China A shares emerging from the bear?

Dominic McCormick | Select Asset Management | 17 November 2014

Earlier in the year, my article "A tale of two sharemarkets" made the point that the US share market had the characteristics of a mature and increasingly vulnerable bull market, while the China A share market showed the characteristics of an ageing but close to bottoming major bear market.

Since then, the US equity market has gone on to make a series of record highs, if in a somewhat unconvincing manner with a significant recent slowing of upward momentum. As at 12 November 2014, the US market as measured by the S&P 500, had returned 9.4% since 30 April. Over the same period, the Australian sharemarket returned just 2.4%. However, it may surprise many that over the same period, the China A Share CSI 300 index has returned 23.4% and almost 28% since it bottomed on 20 March 2014. Even with this rise, the index is still over 50% below its high back in October 2007. And, these returns are in local currency, so US equity and Chinese equity returns have been even better for Australian dollar investors given AUD weakness against both currencies (with the China A return further enhanced by Yuan strength against the USD).

Despite this strong recent sharemarket move, it is hard for investors to think positively about China in the current environment. The media is full of news about the China properly bubble, shadow banking problems and risks of a hard landing. And these risks are real. There is clearly a significant slowdown in part of the Chinese economy as many Australian miners no doubt know. However, even if greater problems in these areas develop, this does not automatically translate to the Chinese sharemarket, as the bear market through years of very strong economic growth attest. However, the focus on these issues is blinding investors to potential opportunities, both in the short and long term, particularly as the cheap valuations after the multi-year bear market are already incorporating plenty of bad news.

Other investors focus on China's poor governance, lack of capital market access, and the role of inefficient state-owned enterprises as a significant component of the market. However, the reality is that all these issues are being gradually addressed. In any case, if investors wait until every major barrier or excuse against investing is resolved, they will pay a much higher price and set themselves up for lower future returns.

In September this year, MSCI wrote a research paper entitled "China A-Shares: Too Big to Ignore," reinforcing the case for inclusion of A shares in global equity portfolios. While it did not neglect the access and tax barriers that have made investment difficult so far, it highlighted the capacity, industry spread, diversification and liquidity benefits of A shares compared to developing, emerging and frontier markets. Interestingly MSCI decided against including China A shares in its emerging market indices early this year, based on some of these barriers. However, it seems increasingly likely that it will have a different view when it re-visits the issue again in the first half of 2015. How well the Shanghai/HK Stock Connect program goes, which commences today (17 November) and allows allowing two way trade in many shares in each market, will be a significant factor impacting this consideration.

One way we have been participating in the China A share story is through the listed AMP Capital China Growth Fund (ASX Code AGF). AGF also comes with the benefit or problem (depending on your perspective) that it still trades at a very large 20% to 25% discount to Net Asset Value (NAV), despite the fact that many broader-based global listed funds trade around NAV or at premiums. It also differs from many of these in that it is a listed unit trust rather than an investment company structure.

One of the primary reasons why AMP launched the fund in 2007 as a listed closed-end vehicle was that it then had what was a scarce QFII (Qualified Foreign Institutional Investor) quota. However, one of the ultimate outcomes of China opening up their share and capital markets will be that QFII licenses will either become freely available or obsolete so this rationale for the current structure could disappear at some time in the future. At that point, a case could be made that this fund should simply convert to a regular unlisted unit trust offering applications and redemptions at NAV thus avoiding the problem/opportunity of fluctuating premiums and discounts (although from a fund manager's perspective, the funds under management become less permanent and more dependent on good performance and marketing).

The possibility of such a development or others factors/measures that substantially narrow or eliminate the discount to NAV at which this fund trades could therefore provide, at some point, an additional 20% to 30% one-off boost to returns. In our view, this should certainly not be the main driver to this opportunity given the attractive fundamentals and long-term growth story - however, it would be a nice bonus.

We have built up and maintained AGF as a significant weighting in portfolios where we control the allocation. Unfortunately, some mandate changes and redemptions on some funds recently have led us to (reluctantly) sell a significant number of AGF units. Despite our own high conviction on China A shares and AGF as an investment idea, we have struggled to fully convince investors of the merits of a stand-alone China A exposure for the long term in the current environment. Of course, this is not surprising given the headline issues discussed above and the inherent volatility of, and perceived risks around, this market. Further, difficulty in convincing other investors of the merits of an investment idea is an inherent characteristic of many of the best contrarian ideas. In the 6 May article, I wrote that "often, the true dangers reside where investors are most comfortable going and the best opportunities where investors fear to tread."

Indeed, from the behaviour of the buyers, I suspect relatively few of the units we have sold recently have made their way to retail investors or advised clients. Rather, it seems it may be more professional and institutional investors who are interested from the activist, discount narrowing angle rather than a fundamental angle that are buying. Time will tell.

As I argued in the 6 May article, the key to coming to grips with significant long-term investment in an area that is not on many investors' radars and is perceived as excessively risky when it is, is to try and envisage what the world will look like in 10 to 15 years or even 20 to 30 years. From this perspective, the absolute and relative size of the Chinese economy and markets is likely to demand a very significant weighting in most global equity portfolios. At a recent China Equity Access Seminar, one speaker put it in stark terms by suggesting that the world was eventually heading back to a pre-industrial world GDP split of one third China, one third India and one third the rest, largely driven by demographics. In today's global and information driven, financial markets will follow.

In a world where record low interest rates and quantitative easing have driven up the price of almost all investments, finding attractively valued out of favour assets is no easy task. It is even harder to find assets that are large and liquid and likely to become even more so in the future. By definition, if the assets are out of favour, there will be plenty of well publicised reasons why investors should stay away from them. But such assets can help add to the robustness of portfolios not just because of their better long-term return prospects but because they will typically be less correlated to the majority of other assets they hold, most of which have been the focus of the chase for return and yield. Despite the strong run up over the last few months, after a multi- year bear market, China A shares remain one such asset class.

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