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2012 PremiumChina Study Tour

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Chasing the dragon: why investing in China remains a long-term game

It’s the economic success story of a generation, but investors in China in the past 18 months might be scratching their heads wondering where the returns went. Simon Hoyle reports that the outlook remains bright, despite recent disappointment.

It is impossible to frame an economic outlook and hence a long-term asset allocation picture for domestic or international assets without understanding what is taking place – and what may continue to take place – in China.

China is rightfully regarded as an emerging global economic powerhouse, and certainly in recent years all eyes understandably have been on how the Government there manages its booming economy, but it’s not simply that growth will continue indefinitely, nor necessarily even at current levels. (See box.)

Clearly, however, a growth rate in the region of 8 to 9 per cent a year will inevitably throw up outstanding opportunities for investors. However, investors first have to identify those opportunities and determine whether the risk of pursuing them is worthwhile. Assessing how best to access the opportunities is another matter.

Direct or indirect

There are several approaches that investors can take. One is to invest in China either via direct equities or via a managed fund that focuses on that country alone; another is to invest in an Asian fund, or in Asian equities that benefit from the growth and development of China; a third is to invest in a global emerging markets fund; and a final approach is to invest in a global equity fund, which may include companies that are benefiting from the growth of China.

Briana Lam, a senior investment analyst with van Eyk Research, says it’s a good idea for anyone attracted to the concept of investing into China to first carefully assess the exposure they may, perhaps unwittingly, already have.

If an investor is wondering whether they should have an exposure to China at all, Lam says “the short answer would be: ‘Yes, but...’.”

“There’s things you need to be aware of,” she says.

“A good starting point would be to assess what is your current exposure to China. Perhaps if you’ve got even just an Australian equities exposure, I’m sure that everyone is aware that a lot of Australian companies are heavily exposed to the China growth story. That’s something that you should be aware of.

“Even some fund managers cannot say specifically that X per cent of a certain company is exposed to China, but just to have a broad over view of that would be a helpful starting point.

“Then you move on to, exactly how much exposure do you want? Depending on that, you can either go into a direct China fund; there’s several available in Australia that we rated back in 2010. Or, you can go for a slightly more diversified approach – regional Asian equities funds, which typically will have 30 per cent or so exposed to China, either through Chinese stocks directly or via Hong Kong, or even via Taiwan – we refer to them as Greater China.

“The short answer would be: “Yes, but...”. There’s things you need to be aware of.”

Reflecting sentiment

Sweeney says that in the past 18 months or so China has not been “a great hunting ground”.

“It’s been very popular [but] the MSCI China index is down 20 per cent for the year in 2011 and if you take five–year view, it’s pretty flat,” he says.

“So while the economy has been going very strong, it hasn’t really translated to returns. As an emerging market, it very much reflects sentiment, and it can be seen as a ‘risk-on’ trade, or it has been [seen that way].

Have you seen what Asia can offer?
There’s been a concern that China has grown too fast and is heading for a hard landing; it’s susceptible to hot-money flows.

“I’ve covered this space for a while and Asian equity managers have been quite bearish on China for the past 18 months or so, on concerns about that overheating economy.

However, I’d say the retraction in equity values means it’s starting to look quite attractive, and a number of managers are starting to move to a neutral or overweight position.

“Valuations are trading at huge discounts to historical levels. The Hang Seng is trading at nine times versus the peak of 16 times in 2010. If you take a long-term view you’d think this might be quite an attractive entry point to China.

“Within an emerging market context, China and India have been two of the poorer-performing [markets], and obviously they are BRIC economies and they’ve been two of the worst in the past year.

“But if you’re talking to managers, they’re starting to think that cannot last. There’s evidence that China is managing its economy quite well.”

Sweeney says before committing clients’ money to China, advisers should ask some basic questions.

First, what is their tolerance for risk?

**Not transparent**

“China is not a very transparent market and it will have great years and it will have periods of underperformance. In the last few years, it has not been a great market,” he says.

“I’d also say, consider overall exposure to China from within your global equities allocation. You may have some benchmark-unaware managers in your global equities that are already getting exposure to China, so you do
not want to be doubling-up on that risk. “If you’re particularly bullish on China, then maybe an Asian fund is a good method of gaining exposure; and if you’re really, really bullish, consider [whether] a single-country fund is appropriate.

“And be active, rather than passive.”

**Chugging along**

Jonathan Wu, head of distribution and operations for Premium China Funds Management, says advisers are having a hard enough time convincing clients to put money back into domestic equities, let alone to invest in Chinese equities.

“For clients who have been out of equities for most of last year, it’s still pretty difficult for [advisers] to convince them to go back in, given that there is no solid solution out of Europe,” Wu says.

“Based on that, it’s going to be easier for people to convince clients to go back into Aussie equities initially, simply because it’s an easier story to tell. They are going to use the ‘China story’, and say China is still chugging along, but that’s all they know. But then they’ll say because China is still chugging along, that’s why you should invest into Australian equities.

“The same sales pitch the adviser uses for Aussie equities should be no different to [the case for] Chinese equities. But the problem is that the standard adviser isn’t equipped to deliver that message to clients. I think that is the biggest challenge, ultimately.”

Wu says many advisers are also “hamstrung” by their approved product lists (APLs), and even if they do grasp the issues related to investing in China, their dealer group’s focus is on risk control and restricting products on APLs.

Changing advisers’ mindset towards China will take time, Wu says.

“The issue we have is humans develop over time and adopt new things, but the fact of the matter is that advisers who adopted Japan, for example, were way too late in the piece.

“People think that because a market is non-transparent, that it’s not safe to invest. They assume that we should be able to generate a lot of alpha, above and beyond the index, in transparent markets, which we have never seen in the history of investing that has occurred.

“Recently I told some advisers that if you find an Aussie equities manager that over the last five years has outperformed the index benchmark by 2, 3, 4 per cent per year, they’re like a god.

“We’ve outperformed the index in China by 20 per cent for the past 20 years, but they cannot seem to grasp the difference that you can make money in a market that is not transparent.

“It’s a big advantage for people to see that a non-transparent market is a place to invest. If you put it with the right person...then why not?”

Wu says that when investors move back into equities they will almost inevitably invest too much. Investing, say, 40 per cent into Australian equities represents a very strong home bias and a source of risk.

“We’re saying, why don’t you consider 5 to 10 per cent in China?” Wu says. “You’re already putting 40 per cent into Aussie equities, and you do not see that as a single-country risk. Advisers are happy to do 40 per cent, but are not happy to consider 5 per cent in the region that effectively drives what Australia does.

“So for us, we just keep pounding the pavement.

“We want to create awareness. We’re not saying we’re the be-all and end-all. This is not a fund-selling exercise; it’s just to get people comfortable with it.

“We’re not saying you should stick your entire portfolio into this. But if you’re putting 40 per cent in Aussie equities, why not put 5 to 10 per cent there? You’re diversifying your risk away from Aussie equities.”

Wu says he urges advisers to have an open mind “and look a little bit outside the box, instead of buying more BHP and Rio after they listen to someone talk about China”.

“Are BHP and Rio really developing companies, or are they pretty much mature?” Wu says. “In my opinion, they’re already pretty much mature, and the share price pretty much fluctuates with the commodity price, and that’s about it. We want people to open up their minds, and to listen and take hold of investment options where they can provide a fresh perspective to their clients.”

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**GLIDING, NOT CRASHING**

There is no shortage of commentary on and analysis of the Chinese economy, and whether or not its current slowing presages a hard or a soft landing. The International Monetary Fund (IMF), for one, predicts there will not be a hard landing for China, and a number of analysts agree. One such analyst is HSBC’s global research unit, which says that in the fourth quarter of 2011, Chinese economic growth slowed from 9.1 per cent, year-on-year, to 8.9 per cent. This was the slowest growth rate in the 10 previous quarters.

HSBC says this slowdown was “widely anticipated by both the market and us”, and that it “reflected the continued cooling of domestic demand in response to Beijing’s earlier tightening measures, on both the credit and property fronts, as well as the recent weakening of external demand”.

HSBC says the rate of slowing remains “under control, and in much better shape than the sharp deceleration (to as low as 6.6 per cent year-on-year in the first quarter of 2009) during the 2008–09 financial crisis”.

“A total collapse is not expected, however, as global growth is not expected to slip into an outright recession within our current base scenario,” HSBC says. “Although risks to China’s growth remain tilted to the downside in the near term, our view of a soft landing is secured by the fact that Beijing has sufficient room to ease policy on both the monetary and fiscal fronts to stabilise growth and revive the economy – especially with inflationary pressures now in decline.”

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Eight Investment Partners’ chief investment officer, Kerry Series, says investing in China indirectly, for example, buying resources companies, presents a different set of opportunities to investing into the country directly.

**Rethink the approach**

In any case, at some point in the not too distant future, Series says “indirect” investors will have to rethink their approach.

“The direct approach gives you the opportunity to access more parts of the Chinese economy,” he says.

“Resources is a pure play on the investment-led nature of the Asian economies, and particularly the Chinese economy. At some point – I do not think it’s yet – but at some point in the next few years, the investment-led model will become less important and domestic demand, particularly consumption, will rise as a percentage of GDP.

“[Investing in] resources only gives you exposure to that investment-led part of it, because investment-led is building railways and roads, and office towers and essential housing and stuff. And we’re very bullish on resources as a result of that.

**A good bull case**

“The problem with resources is there’s two sides to the decision, or to the research. One is demand, and I happen to think demand is going to be very strong; and the other is supply, and my view is that while supply is going to increase, for the next few years it’s going to be constrained by infrastructure in particular – which will make a good bull case for resources for the next three to five years.

“Beyond that, resources will stop being a way to access the Asian story, the China story. It works now, and I still recommend people invest in resources to get exposure to China; but they need to be aware that it’s really only giving them exposure to one part of the story.

“Whereas investing directly, you can invest in...transportation, tourism – a much broader range of opportunities.”

Series says that if you “look back to 2007, the Chinese market was one of the most highly valued markets in the world”.

“If you invest in Asian equities and you do not hedge the currency you will lose – in our opinion – a lot of the gain from the shares rising in price, because the Australian dollar will rise in price.

“We actively manage it, but our decision at the moment is to fully hedge. In fact, we’ve got a chart with [shows] the correlation of the Aussie dollar against the Asian stock markets since 1990. And what’s fascinating about it is that there was no relationship between the Aussie dollar and Asian stock markets before 1995, and then there’s a very close – it’s about 0.7 or 0.8 – correlation for the last 16 years.

“My answer to what changed is that in the mid-90s the Asian economies had been growing at a very fast rate for 25 years already, but they were growing from a very low base. By the mid-90s they had reached such a size that the next year of 7 to 8 per cent GDP growth had an impact on global growth, and in particular had an impact on demand for commodities.

“So the linkage is that the Asian stock markets forecast the strength of the Asian economies; the Asian economies since 1995 have driven marginal demand for commodities; commodities drive the terms of trade; and the terms of trade drive the Aussie dollar.

“It was a tipping point, in the mid-90s, and it will hold. I think, until the Asian economic model changes, from investment-led to consumption.

“And at the earliest, that’s five years away.”
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**Premium China Fund**

**Performance as at 30th December 2011**

<table>
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<tr>
<th>Performance</th>
<th>Premium China Fund</th>
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<tbody>
<tr>
<td>Since Inception (Oct 2005)</td>
<td>73.50%</td>
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<tr>
<td>Annualised (p.a.)</td>
<td>9.20%</td>
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<tr>
<td>Annualised Volatility (p.a.)</td>
<td>19.20%</td>
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Source: Macquarie Investment Management Limited. The value of an investment can rise and fall and past performance is not a reliable indicator of future performance. Past performance figures are net of fees and assume reinvestment of income.

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