THE EARLY BIRD CATCHES THE WORM

Selectivity is key for investing in China's large stock market

Comgest has been in China for over two decades. We understand the pitfalls and opportunities, from governance risks to the ample growth opportunities of the New China which is all about the consumer and services. And we observe the widespread skepticism about China's prospects triggered by concerns about its debt situation and, more lately, a possible US trade war. However, do investors acknowledge that China's funding situation is strong and leverage has been used for investment rather than consumption? Do investors notice that China's globalization dividends have already diminished? Exports as a share of the Chinese economy have almost halved to below 20%, a level comparable to the early 2000s before China joined the World Trade Organization. In view of the rise of consumption and services, external demand is not the game changer any more for the development of China it has been 15 or 20 years ago.

While we are constructive on the development of China's economy, the key for our investment in China are bottom-up convictions focused on the rising middle class in the country. Our global emerging markets portfolio is exposed to a handful of quality growth companies in China reflecting an economic reality: China is the 2nd largest economy and stock market in the world. Via the Connect Scheme foreign investors can now directly invest in close to 1500 stocks representing 50% of China's market capitalization. An active emerging markets fund manager like Comgest with 2 decades of experience on the ground should be able to fish in such a big pool. Otherwise we simply wouldn't do our job.

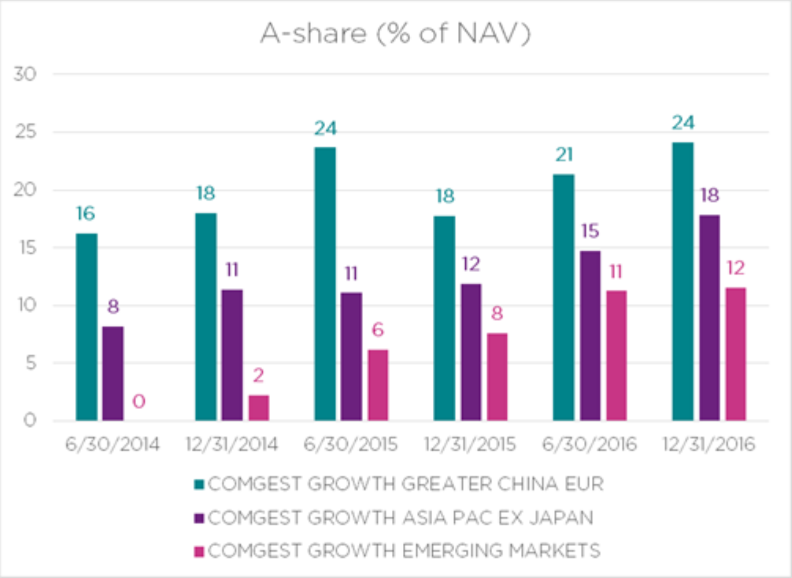
And that is where a paradox comes into play. The more active emerging markets fund managers are, the more underweight China they are. According to Copley Fund Research global emerging markets funds with an active share of more than 75% and fewer than 75 holdings are more than 8% underweight China. But China's record high share return dispersion signals very strong alpha opportunities! How does that go along?

Indeed foreign investors have not embraced the opening of the Chinese equity market: only 1/3rd of quotas available via the Connect Scheme and the QFII program have been used by foreigners so far. Only 1% of the mainland Chinese market capitalization are held by foreign investors. 90% of the market is in the hands of state and retail shareholders, which is why the market is still not efficient.

Is foreign investors disinterest in mainland China shares explained by their absence from the MSCI Emerging Markets index? If so it would be a bad reason to stay away. Firstly capitalization weighted indices do not fairly reflect the opportunities in the Chinese equity market linked to the rapid shift towards consumption and services. The old China, represented to a large part by state owned enterprises, still represents about 50% of the index. Secondly, selectivity is key. The very high dispersion of returns means a strong difference between strong and weak performers. Thus investing in a broad index is probably a suboptimal way to invest in mainland China if you have local stock selection skills.

Another reason for the large underweight could be that country allocation elements driven by negative macro views prime over alpha opportunities. We acknowledge the imbalances in the Chinese economy, most notably the strong debt built up. But our selective approach means we invest in companies with strong growth prospects combined with strong self-financing capacity.

Contrary to the industry Comgest therefore embraced the opportunity to invest in the world's second biggest economy. Our global emerging markets strategy is more than 8% overweight China in stark contrast to the industry. Its active share is 88%. We don't try to be contrarian for its own sake. However our local portfolio management team in Hong Kong allowed us to spot a number of stock picking opportunities. Importantly we don't need to be macro bulls on China although our view is probably more constructive than the consensus view and our quality growth approach obliges us to be very selective. Our global emerging markets strategy, for example, is invested only in a handful of quality growth franchises of the New China which means consumption and services.



And the contribution of our A-share stock picking has been homogeneous and positive across the 3 funds, similar to the contribution of our Chinese stock picks in Hong Kong as well as the ADRs. Chinese stocks contributed between 60% and 70% to the performance of our global and regional emerging markets funds over the past 3 years. Our contrarian exposure to Chinese stocks has thus been a sound investment for our clients.

In our view, here are some intriguing stock examples of the New China:

Baidu is China's Google with a dominant share of the online search and video markets. It has an online auction platform that allows the company to attract digital advertising money. China already represents around 20% of the global digital advertising market since the internet is the dominating advertising platform in the country. In a recent MIT Technology Review, Baidu was ranked the second most innovative company as a result of the accuracy of its speech recognition technology – outperforming Google's software. Innovation has been, and continues to be, the key to Baidu's success.

Kweichow Moutai is the market leader of the high-end Chinese liquor market. Production of this specialized liquor is limited to the Moutai region in the Kweichow Province. Kweichow successfully transitioned from being the official banquet liquor of the Chinese military to a strong brand preferred by the Chinese middle class. Branding and distribution skills have been the key to this successful transformation. Notably, management is very invested in aligning the company's interests with ours.

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About Comgest:

Founded in 1985, Comgest is an independent, international asset management group with global headquarters in Paris along with investment companies in Dublin, Boston, Hong Kong, Tokyo and Singapore. Since its founding, Comgest has distinguished itself with its unique "Quality Growth in the Long Term" investment style, enabling it to select companies of proven quality with solid prospects for sustained growth. Comgest serves a diversified client base around the world, with a committed staff of more than 140 employees of 20 different nationalities managing client assets of over €21.8 billion (as at 31 December 2016).