2018 Annual Review

December 2018

PRESCIENT

CHINA

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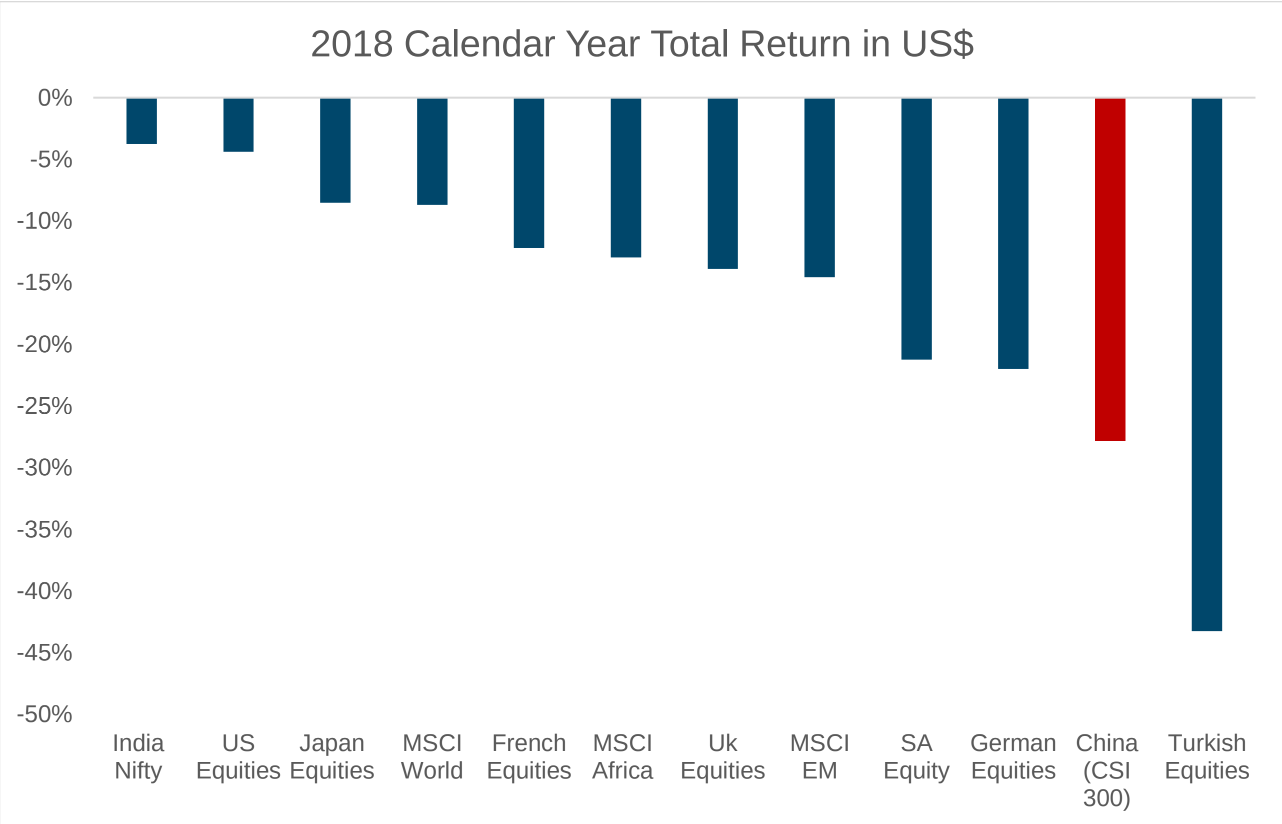
2018 was an extremely weak year for the global equity market and China especially. The Chinese equity market fell 24% for the year in CNY and combined with a 4% depreciation of the currency, resulted in the Chinese market falling by 28% in US$ for the year. China though was not alone with its poor performance. The chart below shows 2018 calendar year total return of global equity markets, almost no equity market in the world registered a positive return. With the Fed hiking in 2018 as well as a plethora of problems plaguing different countries, with US$ returns reflecting that; the UK (Brexit) down 14%, the Dax down 22%, South Africa down 21%, Turkey down 48%, French equities down 12% and even the US down around 4% for the year.



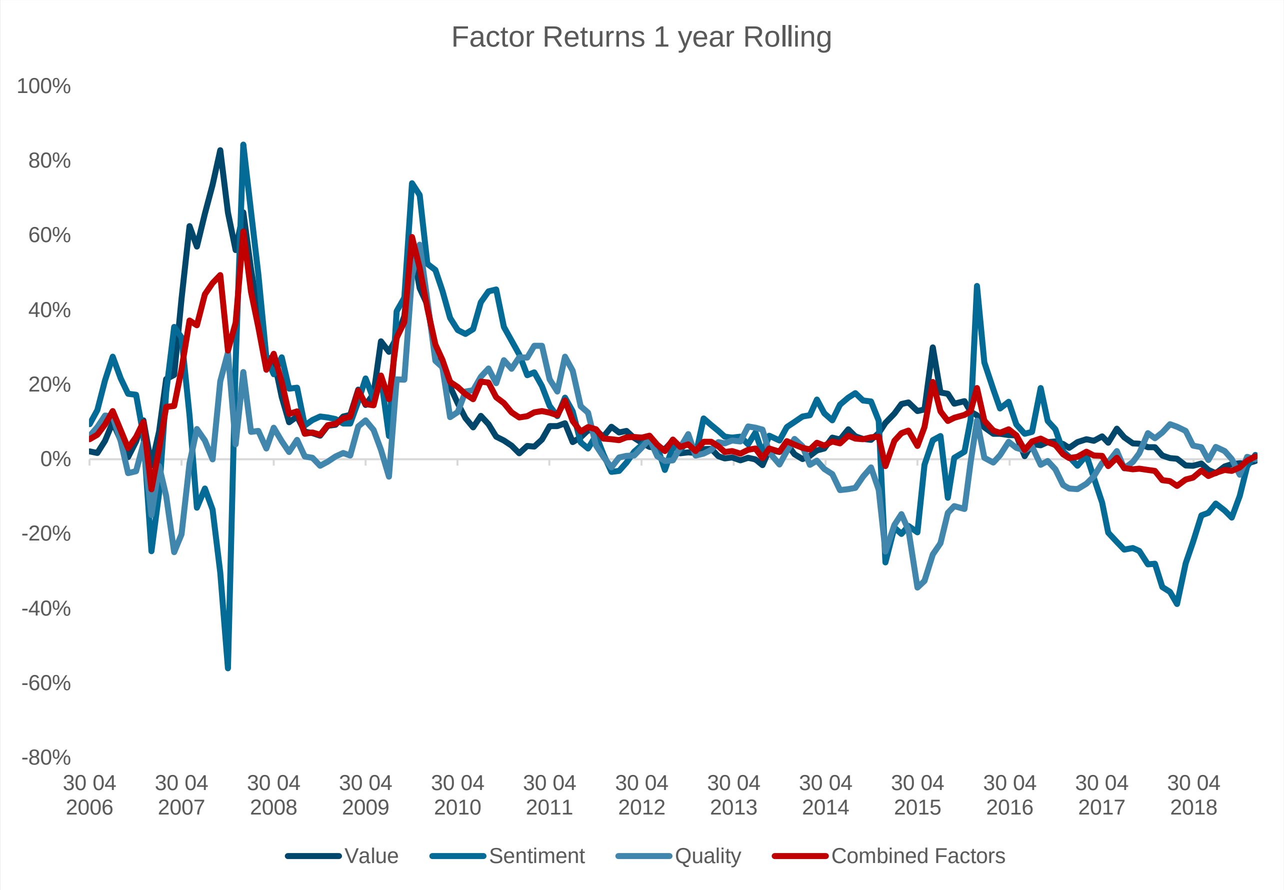
Source: Bloomberg

Overall, except for China, most markets fell from extremely high valuations to something slightly more reasonable, with most global markets starting to run out of steam after an extremely strong bull market.

Focusing more on China, a combination of factors resulted in a very weak performance for the equity market for the year after a strong 2017. In 2018 the market was beset by tighter credit overall in the Chinese economy, a slowdown in housing prices for tier 1 cities, a trade war with the US and towards the end of the year a weaker economy. So far, our economic model on China remains weak despite a number of fiscal stimulus measures announced, as their combined impact has not yet filtered through to the real economy. With the majority of the tax cuts occurring in 2019, and the China market so ridiculously cheap, we are keeping a close eye on sentiment and the economics before increasing our equity exposure.

EQUITY FACTOR PERFORMANCE

Our equity factors have also recorded a strong comeback since the middle of 2018. In 2018 our volatility factor was the best performing factor for the year adding 6% to alpha, with the other factors all being flat. Since September 2017 almost all quantitative factors struggled against the market cap index, with around the top 7 stocks contributing to 100% of the returns of the index, with almost nothing beating the market unless you were overweight the biggest shares in the index. It seems that this strange period has run its course and quantitative factors are starting to normalise, once again showing signs of recovery.

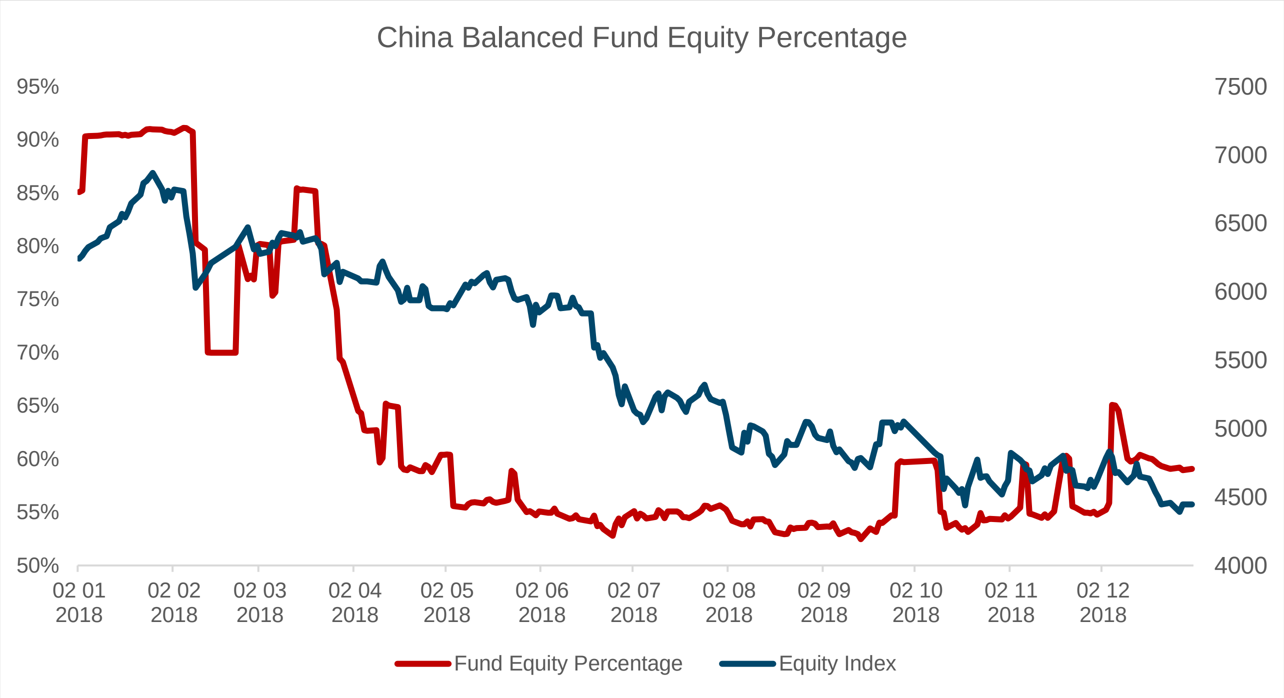


Source: Bloomberg

Prescient launched the China Equity Fund in October 2018. This is a fully invested equity proposition for clients who prefer to do asset allocation themselves. With the market in a 3-year low, PE ratios of 10 and quantitative factors starting to perform strongly again, the Equity Fund is a fantastic way of getting pure Chinese equity exposure at low cost with potential for very high returns in future.

ASSET ALLOCATION

The chart below shows the China Balanced Fund equity allocation together with the equity market performance.



Source: Bloomberg

In 2018 we started the year with an extremely high equity weighting in the Balanced Fund as sentiment was very positive, economic data robust and valuations still reasonable. Towards March the data started to change dramatically with both economic data and sentiment weakening rapidly. We cut equities after the data release and avoided a lot of subsequent fall of the market. Interestingly, as can be seen towards the 4th quarter of 2018, our sentiment model started to show the initial signs of a rebound and a bottom forming process, with the earliest indicator that the market is starting to turn positive. By avoiding most of the downturn, we are monitoring data very carefully and are ready to increase the equity weighting when the economic situation turns more positive.

CONCLUSION

With the Chinese market once again falling below what we consider fair value it is worthwhile to take stock and review investing in China.

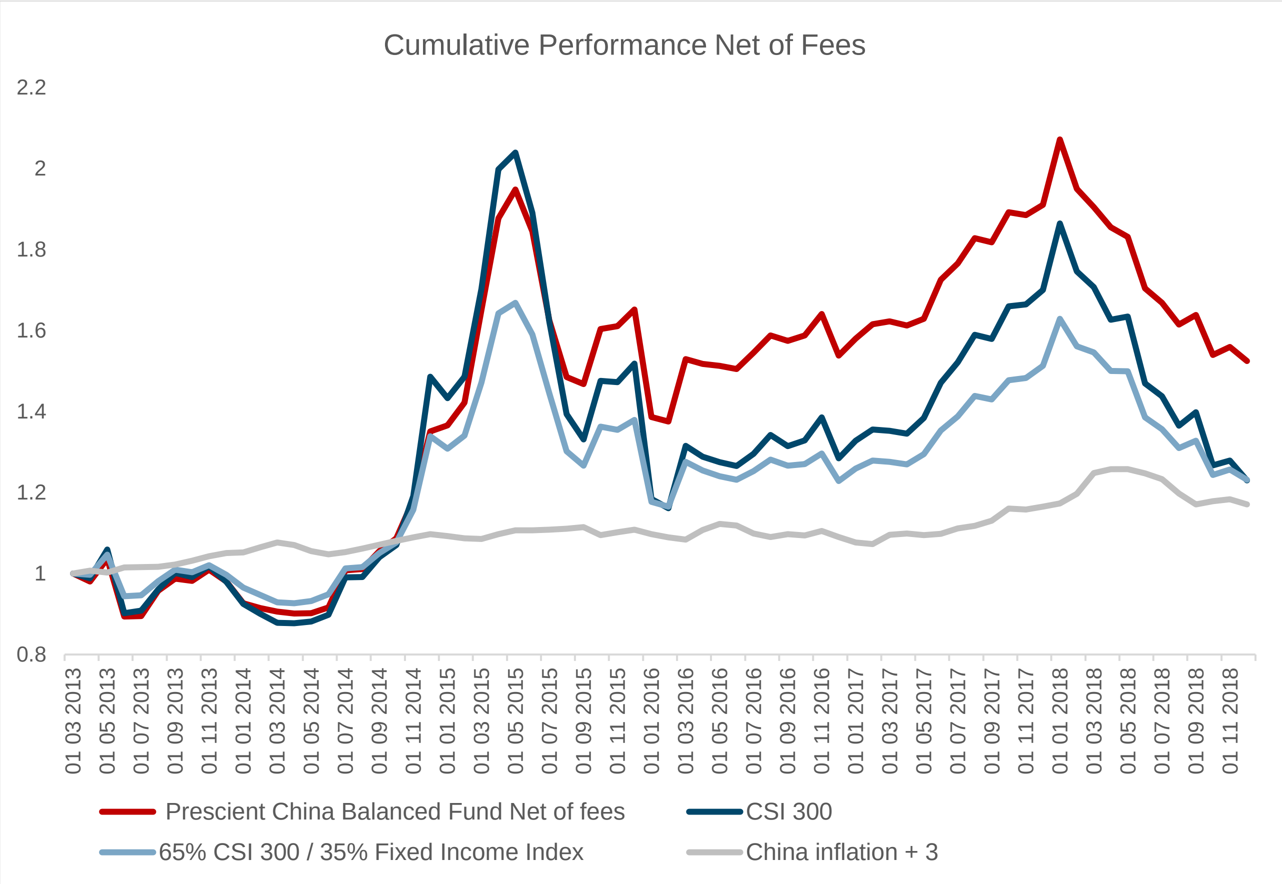


Figure 1: Cumulative Performance in US$ since inception

Despite the bear market and how depressed the Chinese market is, the Chinese stock market, and a balanced portfolio of 65% stocks 35% fixed income would still have delivered inflation +4% p.a. over the period since inception of the Fund. Through active choices and varying our asset allocation, the Fund has more than tripled the returns of the equity market after fees, delivering Chinese inflation + 8% p.a. compounded over time. With the market near its lows, a PE ratio of 10 and a massive shadow banking clampdown reducing a lot of the risks in the market, we think the environment going forward is very attractive.

Likewise, our process has been thoroughly tested over 2 cycles and delivered consistent alpha throughout, showing that outperformance of the Chinese market remains quite possible if you are disciplined and patient.

With the horrible 2018 also brings opportunities in 2019. The crash left almost all sectors and all shares trading at incredible valuations, creating opportunities for high forward returns. We remain hard at work carefully studying the market looking to deliver inflation +8% returns over the next cycle.

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