FUND INSIGHTS

INVESTING IN CHINA: WHY CHINA NOW?

EASTSPRING INVESTMENTS – CHINA EQUITY FUND
OCTOBER 2014

REFORMING CHINA INC

China unveiled its boldest set of reforms in November 2013. It has since gripped investors' attention as the initial progress looks encouraging and credible amid the government's efforts to avert a hard landing and breathe new life into the country's faltering economy.

These social and economic reforms, if successfully implemented, will help the world's second-largest economy to gain a more stable footing as it transitions to a consumption-driven society from a producer model. The 60-point reform plan, which many say is the most significant since Deng Xiaoping led a series of reforms in the late 1970s and early 1980s, included a raft of specific policy plans ranging from the relaxation of the one-child policy and revamp of its restrictive household registration system, to interest rate and currency regime liberalization. President Xi Jinping and his administration are giving themselves until 2020 to achieve "decisive" results.

A much ballyhooed component of the reform slate is the transformation of the state-owned enterprises (SOEs). China remains heavily state controlled. The government seeks to transform these SOEs, numbering around 150,000, which generally suffer from overcapacity, low efficiency and high leverage ratios. Ownership diversification, removal of favoured access to markets and resources, and creation of state-owned capital management companies are key features of SOE reform.

While the proposed reforms look daunting, we believe there will be dividends from these reforms in the long term. The MSCI China Index is weighted heavily toward financials, industrials and energy companies – sectors dominated by SOEs.

If things go as planned, by the time the Chinese President Xi is expected to leave office (possibly in a decade's time), these SOEs, except for a strategic few, will resemble private companies in terms of efficiency and profit orientation. So far, there has been considerable progress on the SOE reform front.

PROGRESS OF REFORMS EVIDENT

The rhetoric on reform has been followed up with actions from various fronts in recent months. In the first half of 2014, earnings of SOEs reflected the positive impact of the government's anti-corruption campaign as well as SOE reforms. While SOE revenues fell 6.1%[1] in the first half of the year, earnings before interest and tax (EBIT) margins improved. Many SOEs, under pressure to reform and curb corruption, started to trim expenses which led to better earnings. Large SOEs in the oil and gas, capital goods, health care and telecom sectors reported reduced expenses. Moreover, the net gearing of SOEs dropped for the first time since 2010 and were especially seen in the solar, coal, utilities and transport sectors.

[1]UBS Securities Co Ltd, 10 September 2014.

Another signal of financial reforms in China is the introduction of the Shanghai-Hong Kong Stock Connect, commonly referred to as Mutual Market Access (MMA), as it will open up the A- and H-share markets to a new set of investors. This program will allow investors in mainland China to buy Hong Kong-listed stocks for the first time while also enabling all types of overseas investors to buy shares on the Shanghai Stock Exchange. The program not only strengthens the stock markets of Hong Kong and Shanghai but it is a significant step by China towards further opening up its capital market to the world.

EASTSPRING INVESTMENTS – CHINA EQUITY FUND IS WELL-POSITIONED TO BENEFIT FROM CYCLICAL GROWTH RECOVERY

The Fund is well placed to benefit from a cyclical growth recovery. We believe that a value-oriented investment style can generate superior long-term returns and that the market's recent preference for momentum and growth is temporary. Value stocks are often stocks of cyclical industries which typically perform well in an economic recovery. As of end-August 2014, the Fund has the biggest overweight in consumer discretionary and materials sectors.

The Fund's heavy bias towards China's so-called old economy stocks such as banks and commodities will also serve it in good stead as valuations of "new economy" stocks or those in the technology sector, for instance, reverse from overdone levels.

As a high conviction portfolio, the portfolio manager is able to develop a thorough understanding of Chinese stocks, increasing the chances of improving overall investment performance.

The Fund outperformed its benchmark in August 2014 by 92 basis point on a bid-bid basis with stock selection in consumer discretionary stocks as a major contributor. In the three months to August 2014, the Fund outperformed the benchmark by 116 basis points, on a bid-bid basis, thanks to stock selection in consumer stocks and materials.

The Fund's underperformance, however, in 2012 and 2013 may be attributed to investors riding the market's momentum and chasing stocks on prospects of potential growth.

Fig.1. MSCI China 12 months forward price-to-earnings (x) (31/12/2005 - 31/7/2014)

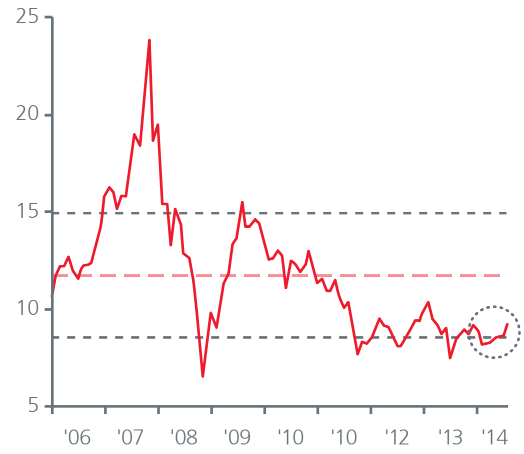


Fig.2. MSCI China 12 months trailing price-to-book (x) (31/12/2005 - 31/7/2014)

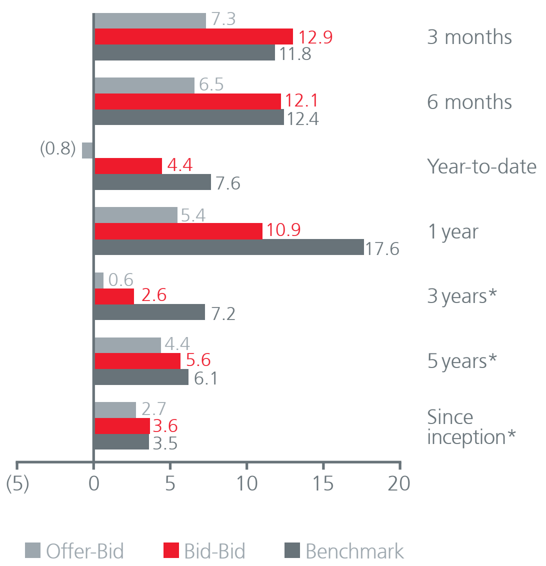
Fig.1. and Fig.2. Source: IBES MSCI China from Datastream, 31 July 2014. Note, the forward price earnings multiple shown above is calculated on an 12-month rolling basis. The horizontal lines represent the average (the middle line) and one standard deviation either side of this average for the period shown. Nearly 70% of all values shown lie within the range shown.

CHINA MARKET IS TRADING AT ATTRACTIVE VALUATIONS

China is trading at attractive valuations and our portfolio manager believes a margin of safety has already been priced into its markets amid uncertainties about the sustainability of the country's future growth. China's stock market suffered a huge sell-off in 2011 amid worries of a hard landing but the next two years saw a reversal of declines.

The MSCI China index[2] has risen 8% in USD terms year to date, bolstered by targeted easing measures at the start of the year, followed by signs of a stabilising economy and more recently by the progress of reform initiatives. Mid-year top sector performers such as telecom and energy were driven more by reforms rather than sector cyclical earnings.

Fig.3. Performance track record (%)



Fund: Eastspring Investments – China Equity Fund Class A

Source : Eastspring Investments (Singapore) Limited; Prior to 1 May 2012, benchmark returns were on a Gross Dividend basis. With effect from 1 May 2012, the benchmark returns are on a Net Dividend basis. The two series are chain-linked to derive the longer period benchmark returns.SGD; Net income reinvested; Offer-bid includes 5% sales charge. Prior to 01 August 2012, Initial Sales Charge was 5.75%.; Inception Date: 02 July 2007. USD; Bid-Bid; Net income reinvested. Benchmark = MSCI China. *Annualised.

At 9.3x FY2014 P/E and 1.5x Trailing P/B, valuations are undemanding for MSCI China as it is trading significantly below its historical averages. The MSCI Asia Pacific ex-Japan index[2] was trading at 12.6x P/E, its historical average and at 1.7x Trailing P/B, a tad below its historical average of 2.0x, as of end-August 2014.

LONG-TERM POTENTIAL REMAINS PROMISING

While China's economic growth may have slowed in the near term, the portfolio manager is of the view that the country's long-term growth potential remains promising. The magnitude of China's middle-class growth will be an impetus for consumption growth. China's upper middle class[3] will account for 56% of urban private consumption by 2022 from 20% in 2012. The expected number of urban middle class households in China will rise to 272 million families in 2022 from 174 million families in 2012.

> We are positive about the government's realisation that the country's old growth model has run out of steam.

We laud the political resolve and zest shown so far to correct the structural ills but we believe that consistency in working at these reforms will be key to their success. The portfolio manager expects that the government's approach to these reforms will be measured and will likely be a multi-year process. Against this background and with our bottom-up investment process, the portfolio manager will continue to seek attractively priced companies in China which are trading way below their intrinsic values.

[2]MSCI China Index and MSCI Asia Pacific ex Japan Index from Thomson Reuters Datastream, Factset, GS Global ECS Research, 31 August 2014.
[3]McKinsey Quarterly 2013.

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