# FEG INSIGHT

MAY 2018

## AN APPROACHABLE ASIA

### FEG CIO Corner Event Highlights

F·E·G®
investment advisors

*This past March, FEG welcomed attendees to our inaugural FEG CIO Corner: An Approachable Asia. Select FEG representatives and clients spent several days in Hong Kong to learn more about the nuances of investing in Asia, specifically China.*

*We were inspired to host this event because we expect that most institutions will be underweight China as their capital markets grow in tandem with their increasing percentage in various benchmarks. It is our opinion this growth will provide numerous alpha opportunities for patient investors. While FEG is optimistic about this market, caution is still warranted, as this growth may not always be steady amidst concerns regarding relatively high debt levels.*

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## FROM A-TO-H

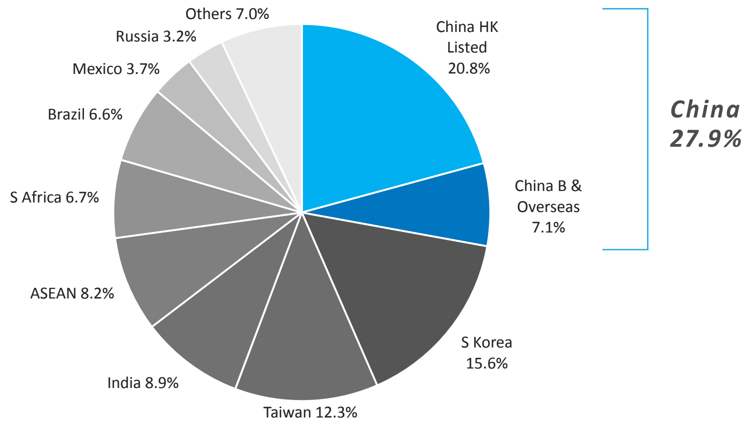
From the beginning of its market-oriented period, China has funded development internally through domestic savings and bank lending. This led to amazing growth but also a large build-up of internal debt. The solution to this problem was to develop a fully functioning capital market for public issuance of both equity and debt. While there has been progress on both fronts, the most headway has been made in relaxing capital mobility and restrictions on equity trading.

In recognition of these improvements, MSCI officially announced the long-awaited A-shares stock inclusion list in June 2017. A-shares are the shares of domestically listed Chinese public companies, as opposed to H-shares, which are companies listed on the Hong Kong Stock Exchange. There are well over 3,000 A-shares on the stock inclusion list, and the number continues to grow.

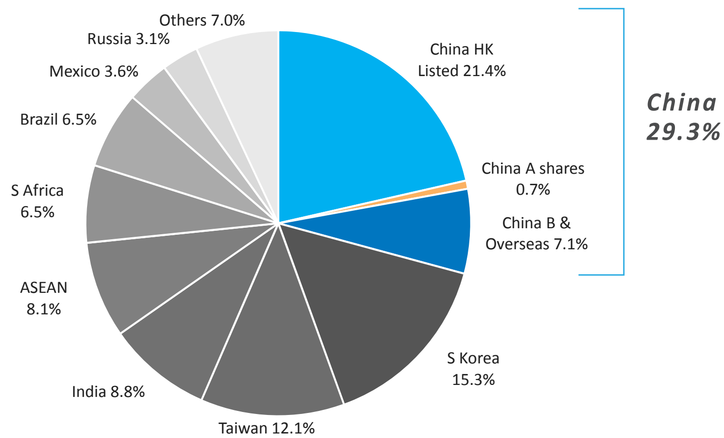
Bo Meunier, emerging markets portfolio manager (PM) and partner at Wellington Management, focuses on China equities and walked us through the implications of this event. Currently, the MSCI Emerging Markets Index has a weight to China of about 28%, comprised mainly of Hong Kong listed shares and ADRs, or shares of Chinese companies listed in America. With the A-share inclusion, the weight of China in the Emerging Markets Index will surge to about 40%. This will happen gradually over the next several years, but the broad implication is that many institutional investors who use this index as a benchmark could become underweight China.

## POTENTIAL SCENARIO FOR MSCI EMERGING MARKETS INDEX

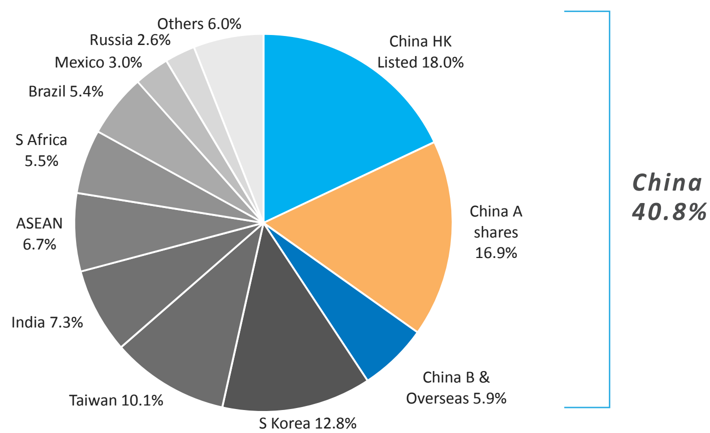
### CURRENT STATUS




### EM WITH INITIAL A-SHARES INCLUSION




### MSCI EM WITH 100% A-SHARES*




**Based on all the constituents of the MSCI China A International Index at 100% inclusion of free-float market cap.*
*Note: Pie charts updated as per MSCI's 2017 Country Classification Review. Results released on 06/20/2017 MSCI has not committed to full inclusion. This information is for illustrative purposes only.*
*Data sources: MSCI Index Inclusion Roadmap of China A-Shares Emerging Markets and MSCI "Are you ready for China A-shares?" white paper.*

## EQUITY OPPORTUNITIES AND RISKS

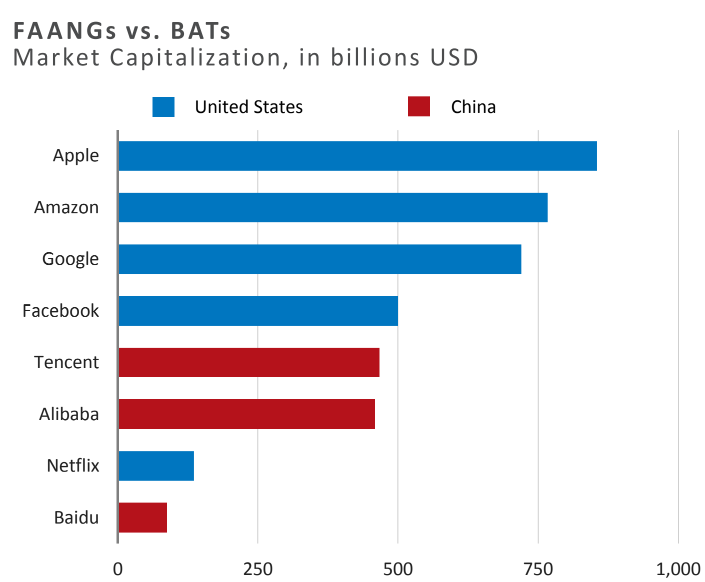
Both Meunier and Munib Madni, PM of Morgan Stanley's emerging markets team, spoke of some of the opportunities and risks associated with Chinese equities. One of the potential advantages of an active equity approach to A-shares is how dominated they are by the retail investor. We believe alpha is a zero-sum game. To achieve alpha, one must take it from somebody else. In the U.S., and in most developed markets, smart, sophisticated, institutional money flows dominate the investment landscape—up to 70%-80%—with retail investors making up the remainder. China, however, is the exact opposite in that retail dominates, creating an untapped opportunity.

On average, China also looks more attractive from a valuation perspective, at least on the surface. Old Economy names in industrials and banking are able to trade at 5x P/E, while New Economy names in healthcare and technology can trade at 40x-50x P/E's. Again, this may lend itself to a more active approach in the A-share market.

## FAANGs vs. BATs

In the U.S., the FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google) and in China, the BAT stocks (Baidu, Alibaba, and Tencent) have come to dominate and heavily influence the performance of the broader market. A handful of high-growth tech companies dominating Chinese market performance may come as a surprise to some investors. Many still view China as a low-cost, low-quality manufacturer; however, that reality no longer exists.

With the China 2025 initiative, the country looks to become the world leader in cutting-edge areas like high-tech manufacturing, artificial intelligence, quantum computing, and biotech. Even now, China boasts world-class technology companies that are bringing competition to U.S. companies based on market capitalization.




*Data source: Bloomberg, L.P.; data as of 5/1/2018*

It is amazing what Alibaba and other Chinese tech leaders have accomplished in the last few years, from e-commerce to mobile payments. During our event, we were lucky to hear directly from Alibaba senior executive Michael Yao who detailed the company mission—to make doing business easier—and strategic vision. The sheer size and scale of the company, with more than 515 million active users and 1.7 billion products, provided the group an appreciation of the data-driven technology platform. The dominance of BATs, especially domestically in China, was further elaborated on by Carl Huttenlocher, founder and CIO of Myriad, long-time investors in Chinese technology companies, including the pre-IPO shares of Alibaba.

*One example of Chinese technology is Alipay which is increasingly used to facilitate business through mobile payments as opposed to cash or credit cards. Linked directly to a Chinese citizen's bank account, it is now so prevalent that Chinese tourists visiting Europe can receive their value-added tax (VAT) refund through the app.*

## STRONG PRIVATE MARKET

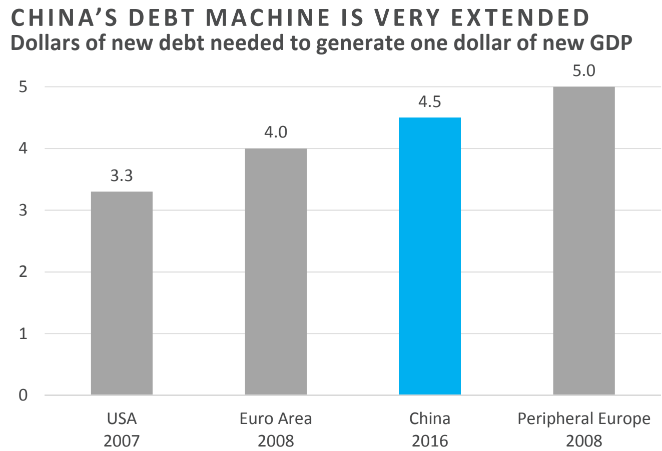
While a lot of focus has been on the liquid markets, China also has a vibrant private market. Realizations may sometimes take longer in Asia; however, strategic acquisitions and initial public offerings (IPOs) have remained robust of late. In 2017, for example, there were a record 440 IPOs in the domestic China market, and another 80 in the Hong Kong market.

Rebecca Xu of Asia Alternatives helped educate our guests on the private equity landscape in China. While traditional buyout strategies are still nascent, the venture and growth equity markets are extremely vibrant. China private equity dry powder totaled $293 billion in 2017 and is further increasing into 2018. Technology, new retail, healthcare, and industrial 4.0 continue to be popular sectors and themes.

## EYES WIDE OPEN

Although there are many opportunities in China, they are not without risk; therefore, investors must proceed with eyes wide open. John Pinkel, partner of Indus Capital & PM of the Asia Pacific and Select Funds, led a fireside chat with Jamie Allen, secretary general at the Asian Corporate Governance Association. Both gentlemen helped to explain the difference in governance and focus of the various Asian markets, many of which have already adopted stewardship codes. China has made many strides—especially in enforcement—but they remain behind Asian peers in terms of overall corporate governance levels. Hong Kong—which is a part of China but has the privilege of running a different economic and governing system—continues to be highly rated. Therefore, Hong Kong maintains prominence and importance as a doorway for the rest of the world doing business with China.

Besides corporate governance challenges, China's amazing growth has been fueled by debt. This debt, while large by Western standards, is serviceable if China continues to grow GDP in the 6% range. Much of this debt resides on bank balance sheets as non-performing loans associated with industrial conglomerates and real estate developers. China must strike the perfect balancing act of maintaining continued growth while also enduring the restructuring of bad debts. This is akin to pressing hard on the gas pedal while simultaneously slowly stepping on the breaks. Luckily, as mentioned above, most of the debt is held domestically, and it is far easier to restructure without having to deal with foreign enterprises—especially when the government may also control both the bank and the industrial company debt in need of said work-out.




*Sources: Morgan Stanley, MSIM EM Research, BIS, Haver, as of December 2016*

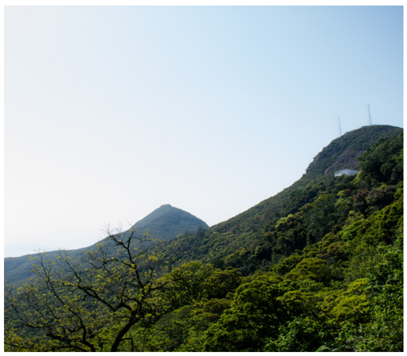
Lastly, when thinking of debt in China, the inevitable images of "ghost cities" comes to mind. During our trip, John Saunders from BlackRock Real Estate gave the group an overview of Chinese real estate. While issues remain in certain cities, most of the more egregious, unoccupied, real estate developments have remarkably been absorbed. Perhaps this should not be surprising given the millions upon millions of people who migrate every year to Chinese cities from the neighboring rural areas. The need for new housing in China on an annual basis alone could fill a mid-sized country. Thus, when building these ghost cities, Chinese developers are merely pulling forward demand from the future. This is not to say there is not waste and obsolesce in this practice, which is why Saunders pointed out that investors must be targeted in their approach. Money can still be made in China real estate, especially in the tier-one cities of Shanghai, Beijing, Shenzhen, and Guangzhou. Investors simply will need to practice caution to ensure they are not burned.

*"When building these ghost cities, Chinese developers are merely pulling forward demand from the future"*

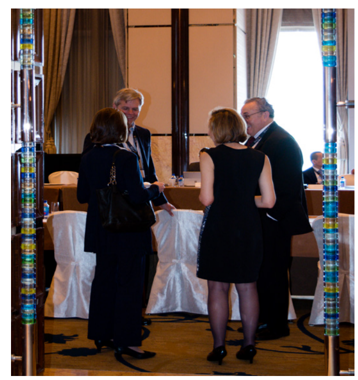
## A HIKE TO REFLECT

After two days of boardroom-style educational sessions and numerous manager meetings, we finished our journey with a hike around Victoria Peak to relax and reflect upon all that was learned.

While a single visit cannot truly encapsulate the complexities of China, trips abroad provide meaningful context and can serve as a springboard for further research. This trip was informative and inspiring, and we hope that you will consider joining us for a future educational journey.



*From listening to a fireside chat between Michael Yao of Alibaba and John Pinkel of Indus, hiking Victoria peak, and chatting with other attendees, the CIO Corner aimed to make Asia approachable.*



*A special thanks to all our investment partners. We could not have made this trip without your time, suggestions, and advice.*

*We specifically want to thank Indus Capital, Myriad Asset Management, Morgan Stanley, Wellington Management, BlackRock, Asia Alternatives, Asian Corporate Governance Association, Alibaba, Credit Suisse, Pleiad, Unicorn, and Tybourne.*

*Thanks for making our event a success!*

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