Prescient
INVESTMENT MANAGEMENT

PRESCIENT CHINA QUARTERLY COMMENTARY

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QUICK VIEW

2021 was an interesting year for Chinese financial markets, with one of its historically favourite sectors – Big Tech – undergoing a large correction. Over the years, the sector benefitted from loose regulation, innovation (largely helped by the intentional lack of regulation) and aggressive expansion. When combined with Chinese retail investor access through the Hong Kong stock connect program, the performance of these shares was boosted to all-time highs both in terms of price and valuation by February 2021. The road post-February 2021 got a lot tougher for China's most loved tech companies as regulatory changes prompted negative sentiment and the sector underwent a significant correction.

In addition to industry regulation changes, the introduction of "Common Prosperity" goals in China have had mixed coverage. We certainly do not believe it is a change of direction back towards old-style communism for the world's second-largest economy. In contrast, we believe it is healthy to reduce income inequality, a problem many emerging and developed market peers face. Successfully addressing the issue will allow for a more stable society and economy, paving the way for sustainable future economic growth.

In terms of performance, our Prescient China Equity Fund has performed solidly under difficult conditions during 2021, with calendar year US dollar returns of 3.45% after fees, compared to the benchmark CSI300TR return of -1.23%, an outperformance of 4.7% for the year. The Prescient China Balanced Fund[1] performed similarly to the equity fund, returning 3.23% but underperformed China CPI +3% due to a strengthening Chinese yuan (CNY) and higher inflation for the year. From time to time, when equity markets struggle the Prescient China Balanced Fund will underperform its inflation-plus target in the short term. Over the cycle, we are confident of consistently producing strong real returns.

1 USD A Class net of fees

COMMON PROSPERITY

BACKGROUND

During 2021, the Chinese government launched the Common Prosperity drive, which resulted in a set of policies with the intention of reducing income inequality in the country over the next 15 years. So what exactly is Common Prosperity? Many traditional media outlets have translated it as China returning to old-style communism. The reality is quite different. Common Prosperity is actually an age-old concept in China. When China's economy first opened up more than 40 years ago, Deng Xiaoping – the architect of China's modern economy – planned for part of the population to get wealthy first. The wealthy would then help the more underdeveloped areas to develop and catch up. Not many of the wealthy have remembered the second part of the plan. As the Chinese government begins to unpack and structure the Common Prosperity drive, we summarise the key objectives and policies that were released last year and some of the investment implications.

PLAN & ACT

As China changes from unfettered growth in the early 2000s to a new era of balanced and higher quality growth in the 2020s, so too will China's "unique socialist system" influence the capital markets. Looking at numbers, the Chinese economy has created the world's largest middle class of over 340 million people, very impressive, right? Unfortunately, there remain over 600 million of the population making less than US$1 500 a year, above the official poverty line but still extremely poor. The Common Prosperity drive focuses on reducing income inequality and strengthening the government-funded social security net for the financially vulnerable, eventually helping the most vulnerable 600 million to make their way into the middle class as well.

So how does the government go about doing this? So far, the government has identified a three-pronged approach:

- Firstly, a series of progressive taxation policies sought to close tax loopholes for the ultra-wealthy. Like many of its global peers, China's tax rates are progressive, where the wealthy pay higher tax rates. However, the rich also have access to the best lawyers and accountants to help them take advantage of tax loopholes or take risks in "grey areas" of tax legislation. As tax enforcement becomes stricter, questionable tax avoidance can now become a costly exercise in China. Over the past two years, we have seen some highly publicised cases of tax evasion and subsequent fines, seemingly to send a strong message to those wealthy individuals not paying their fair share of taxes. Late last year, China's "live-streaming Queen" Viya (18 million followers on Weibo and 80 million followers on Taobao) was fined a record CNY1.34 billion (US$210 million or R3.25 billion) in unpaid taxes and penalties for tax evasion. However large the penalty, tax evaders are very quick to sell assets and pay the fine when faced with possible jail time – another example of the Chinese government's brutally effective institutions. The publicised fine is often followed by a warning that all other offenders have a year to voluntarily disclose and make good on their taxes before the government begins official audits. Enforcement of tax rules in China, especially on the wealthy, is expected to be ramped up as China's fiscal income sources adjust from focusing on land sales to a more diversified tax base. With a good social security system paid for by a more mature and effective taxation system, reducing income inequality appears to be having a good start.

- The second part of the Common Prosperity drive is reining in illegal practices and formalising regulations in new business sectors. This part is specifically applicable in the areas of:
  - Anti-monopoly regulation
  - Data privacy and protection, and
  - Labour law compliance.

  This is where sectors such as Educare and Big Tech have been hard hit. Previously, without proper regulation and regulatory enforcement, profitability across the sector was unrealistically inflated. For example:
  - Delivery companies such as Meituan avoided paying minimum wages and social security, such as medical insurance and pension contribution, to its army of delivery staff.
  - Ride-hailing services like DiDi (China's Uber) committed privacy breaches on trip information of its millions of customers.
  - Global technology giants Tencent and Alibaba locked out competitors and potential competitors from its ecosystem. With their power to reach more than a billion users, small businesses often face the harsh choices of giving up or giving in to become part of either giant. This is part of why Tencent has over 700 investee companies and largely why the government introduced anti-monopoly regulation in the sector.

    Resolving anti-competitive issues should allow China to have a more innovative, competitive and flourishing software market. Allowing smaller businesses to operate and thrive will be healthy for the industry and economy; after all, this is how both Alibaba and Tencent started out. Similarly, platforms like Didi and Meituan should be reasonably expected to pay minimum wages and legally required medical and pension benefits to their employees, and always act to protect customers and their privacy.

    All of this is actually not unique to China. Global technology giants such as Google, Facebook, Amazon, and Uber face similar issues. The "resolution" process often results in lengthy consultations and congressional/senate hearings, but to date, no tangible changes. China's first step at regulating Big Tech has caused shareholder nervousness. However, we believe maintaining quality services and innovation while at the same time being socially responsible by paying a living wage, medical and pension benefits will help the industry be more sustainable and prosperous over the long term.

- The third part is to encourage a culture of giving, especially by the wealthy, for worthy causes, such as uplifting the poor and needy. This announcement triggered a wave of 'Voluntary' donations by large corporates. Tencent and Alibaba both announced commitments of CNY100 billion each towards Common Prosperity initiatives. Many billionaire founders of Chinese technology companies joined in, promising to donate and promote Common Prosperity values to help grow earnings for low-income groups. Unfortunately, famous billionaire beneficiaries of the Chinese market, such as Bill Gates or Elon Musk, weren't on the list of wealthy individuals pledging donations for China's Common Prosperity drive; perhaps more prompting by the government in future will encourage them to join.

WHAT TO EXPECT

So how does Common Prosperity affect the financial markets? If we consider when anti-corruption campaigns started, consumer and luxury goods companies' valuations suffered under the assumption that it was a politically-motivated campaign that would dampen China's consumption of luxury goods. The actual effect a few years on has been quite the opposite. Less corruption appears to have resulted in better growth, which translates into higher consumption for the average person. With China's middle class of more than 340 million people, this has helped generate higher consumer and luxury goods sales.

Expectedly, conventional media's average interpretation of Common Prosperity has been limited to the surface level, viewing it as negative for China's Big Tech sector. For long-term investors like ourselves, we are bullish for the future. The drive and reforms mean China will be able to sustain a longer growth phase with a healthy and robust small business sector. A larger middle class will also increase China's consumer base, helping the country grow faster for longer. China clearly understands the risks of unequal development. The path to long-term economic success is to have a dynamic and entrepreneurial population akin to the US during the 1970s/1980s, with fewer monopolies, plenty of competition and higher growth. If China can add another 340 million people into its middle class, the extra demand and consumption will benefit the global economy.

CHINA BIG TECH

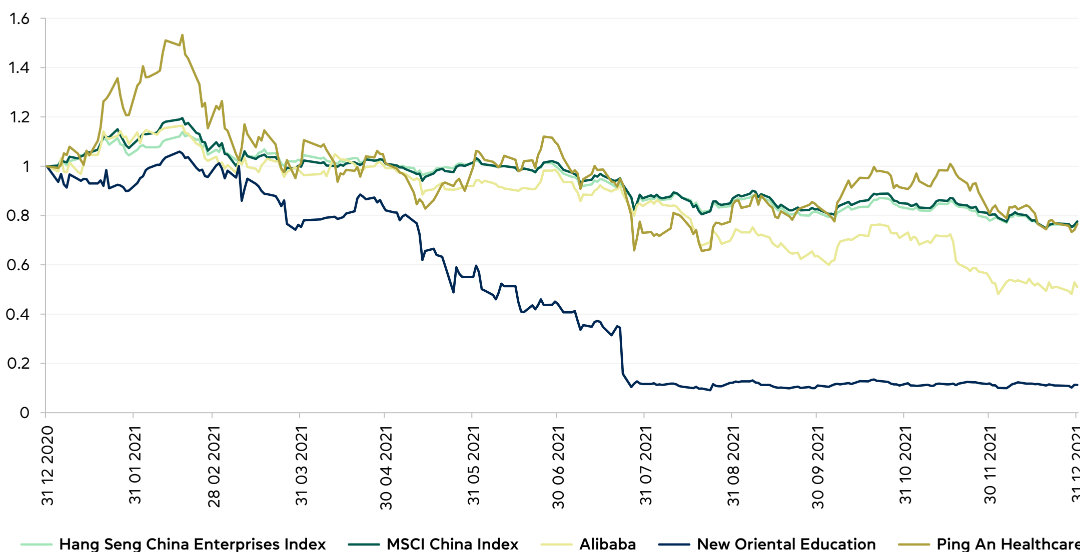
MSCI CHINA = CHINA TECH INDEX?

For a long time, we mentioned the risks of the MSCI China Index, an index with great potential and historical performance. However, Prescient's view has always been that it is not a realistic representation of China's economy, with high levels of concentration, especially in the Chinese technology sector. The MSCI China Index started out well in 2021 but continued to struggle after the Chinese New Year break, which ended mid-February. The Index posted a negative US dollar return of -23% for the year and has lost -35% since its peak in February 2021. At current valuations, we believe the opportunities are more balanced.

CHINA BIG TECH STILL INVESTABLE?

We have always believed that Chinese tech companies are fantastic businesses. Valuations, however, were difficult to stomach. For a long time, the companies were priced for perfection and, with the introduction of the Hong Kong stock connect for Mainland Chinese retail investors to access, valuations metrics became statistics with little meaning until February 2021.

Cumulative returns for 2021



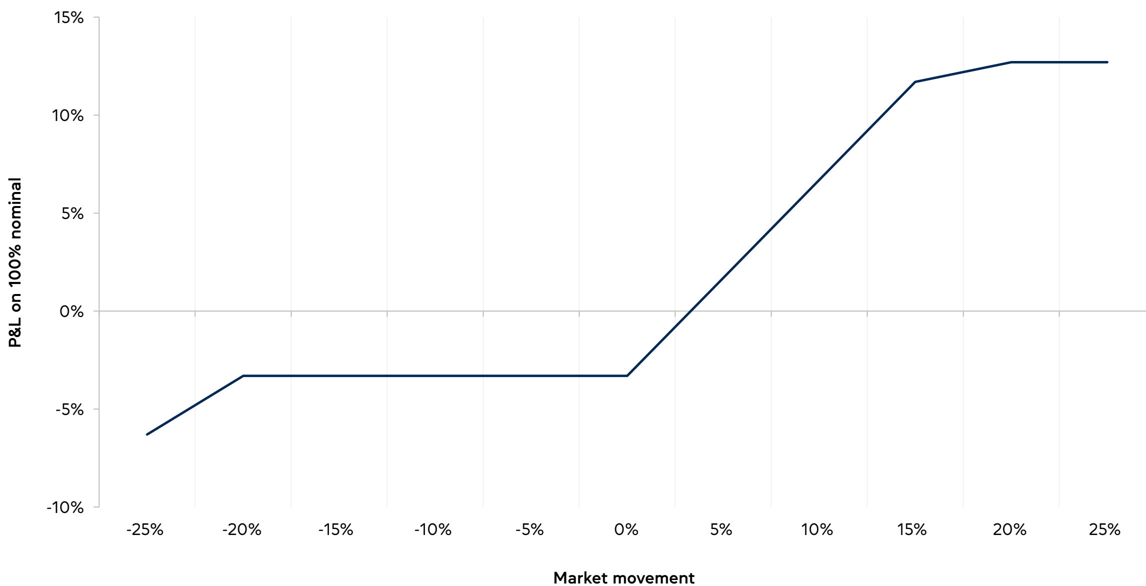
Sources: Prescient, Bloomberg (as at 31 December 2021)

New regulatory changes in 2021 put an end to the previous “freewheeling” practices in the sector. This also resulted in a dramatic shift in investor sentiment towards Chinese tech companies, as can be seen in the MSCI Index going through a peak to trough correction of over 35%. Investors have previously priced in aggressive and perfect growth paths, which were always unlikely. Today Alibaba is still the giant it was back in February 2021. The only significant change is future expectations on the company have become more reasonable, with the forward PE ratio of the company at 17 times during January 2022, less than half the February 2021 figure. A deeper look at the regulatory changes shows clear intentions to healthily regulate rather than “kill” the industry, as certain media outlets have hinted at. Healthy regulation and reasonable valuations are making the sector attractive again for us.

HOW DO WE PICK COMPANIES?

As a quantitative asset manager, we do not like to take bets on singular risks such as future policy or company-specific risks. We prefer diversification, using our expertise in indices and derivative structures. For the Prescient China Balanced Fund, we have the flexibility to take advantage of this correction by using options, making a tactical allocation for a good risk-adjusted return profile.

Derivative structure profile



Source: Prescient (as at January 2022)

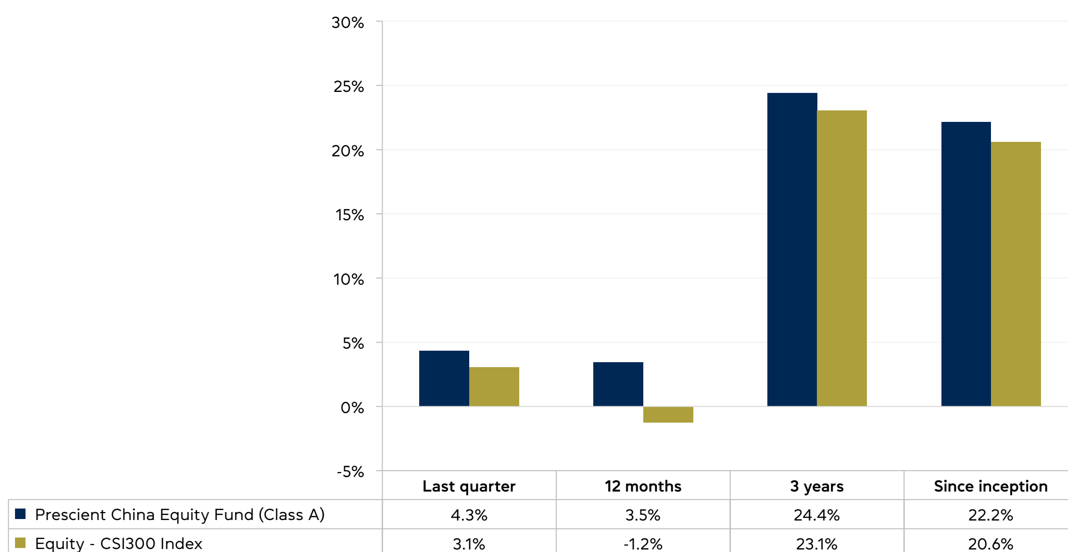
The structure in the chart above is one we recently implemented for a portion of the Prescient China Balanced Fund, we are risking 4% cost and aiming for a potential 12% payoff on the upside. As this opportunity develops, we may continue to add similar derivative structures depending on market pricing. These structures allow for upside equity market participation with limited downside, giving us exposure to China’s Big Tech stocks listed outside China with very limited downside risks. Taking advantage of these opportunities over the long term will help us add alpha and achieve our real return goals.

FUND PERFORMANCE

CHINA EQUITY FUND

The Prescient China Equity Fund delivered 4.7% of outperformance after fees for 2021 under difficult market conditions. Since inception, the annualised outperformance after fees is 1.6%. 2021 was the first time in a long time that the popular Chinese tech and consumer sectors faced a major correction. Our diversified and risk-controlled quantitative approach continued to prove its worth in very challenging circumstances, where many of our global peers struggled both in terms of absolute and relative performance.

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



	Last quarter	12 months	3 years	Since inception
Prescient China Equity Fund (Class A)	4.3%	3.5%	24.4%	22.2%
Equity - CSI300 Index	3.1%	-1.2%	23.1%	20.6%

	Fund	Benchmark
Highest rolling 1 year	59.95	58.23
Lowest rolling 1 year	-8.65	-7.93

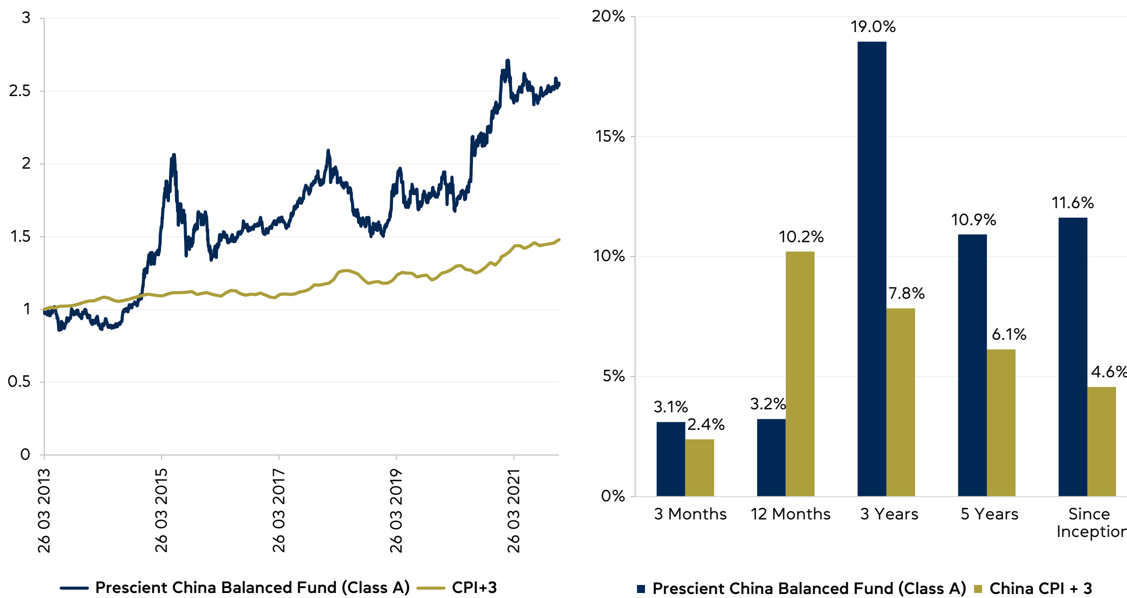
Source: Prescient, Bloomberg (as at 31 December 2021)

Inception date: 31 October 2018

CHINA BALANCED FUND

Although the Prescient China Balanced Fund reached an all-time high in NAV during 2021, in a year where the equity market produced negative returns, the fund's 3.2% US dollar return underperformed its China CPI + 3% target. It is not possible to beat inflation every calendar year, especially during market downturns. Our strategy has always been, and continues to be, positioned for the long term. Our long-term track record of China CPI + 10% after fees since 2013 shows the success of our dynamic investment strategy. With current market valuations, expected returns going forward will not be as high as historical returns. However, we believe we can still deliver solid real returns over the coming market cycle.

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



	Fund	Benchmark
Highest rolling 1 year	116.82	17.08
Lowest rolling 1 year	-22.10	-2.43

Sources: Prescient, Bloomberg (as at 31 December 2021)
Inception date: 26 March 2013

SUMMARY

Our risk-controlled quantitative methods delivered solid results for our clients in a difficult year for China and specifically the hot Chinese technology and consumer stocks. We continue to focus on diversification, dynamic asset allocation and risk management to continue to consistently add value and outperform for our clients over the cycle.

Chinese New Year is just around the corner, with New Year's eve on January 31st. This is the longest and most important national holiday in China, and as such, statistics like money supply, PMI, productivity numbers and GDP will be distorted until the March statistics are released in April. Do not be concerned if you read sensational headlines of China's "crash" in productivity in February; it is expected when 1.4 billion people take a break.

Thank you for being with us on the journey through a turbulent 2021. We hope that 2022 will be a fruitful year. Until next quarter, Happy Year of the Tiger!

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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.

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