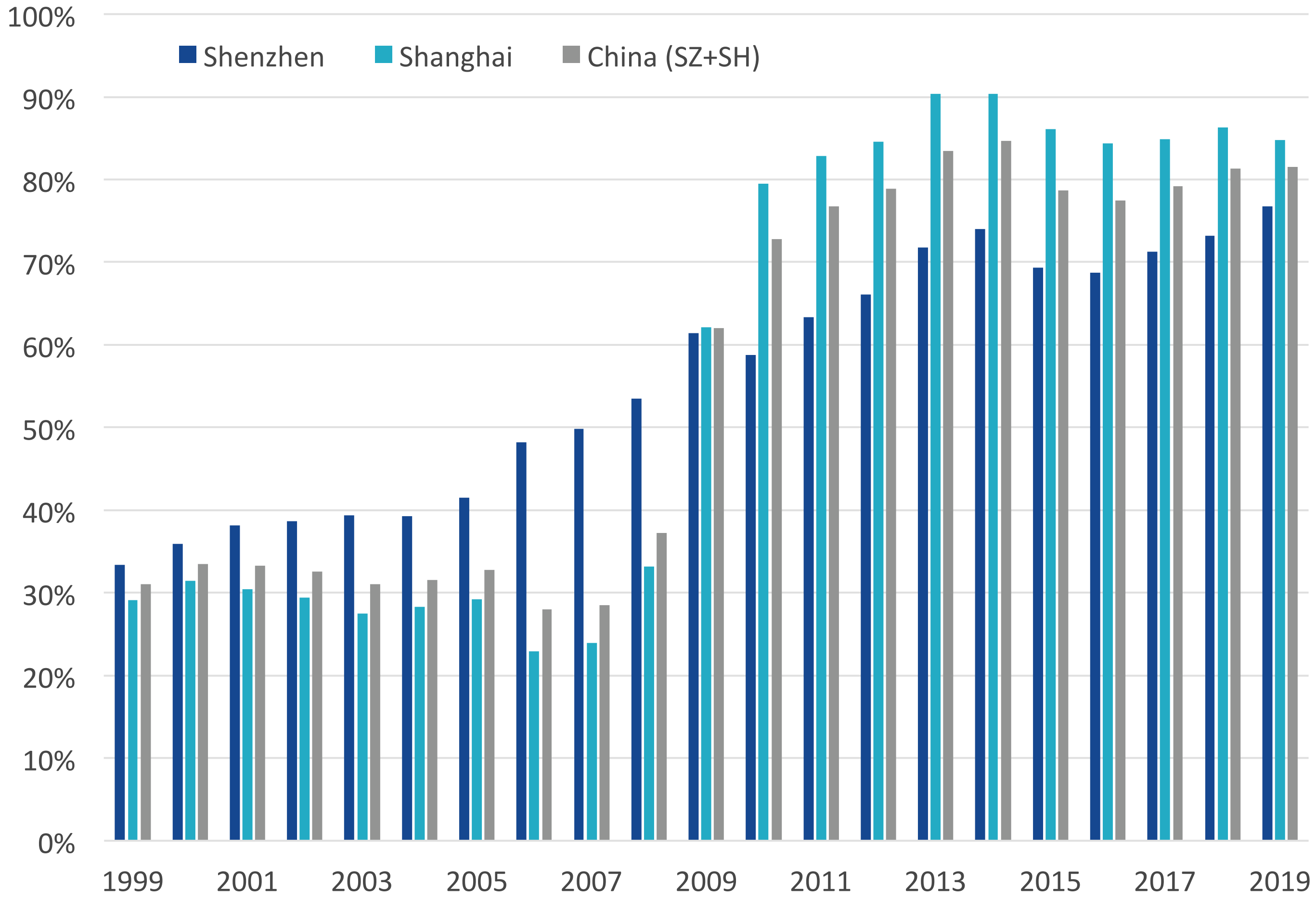
How was this implemented?

1. State allowed the creation of two types of shares:

    - 'A' shares, to be freely tradable.
    - 'LP' shares, owned by local governments, central government or state-controlled entities; could not be traded.

2. State-related entities and local governments contributed "assets" (such as a factory or a power plant) into its newly "corporatized" entities, which were then privatized using the dual-share model.

Negotiable Market Cap as % of Total Market Cap, China 1999-2019



Sources: Shanghai Stock Exchange & Shenzhen Stock Exchange

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China’s Privatizations: SOEs as Drivers of China’s Industrial and Social Policies

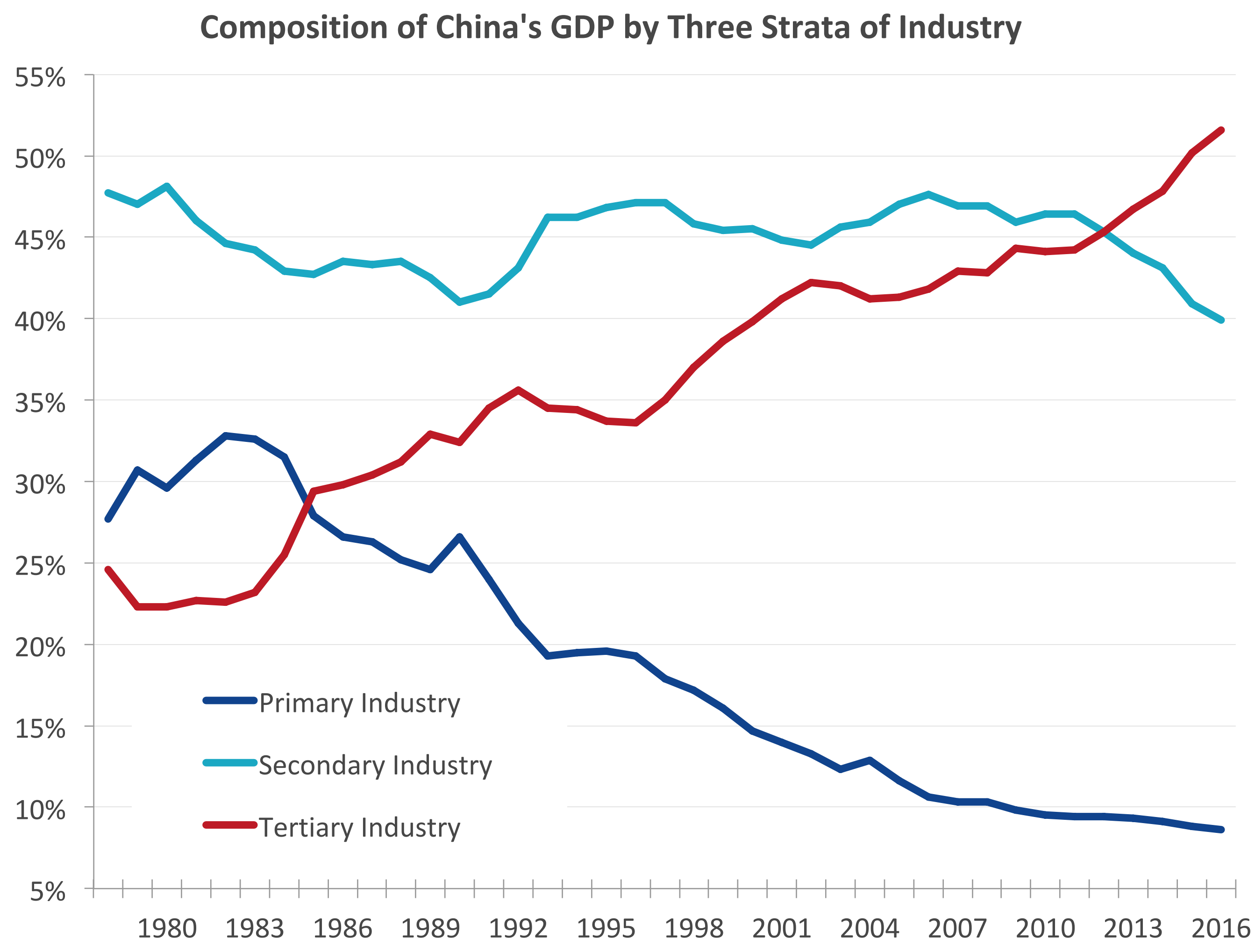
China decided not to give up control of its SOEs when it privatized them because it needed them to carry out the government’s industrial and social policies.

Industrial Policies

SOEs act on behalf of China’s government in its industrialization and modernization drive. These companies become responsible for allocating credit, procuring resources and basic materials globally, building the country’s infrastructure and developing its manufacturing base.

Social Policies

SOEs must help the government maintain high levels of employment, especially as its urbanization drive accelerates in the 1980s and 1990s. Additionally, SOEs act as an extension of the government in providing social services, health care and retirement benefits to millions of Chinese.



Primary Industry refers, essentially, to agriculture; Secondary Industry refers to mining, manufacturing, energy production and construction; and Tertiary Industry refers to consumption and services. Source: National Bureau of Statistics of China

The State-Owned Enterprise Dilemma

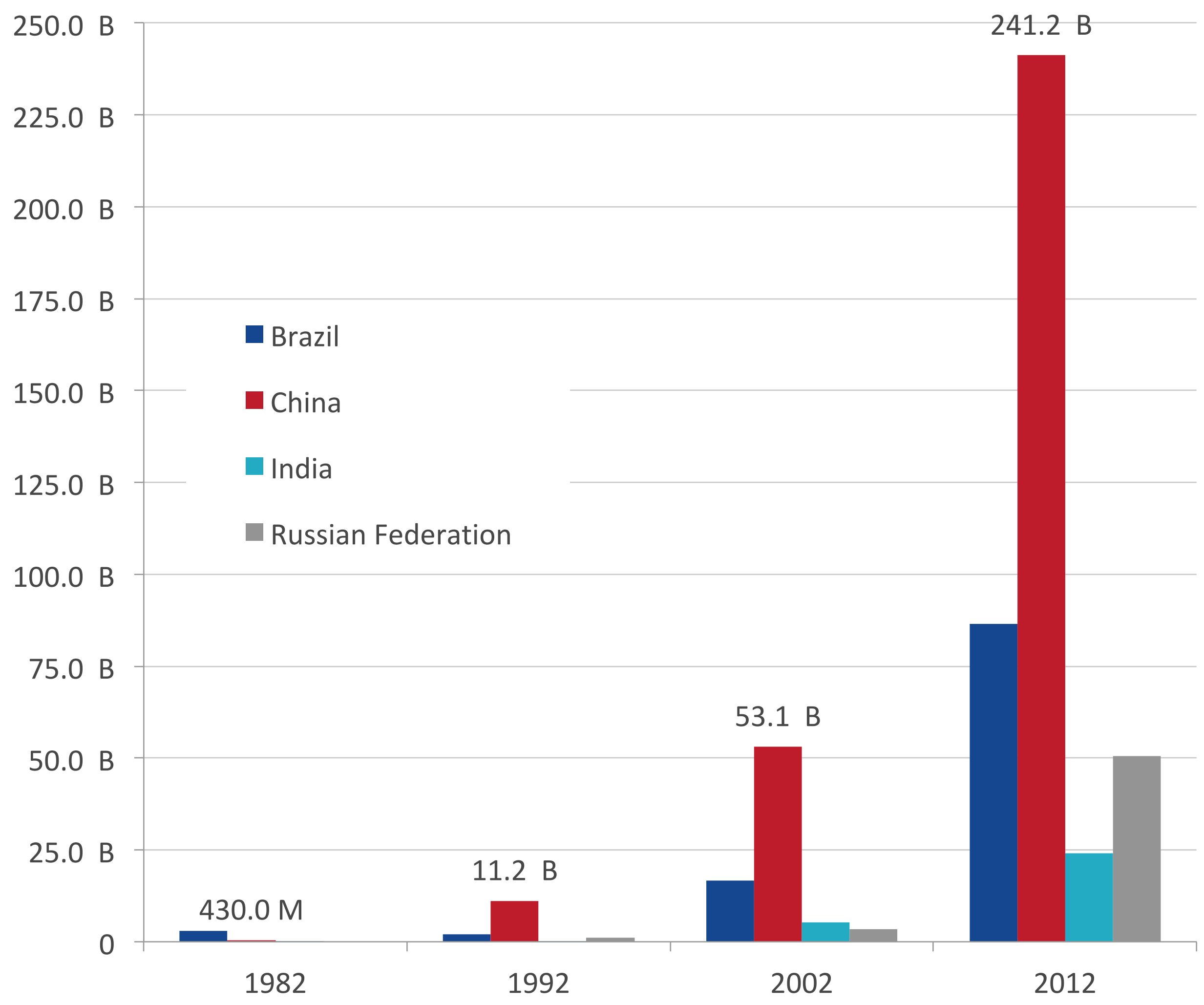
As China's privatization program succeeds, its hybrid design gives rise to what we call the 'State-Owned Enterprises Dilemma':

SOEs must serve two 'masters' with very different objectives:

1. The Chinese state, whose priorities are the industrialization of the country's economy while maintaining high levels of employment and social stability.

2. The private owners of the newly-privatized companies, who seek profitability and the maximization of shareholder value.

Foreign Direct Investment, Brazil, China, India & Russia 1982-2012



Foreign direct investment, net inflows (BoP, current US$). Source: World Bank

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The State-Owned Enterprise Dilemma

A good example of SOEs acting on behalf of China's political interests is the Belt and Road Initiative (BRI), mostly executed by SOEs with the guidance—and credit—supplied by China's government.

Chinese SOEs participate actively in:

- Construction of roads and railways
- Development of ports
- Construction of nuclear power plants
- Oil & gas projects
- Provision of credit to governments with limited access to public markets (e.g. Venezuela, Ecuador)

"As of October [2018], Chinese SOEs contracted about half of BRI projects by number and more than 70% by project value."

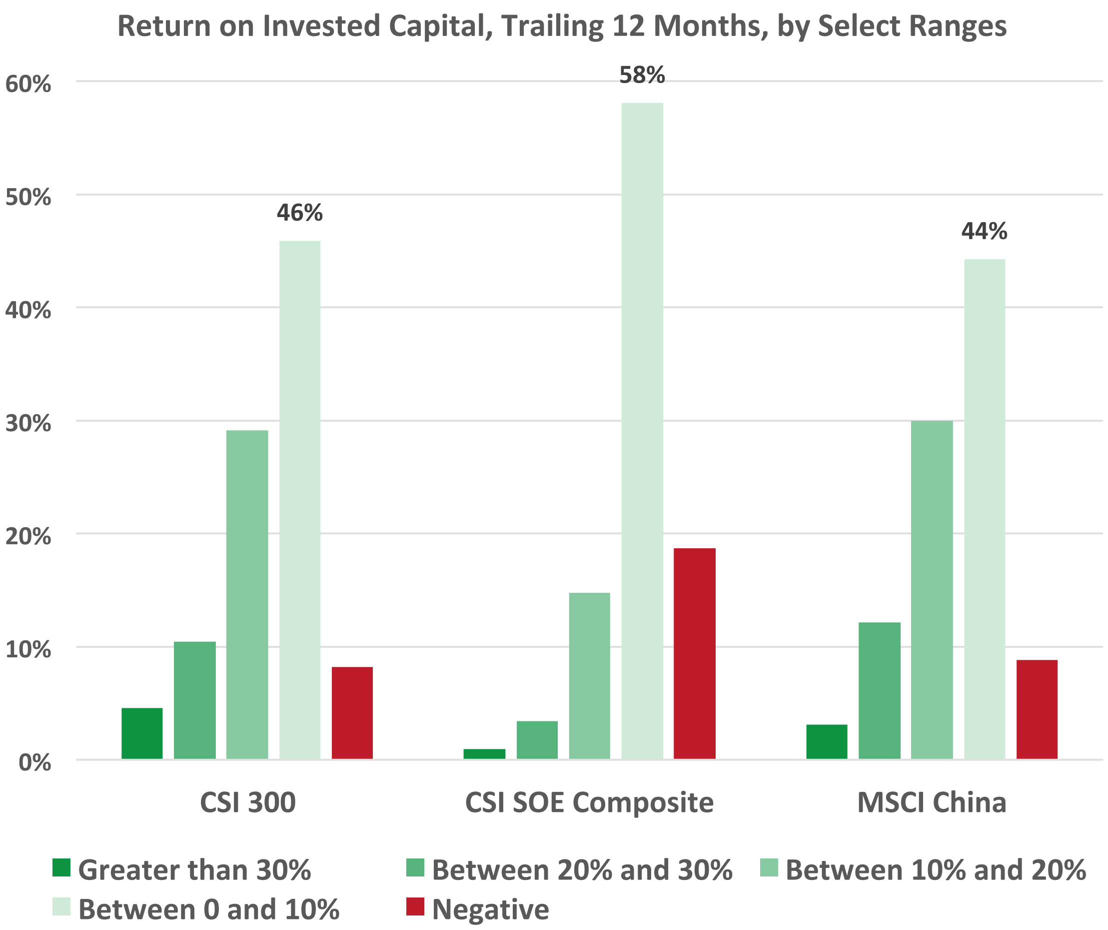
Source: The Lowy Institute, 'China's Belt and Road Initiative, from the inside looking out', July 2019

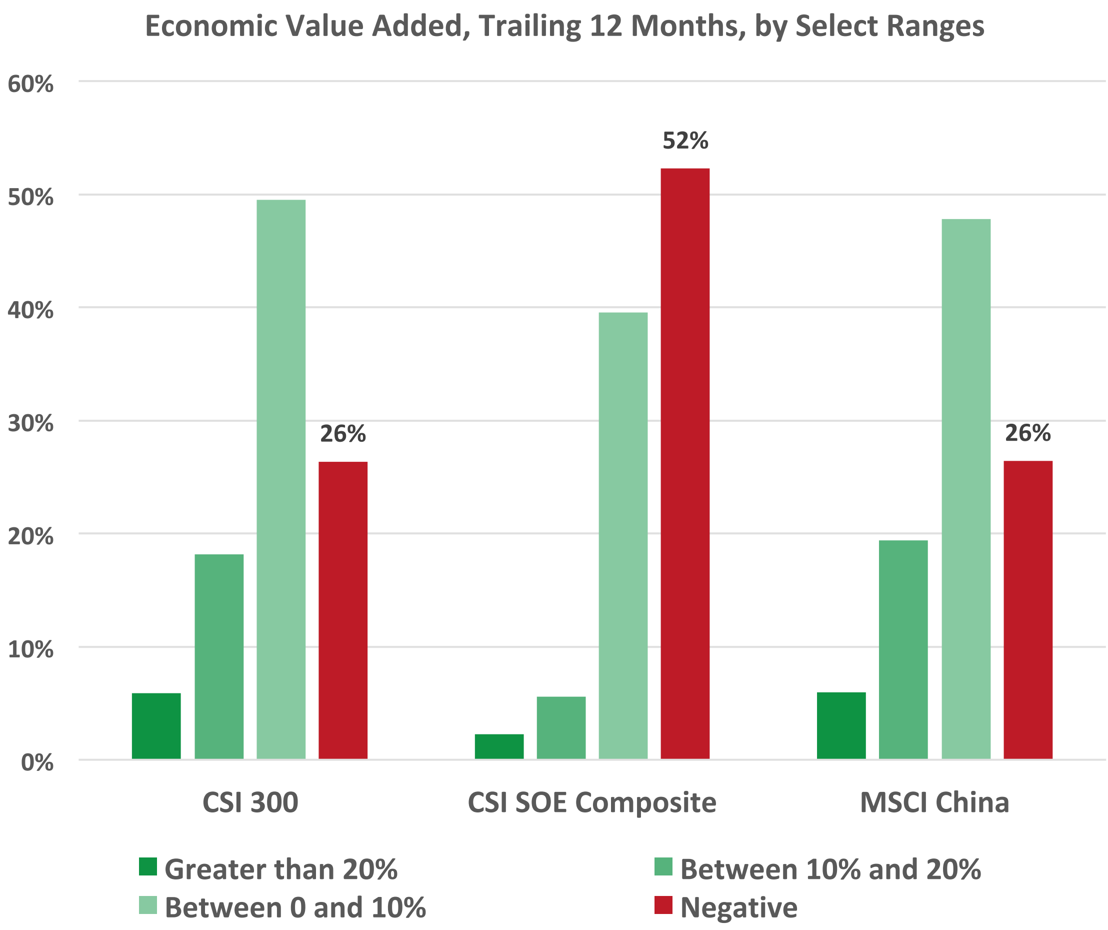
"China is home to 109 corporations listed on the Fortune Global 500 – but only 15% of those are privately owned."

Source: World Economic Forum, 'The role of China's state-owned companies explained', May 2019

The State-Owned Enterprise Dilemma

SOEs' execution of government policies has resulted in massive misallocations of capital





Data is as of April, 2020 and excludes all indexes' constituents in the Financials sector. Sources: FactSet, MarketGrader, China Securities Index Co.

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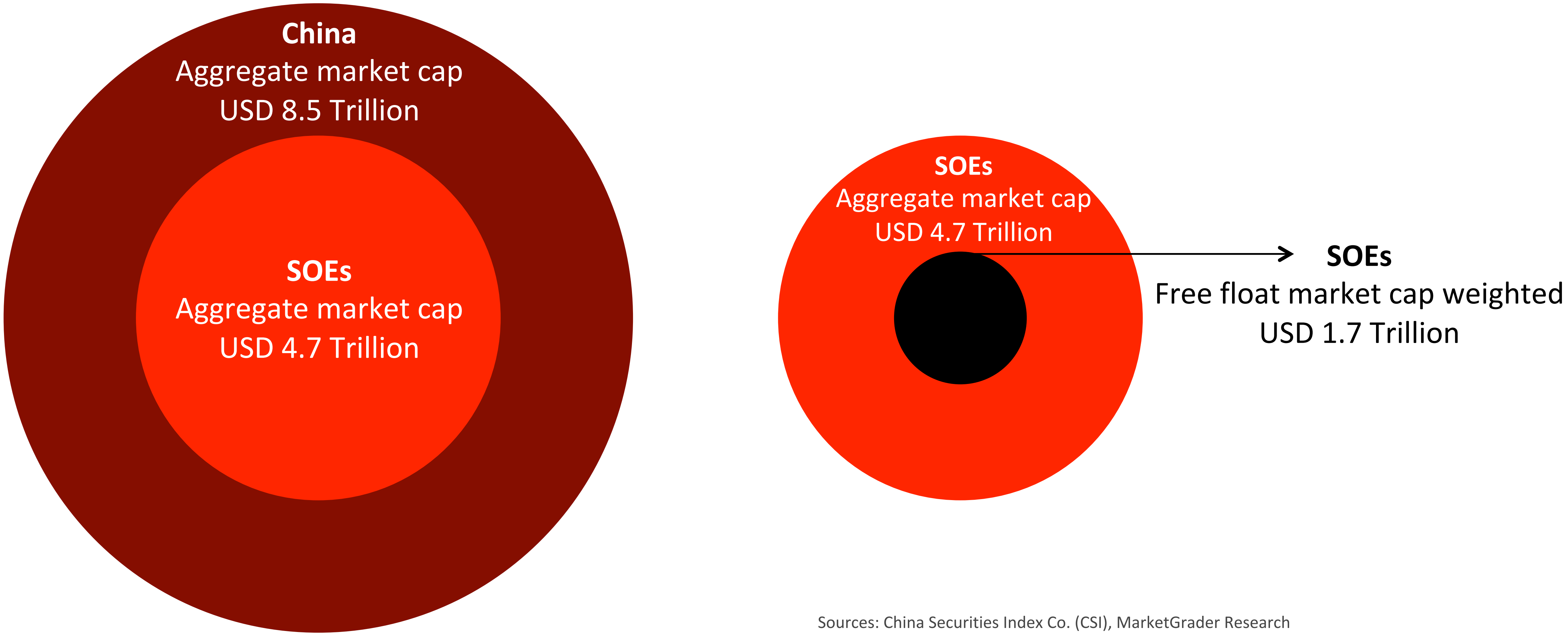
How Pervasive Is the SOE Problem in China's Equity Markets?

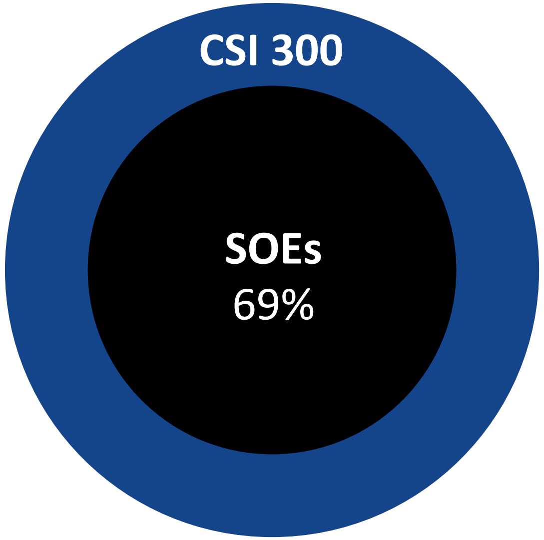
SOEs account for 55% of the aggregate market cap of China's equity markets and only 36% of their shares are freely tradable

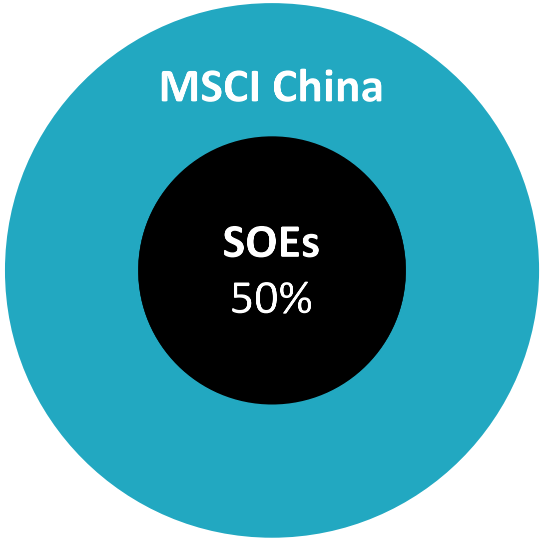


Sources: China Securities Index Co. (CSI), MarketGrader Research

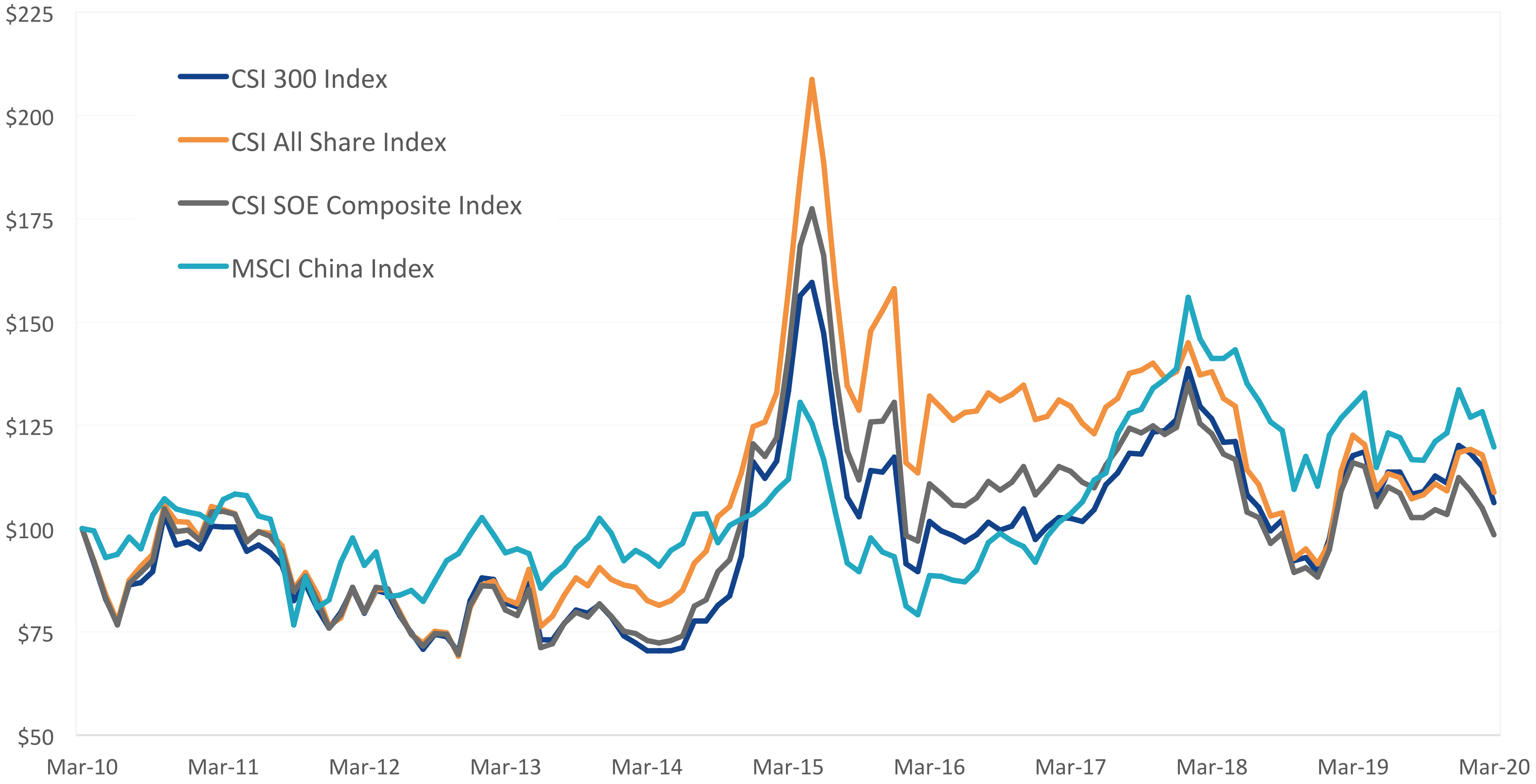
How Pervasive Is the SOE Problem in China's Equity Markets?

If SOEs dominate China's equity market, by definition, they also dominate the benchmarks tracking the market on a market cap weighted basis. Unsurprisingly, this has led to very poor shareholder returns in the last decade.





$100 Investment in China's Benchmarks a Decade Ago (March 2010 - March 2010)



Sources: China Securities Index Company (CSI), MarketGrader Research, Bloomberg.

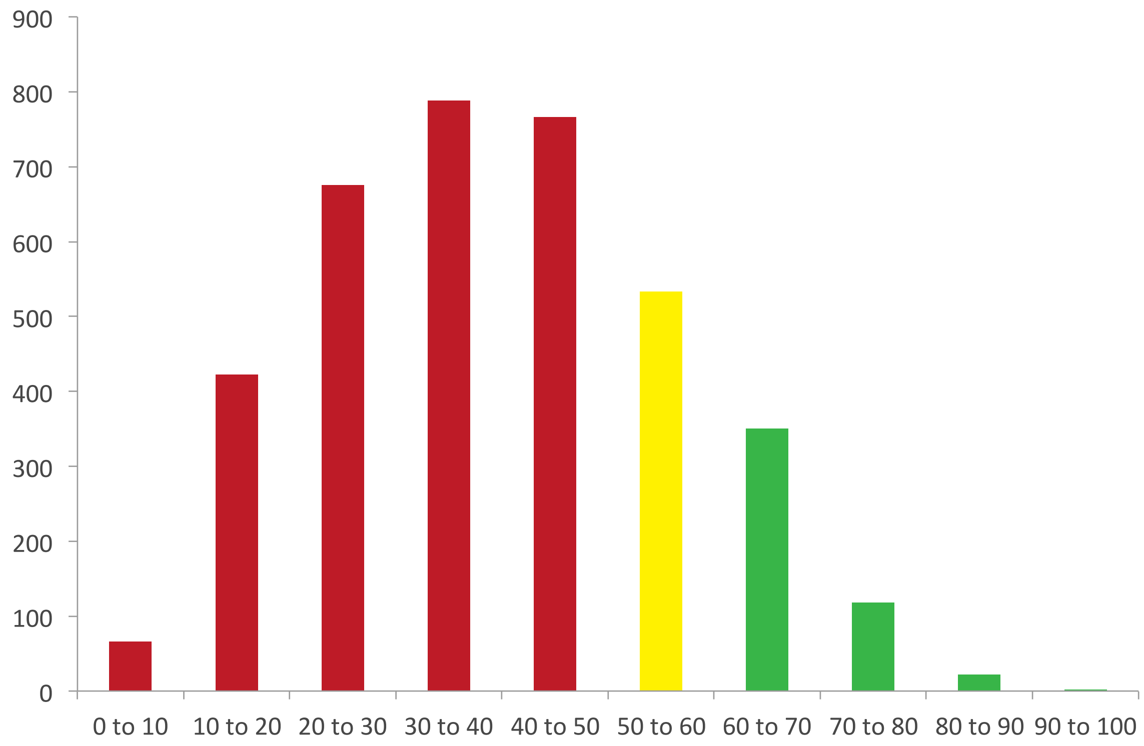
How Can Investors Avoid Owning China's SOEs While Maintaining a Significant Exposure to the Country's Growth Engine?

MarketGrader's approach is to focus on **stock selection** in order to identify what we call 'Growth Compounders.'

Three core premises underlying MarketGrader's ratings and our index selection methodology:

- Growth compounders are the bedrock of a portfolio's long-term performance.
- In order to identify long-term growth compounders, single metrics don't tell the whole story about a company's ability to sustain growth.
- There is a significant difference between buying cheap stocks, with limited upside, and buying long-term growth compounders at a reasonable valuation.

Decile Grade Breakdown for China, April 2020



BUYs (Overall Grade > 60)	492 Companies
HOLDs (Overall Grade 50-59)	533 Companies
SELLs (Overall Grade < 50)	2,717 Companies

Source: MarketGrader

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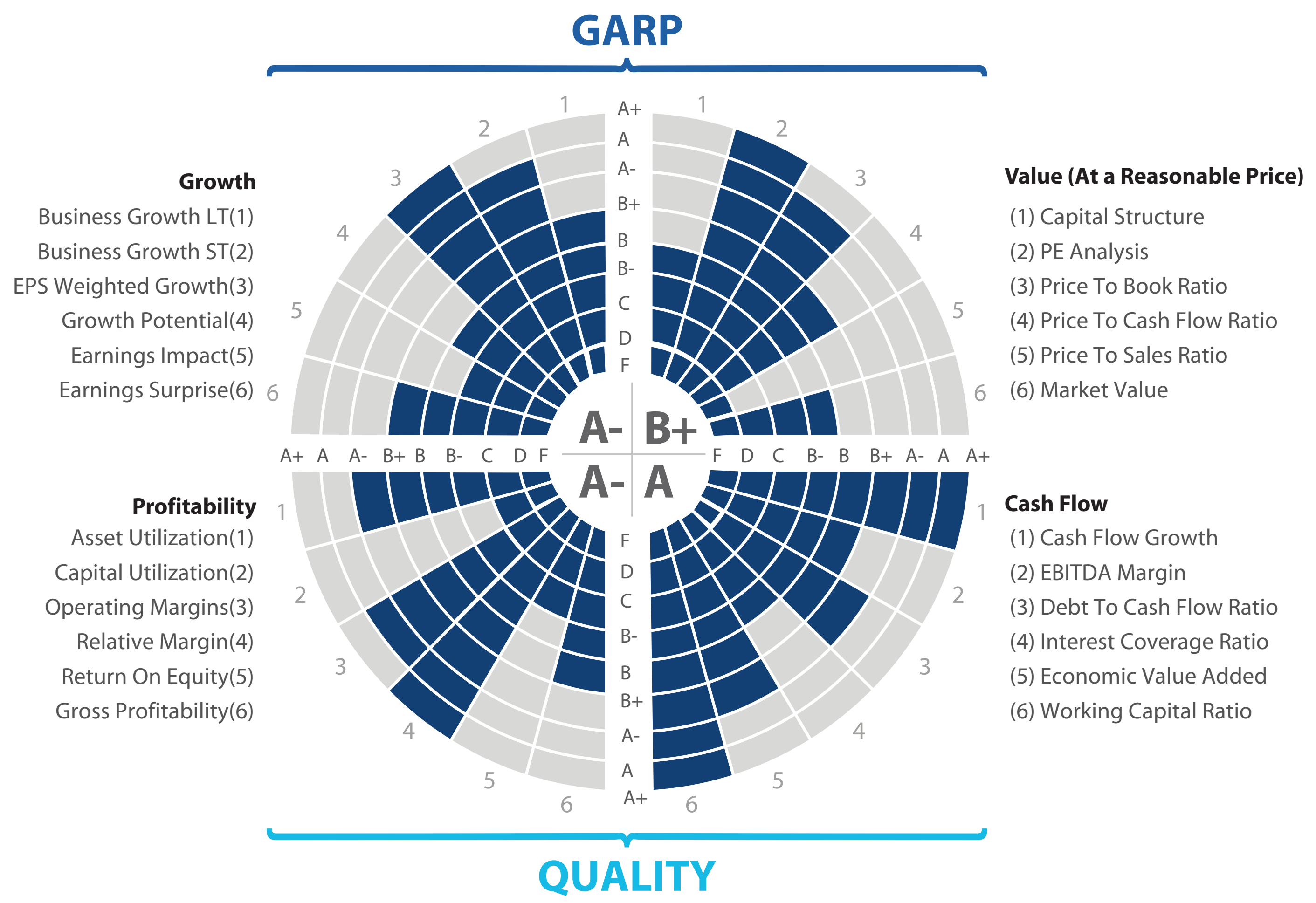
What are Growth Compounders?

MarketGrader's GARP + Quality methodology seeks to identify companies with the following characteristics:

- Consistent top to bottom line growth—not just explosive short-term growth—with sustainable margins and high cash flow generation.
- A sound capital structure that doesn't impair operating growth, combined with high returns on invested capital and low capital intensity.
- Reasonable valuations relative to sustainable growth rates, and not based just on absolute, out of context, valuation multiples.

Jiangxi Fushine Pharmaceutical Co., Ltd. Class A (300497.CN)

Overall Grade: 77.6, MarketGrader Rating: **BUY**



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The CSI MarketGrader China New Economy Index: Growth Compounders in China's Most Dynamic Economic Sectors

Our New Economy Index focuses on the fastest growing sectors of the economy, which also happen to be those with the least number of SOEs:

Consumer Discretionary, Consumer Staples, Health Care, Technology

Number of SOEs in Index: 18 (out of 120)

Aggregate market cap of SOEs as a percentage of total Index market cap: 15%

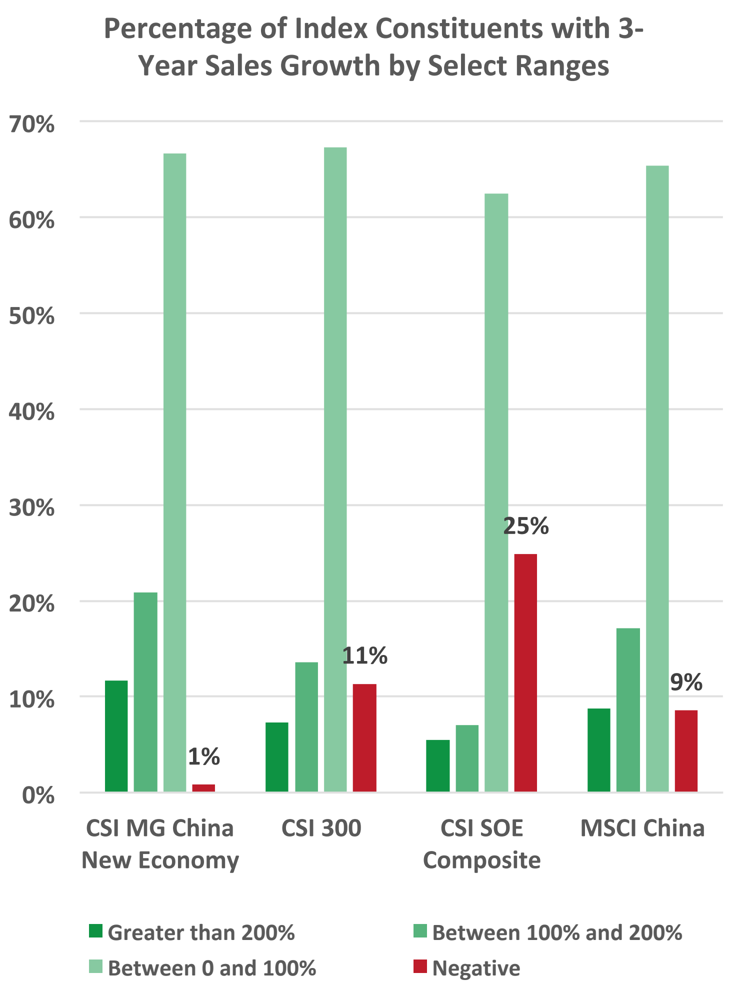
China's Growth Compounders Honor Roll (Companies with Most Selections to New Economy Index)*

Ticker	Company Name	Times	First Selected	Growth In Sh. Equity	Total Return
600519.CN	Kweichow Moutai Co., Ltd. Class A	26	Dec-07	1711%	725%
000568.CN	Luzhou Laojiao Company Limited Class A	23	Dec-07	679%	113%
000858.CN	Wuliangye Yibin Co., Ltd. Class A	23	Dec-07	757%	243%
600809.CN	Shanxi Xinghuacun Fen Wine Factory Co. Ltd. Class A	20	Dec-07	572%	620%
600276.CN	Jiangsu Hengrui Medicine Co., Ltd. Class A	20	Dec-07	1516%	1582%
000895.CN	Henan Shuanghui Investment & Development Co., Ltd. ClassA	19	Dec-07	725%	149%
000538.CN	Yunnan Baiyao Group Co. Ltd. Class A	16	Dec-07	2808%	432%
002035.CN	Vatti Corp. Ltd. Class A	15	Sep-10	690%	311%
002001.CN	Zhejiang NHU Co. Ltd. Class A	15	Sep-08	1035%	505%
600298.CN	Angel Yeast Co., Ltd. Class A	15	Dec-07	550%	270%
600436.CN	Zhangzhou Pientzehuang Pharmaceutical Co., Ltd. Class A	14	Sep-10	746%	1166%
002415.CN	Hangzhou Hikvision Digital Technology Co., Ltd Class A	14	Mar-12	581%	544%
603288.CN	Foshan Haitian Flavouring & Food Co., Ltd. Class A	12	Sep-14	181%	605%
002507.CN	Chongqing Fuling Zhacai Group Co., Ltd. Class A	12	Sep-12	244%	868%
002236.CN	Zhejiang Dahua Technology Co. Ltd. Class A	12	Sep-10	1737%	311%
000661.CN	Changchun High & New Technology Industry (Group) Inc.	12	Sep-09	2066%	3444%
600183.CN	Shengyi Technology Co., Ltd. Class A	10	Dec-07	351%	248%
600566.CN	HUBEI JUMPCAN PHARMACEUTICAL CO., LTD Class A	10	Sep-15	184%	36%
600779.CN	Sichuan Swellfun Co., Ltd. Class A	10	Sep-09	81%	229%
000799.CN	Jiugui Liquor Co., Ltd. Class A	9	Sep-09	300%	216%

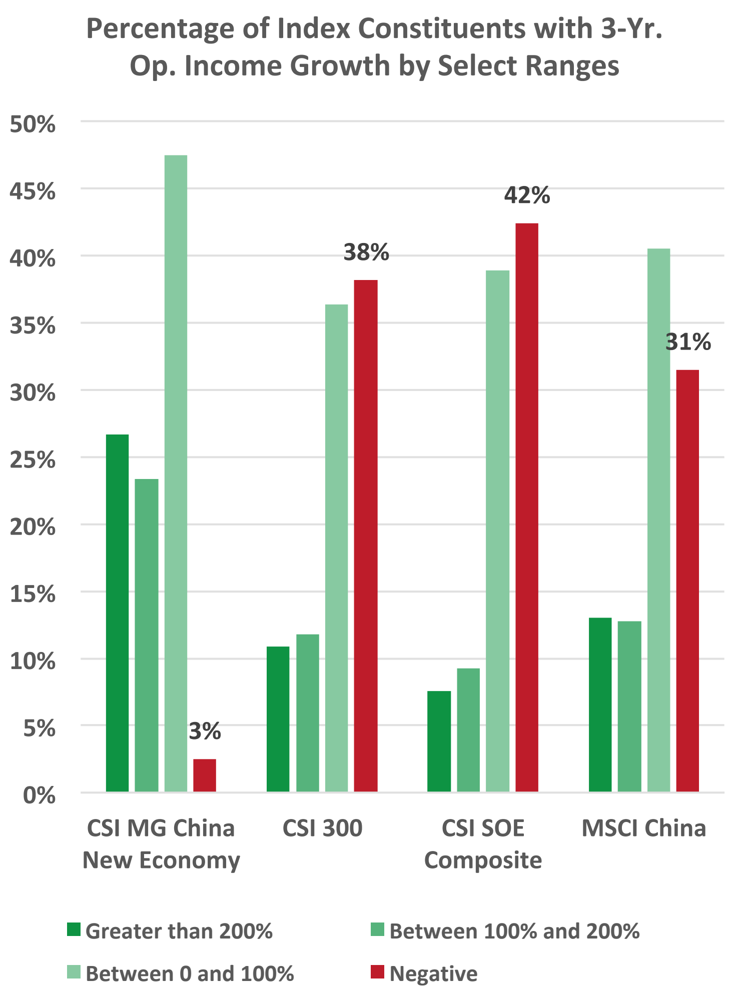
*Not all companies in the list have been continuous members of the Index since its base date on December 31, 2007.

What are Growth Compounders?

Our methodology focuses on rewarding companies with consistent top and bottom line growth …



Sources: FactSet, MarketGrader, China Securities Index Co.



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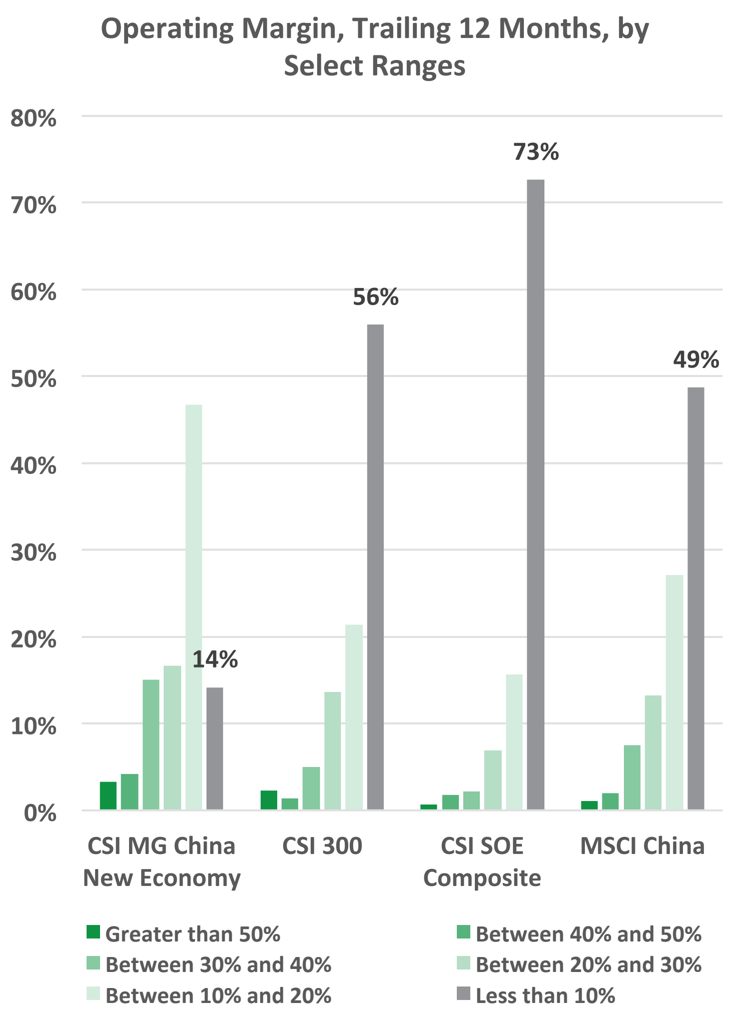

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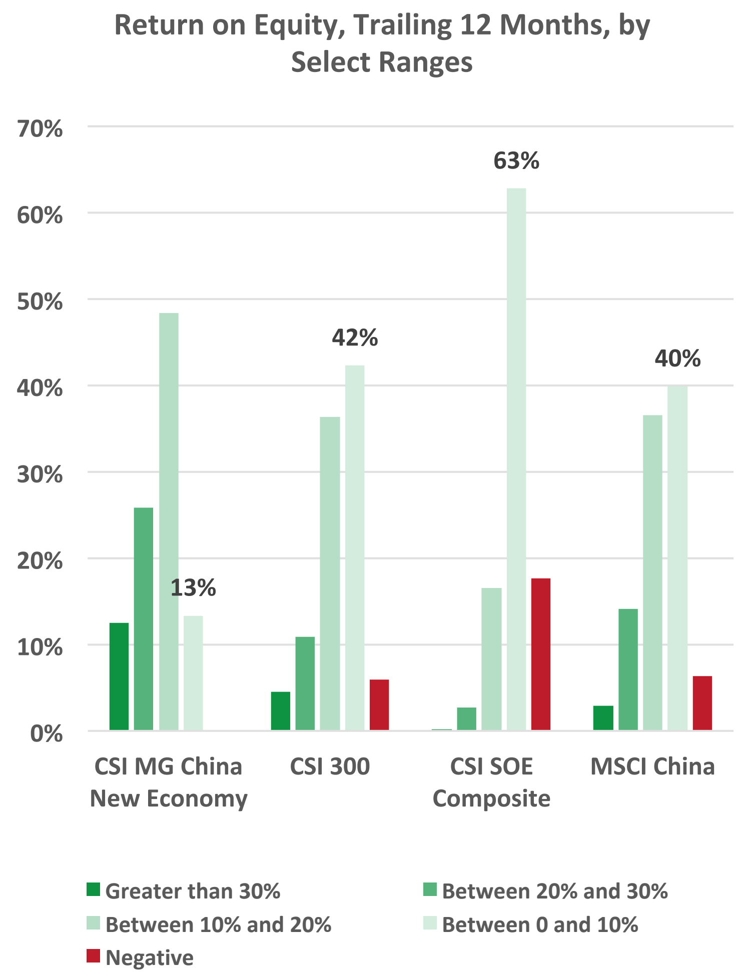
What are Growth Compounders?

Without losing sight of profitability and leverage …



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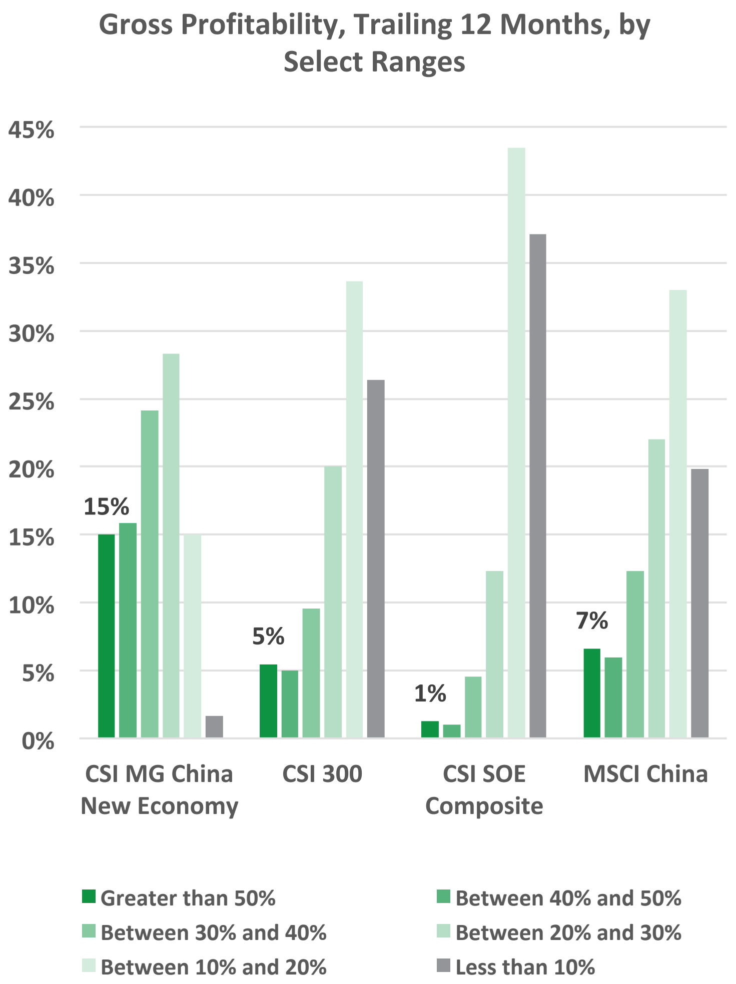

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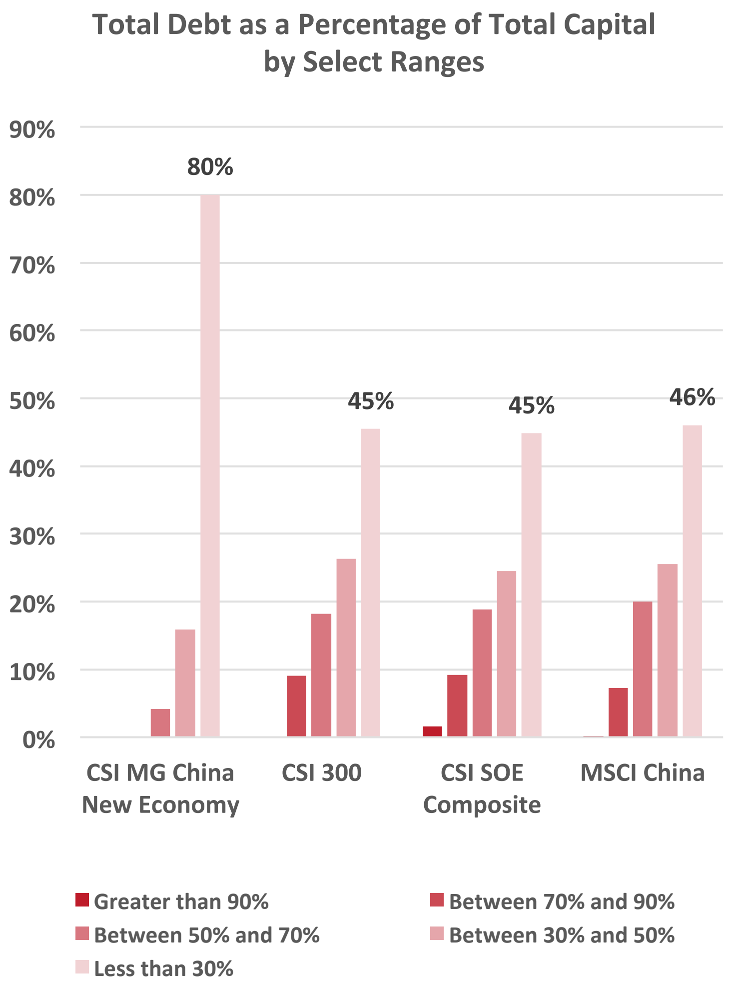

Sources: FactSet, MarketGrader, China Securities Index Co.

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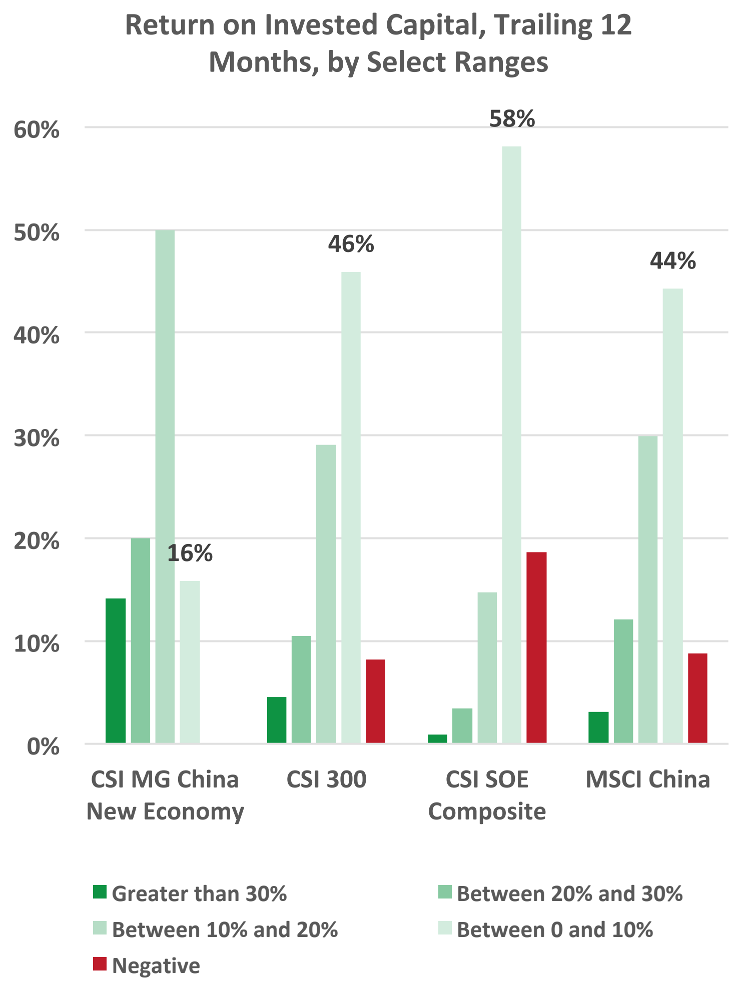
What are Growth Compounders?

Resulting in sound capital allocation, which leads to superior shareholder returns



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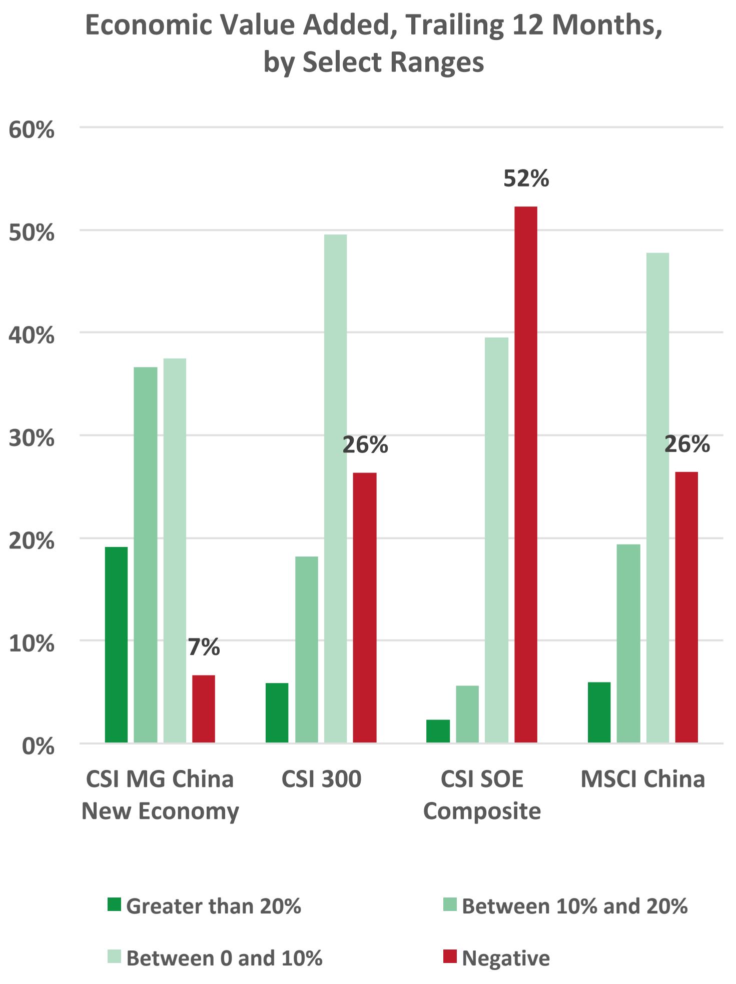

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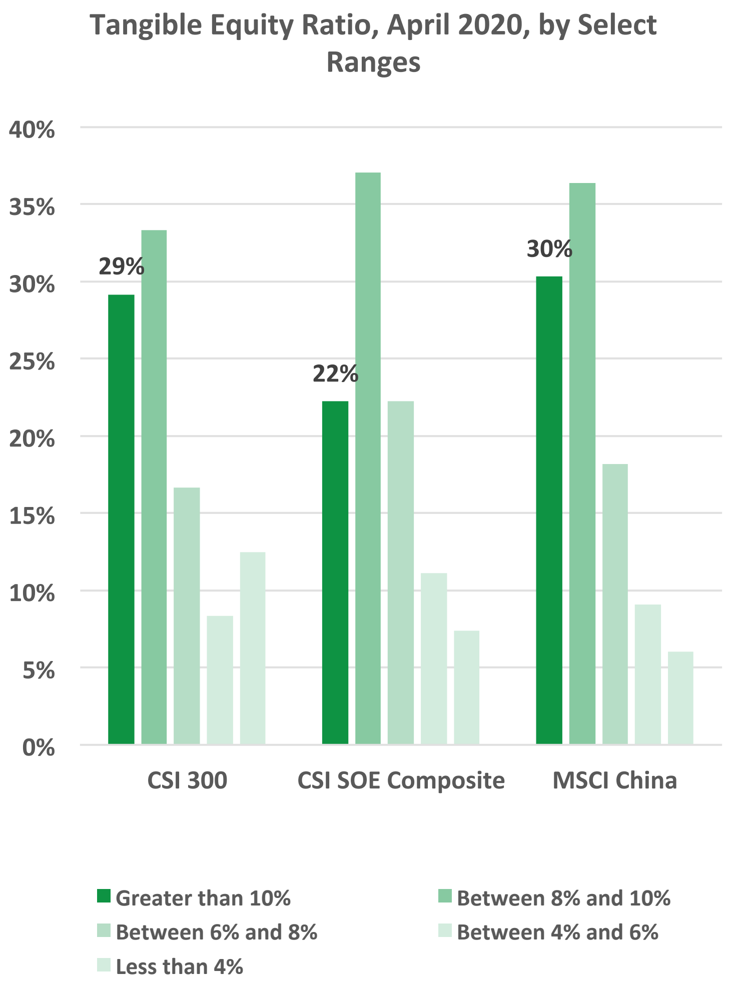

Tangible Equity Ratio is measured as non-performing assets as a percentage to total tangible equity and reserves for loans and asset losses. It is used only for Banks. Sources: FactSet, MarketGrader, China Securities Index Co.

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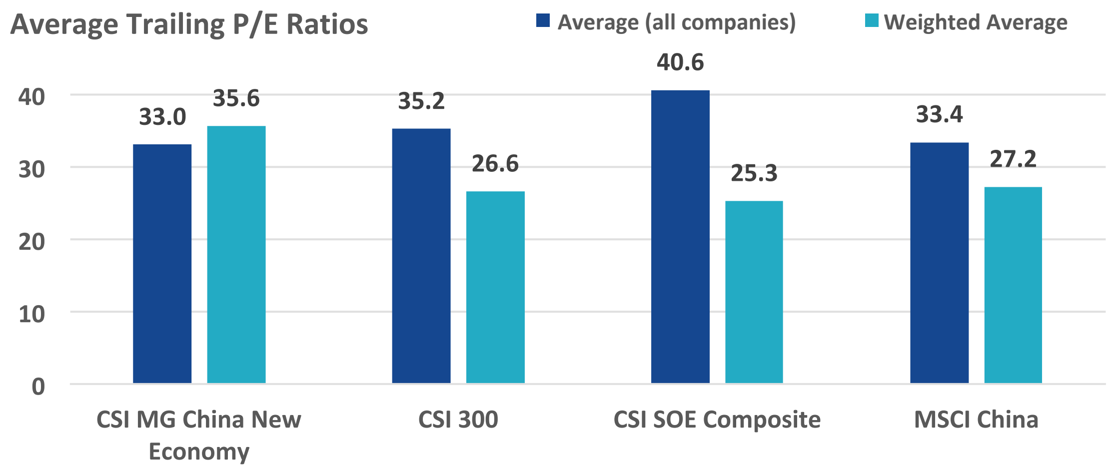
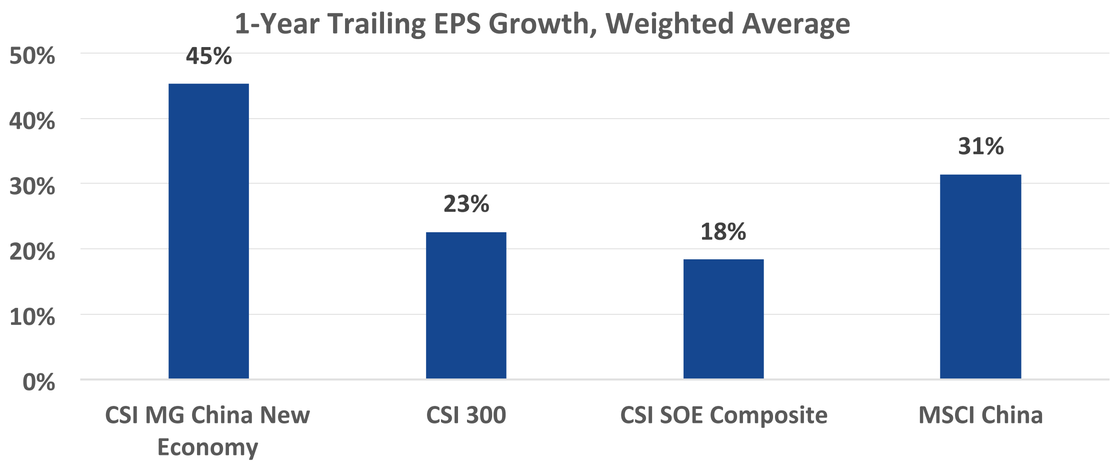
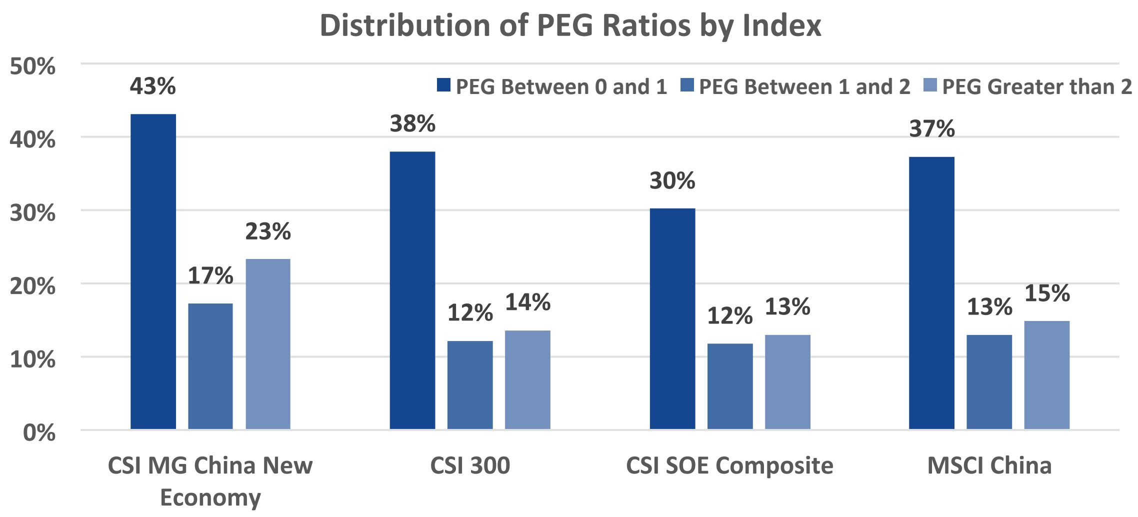
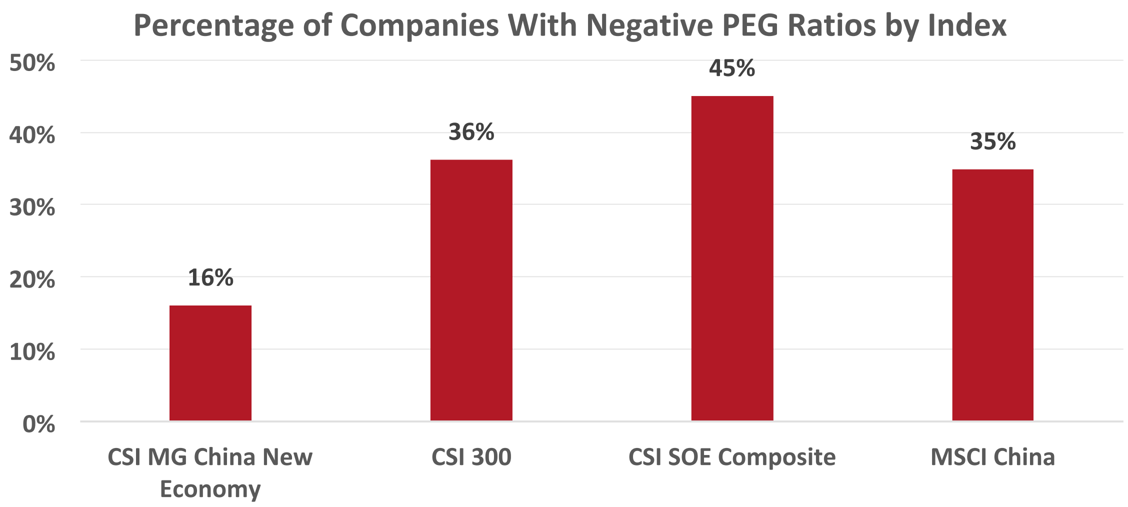
Does GARP Work in China?

There is a significant difference between buying cheap stocks, with limited upside, and buying long-term growth compounders at a reasonable valuation









Sources: FactSet, MarketGrader, China Securities Index Co.

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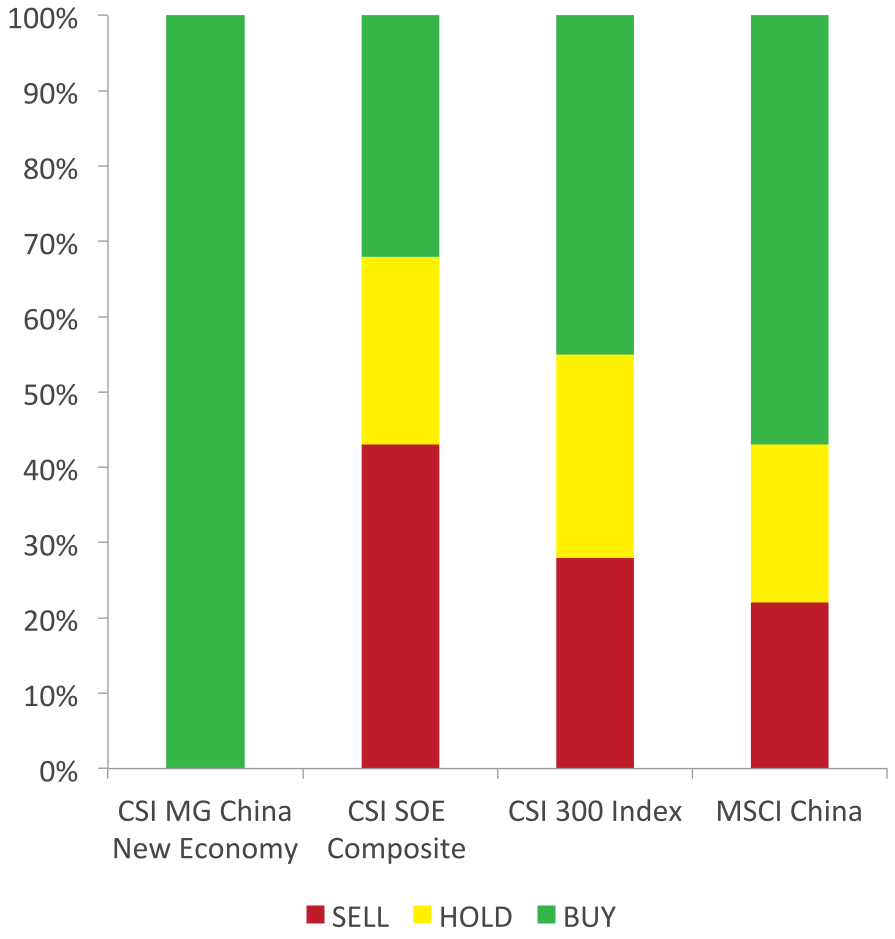
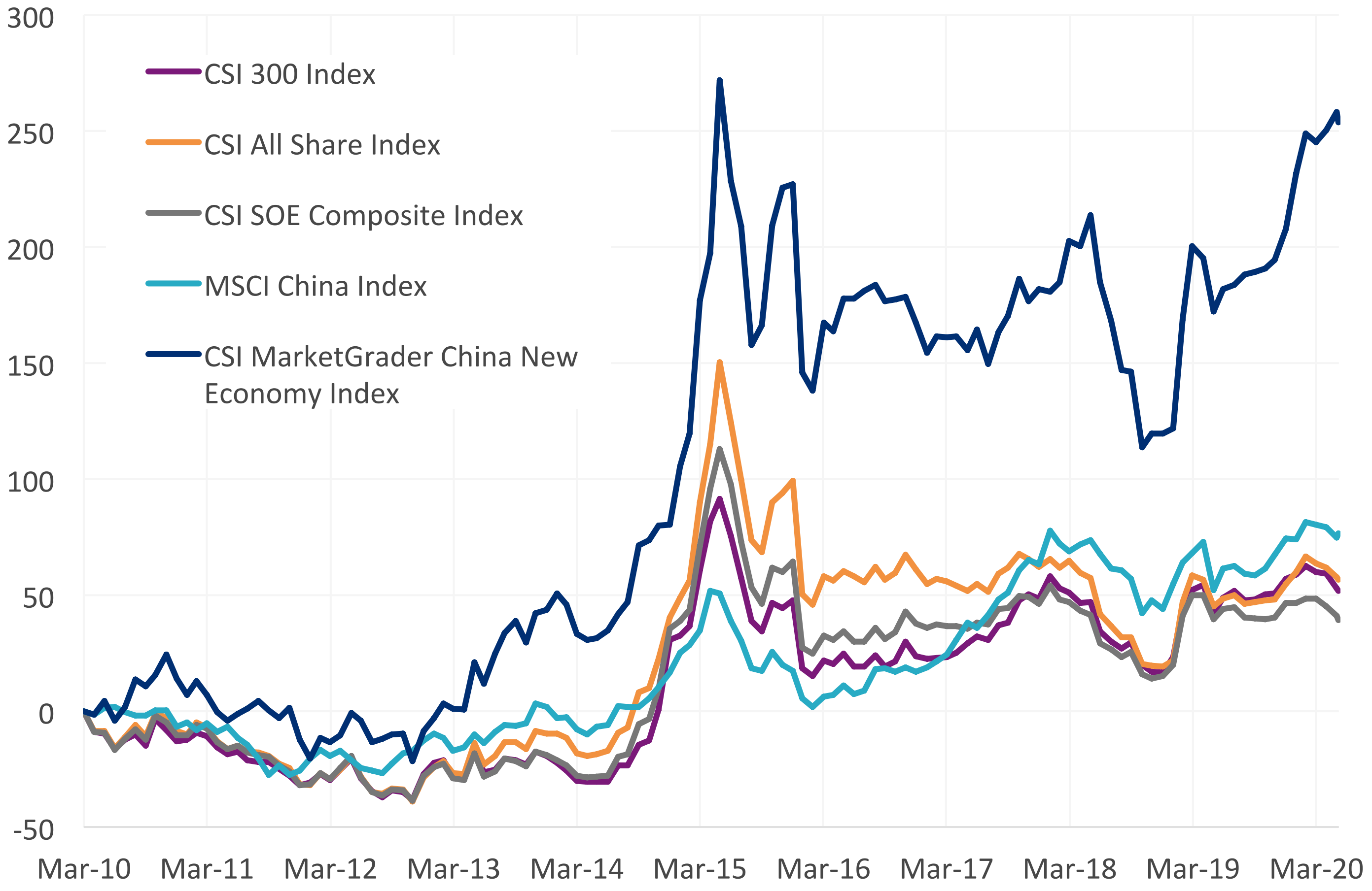
A Better Portfolio Construction Methodology Translates Into Superior Investment Returns

MarketGrader Ratings Breakdown by Index, May 2020



Source: MarketGrader

Cumulative Price Return in AUD for CSI MarketGrader China New Economy Index vs. Select Chinese Benchmarks 2010 - 2020



Source: Bloomberg

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Conclusions

1. Many of the problems that plague China's equity markets today can be traced to the dual ownership structure promoted by the government when it implemented its privatization program.

2. Coupled with strict capital controls, which forced many of China's most promising companies to list offshore, this means that in terms of aggregate market cap more than half of the China's equity market is still comprised of SOEs.

3. Publicly traded SOEs are unlike privately owned companies also listed on China's exchanges in that their primary objective is not to maximize shareholder returns but to implement the state's social, industrial and political goals.

4. Traditional benchmarks, which select the country's largest companies and, by design, weights them according to size, are overweight SOEs and underweight privately owned companies in the economy's most dynamic sectors.

5. A differentiated approach to China focused on stock selection based on company quality and alternative weighting methodologies offers a better way to harness China's economic growth and translate it into portfolio returns.

Thank You

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