Q1 2019 Review

March 2019

PRESCIENT
CHINA

GONG XI FA CAI

During Chinese New Year the Chinese people says Gong Xi Fa Cai, it means “wishing you a prosperous year”. And indeed, what a prosperous New Year this has been. The Chinese equity market is up over 32% since the start of the year and is by far the best performing equity market in the world YTD after a very weak 2018.

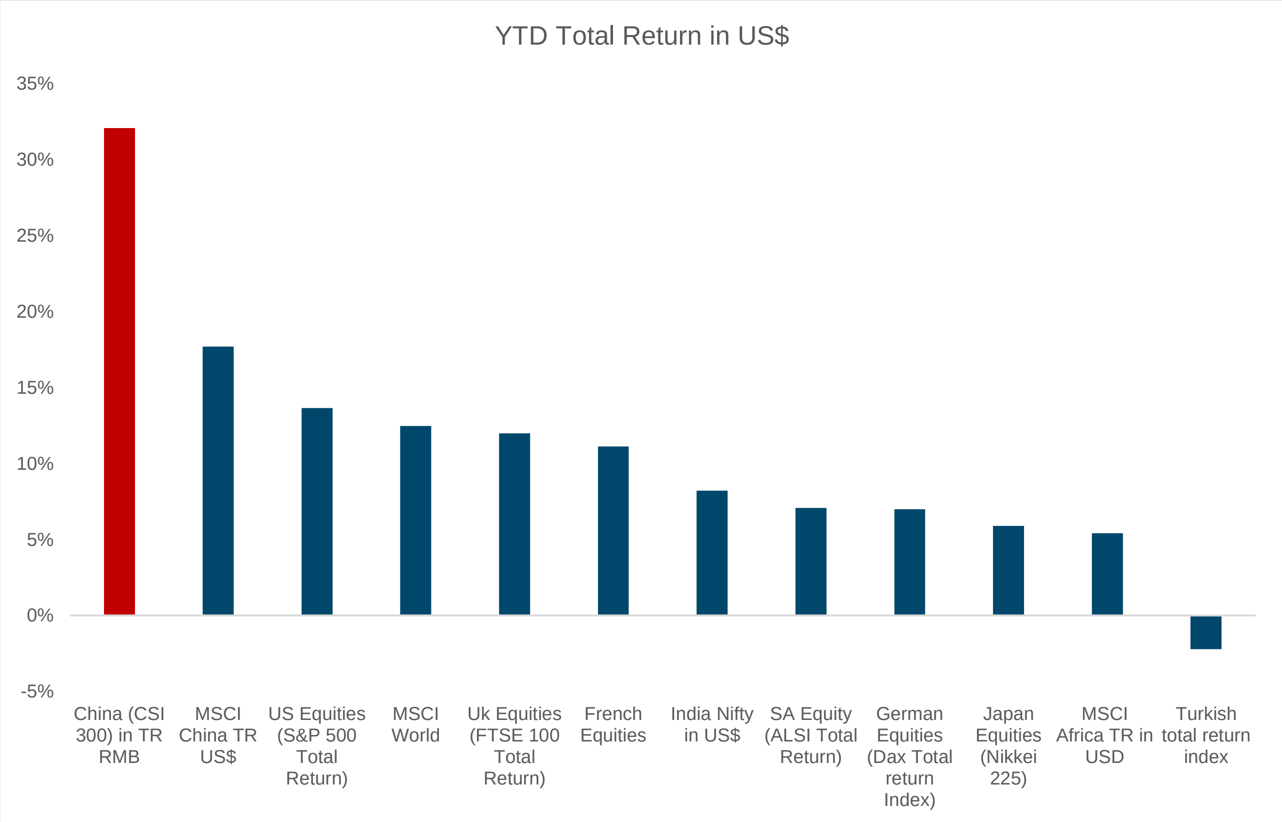


Figure 1: Source Bloomberg, Data to end of March 2019

The rally this year was driven by little on the fundamental side. Bloomberg published an article headlined “Chinese stock market improves on the back of economic fundamentals”. This article cited the leading indicator, of which the market was the primary contributor, as the impetus behind the strong rally, effectively saying that the market is up because market is up (whilst most other economic statistics remained somewhat weak).

There are however some other reasons for the recovery. Trade war tensions have improved with the US and China heading towards a deal. There are still some areas of contention, but with the election in 2020 getting ever closer and the desire for a higher equity market from President Trump, a deal seems to be in the works. MSCI also improved the inclusion factor, increasing the inclusion factor from 5% to 20%, resulting in A-shares changing in weight in the MSCI EM index from 0.8% to 3.3%. This may trigger many managers who use the benchmark to start investing in China A-shares, given that a market with such volatility can be highly risky and prone for managers to underperform. Finally, of course as mentioned before, the crash last year was almost certainly over-done, with the market extremely depressed at the end of December 2018.

Moving onto the hard-economic numbers in China, the economic data so far has been weak with our own models pointing to growth below trend. However, those who understand the Chinese economy knows that much is distorted by the Chinese New Year, with everyone essentially taking at least a week long holiday and given that the norm in China is only 5 days of annual leave, it is also common for migrant workers to change jobs during Chinese New Year, who then take 1-2 weeks leave before returning to a new job in the new year. The result is economic data that is massively distorted with the first meaningful economic data coming through only in April, reflecting end of March numbers. As such, although our models show weakness, we are also fully aware that currently the model is not yet accurate, and we will be looking at the data very closely in the next 3 months. Should the data improve, it will confirm this recovery and we will be as bullish as we can be. However, should it deteriorate, we will be cutting our overweight position in equities. Our base case is for an improvement. As mentioned before, property is the biggest investment for all Chinese people, and property prices had a stealth recovery over the past 6 months, which the media is only now starting to report on. With a recovering property market, though not strong yet to cause a wealth effect, at least fear is reduced in the market. This combined with attractive valuations and positive sentiment, makes us quite bullish towards Chinese A shares. Our process likes the combination of good sentiment, attractive valuations and supportive policies.

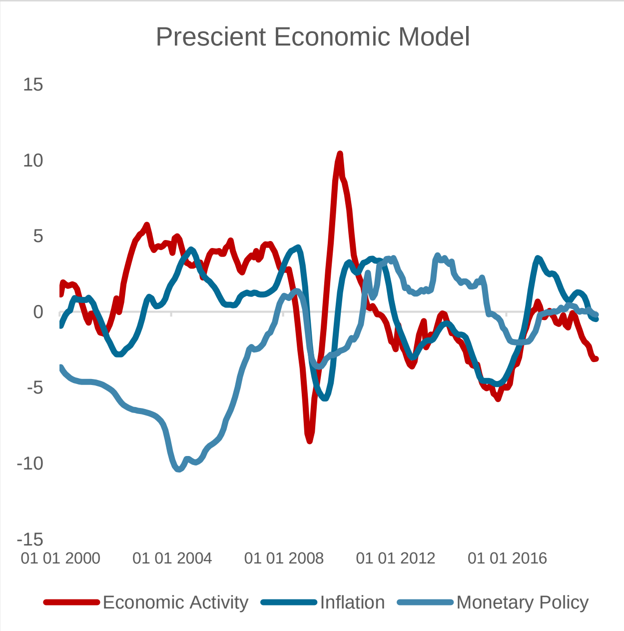


Figure 2: Source Prescient Data to end of March 2019

Figure 3: Source Bloomberg Data to end of March 2019

Equity Fund or Balanced Fund

With the launch of our Equity Fund in October, our clients often ask which fund they should invest in - the Equity Fund or the Balanced Fund? For extremely long-term investors like i.e. pension funds, the Equity Fund is probably the right choice. Over the very long-term, beating 100% equities is quite difficult. However, for the vast majority of investors, we would say the Balanced Fund is a superior solution. With the Chinese market going through far more extreme cycles compared to markets such as those in the US, asset allocation can be a valuable source of alpha, having less in equities when the forward returns look poor, and more in equities when the forward return are more attractive. Over the long term, our equity portfolio and our balanced portfolio both have reached more or less the same performance, with balanced having less volatility.

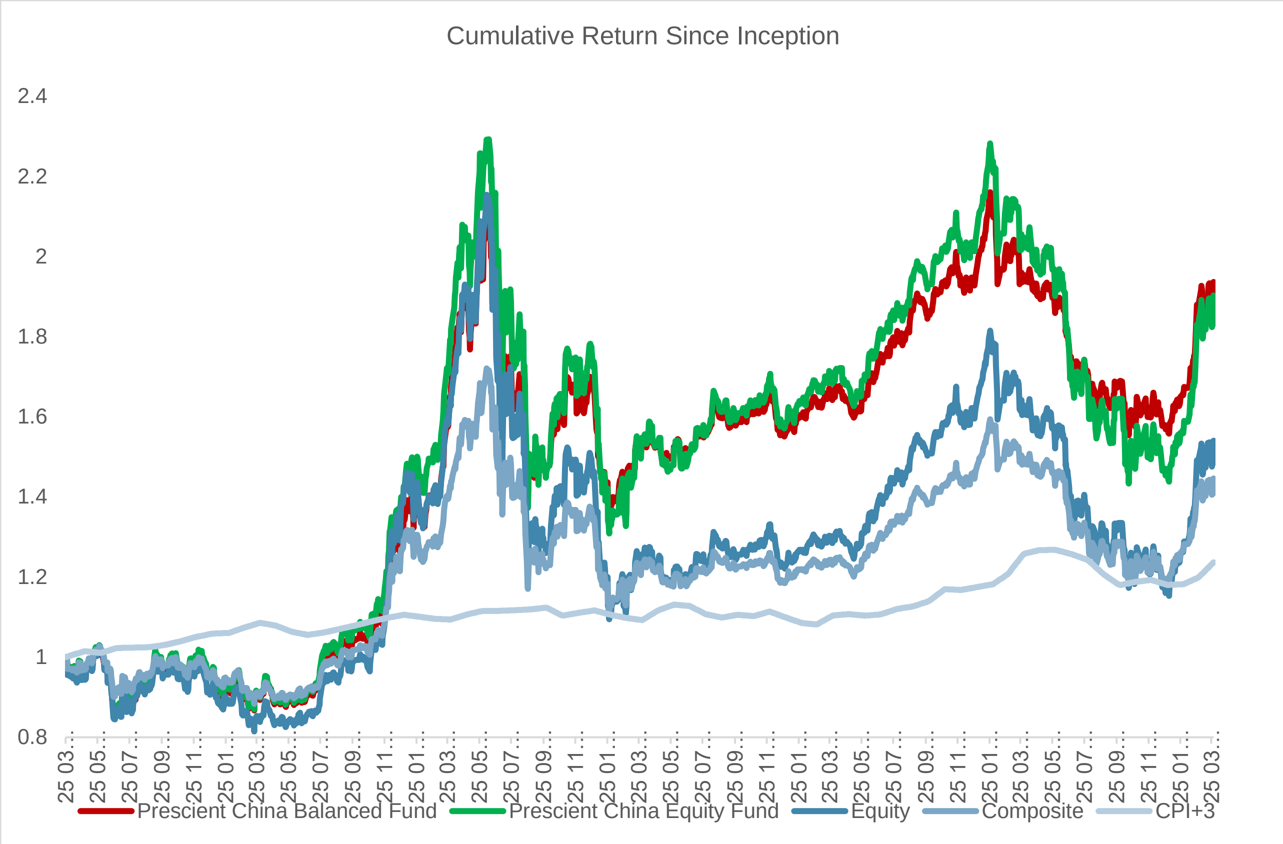


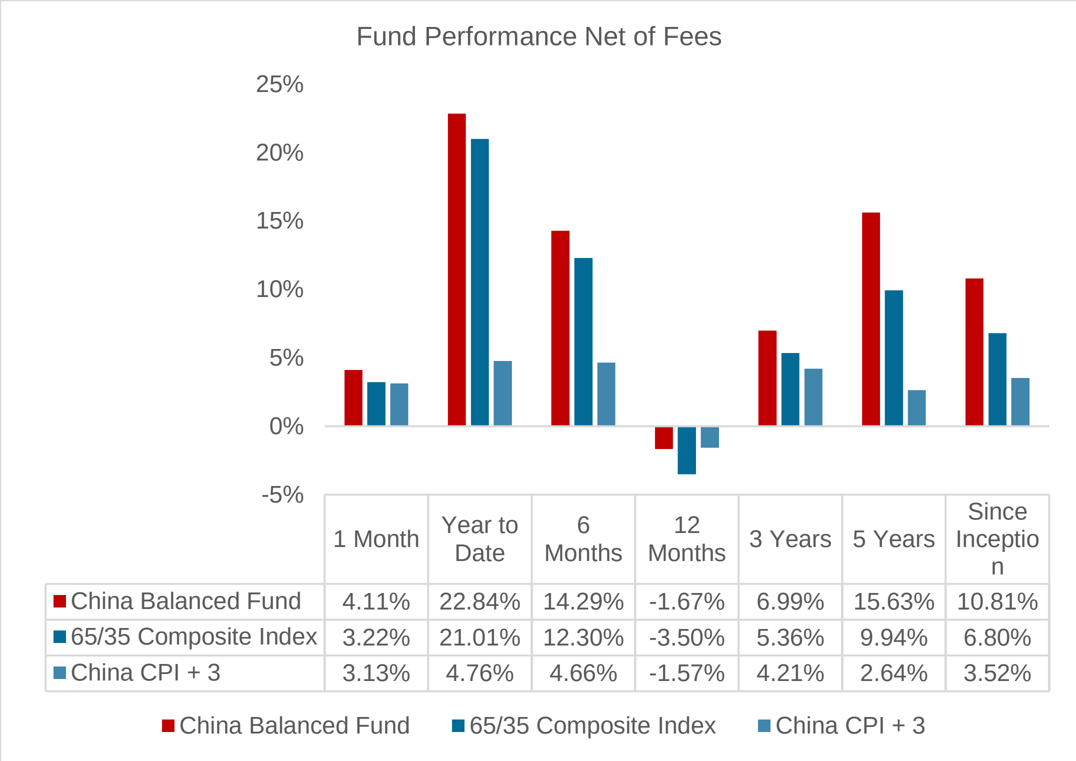
Figure 4: Source Prescient Data to end of March 2019, Gross of fees for strategy comparison purposes

Another way to use the Equity Fund is to separate strategic asset allocation and tactical asset allocation. Holding a long-term strategic exposure to China, it is arguably more prudent to invest in the Balanced Fund, whilst when doing tactical asset allocation and deciding on a tactical overweight to China, allocating to the Equity Fund might make more sense.

Our own models suggest that forward real returns remain extremely attractive at this point and the environment is somewhat benign, and hence our China Balanced Fund currently has a meaningful overweight to equities. Of course, in China the information and environment can change very quickly, and we will be ready to act, but until that time, Gong Xi Fa Cai! May 2019 be a prosperous new year!

Performance

With such a strong quarter, it goes without saying that both funds have done extremely well. The China Balanced Fund was up around 23% in USD in the first quarter, compared to 21% for a 65% equity / 35% fixed interest strategic composite index. Over the longer term, the China Balanced Fund has delivered an annualized 10% real return over the past 6 years, delivering handsomely on high real returns and diversification.



	1 Month	Year to Date	6 Months	12 Months	3 Years	5 Years	Since Inception
China Balanced Fund	4.11%	22.84%	14.29%	-1.67%	6.99%	15.63%	10.81%
65/35 Composite Index	3.22%	21.01%	12.30%	-3.50%	5.36%	9.94%	6.80%
China CPI + 3	3.13%	4.76%	4.66%	-1.57%	4.21%	2.64%	3.52%

Figure 5: Source Prescient data to end of March 2019 net of fees 1% fee class

The China Equity Fund was recently launched in October 2018 and performance was even stronger, rising by 30% in the first quarter. Since inception, the Fund is currently 60bps behind benchmark. With only 6 months of history since launch, this is well within the normal variation of the strategy. Over the longer term, our target is to outperform the Chinese equity market by roughly 3% p.a.

From these levels of the market we continue to see real returns over the next cycle being quite high and, combined with the opportunity of alpha, we think looking forward long-term real returns are expected to be quite high.

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

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