

Client: Chi Med
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Reform agenda could support a rerating of Chinese stocks

The Year of the Horse is under starters orders with the Chinese New Year festival kicking off tomorrow (31 Jan).

An opening up of domestic stock markets and reforms to the country's economy could act as catalysts for undervalued and under-owned Chinese equities in 2014. These could outweigh concerns over a possible credit crunch and the potentially painful transition from an infrastructure to consumer-driven economy.

Investors looking to play this theme might consider passive exposure

through the newly launched exchange-traded fund (ETF) **db X-trackers Harvest CSI 300 China A-Shares Fund (ASHR)**, the actively managed **Threadneedle China Opportunities Fund** and, in order to capture growth in the country's medical sector, **Hutchinson China Medi-Tech (HCM:AIM)** (see 'Ways to play China', page 57).

Many observers are sceptical about the 7.7% annual growth in Chinese gross domestic product (GDP) reported for the last quarter of 2013 (20 Jan) – arguing it does not tally with more negative measures of underlying economic activity. The consensus forecast is for GDP to expand 7.5% in 2014. This is exactly in line with the government's target rate (which could suggest economists see an element of manipulation in the country's official statistics) and would represent the slowest rate of

expansion since 1999.

A slowdown is seen as inevitable as China looks to deliver massive structural change from an economy driven by infrastructure spending and exports to one supported by household consumption. Household consumption currently accounts for around 36% of GDP against around 69% in the US.

However it is worth remembering that economic growth is not necessarily a

good barometer of financial returns. As of the end of 2013 the MSCI China index had produced an annualised gross return of 0.65% since 31 May 1994, despite two decades of rapid GDP growth. According to number crunchers at Nomura, Chinese shares are trading at around 8.6 times 12-month forward earnings, 28% below their long-term mean of 12 times.

Whether you have direct exposure to the country or not China matters, it is

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the world's second largest economy and the most significant consumer of many global commodities (see Cover, page 18). With the FTSE 100 packed full of resource plays, its fortunes are likely to have a significant influence on the UK's headline index. Companies such as luxury fashion brand **Burberry (BRBY)**, alcoholic beverages firm **Diageo (DGE)** and consumer goods giant **Unilever (ULVR)** all have significant footprints in the country as they look to tap an emergent Chinese middle class.

Moving into the open

The gradual opening up of domestic stock markets has supported the launch at the start of this year of Europe's first two physically-backed ETFs which track China A-shares (see 'Chinese markets', left). Source has a physical-backed product tracking the FTSE China A50 index, **Source FTSE China A50 UCITS ETF (CHNP)**,

while Deutsche Asset & Wealth Management's (DeAWM) db X-trackers Harvest CSI 300 China A-Shares Fund tracks the broader CSI 300 benchmark.

DeAWM's head of passive asset management for Asia-Pacific, Marco Montanari, explains why the product is significant for investors: 'While some Chinese companies have shares listed in Hong Kong or international markets these don't tend to cover

the consumer or healthcare sectors. Many analysts believe the future for China will see it transform from an investment-driven economy to a consumer driven economy, in line with other developed economies.'

Montanari explains that only foreign investors approved by China's regulator as Qualified Foreign Institutional Investors (QFII) or Renminbi Qualified Foreign Institutional Investors (RQFII) can invest in A-shares. 'The main disadvantage of the RQFII scheme is that until recently it only provided monthly liquidity, and even though it now provides for weekly liquidity, it is still not possible to use it to create a product with daily liquidity that is physically-invested in Chinese A-shares.'

According to Montanari until last year these issues could only be managed using a synthetic model. 'Since March 2013 funds based outside of Hong Kong have been able to make use of the RQFII scheme which does facilitate daily liquidity.'

Both DeAWM and Source have teamed up with Asian asset managers holding the RQFII license. DeAWM has partnered with specialist Asian asset manager Harvest Global Investments, whereas Source has collaborated with Hong Kong-based CSOP Asset Management. Montanari believes a more open Chinese market is likely to prove a boon for Chinese shares in general. 'Europe and US has

less than 2% of assets linked to China. The exposure is very small and one of the key reasons for that is access has been restricted. It is now opening up.'

Last year index providers FTSE and MSCI announced they were considering adding China A-shares to their global benchmarks and this could see increased flows of capital into Chinese equities, as Montanari explains: 'Research conducted by Deutsche Bank in June 2013 estimates that when MSCI and FTSE include China A-shares in their benchmark emerging market indices »

China's representation will rise from 18% to 30%. Passive and active fund managers will therefore automatically have to increase their exposure.'

The Third Plenum reforms (see 'Reform agenda', right) announced last November should support a further shift to greater transparency and accessibility in China and Montanari's view tallies with that expressed in asset management firm BlackRock's 2014 *Investment Outlook*. 'Markets like reforms – a lot. Positioning in emerging markets and Chinese equities is low. Valuations are cheap – and performance could change on a dime if investment tourists spot a catalyst for change.'

Risk management

A key risk to any positive view on Chinese stocks in 2014 is the increasing levels of debt in the economy. Earlier this month (21 Jan) the People's Bank of China (PBoC), the country's central



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bank, injected \$42 billion into money markets to avert a potential credit crunch. Before this intervention, the latest of a series in the last six months, a shortage of day-to-day cash among commercial banks had driven interest rates to 7.5% (20 Jan).

When the global financial crisis hit in 2008, the Chinese government mandated an opening up of credit lines. Banks and other lenders responded and this helped to finance massive building and infrastructure projects. In the short-term the strategy was successful, and China was left relatively unscathed by the global financial crisis. But credit growth has continued unabated.

There are concerns that new credit is no longer generating strong economic returns. The rapid increase in borrowing could even prove a drag on growth if the central government is forced to prop up defaulting local governments or agencies, through which much of the lending flowed. An official


report released at the end of last year (30 Dec '13) revealed China had local government debts of \$2.9 trillion, up 70% in three years. These concerns are exacerbated by the fact an increasing amount of credit in China is being issued by trust companies, securities dealers and underground operators that make up a largely unregulated 'shadow banking' system.

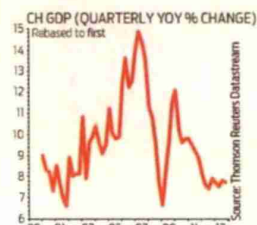
Currency analyst at FOREX.com, Kathleen Brooks outlines the dilemma facing Chinese policymakers in addressing this issue. 'While we expect the PBoC does not want China to

experience a dramatic growth slowdown, it also wants to teach the banking sector a lesson... how harsh that lesson is going to be, could determine the markets' reaction.'

Corporate governance is another potential red flag. A report released last week (21 Jan) by the International Consortium of Investigative Journalists suggested several of the country's top leaders and their families have held offshore accounts in tax havens to hide their wealth, while China's corruption-dogged oil majors are linked to dozens of firms in the British Virgin Islands. It adds that by some estimates, between

\$1 trillion and \$4 trillion in untraced assets have left the country since 2000.

Nonetheless Daniel Stewart's chief economist Alastair Winter remains positive on the outlook for 2014 and says the benefits from the reform agenda being pursued in China could have a read-across to the commodity-driven economies: 'The Third Plenum reforms are creating their own dynamics. If any potential banking crisis is successfully managed then prices could well end the year higher by 10% or more. There could well be a knock-on effect not just to other Asian markets but also in Australia and Canada.' 



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Reform agenda

Third Plenums refer to the third time new Chinese leaders hold a 'plenary' session of the Central Committee. They generally take place a year after new leaders take office, when they have established their power base, and have a track record of delivering significant reforms. The latest summit took place from 9 to 12 November and while the initial reaction to the agenda was lukewarm, a more detailed report did get the thumbs up from the market. Analysts at investment bank Goldman Sachs identified four key messages:

-  **Pro-market stance:** the reforms include development of market mechanisms, more opening up of markets to competition, curbing the power of state-owned enterprises (although the state is to remain dominant), reducing government intervention, and pushing through continued financial reforms.
-  **Social fairness:** greater focus on farmers' property/land rights and even access to public services by rural and urban residents, in addition to public policies to protect vulnerable groups.
-  **Growth sustainability:** significant emphasis on fiscal reforms will increase transparency and re-align central and local spending responsibilities. There will be mechanisms to monitor and manage debt and financial risks, and an emphasis on environmental protection.
-  **Top-down decision making:** a centralised strategy will be led by a reform committee at the top.



Chinese markets

There are three main stock exchanges in China: Shanghai, Shenzhen and Hong Kong, and three categories of shares – A, B and H.

-  **A Shares:**
These are companies incorporated in mainland China and which trade on the mainland A-share markets of Shanghai and Shenzhen. A-shares are generally restricted for purchase by mainland citizens and foreign investment is only allowed through a tightly-regulated system. A-shares are quoted in renminbi.
-  **B Shares:**
These are open to both domestic and foreign investment. B-shares are quoted in US dollars for Shanghai-listed stocks and in Hong Kong dollars for Shenzhen B-shares.
-  **H Shares:**
These are companies incorporated in the Chinese mainland listed in Hong Kong. They are denominated in Hong Kong dollars. There are no restrictions for international investors.



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Room for growth: foreign ownership as a percentage of domestic market



WAYS TO PLAY CHINA

db X-trackers Harvest CSI 300 China A-Shares Fund (ASHR)

\$7.47

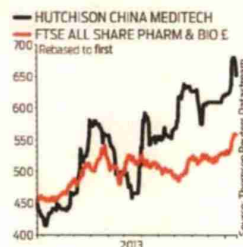
This is one of two new physical ETFs which track mainland securities in China. Unlike the product issued by Source – which mirrors the 50 blue-chip companies covered by the FTSE China A50 – this instrument offers exposure to the more broad-based CSI 300 index. The index is composed of the 300 largest and most liquid stocks in the China A-share market on the Shanghai Stock Exchange and Shenzhen Stock Exchange. It should capture the consumer and healthcare companies in line to benefit from the anticipated shift to a consumer-driven economy and has less exposure to financial services. Financials have a weighting of 38.9% in the CSI 300 compared with 64.7% in the FTSE China A50.



Hutchinson China Medi-Tech (HCM:AIM)

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Although the £345 million cap has already enjoyed a stellar run there could be more to come as it benefits from exposure to the fastest-growing healthcare market in the world and a supportive environment for clinical research. In particular a stream of new drugs could help support the momentum through 2014. The group has three divisions: research and development unit Hutchinson MediPharma; China Healthcare which markets a range of traditional Chinese medicines; and Consumer Products which is developing a range of healthy living products. A 2013 industry audit by business intelligence firm WiCON International predicts growth in China's healthcare sector of around 20% per annum through to 2020, when China is expected to become the world's second largest drug market (after the US) with an estimated worth of \$120 billion.



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Threadneedle China Opportunities Fund

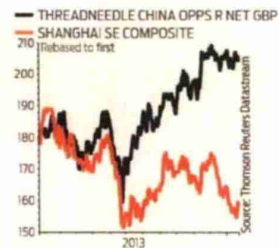
ISIN: GB00B1PRW734

Minimum investment: £2,000

Five-year annualised performance: 16.5%

The £78.5 million fund is headed up by Vanessa Donegan and is a top-quartile performer in the IMA China/Greater China category, according to the latest figures from Trustnet having generated a 114.7% total return over the past five years. The fund, launched in March 2007, invests at least two-thirds of its assets in Chinese-listed companies, or businesses with significant operations in the emerging market. Its top holding at 7.6% of the portfolio is **Tencent (0700:HK)** – a provider of social networks, online advertising and games and mobile phone services which is now the third largest internet company in the world by market cap behind **Google (GOOG:NDQ)** and **Amazon (AMZN:NDQ)**.

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