INSIGHTS

March 2013

In Conversation With Our China Equity Fund Manager

Nicholas Koh
Investment Director

The SICAV China Equity Fund ("the Fund") recently won the Edge Lipper Fund Awards Best Fund over 5 years, delivering strong risk-adjusted performance. What is behind your winning strategy?

The Fund has delivered its strong risk adjusted returns by following the disciplined investment process - namely a bottom-up valuation focused stock selection after determining a stock's price relative to its intrinsic value.

As China's equity market has been quite volatile over the past 5 years, these large price movements have in fact revealed some good buying and selling opportunities for the Fund. As stock prices become more and less attractive, we recycle our capital by trimming some positions where we have had strong gains, taking profit in line with our valuation driven process and using those proceeds to purchase equities which are undervalued.

For example, during 2012 some opportunities materialized within the Chinese consumer discretionary and consumer staples sectors. Negative market sentiment provided opportunities to establish new positions with softening consumer sentiment and cyclically slower growth resulting in a de-rating of valuation multiples in solid companies like Belle and Wumart Stores. Similarly, a weakening of Sino-Japanese relations caused the share price of Dongfeng Motors to fall. As the share prices fell, buying opportunities below intrinsic value were revealed. These companies were trading at attractive multiples, with good balance sheet, free cash generation and strong management teams.

Source : Eastspring Investments (Singapore) Limited, Mar 2013

Faced with the risk of a hard landing earlier, latest data suggests that China's economy is rebounding, prompting economists/analysts to make bullish forecasts for growth in 2013. What is your view on this?

At Eastspring Investments, we do not forecast GDP growth. To us, Consensus Economics GDP estimates for 2013 of 8.1% (as of Jan 2013) look reasonable or a bit high relative to the government's official target of 7.5% (same as 2012 target). More importantly, for us as investors in the equity market, earnings expectations for 10% EPS growth for 2013 looks fair (IBES MSCI China from Thomson Datastream, Jan 2013).

With the benefit of hindsight, Chinese policymakers provided excessive stimulus in response to the Global Financial Crisis 2009, causing some cyclical overheating. Subsequently, policymakers tightened property policies and reduced stimulus in some areas. This cyclical weakness was combined with a more gradual slowing in the longer term growth potential as the Chinese economy continues to mature.

My observation is that analysts were previously too optimistic on growth in top-line sales growth and bottom-line profit growth. Over the past couple of years, prior high growth expectations from both economists top down and companies bottom up have had to be adjusted – leading to persistent downgrades. The inflation and overcapacity in selected industries – which were the costs associated with this stimulus – resulted in profits falling in some sectors. Since then, the Chinese economy has also endured a softer patch of activity to unwind those prior excesses.

Going forward, after 24 months of downgrades, earnings growth expectations are now much lower. As expectations fall and as valuations remain low, these are critical ingredients which make me more optimistic about future returns for China.

We expect economic growth rates for China to moderate in the mid-term. That said, it should continue to be strong relative to the world average. GDP growth moderating is not necessarily bad for equities longer term especially if the quality and structure of economic growth improves.

But, it is a good reminder that as investors we buy companies and their cash flows and not a country's GDP growth.

Another rising concern is the falling profitability of Chinese companies. Are these concerns justified?

Falling profitability is a risk in certain industries, but in aggregate we think even factoring in reduced profitability, current valuations look inexpensive to us and appear to offer a margin of safety.

Firstly, expectations now seem reasonable. Previously, the market was too optimistic not only on China's GDP growth but also on its company earnings growth as well. The disappointments combined with a higher starting point on valuation resulted in the underperformance of Chinese equities in 2010, 2011 and for much of 2012.

Source : Eastspring Investments (Singapore) Limited, Mar 2013

Some sectors and companies with excess capacity (an unintended consequence of stimulus measures and overly optimistic companies' investments) will continue to face pressures on profitability going forward.

However, we observe that the consensus expects 2013 earnings per share growth to be around 10%* for MSCI China which is a more sensible starting point than previous years.

Secondly, valuation still provides support. 2013 consensus P/E is around 10x while 2013 consensus P/B is around 1.5x**. Both are around 1 standard deviation below its historical levels (historical average is 13x earnings & 2.2x book over the past 10 years**).

By comparison, China is currently trading cheaper than both Europe (12.1x P/E and 1.5x P/B)** and the US (13.8x P/E and 2.1x P/B)** despite the issues that are still ongoing in these respective regions.

**IBES MSCI China from Thomson Datastream, Feb 28, 2013; **P/E and P/B is based on IBES MSCI China, IBES MSCI Europe and IBES MSCI US from Thomson Datastream, Feb 28, 2013.*

Based on your outlook, how would you be positioning the Fund in 2013?

Our investment strategy has not changed – that is, to find attractively priced companies which will generate good returns for our investors over the long term. We are guided by bottom up estimates of intrinsic value in picking stocks and constructing our Fund. The implementation of our philosophy and process has not changed.

Longer term, it is likely that China's economic growth remains much higher than many countries in both the developed and developing world. We continue to believe capital deepening and urbanization will remain economic drivers for China – although likely to be less important drivers than the previous 10 years.

It is important to note that we invest in companies rather than the economy. When we meet companies, we see many moving up the value chain through product innovation and focusing on servicing a growing domestic market. These are likely to continue to be powerful drivers of productivity growth and economic growth.

From a bottom up basis, we continue to uncover what we think are cheap stocks. As patient bottom-up valuation driven stock pickers, we look forward to bumpy roads and murky waters to uncover attractive opportunities.

In a nutshell, what will be the performance drivers and the biggest risks going forward?

These are very interesting times for China with the change of its leadership as President Xi Jinping and Premier Li Keqiang take over. This change highlights both the opportunities and challenges of investing in China. The generational shift in leadership brings hope that China will re-embark on the reform process and aid its rebalancing. The challenges are that many people are guessing the implications, but the truth is that they are just guessing. The reality is that Chinese politics is quite complex and opaque. Similar to a lot of other countries, there will no doubt be roadblocks to reforms.

Source : Eastspring Investments (Singapore) Limited, Mar 2013

We were in Beijing back in January of this year and after talking to academics and people on the ground, there seemed to be a sense of cautious optimism that Xi Jinping and Li Keqiang would make some strides on reforms and rebalancing.

We prefer to watch the actions rather than guessing or reading too much into speculation at this point. Reforms are important for China's long term future, but they may not be good for earnings of some sectors.

For example, an anti-corruption drive may hurt the earnings and price to earnings rating of some Macau names. Additionally, interest rate reforms may hurt the overall profitability of the banking sector but on the other hand help the insurance sector. Whilst reforms may hurt some sectors' earnings and MSCI China, a more balanced trajectory could also see a re-rating of the market.

As bottom up valuation driven investors, we acknowledge that there are risks in China (just like there are in many parts of the world) but given that China is still one standard deviation cheap and with relatively low expectations (i.e. low EPS growth relative to the rest of the world), there is still a margin of safety for investing in China. More importantly we will continue to identify and find the needle in the haystack which makes us optimistic about China's future returns.

Source : Eastspring Investments (Singapore) Limited, Mar 2013

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Eastspring Investments (Singapore) Limited
10 Marina Boulevard #32-01 , Marina Bay Financial Centre Tower 2
Singapore 018983

Tel (65) 6349 9100 Fax (65) 6509 9318
www.eastspringinvestments.com.sg