FSSA INVESTMENT MANAGERS

China – what's in store for 2021

Part 2

Martin Lau
Managing Partner
FSSA Investment Managers

Martin has been with FSSA Investment Managers for more than 18 years, starting with the firm as Director, Greater China Equities in 2002. Martin is the lead manager of a number of FSSA strategies such as the FSSA China Growth Strategy and FSSA Asian Equity Plus Strategy to name a few.

This Q&A was adapted from a live webcast Martin did in January.

2020 has been an extraordinary year – the fluctuating market has led to a great deal of uncertainty for investors. Were there any learnings?

At the end of last year, as a team, we conducted a virtual offsite to review the decisions that we had made during the year and we concluded that we made one right decision as well as one wrong decision.

When the stock market was in panic mode in March and April last year, everyone was saying that the economy was suffering from an unprecedented shock and that the situation would only get worse. If there were 100 cases today, there might be 1000 cases tomorrow.

We decided to exclude the year in our company analysis as we knew that the profits would be poor regardless of the outcome. Instead, we focused on companies that would be worthwhile investing in up to 2025 and had strong balance sheets to keep them afloat even if other companies went bankrupt. We also identified companies that we thought were significantly undervalued and invested in these companies while prices were low.

On the other hand, in hindsight, instead of focusing our efforts on valuation and finding undervalued companies, perhaps we should have invested in growth stocks, such as internet companies and electric vehicle companies, as they have exceeded expectations. It is easier to look back on past events, but we have to remember that we are conservative investors.

Growth stocks indeed outperformed last year. However, the Chinese government has announced new measures targeting tech giants, such as anti-monopoly rules and increased regulations of online finance. How will this impact the portfolio?

We have been expecting increased regulations, though we did not expect the measures to be quite as stringent. Regulations are not unique to China. Even tech giants such as Facebook or Google are targeted every one or two years and forced to attend hearings. In the eyes of many governments, the internet has become a powerful tool, especially if you look at events in the US. Even a user's comment may have far-reaching effects. This is a concern for governments, especially in China, where the government may be more inclined to introduce regulatory controls.

If we look at the e-commerce sector, it is unlikely that one company would develop a monopoly as the competition is

fierce. There are various companies in the industry – Alibaba, JD.com, Pinduoduo, so there is not a monopoly to speak of. However, after last year, some internet companies may adopt a more cautious growth strategy, which I believe may be beneficial for profits as companies would not have to keep spending huge amounts of money to fund their expansion or to entice new users.

What are your thoughts on the electric vehicle sector? Many predict that the sector will see the same growth the smartphone sector experienced 10 years ago.

We have been observing the electric vehicle sector as well as software services and cloud computing. However, as long-term investors, we need to decide whether the industry is as promising as people think and whether the companies have built an economic moat.

As an example, the smartphone industry experienced rapid growth in the past, but companies such as Nokia and Motorola that produced the older generation of phones eventually disappeared.

In the future, semiconductor chips and lenses could play the most important role in the smartphone sector. In the electric vehicle sector, it could be car batteries and glass, which we have been keeping an eye on too. We have also applied the same lens to the solar power industry – though we believe when everyone starts producing solar panels, there might be a risk of oversupply.

Over the years, electric vehicle stocks may have increased 11-fold but we must take a long-term approach and examine what kind of growth these companies will benefit from. For example, last year China produced 1.5 million new electric vehicles and the government has announced that 20% of vehicles in China will be electric by 2025 or 2030. We are confident about these forecasts – that said, does that really mean everyone will see 20-fold returns?

When the market is focused on a particular theme – what we call a thematic market – we must be cautious and think outside of the box and not have a herd mentality.

The portfolio has never had a substantial holding in Alibaba. However, of late, the holding has increased. Was there any reason driving this change?

We have never doubted the online trend. The online trend has been huge over the last 10 years and companies such as Tencent have always been among our largest holdings. Tencent listed on the stock market in 2004, and we became shareholders in 2005.

Things are a slightly more complicated with Alibaba, because it listed much later and was already a large company then. The company has been the subject of debate for quite a while – not just since last year. I have always believed that Alibaba is a quality company with a great philosophy, as demonstrated by its 80% market share. However, over the past few years, there have been some concerns. For example, the company's market share has dropped from 80% to 65% due to competitors such as Pinduoduo and JD.com. Not to mention, the recent regulatory issues.

However, because of that, the valuation has become more attractive recently and we felt that it was a good opportunity to add more to our holdings.

The US has blacklisted several Chinese companies. Although we are relatively less affected, how will we deal with these companies?

I think there are two key points here. You can look at the fundamentals, and then you have to consider what happens in reality. Theoretically, if you look at the fundamentals, sanctions should not have a serious long-term impact on a company. The long-term value of a Chinese company is not directly related to whether it has US-based investors. Of course, if the company has lots of business in the US, then that is another story.

The only companies we really invest in are Chinese companies focused on the domestic market. When the sanctions were imposed and share prices dropped, it actually presented an opportunity to increase our holdings. When shares in China National Offshore Oil Corporation were at their lowest, the dividend yield was 8%. For China Mobile, the dividend yield went as high as 7.8%, so in some respects, these shares were an excellent buy.

However, in reality, there are lots of investors, particularly fund managers and institutional investors, who find it difficult to increase holdings in these companies when share prices fall significantly. That's because foreign investors, US investors, US custodian banks, US regulators and overseas fund platforms are likely to object to this positioning, and clients will ask lots of questions.

How do you decide which companies have potential and whether valuations are reasonable?

First of all, valuations are often expensive – you can see that with companies that have a P/E ratio of 20, 30 or more.

In theory, popular brands have high valuations, while those who manufacture for others (contract manufacturers) should be cheaper. For example, Nike's valuation should be higher than Yue Yuen because Yue Yuen is just a contract manufacturer. In other words, there is a premium for brands that have a high market share. If we look at the sports wear industry, the leading brands are not Chinese companies

but rather Nike or Adidas. Even if these Chinese companies increase their market share, the bigger companies will still have a higher P/E ratio.

We do not normally invest in consumer brands that have a very high P/E ratio. If we look at our top 10 largest holdings, they are mostly consumer-oriented companies, and we have been investing in these companies for the past decade or so. The P/E ratios of these companies is around 20 or so – they have become more expensive recently. In the past, the P/E ratio was only around 10. However, this does not mean that they are inferior to the more expensive companies. Our team compares valuations – we call this “valuation conscious”. We do not purposefully look for cheap companies, but experience has taught me that companies that have unusually high valuations might not perform as well as you expect.

The China A-shares market outperformed last year. With that said, will you be increasing the proportion of A-shares in your portfolio?

There are both short-term and long-term considerations here. If we look at our China strategies, A-shares account for around 35% to 50% of the portfolio, a figure that has been steadily increasing over the last decade. 10 years ago, it might have only been 5%. There is a simple reason for this. The A-shares market is huge. When we are deciding how much to invest, in addition to looking at a company’s valuation, we also consider how much trust we have in the company. There are many companies on the A-shares market, but not all of them are quality companies. Some of them go off the radar after a couple of years. If you only look at the market cap and ignore all the other considerations, the A-shares market should account for about 50% to 60% of our portfolio, but unfortunately not all companies meet our requirements.

Over the next 6 to 12 months, are there any risks that we should be aware of when investing in China’s and Hong Kong’s stock markets, especially with the significant inflow of capital from China recently?

I have been following the Chinese market for the last two to three decades. Based on my experience, the best time to invest is when everyone else thinks the market is bad. Actually, around three years ago, many people were concerned about a hard landing, a property bubble, bad loans, zombie companies and oversupply, so they were not very optimistic about the A-shares market. Yet in my opinion, China is a huge market with huge potential. Every so often, people would say how the Chinese economy is in a great or terrible state. I am more of an optimist – that does not mean that I am extremely bullish, but I do not see a bubble either.

In recent months, people have rushed to invest in newly-listed companies. However, if you look at what happens afterwards, more than 90% of Chinese-listed companies are actually trading for less than the IPO price. Why is that? If you were a quality company, why would you wait until today to list on the stock market? Has today’s market become so attractive that all companies want to go public?

I am sure that there are some quality companies out there among the newcomers, but we prefer to adopt a cautious approach. That does not mean that we do not think these companies have potential, rather we like to think of it as getting to know a new friend – it takes time to gradually learn more about them. Same for newly-listed companies - there is an element of risk.

Besides that, there is lots of capital flowing into markets at the moment, which has both upsides and downsides. On the upside, share prices have increased and companies have found it easier to access financing. On the downside, too much capital can result in oversupply. It also drives down returns within an industry. For example, in the electric vehicles industry, everyone is raising capital. However, what can companies do with all this influx of capital? They will only compete with each other to expand production. Internet companies would spend huge amounts on acquiring new users. It is the same with the cloud computing industry and the education industry – they are all raising lots of capital. When you see things from this perspective, large amounts of capital can be detrimental. When capital is in short supply, everyone cuts capacity and prices increase. When there is too much capital, the opposite happens, but of course no one is talking about this at the moment. However, this is something that people should consider over the next one to two years.

Source: Company data, as at February 2021

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