4Q Commentary

December 2019

PRESCIENT
CHINA

2019 ANNUAL RECAP

Despite the terrible headlines in 2019, global markets were strong, and China is no exception.

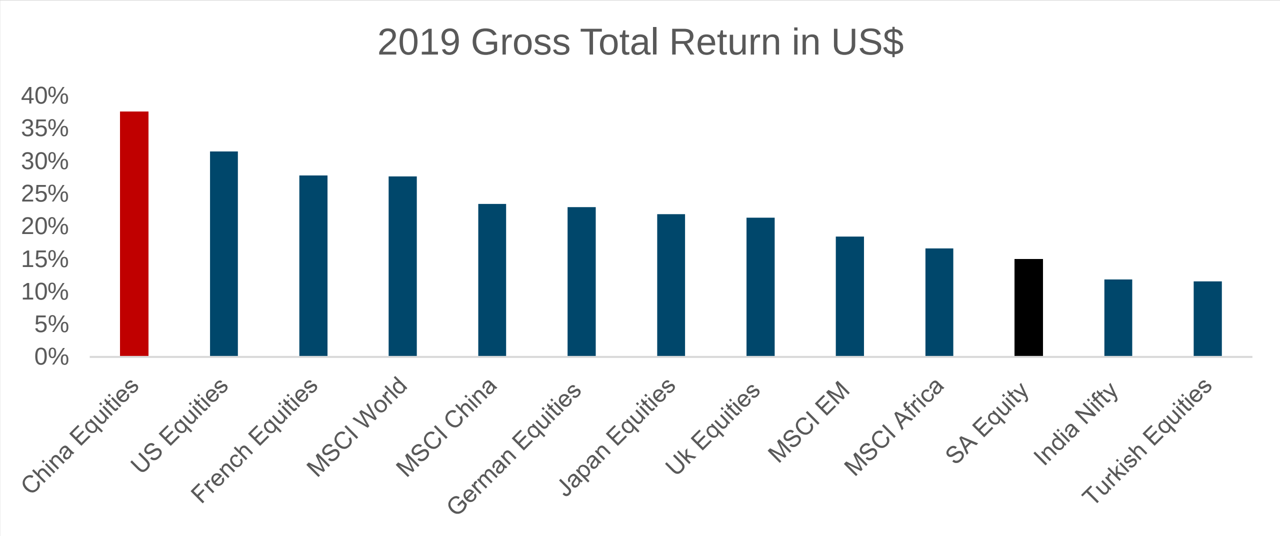

Figure 1: Source Bloomberg/Prescient data to end of Dec 2019

The Chinese market ended the year up 42% in local currency and up 37% in USD terms. This was in the face of the trade war, the slowest Chinese economy in 20 years and record bond defaults (including the first state owned enterprise default). So how did this happen?

After much volatility and negotiation, a Trade War truce was found as expected, in a timeline that was also no surprise. Phase 1 of the trade deal was agreed upon at the end of December with the signing ceremony scheduled to take place mid-January, when more details on the deal is expected to be released. Early news flow surrounding this topic suggests the US have agreed to stop adding new tariffs and lower a small portion of existing tariffs while China will concede to increasing agriculture purchases from the US. The end results seem pretty much three fold:

1. The American people pay a little more on duties, probably resulting in slightly lower consumption for the American consumer over the coming year.
2. China's government lowered taxes and boosted support for exporters. Combined this with a naturally weaker currency means Chinese export competitiveness should not be materially impacted.
3. Perhaps the start of de-globalization. Thus far, we've seen many global companies starting to build factories where consumer demand is heightened. A perfect example is Tesla building an extremely successful Gigafactory in Shanghai in record time and also starting to build a factory in Germany. Over the longer term, this means profit margins of these global companies who are used to manufacturing in China will be squeezed. Comparing this to Chinese companies, who on the whole, are significantly less dependent on global markets.

Ultimately the trade war seems overblown. Earnings continue to be strong in the Chinese market. The last time the market was at these levels, earnings were 15% below what they are now, and in spite of the rally, the

Chinese market continues to be valued cheaply with sentiment still also positive. On a relative basis, Chinese equities offer more value than their US counterparts.

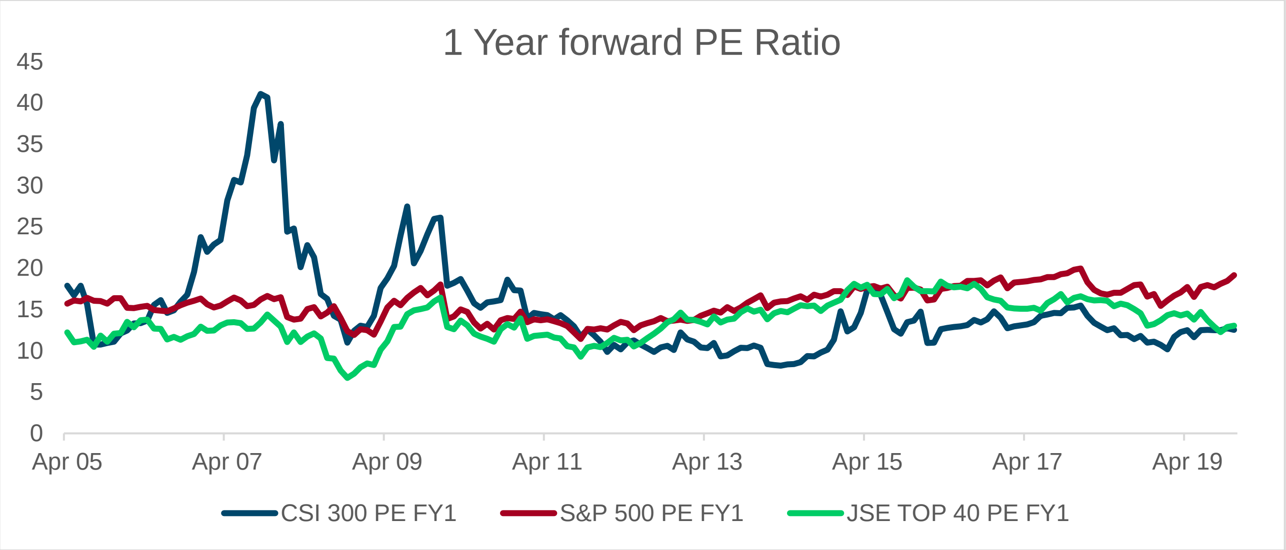

Figure 2: Source Bloomberg/Prescient data to end of Dec 2019

To this end, long term valuations continue to show the large discount on Chinese companies relative to those in the US and for the first time in a long while, the SA market is showing a similar discount. In spite of rising markets last year, overall healthy earnings delivery kept a lid on Chinese valuations that are presently at levels that have historically resulted in decent real returns.

Over the year, charts such as below have been the mainstay of financial reporting on the China bond market.

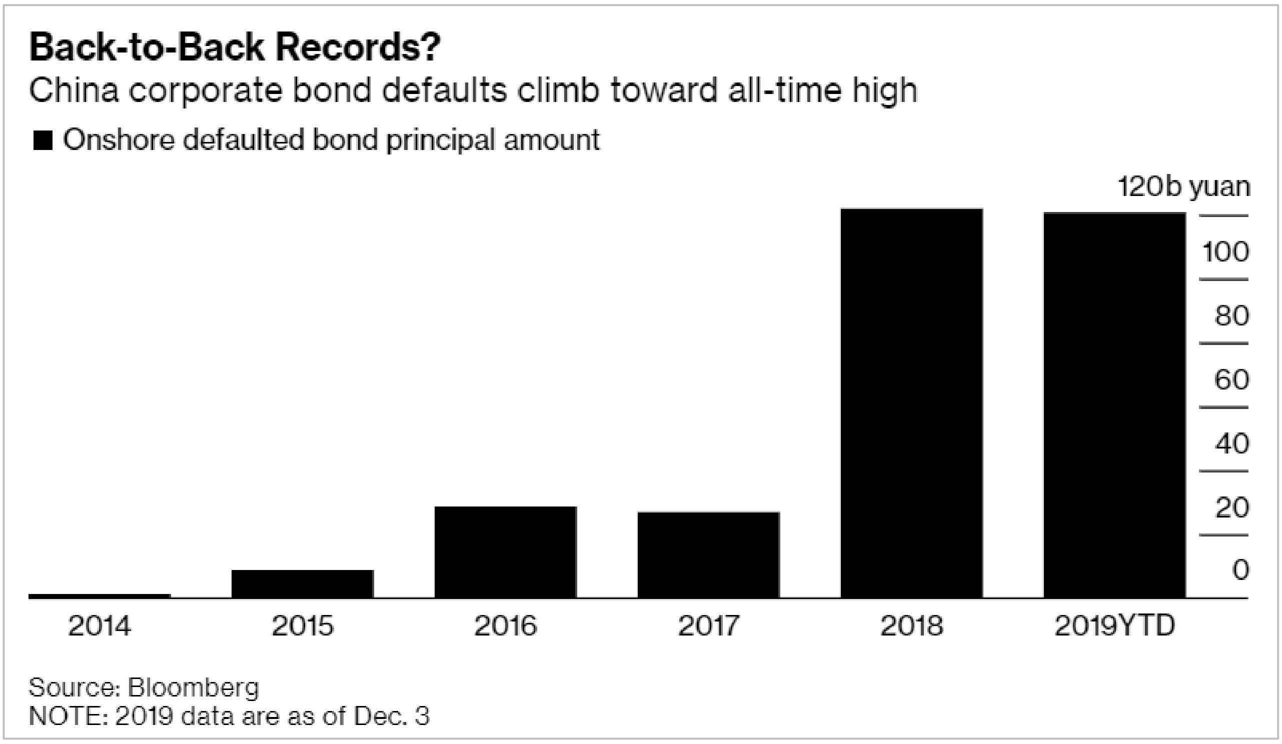

Figure 3: Source Bloomberg/Prescient data to end of Dec 2019

China's bond market saw record defaults last year as implicit guarantees were being phased out. The history of no defaults was extremely unhealthy, with moral hazards contributing to high speculation. Investor thought process was along the lines that when things went right, they made money and when things didn't, they would be bailed out by government. This resulted in years of speculation and hot money, while money was not channeled to productive sectors in the real economy. Although on the surface, defaults look scary, with many projecting the doom and gloom scenario of the great financial crisis, it is in fact the opposite. Defaults are a necessary consequence of bad investments, and along with regulatory reform on disclosure, it helps form a healthier bond market, one that prices risk and reward. Thus far, regulators have done their jobs with aplomb, allowing defaults to occur while stepping in immediately on the first sign of systemic risks, e.g. letting a giant poorly run SOE default, while rescuing small banks with bad debts. Although defaults look high relative to historical levels, as a percentage of overall debt, defaults remains extremely low (below 1% of the total bond market). Looking forward then, we expect more defaults in China, but also better and better default resolution and normalization. At the end of the process, the Chinese market will hopefully result in a functional bond market, with regulator, investor, rating agencies and the courts, all functioning well by matching correct investors with the correct risk appetite. This will ultimately shrink the reliance of companies on only the banks for credit and provide private companies the much-needed avenue to capital raising.

In terms of our process, we continue to look for arbitrage opportunities as and when they occur. In last quarter's update, we highlighted the opportunity with the futures discount. We are happy to say the discount closed at the end of December. The chart below shows our entry and exit points over the 6 months where the position delivered around 1% alpha to the Fund. China remains a good market to generate extra return for those who are vigilant.

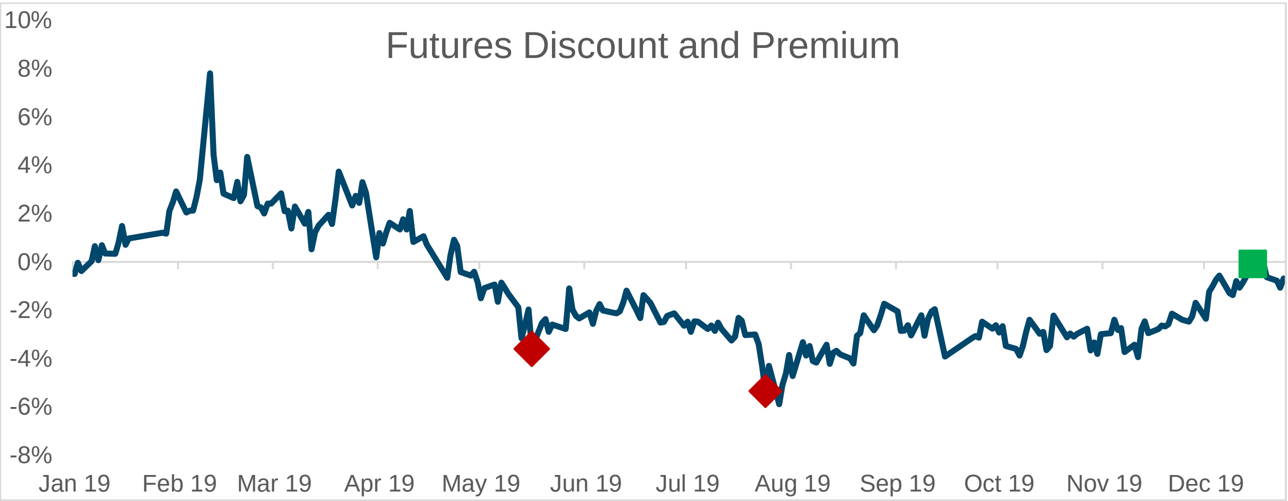

Figure 4: Source Prescient data to end of Dec 2019

Although the futures discount closed, another big opportunity still presents itself. Dual listed shares trade at a steep discount in Hong Kong, the most in history. For all these companies, the vast majority of their business remains on Mainland China. As such, the protests do not affect the fundamentals of the business but merely the Hong Kong market's perception of them. We expect this discount to close as protest action in Hong Kong begins to settle down. This should further contribute around 1.6% to the Fund overall.

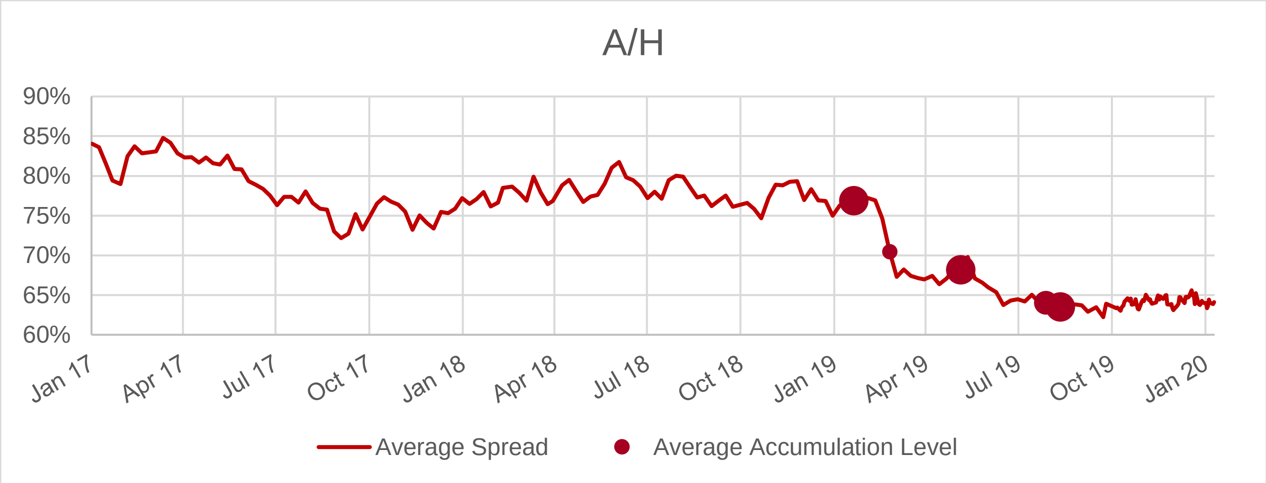

Figure 5: Source Prescient data to end of Dec 2019

Over Q4, we completed our ESG research into the equity selection process for the first time. This means that our investment process now directly incorporates ESG factors. As with any new market, obtaining the ESG data was challenging. After much deliberations, we decided to use a Chinese ESG company founded in 2007 that specifically analyses ESG issues in China. Their A share data started in 2015 compared to other competitors which only started in 2018. Importantly however, they also have a more practical take on ESG. The Chinese market being less mature has not placed much focus on ESG issues. As such, Chinese ESG scores are typically lower than the developed world. However, this doesn't mean one should simply give all companies a failed score as a differentiation between different companies within China can still add value. ESG concerns have started to pick up in China over the last 2 years as more institutional investors enter the market. By incorporating ESG factors in our model, not only are we picking companies with better risk profiles, but at the same time, it encourages companies to do the right thing from making more disclosures to being cognizant of how much investment they get that is not only purely driven by short term financial factors but also long term sustainability. The chart below shows our portfolio before and after the change. The incorporation of ESG will be one more component in our process with the view of improving long-term returns. As can be seen, the process lowers exposure to companies with extremely low Governance scores and redistributes to higher Governance scores whilst maintaining a similar risk profile in our original portfolio.

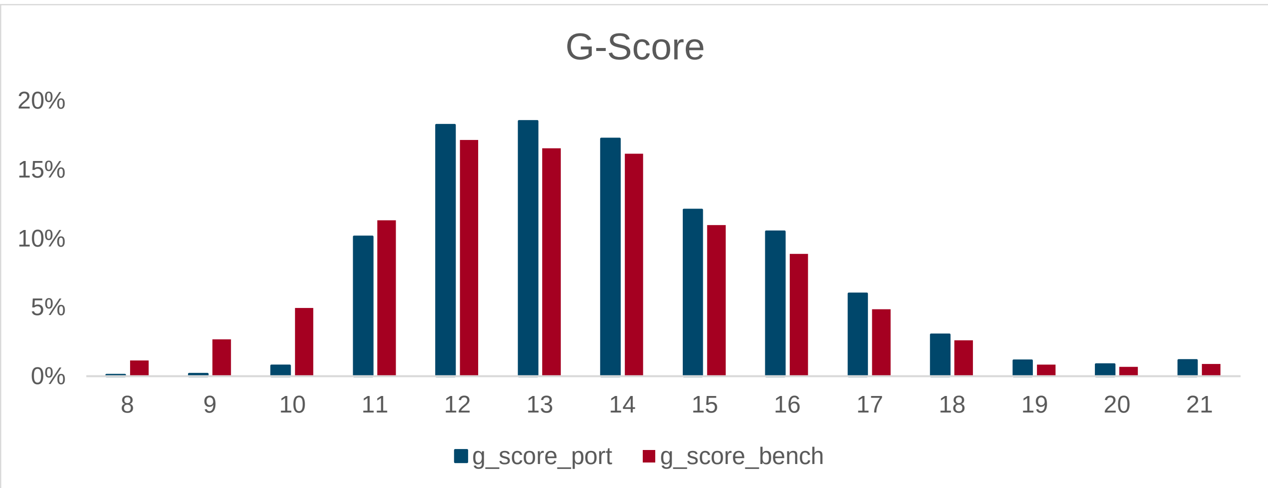

Figure 6: Source Prescient data to end of Dec 2019

Looking ahead into this year, despite the market rally, valuations in China remain extremely favorable. Sentiment is still positive, and the weakened economy is on the mend. We are still positive Chinese equities at the moment, in a world of extremely low interest rates and quantitative easing, cheap valuations are a rarity and can be overlooked at one's own peril. After the turmoil seen over the last few years, China is well positioned to move forward. Eliminating the shadow banking sector, opening the financial sector, negotiating a trade war, record defaults in the bond market, stability in the housing market, a currency that now truly floats are all points to normalization of the economy and a continued improvement in the resilience of the country. At these current levels, staying for the ride should reap good rewards going forward. Our own economic model also shows an economic recovery over the past 2 months driven mostly by improvements in PMI's, which remains to be seen if it is sustainable.

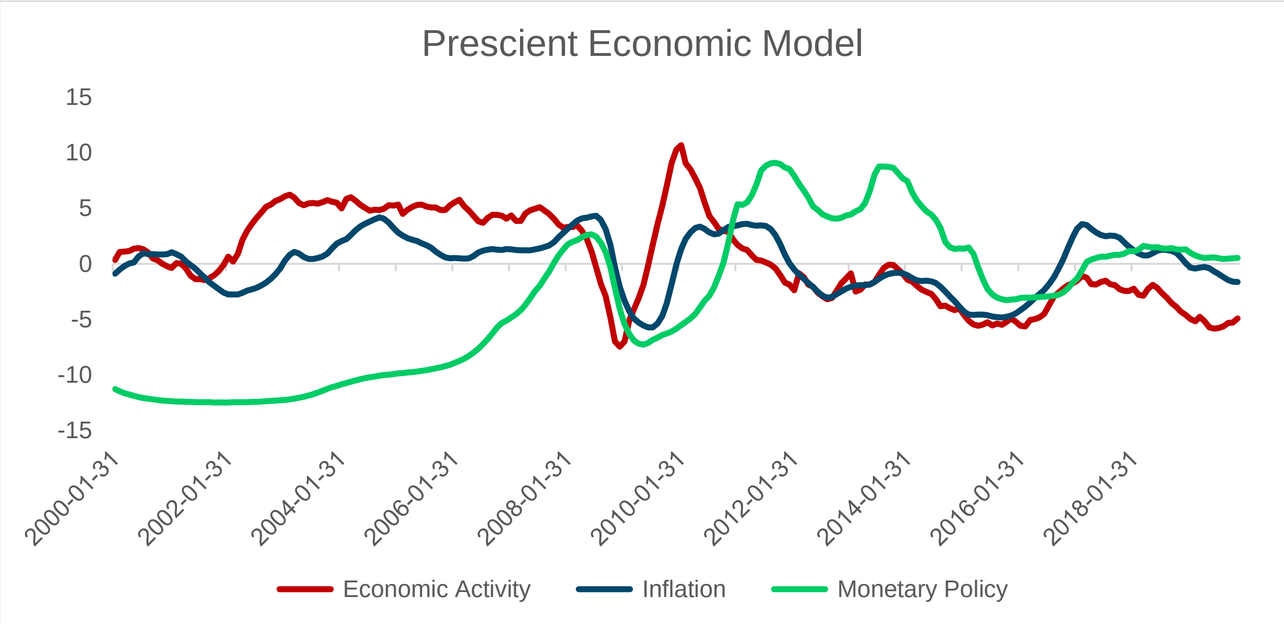

Figure 7: Source Prescient data to end of Dec 2019

What then are the key takeaways over the longer term? China continues to hum on as an investment destination delivering on its promise of high real returns with good diversification benefits. Over the past 6 (coming up to 7) years in China, proves that the Chinese market is not as different or mystical as claimed by others, and despite problems, the outcome over the longer cycle is relatively predictable (a market with attractive opportunities and high real returns). With an experienced team and consistent process that's been tested over multiple cycles, we believe getting China exposure through Prescient remains an extremely attractive proposition.

CONTACT INFORMATION:

For more information, please contact:

Liang Du – Executive Director & CEO

Tel: +86-21-54566578

Email: liang@prescient.co.za

Office 3703, K'Wah Center

No. 1010 Middle Huaihai Road

Shanghai 200031

People's Republic of China

www.prescientchina.com

PRESCIENT

CHINA