Prescient

CHINA

PRESCIENT CHINA QUARTERLY COMMENTARY

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QUICK VIEW

To say the first quarter of 2022 was eventful would be an understatement. High and not so "transitory" inflation in the US was cause for concern at the beginning of the year. However, since February 24th, almost all news has been dominated by the ongoing Russia-Ukraine war and speculation about its far-reaching market impacts. Our analysis is that the war will have a significant impact on Russia and Ukraine but a limited market impact in China and the US. The consequences for Europe are largely dependent on sanctions-related decisions, especially on energy products, which may result in variable levels of risk. China has been featured in more news articles criticising its political stance (maintaining neutrality and failure to condemn Russia) than meaningful articles analysing the economic and market impacts of the war.

We also saw a significant recommendation change from JP Morgan during March, calling the Chinese internet sector "uninvestable"[1]. The timing of the call, once again, proved to be a contrarian indicator, as the tech sector bottomed on the day of the downgrade and staged a sharp rally. The downgrade call seems to have been triggered by short-term share price performance rather than materially different fundamentals. For the past few years, we have communicated that although these companies have been great companies, their valuations have been extremely high, pricing in very optimistic future scenarios. High valuations, combined with the opening of the Southbound investment channel from Mainland China, meant that all investors in the Mainland were, for the first time, able to purchase these stocks. As a result, the Chinese tech sector reached its highs in January 2021. After the recent significant corrections, the sector is now starting to look attractive to us, and we have started adding exposure in our China Balanced strategy.

1 https://www.scmp.com/business/markets/article/3170474/china-tech-rout-hong-kong-market-sinks-after-jpmorgan-calls-stocks

In terms of performance, our Prescient China Equity Fund[2] continues to perform as designed, outperforming its benchmark by 0.8% over the quarter. Unfortunately, the market's -14.1% decline in US dollar terms has meant the Fund fell -13.3%. The Prescient China Balanced Fund[1] performed strongly, helped by our robust asset allocation process, returning -5.8% for the quarter, compared with a 65/35[3] composite index, which lost -9.0% - a 3.2% outperformance over a single quarter. The Fund had low equity exposure during the downturn and we added equity exposure during the significant correction in March.

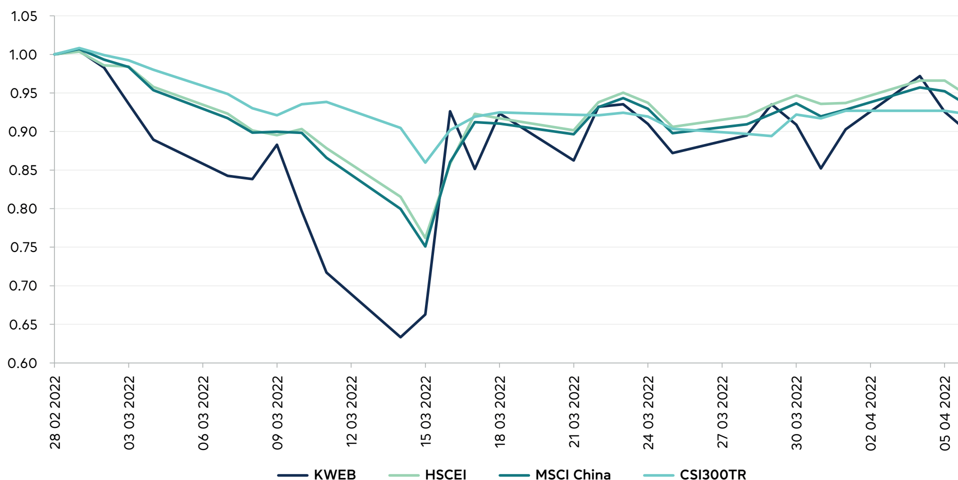
So far, 2022 has been a tough year for global markets and conditions remind us of the market crashes in China during 2015 and 2018. We believe the China A-share market now presents attractive value, with ample opportunities for long-term outperformance. Shares are trading at some of the most attractive valuations we've seen since we created our Prescient China Balanced Fund back in 2013. In this quarter's update, we hope to provide an update on China that cuts through traditional media noise.

CHINA "UNINVESTABLE"?

THE SUDDEN COLLAPSE OF THE CHINESE INTERNET SECTOR

It was during the morning of March 15th in Shanghai that we woke up to see Chinese internet sector shares follow the overnight US market selloff. On the one hand, we were quite relieved that the market had finally become rational after what we believed to be years of overvaluation in the Chinese internet and tech sector (where we had no exposure, of course). On the other hand, we were understandably nervous, given the pace of the correction in the sector. Only two weeks into March and the Chinese internet sector, as represented by the KraneShares China Internet ETF (KWEB), had dropped by a whopping -37%. If -37% seems like a big number, the -65% sell-off from KWEB's February 2021 peak to the end of February 2022 was even more concerning. By the close of US markets on March 14th, 2022, KWEB had fallen by -78% since its February 2021 peak. We have warned for over a year now about the exceptionally overvalued MANIA stocks. However, Chinese internet stocks are now quickly becoming more reasonably priced.

Various China composite/index performances



Sources: Prescient, Bloomberg (as at 07 April 2022)

2 USD A Class net of fees
3 Composite: 65% CSI300 and 35% CSISTTNI

The sudden collapse of the Chinese internet sector sent shockwaves through the rest of the Chinese financial markets. Benchmark China offshore indices, such as the MSCI China and Hang Seng China Enterprises Index (HSCEI), were hit hard, too, dropping intra-month by around -25% each before recovering losses. The China A-Share benchmark CSI300 also struggled but fared better than its offshore-focused counterparts, dropping by a little more than half of the MSCI China and HSCEI indices at their lowest point. This once again shows the importance of a diversified benchmark to help take the risk away from concentrated single sector exposures. Over the past few years, we have warned of the risks concentrated benchmarks such as the MSCI China Index pose, and March 2022 was another month where concentration contributed to significant downside volatility.

UNINVESTABLE?

During our morning meeting on the day of the sell-off, we saw the headline news that JP Morgan's analyst was calling the Chinese internet sector "uninvestable" over the next six to 12 months. Factors contributing to the call included rising geopolitical and macro-economic risks. While we agreed on the rising risks, it was difficult to imagine these risks being the main cause of a -37% revaluation in the sector over a period of two weeks. We believe the right time to downgrade was probably 18 months ago, when new sector regulations and policies were being released and analysed. Fundamentally, the sector has had to adapt to new regulations and overcome short-term challenges, such as the COVID-19 outbreak over the past two years, yet the companies remain the same strong and profitable companies they were before. They still have very large user bases who will not change their habits quickly. Once again, the current lockdown in Shanghai has reinforced how crucial all these tech companies are, with their smart services. Poor market sentiment towards the sector has partially contributed to its sudden volatility. We have viewed many companies in the sector as significantly overvalued, some more so than others, for a number of years. Thus, previous excessive valuations are probably one of the more significant factors that contributed to the recent revaluations.

After the recent revaluations, however, we believe the sector looks significantly more attractive and we have started to add exposure via the HSCEI to our China Balanced strategy, some at the time when the sector was deemed "uninvestable". Having invested in China for over a decade, we've seen the Chinese market called "uninvestable" many times. From 2012/2013's debt fears to 2015's financial market fears to 2021/2022's regulation fears. Each of the previous calls coincided with strong rebounds in the market resulting in high real returns for investors who could see through the risk.

China has been and remains the same as it always has been, the second-largest economy and capital market globally. With the continuous development and "opening up" of the financial services sector, more rules and regulations, along with their proper enforcement in the financial services sector, China has been made a more investor-friendly destination over time. Recently both Chinese and global investors, excited about the prospects for the Chinese tech sector, have priced in growth significantly in excess of GDP, seemingly into infinity at times. Many of the companies, such as Tencent, Alibaba and Meituan, are market-leading companies that will remain market leaders for the foreseeable future. However, many have used flawed or unethical business practices that needed to be regulated. Alibaba and Tencent's strong market dominance allowed them to engage in monopolistic behaviour, including purchasing all promising small startups and limiting access with walled gardens, which eliminates competition. Companies such as Meituan and DiDi essentially skirt employment regulations when it comes to providing social security and minimum insurance benefits for their "contractors", while keeping the profits to themselves. These practices are ultimately unhealthy for the sector and limit the healthy development of the marketplace over the long-term. We have not seen significant changes in the long-term business fundamentals of these tech companies; only temporary adjustments to business and earnings. The key question continues to be: what price are we willing to pay for these market leaders? We've always liked the saying: "actions speak louder than words". Our new active positions in the Chinese internet and technology sectors are clear indications that we believe great opportunities continue to exist.

IS TENCENT NOW CHEAP?

South African investors typically watch the Chinese internet sector closely due to the Tencent connection. As the Chinese internet sector has been revalued, many of our clients have asked for our view on Tencent. Of course, Tencent is significantly cheaper than it was 14 months ago when it peaked at over HK$740 per share, but we would not put the stock in "cheap" territory yet. 2021 was a tough year in terms of earnings for Tencent, with reported earnings per share (EPS) just HK$0.48 - down 97% from 2020. Of course, this drop is expected to be temporary ,and earnings are expected to normalise for 2022. If we consider Tencent's 2020 EPS figure of HK$14.06 (the highest in its history), its PE multiples based on different share prices are as follows:

Date	Share Price	FY2020 EPS	PE Ratio
January 25th 2021	HK$741.93	HK$14.06	52.8
March 15th 2022	HK$298.00	HK$14.06	21.2
April 6th 2022	HK$381.00	HK$14.06	27.1

Sources: Prescient, Bloomberg (as at 7 April 2022)

Simply looking at PE multiples and considering that the EPS used is the highest in Tencent history, the stock does not look cheap. However, comparing current pricing to recent history, while also factoring in Tencent's dominant position in China, something that will be difficult to change even with new anti-monopoly regulations in place, it may become an attractive proposition. At Prescient, we follow a strictly risk-controlled quantitative approach through which we have gained diversified exposure to Tencent and a basket of other Chinese companies. Should Tencent's share price correct further, we will look to add to our current position in a risk-controlled manner.

IS CHINA AS RISKY AS REPORTED?

CHINESE COMPANIES FORCED TO DELIST FROM THE US?

The SEC announced in early March a list of five Chinese companies listed in the US that could face potential delistings. Many attributed the subsequent collapse of the Chinese internet sector to the announcement. While we do believe the SEC's announcement contributed to the negative sentiment surrounding the sector, in our view, the risks are exaggerated. The latest round of delisting threats from the SEC is part of a long-running audit dispute between Chinese and US regulators, not much to do with the companies themselves. To give everyone a brief background to the story, current Chinese regulations do not allow auditing firms to provide certain confidential financial information to offshore regulators without prior approval from local regulators. As a result, the US Public Company Accounting Oversight Board (PCAOB), which oversees audits of US public companies, has been unable to adequately access audit information due to slow or a lack of approvals from the Chinese side. Current law in the US states that if the PCAOB is unable to check audit papers for three straight years, then such companies are to be delisted from US exchanges. This is where the SEC steps in, with related announcements of potential delistings.

We believe the risk of any negative investment impacts due to potential delistings will be lower than the current media hype. The reasons are quite straightforward:

- Chinese regulators have openly stated that the overseas listing of Chinese companies will be supported during March.
- Regulators from both sides have been actively engaging one another since August 2021, and they are expected to make progress. This month, the Chinese side published new draft rules on cross-border audit inspections under a supervised co-operation mechanism. Both sides appear to be actively seeking a solution rather than engaging in conflict.
- In the worst-case scenario that a solution for the auditing dispute cannot be reached and delistings do occur, the first of the forced delistings will only begin in 2024. This gives companies plenty of time to list in Hong Kong, and many of the Chinese companies already have dual listings in Hong Kong. From an investor perspective, the likely downside is the small admin fee charged for converting their ADR holdings to H shares.

GEOPOLITICAL RISKS?

As much as China has been reported in the news recently, most of the coverage has been political speculation rather than market-related developments. China has been criticised for its neutral stance on the Russia-Ukraine war, but in reality, it is in a tough position politically. We all know China-Russia relations are good, but what is underreported is that China and Ukraine also have solid relations. Not many people know that Ukraine helped China build its first aircraft carrier by selling the Varyag carrier to China and that China actually provides Ukraine with a nuclear security guarantee. We expect China to maintain its cautious approach to the conflict and avoid taking sides to minimise the impact of the war on its domestic market. The risk of potential US and EU sanctions is also low as China has been actively engaging with the US on sanction clarification, which shows China's willingness to comply with US-led sanctions on Russia where it is necessary.

IS TAIWAN THE NEXT UKRAINE?

Despite the Russia-Ukraine conflict being touted as a preview of a potential Mainland China-Taiwan situation, this comparison is an extremely over-simplified view of the current geopolitical situation and there are several major differences between the two. For starters, Ukraine is recognised as a sovereign country by most of the world. In contrast, Taiwan is officially recognised as a Chinese "breakaway" province, still fighting the Chinese civil war of more than 70 years ago. Nevertheless, we believe the Russia-Ukraine conflict may actually discourage any military activity in the region:

- The US has been on a path of strategic competition with China. From the Trump administration, where the focus was on limiting China unilaterally, to the Biden administration, where policy is more logical, the core has not changed materially. During the process, the US often tests China's political "red lines". The Russia incident shows the US that "red lines" do exist and what could trigger a hot war. This will likely motivate the US to be more cautious in diplomatic engagements going forward, especially related to the sensitive subject of Taiwan.
- Similarly, if China had any delusions that a military invasion of Taiwan would be fast or sanctions only a threat, it can now clearly see how quickly the West could unite and how sanctions could materially hurt the country, including potentially losing private Chinese assets offshore, even in "neutral" jurisdictions. The current sanctions in place against certain Chinese companies and individuals would be a walk in the park compared to such a situation.
- For Taiwan, it would be the same. Although recent Taiwanese politicians often use "independence" as a dog whistle during elections, post-elections things calm down. This was seen in the 2016 and 2020 elections, where the independence-leaning DPP won the majority in the Presidential race and the Legislative Yuan. In the current Tsai Ing-Wen administration there are seasoned politicians who understand China. Tsai herself was the previous Chairwoman of Taiwan's Mainland Affairs Council, and we are comfortable that she knows where Mainland China's "red lines" are.
  - Before the Russian invasion of Ukraine, polls showed that 65% of the Taiwanese population believed the US military would come to their aid in the event of a Mainland Chinese invasion. Post-Russia-Ukraine, the figure dropped to 35%. We believe the only scenario where Mainland China would invade Taiwan militarily is one where Taiwan formally declares independence from China. The Russia-Ukraine case study will hopefully reduce such urges.

- The combination of forces means peace should be more long-lasting. All sides should understand there is much to lose. Russia and Ukraine would be child's play compared to what would occur if the US and China really started a major conflict, be it military or financial. As terrible as the Russia-Ukraine war is, the potential implications are that it will hopefully result in more co-operative relations between US and China. We hope for a speedy peaceful resolution to the Russia-Ukraine war.

CHINA-US RELATIONS

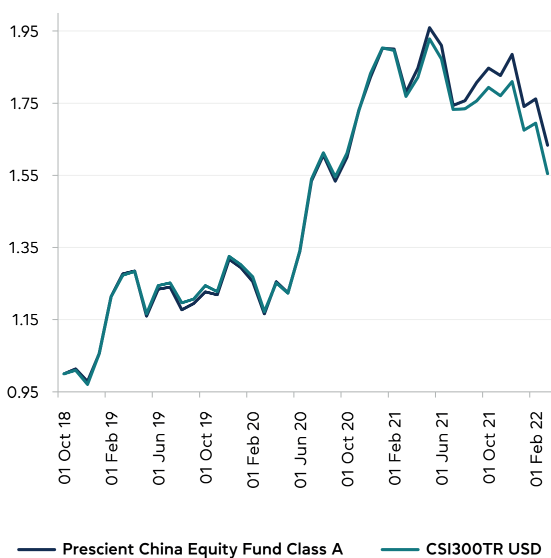
In terms of China-US relations, we are glad that the US has extended tariff exemptions on more than 350 goods imported from China. This is positive for potentially ending the trade war started under the Trump administration. However, we believe the move is largely a result of self-interest as US inflation continues to hit new highs. Politically, our expectations are for China-US relations to be consistently tense going forward and for further sanctions to be imposed on certain Chinese companies where it suits US national interests. We continue to be cognisant of the geopolitical risks when managing our portfolios.

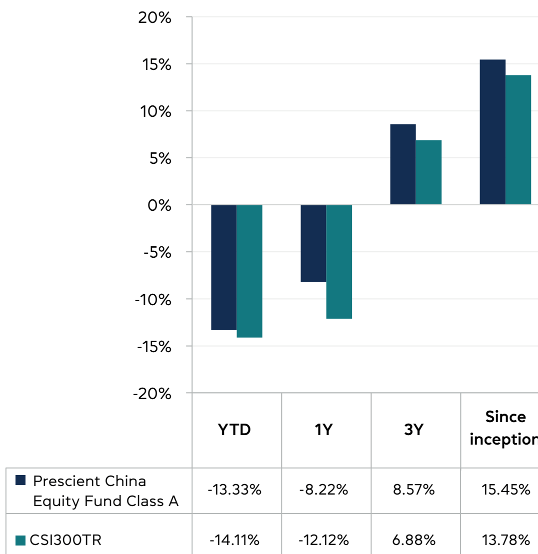
PRESCIENT PERFORMANCE

CHINA EQUITY FUND

The Prescient China Equity Fund returned -13.3% for the quarter, outperforming the CSI300TR benchmark by 0.8% as it lost -14.1%. Since inception, the annualised outperformance after fees is 1.7%. Our diversified and risk-controlled quantitative approach continued to generate consistent alpha in very challenging circumstances

Prescient China Equity Fund Class A – Returns in USD net of fees





	YTD	1Y	3Y	Since inception
Prescient China Equity Fund Class A	-13.33%	-8.22%	8.57%	15.45%
CSI300TR	-14.11%	-12.12%	6.88%	13.78%

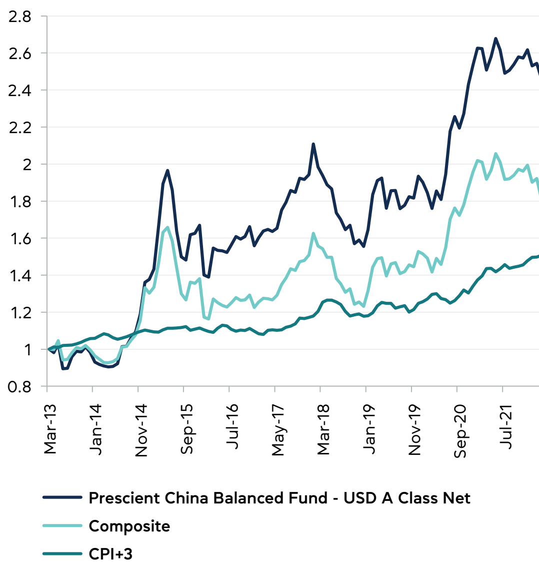
	Fund
Highest rolling 1 year	59.95
Lowest rolling 1 year	-8.65

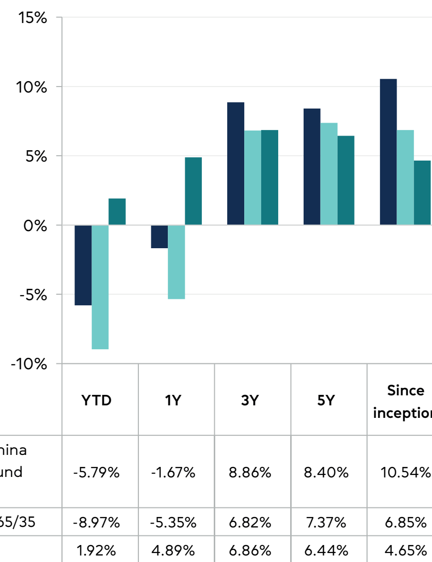
Sources: Prescient, Bloomberg (as at 31 March 2022)
Inception date: 31 October 2018

CHINA BALANCED FUND

The Prescient China Balanced Fund benefitted from our dynamic asset allocation and exposure to the HSCEI over the quarter during which it outperformed the 65/35 Composite by 3.2%. Our strategy continues to position the Fund for the long-term even though short-term performance relative to inflation is struggling, given the market downturn. Our track record since the inception of the Fund is close to China's CPI + 9% after fees, which highlights the success of our robust investment strategy. At current market valuations, especially after the recent correction, we expected strong real returns over the next investment cycle.

Prescient China Balanced Fund Class A – Returns in USD net of fees





	YTD	1Y	3Y	5Y	Since inception
Prescient China Balanced Fund Class A	-5.79%	-1.67%	8.86%	8.40%	10.54%
Composite 65/35	-8.97%	-5.35%	6.82%	7.37%	6.85%
CPI+3	1.92%	4.89%	6.86%	6.44%	4.65%

	Fund
Highest rolling 1 year	116.82
Lowest rolling 1 year	-22.10

Sources: Prescient, Bloomberg (as at 31 March 2022)

Composite: 65% CSI300 and 35% CSISTTNI. Inception date: 31 March 2013

SUMMARY

2022 has started off in a crazy manner. Despite the immense amounts of media noise, market volatility and negative sentiment, we continue to stay focused on our processes and on outperforming for our clients. The quarter has helped our performance stand out even more against some of our global peers, which experienced concentrated drawdowns. Our focus on diversification, dynamic asset allocation and risk management continues to ensure we deliver on our long-term objective to generate high alpha and real returns.

April was off to a unique start in Shanghai. We have all been in lockdown at home, unable to leave our apartments, all in an attempt to pursue an incredibly difficult "Covid-Zero" policy. While we tend to complain about not being able to head to our favourite local restaurant or go to the gym, the experiences of everyone at the office during this lockdown have certainly been a lot better than reported in the media. It is incredible to realise the value placed on every ordinary citizen's life by the government here, which is willing to sacrifice billions of dollars in GDP growth to keep COVID-19-related deaths low.

As we await the end of Shanghai's COVID-19 lockdown and appreciate the simple freedoms we had in our daily lives, we want to thank you for choosing Prescient China and sticking with us during these turbulent times; we are blessed to have your support.

Prescient Investment Management (Pty) Ltd is an authorised financial services provider (FSP 612). Collective Investment Schemes in Securities (CIS) should be considered as medium to long-term investments. The value may go up as well as down and past performance is not necessarily a guide to future performance. CISs are traded at the ruling price and can engage in scrip lending and borrowing. A schedule of fees, charges and maximum comissions is available on request from the Manager. A CIS may be closed to new investors in order for it to be managed more efficiently in accordance with its mandate. There is no guarantee in respect of capital or returns in a portfolio. Performance has been calculated using net NAV to NAV numbers with income reinvested. The performance for each period shown reflects the return for investors who have been fully invested for that period. Individual investor performance may differ as a result of initial fees, the actual investment date, the date of reinvestments and dividend withholding tax. Full performance calculations are available from the manager on request.

Annualised performance shows longer-term performance rescaled to a one-year period. Annualised performance is the average return per year over the period. Actual annual figures are available to the investor on request. Highest and lowest is returns for any one year over the period since inception have been shown. NAV is the net asset value represents the assets of a Fund less its liabilities.

Prescient Management Company (RF) (Pty) Ltd is registered and approved under the Collective Investment Schemes Control Act (No.45 of 2002). For any additional information such as fund prices, fees, brochures, minimum disclosure documents and application forms, please visit www.prescient.co.za

The forecasts are based on reasonable assumptions, are not guaranteed to occur, and are provided for illustrative purposes only.