For professional / institutional investors only

# TAPPING INTO A BROADER RANGE OF INVESTMENT OPPORTUNITIES AS CHINA MARKET OPENS UP

## RISK FACTORS

This document is a financial promotion for The First State China Strategy. This information is for professional / institutional investors only in the EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** Changes in exchange rates will affect the value of assets which are denominated in other currencies.
- **Single country / specific region risk:** Investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.
- **China market risk:** Investing in the Chinese market involves risks such as legal, regulatory and economic risks. The securities markets in China may be subject to greater uncertainty than investments in more developed countries.
- **Concentration risk:** Investments are made in a relatively small number of companies or countries which may be riskier than if investments are made in a larger number of companies or countries.
- **Emerging market risk:** Emerging markets may not provide the same level of investor protection as a developed market; they may involve a higher risk than investing in developed markets.

Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

**If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.**

## Introduction

The China equity market includes a myriad of share classes, each with distinct characteristics. 'Offshore' Chinese equities are listed on overseas stock exchanges such as New York and Hong Kong and denominated in foreign currencies, while 'onshore' Chinese equities are listed on the Shanghai and Shenzhen Stock Exchanges and denominated in RMB.

China's onshore stock market, particularly the A-shares segment, is much larger than the offshore component, with more than 3,600 companies listed on the Mainland exchanges, compared to around 1,200 listed offshore.

| | | | Currency | Total market cap | Number of stocks | Foreign investment restrictions |
|---|---|---|---|---|---|---|
| Onshore | A Shares | Chinese companies incorporated in mainland China and listed on the Shanghai and Shenzhen stock exchanges | RMB | US$6.4 trillion | 3,556 | Yes, but easing |
| | B Shares | Chinese companies incorporated in mainland China and listed on the Shanghai and Shenzhen stock exchanges | USD | | 99 | No |
| Offshore | H Shares | Chinese companies incorporated in mainland China and listed in Hong Kong | HKD | US$2.4 trillion | 262 | No |
| | Red Chips | State-owned Chinese companies incorporated outside mainland China and listed in Hong Kong | HKD | | 164 | No |
| | P Chips | Chinese companies incorporated outside mainland China and listed in Hong Kong | HKD | | 694 | No |
| | N Shares | Chinese companies incorporated outside mainland China and listed in New York | USD | US$1.0 trillion | 165 | No |
| | | **Total China Market** | | **US$9.8 trillion** | **4,940** | |

Source: Hong Kong Exchanges and Clearing (HKEX), NASDAQ, as at 31 October 2018

## Evolving China market access

Despite the size of China's onshore equity market, its shares are largely underrepresented in global portfolios. A closed economy and a history of capital controls meant that foreign investors have, in the past, had little opportunity to participate in the market.

Although the launch of the Qualified Foreign Institutional Investor (QFII) programme in 2002 permitted a small number of overseas investors to purchase China A-shares, trading was subject to strict preapprovals, licenses and quotas.

Restrictions have eased over time; and by the time of the launch of the Renminbi-QFII programme in 2011, the number of qualifying investors and eligible securities had expanded significantly.

However, it was the 2014 launch of the Stock Connect platform which marked a step-change for overseas investors. With Stock Connect, access to the China A-share market became much more straightforward.

Stock Connect provided a link between the Shanghai and Hong Kong stock exchanges, allowing foreign investors to trade selected A-share stocks on a daily basis without needing to apply for individual quotas, or be subject to minimum lock-up periods and capital repatriation limits. It also allowed Mainland investors to diversify their equity holdings and foreign exchange exposure by purchasing Hong Kong-listed stocks.

The launch of the Shenzhen-Hong Kong Stock Connect followed at the end of 2016; and at the same time, aggregate trading quotas were removed (but daily trading limits have remained). In early-2018, daily quotas quadrupled from RMB 13 billion to RMB 52 billion for Northbound trading; and from RMB 10.5 billion to RMB 42 billion for Southbound trading.

Stock Connect now covers around 80% of the market capitalisation of the Shanghai and Shenzhen exchanges – or around 1,400 companies. Foreign ownership of China A-shares has risen steadily (total shareholding value of Mainland companies via Stock Connect has grown to RMB621 billion[1]) and trading volumes have reached record highs.

RMB52 billion daily trading quota

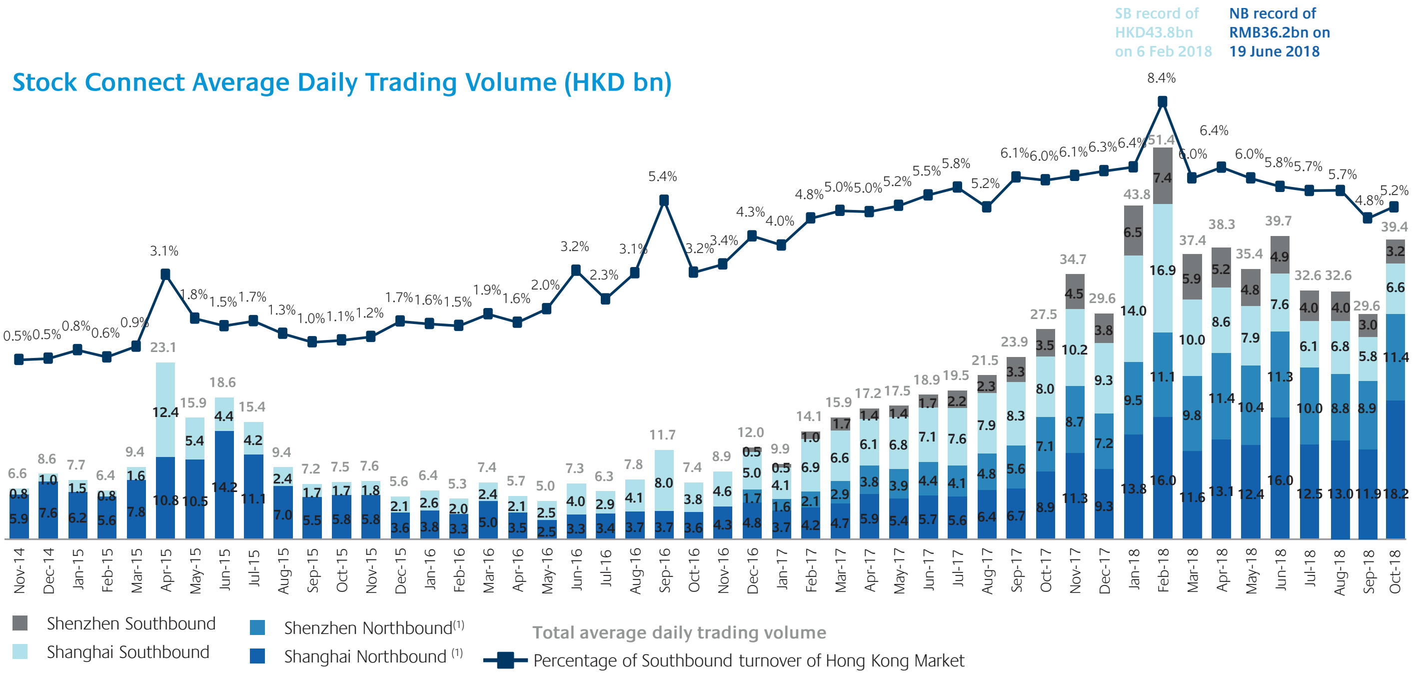
**Stock Connect Northbound trading:** Hong-Kong-based investors, trading securities listed on the Shanghai and Shenzhen stock exchanges

**Stock Connect Southbound trading:** Mainland China-based investors, trading securities listed on the Hong Kong stock exchange

RMB42 billion daily trading quota

[1] Source: Hong Kong Exchanges and Clearing (HKEX) as at 31 October 2018

### Stock Connect Average Daily Trading Volume (HKD bn)




(1) refers to Hong Kong Exchanges and Clearing (HKEX) Stock Connect, data as at 31 October 2018.

## China A-share inclusion in equity indices

Global investors can now choose to invest into the China A-share market via three market access mechanisms: QFII, R-QFII and Stock Connect. As a result, interest in the domestic China equity market has been growing.

In 2018, after a multi-year consultation period and a year-long planning interval, MSCI added approximately 230 China A-shares to the MSCI Emerging Markets Index over a two-phase process in May and August.

While the initial allocation was small – just 0.8% of the MSCI Emerging Markets Index and 2.3% of the MSCI China Index based on a 5% partial inclusion factor (PIF) – it represented an important milestone. A further consultation is underway, which could lead to a rise in the PIF from 5% to 20% for large-cap securities in 2019; ChiNext stocks to be added to the eligible exchanges in 2019; and mid-cap securities to be added in 2020.

According to MSCI data, Chinese equities could eventually comprise more than 40% of the MSCI Emerging Markets Index, with more than 13% weighted in China A-shares. For the MSCI China Index, the domestic equity component could increase to a third.

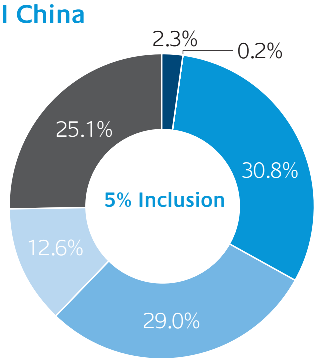
FTSE Russell, another major index provider, said that it would add China A-shares to its indices in three tranches starting from June 2019 and ending in March 2020. Inclusion would be based on 25% of the investable market capitalisation of eligible securities, currently designated by the FTSE China A Stock Connect All Cap Index. After completion of the first tranche, China A-shares will comprise approximately 5.5% of the FTSE Emerging Index and 0.57% of the FTSE Global All Cap Index.

As two of the main benchmark index providers for the industry, these developments mark an inflection point for Chinese equities. Although full A-share inclusion is unlikely to happen quickly, the next five years should see a steady progression towards full representation.

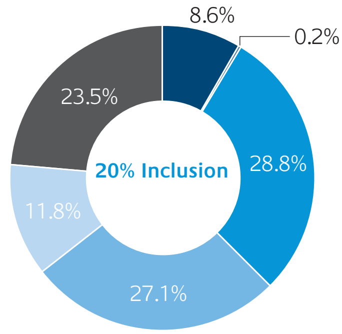
As index weightings change to better reflect the relative size of the China equity market in terms of market capitalisation and trading volumes, Chinese equities could eventually qualify as a standalone asset class.

## What might happen in the next five years?

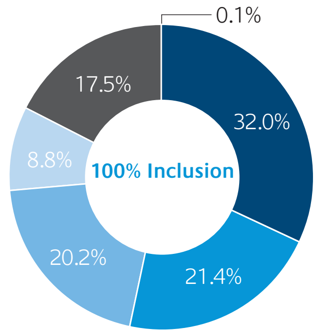
### MSCI China




| | |
|---|---|
| China A | 2.3% |
| China B | 0.2% |
| China H | 30.8% |
| China P Chip | 29.0% |
| China RED Chip | 12.6% |
| Overseas ADR | 25.1% |




| | |
|---|---|
| China A | 8.6% |
| China B | 0.2% |
| China H | 28.8% |
| China P Chip | 27.1% |
| China RED Chip | 11.8% |
| Overseas ADR | 23.5% |




| | |
|---|---|
| China A | 32.0% |
| China B | 0.1% |
| China H | 21.4% |
| China P Chip | 20.2% |
| China RED Chip | 8.8% |
| Overseas ADR | 17.5% |

Source: MSCI, First State Stewart Asia, as of 1st June 2018. Forecasted weights for 20% and 100% inclusion have been extrapolated from MSCI data.

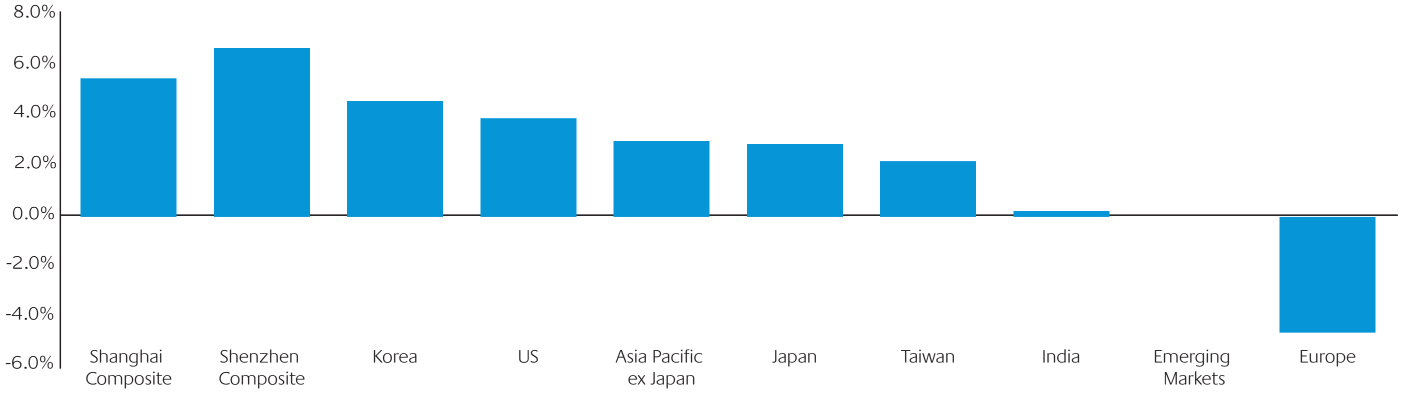
## The broadening opportunity set

The total China equity market, including both onshore and offshore equities, contains plenty of high quality franchises and growth opportunities for bottom-up stock selectors to choose from. Chinese companies have delivered strong earnings growth in comparison to major global markets in the US, Europe, Japan and across the Asia Pacific.

Consensus 12-month earnings growth estimates[2] for the Shanghai Composite is 13.4% at a valuation of 11.9x price-to-earnings (P/E). In the offshore market, the Hang Seng Index is trading at around 10.1x forward P/E with estimated earnings growth of 10.0%, while the Hang Seng China Enterprises Index is trading at 9.0x P/E with a growth outlook of 10.8%.

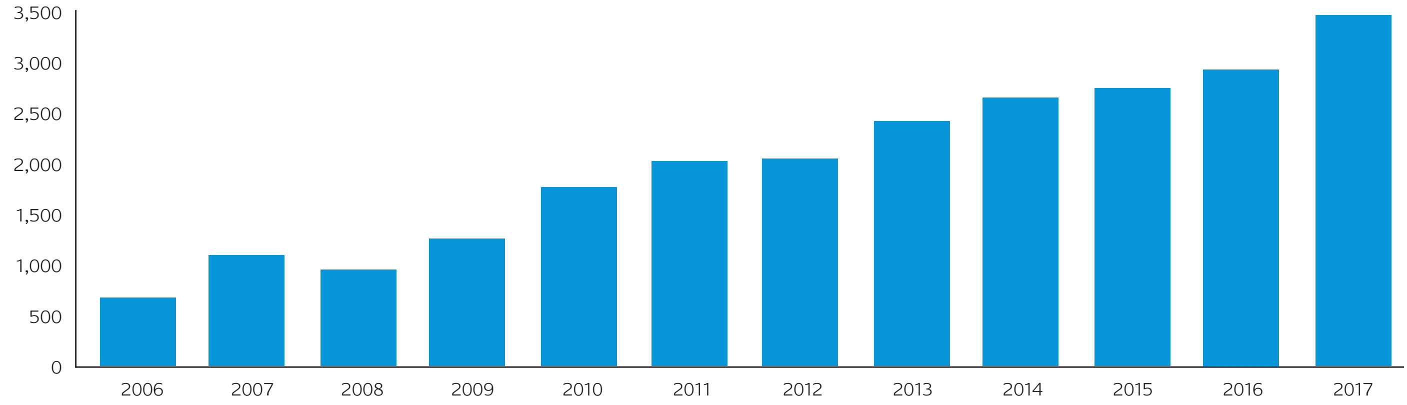
## China has delivered strong historical earnings growth

### EPS CAGR 2008-2017




Source: Bloomberg, First State Stewart Asia. Trailing weighted EPS growth as at 31 December 2017

### A-share aggregate earnings (RMB bn)




Source: FactSet

## Onshore vs. offshore

As investor portfolios might already include offshore Chinese equities, how would the inclusion of A-shares affect the asset allocation? Although there is some overlap – some companies are dual-listed with both an A-share and an H-share class – the broad-based A-share market covers a wider range of industry sectors and is considered to be more representative of the underlying Chinese economy.

For example, home furnishing retailers, housewares and general merchandise stores are exclusive to the A-share market, while others, such as food distributors and diversified real estate investment trusts (REITs) are part of the offshore H-share market, but are not in A-shares.

Within A-shares, there are also differences between the two main domestic exchanges. Due to historical reasons (proximity to the seat of government in Beijing, as well as being the hub for merchant trading since the late 1800s), state-owned enterprises (SOEs), large-caps and 'old economy' industries such as consumer companies, financials and manufacturers form the majority of the Shanghai Stock Exchange.

[2] Source: UBS Securities, Go-goal, IBES, as at November 2018

Meanwhile, the Shenzhen Stock Exchange, which includes the Main Board, the SME[3] Board and the ChiNext Board, contains smaller to medium-sized companies; and includes a greater number of 'new economy' and technology stocks.

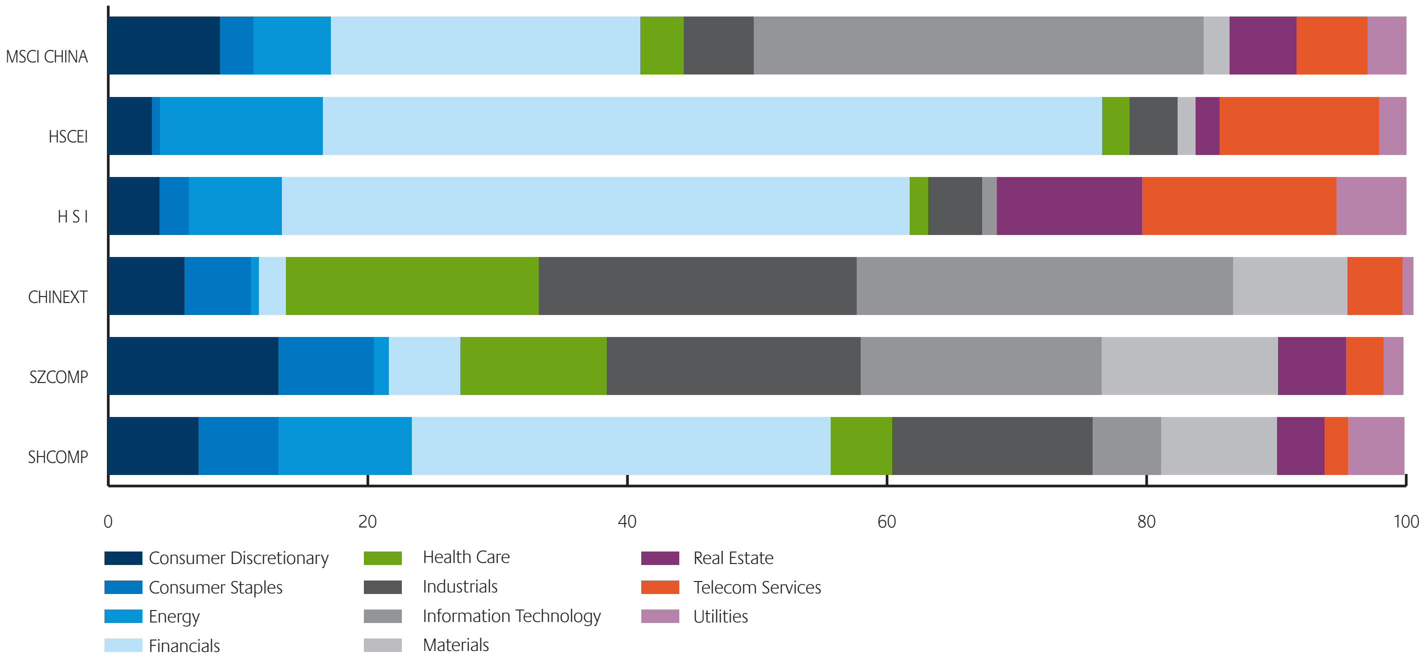
The ChiNext Board, in particular, is similar to the NASDAQ in the United States (or the AIM market in the United Kingdom) and allows fledgling growth companies to raise equity capital with more flexible listing requirements than the Main Board.

In the offshore market, H-shares are dominated by financials, mainly due to the major Chinese banks and financial institutions which chose to list in Hong Kong to raise capital outside of China. Red chips are skewed towards the energy and telecoms sectors, while P Chips and N-shares are predominantly focused on technology and consumer companies.


Note: Green colour indicates New China sectors

Source: Wind, FactSet, Goldman Sachs Global Investment Research

## China Indices - sector differences




Source: Bloomberg, FactSet, First State Stewart Asia, as at 31 October 2018.

[3] Small and Medium Enterprises

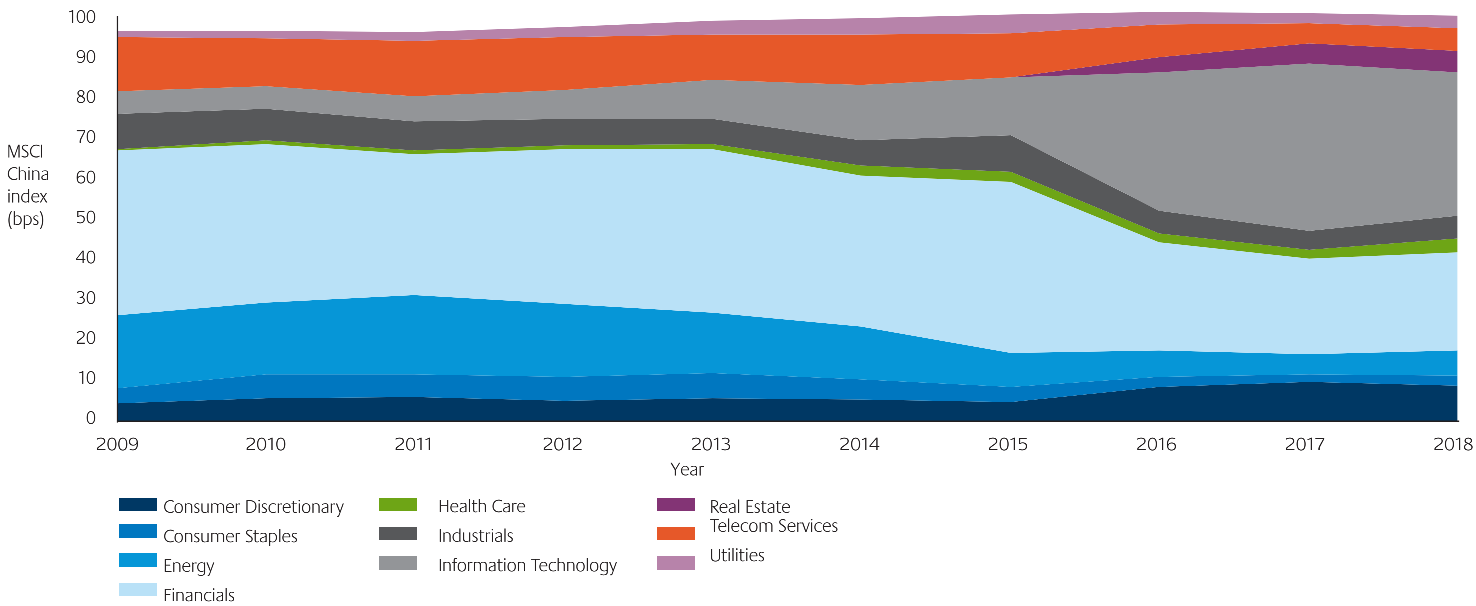
## Index concentration

A closer look at the MSCI China index and how it has evolved over the past 10 years highlight a few interesting observations. Historically, financials and energy companies were the largest constituents of the index.

However, more recent performance of the technology sector has boosted its relative weight in the index. Technology has now overtaken financials; and around a third of the MSCI China is now comprised of just three large tech companies: Tencent, Alibaba and Baidu.

Financials still comprise the second-largest segment of the index and together, almost 60% of the index is weighted to just these two sectors. We believe this reflects an unwelcome concentration of risk – and not truly reflective of the investment opportunities available to the unconstrained investor.

### 10-year evolution of the MSCI China




Source: FactSet, First State Stewart Asia, as at 31 October for each corresponding year.

## MSCI China Index

### Top 10 weights over time

| 2009 | Sector | Weight (%) |
|---|---|---|
| China Mobile Limited | Telecom Services | 10.5 |
| China Construction Bank Corporation Class H | Financials | 7.2 |
| Industrial and Commercial Bank of China Limited Class H | Financials | 6.8 |
| China Life Insurance Co. Ltd. Class H | Financials | 6.4 |
| Bank of China Limited Class H | Financials | 6.2 |
| CNOOC Limited | Energy | 5.1 |
| PetroChina Company Limited Class H | Energy | 4.8 |
| Tencent Holdings Ltd. | Information Technology | 2.9 |
| China Shenhua Energy Co. Ltd. Class H | Energy | 2.7 |
| China Petroleum & Chemical Corporation Class H | Energy | 2.5 |

| 2018 | Sector | Weight (%) |
|---|---|---|
| Tencent Holdings | Information Technology | 13.66 |
| Alibaba Group Holding Ltd | Information Technology | 11.57 |
| China Construction Bank Corporation Class H | Financials | 5.37 |
| China Mobile Limited | Telecom Services | 4.04 |
| Baidu, Inc. | Information Technology | 3.70 |
| Ping An Insurance (Group) Company of China, Ltd. Class H | Financials | 3.45 |
| Industrial and Commercial Bank of China Limited Class H | Financials | 3.30 |
| Bank of China Limited Class H | Financials | 2.38 |
| CNOOC Limited | Energy | 2.16 |
| China Petroleum & Chemical Corporation Class H | Energy | 1.46 |

Source: FactSet, First State Stewart Asia, as at 31 October 2018. Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell the same.

## A few considerations

The China A-share market is still relatively young and, like the overall Chinese economy, remains heavily influenced and directed by the government. This has led to some market idiosyncrasies that investors should be aware of.

Firstly, market participants are mostly retail investors, often trading on margin accounts which provide financing to leverage an investor's stock market exposure. Around 80% of the market (by trading volume) is comprised of small retail investors and day traders who tend to be more speculative and have a shorter-term mind-set. This is one of the key reasons for the A-share market's heightened volatility.

To combat this, general stock prices are subject to daily up/down trading limits of +/- 10%, which restrict an investor's ability to buy or sell securities during volatile periods. If a company's share price hits the price limit (either up or down), trading is automatically halted until the following day.

Companies can also voluntarily suspend trading of their shares, in an attempt to ride out market volatility and avoid investor selling. During the stock market rout in mid-2015, more than half of all listed A-share companies suspended trading in an attempt to stem outflows.

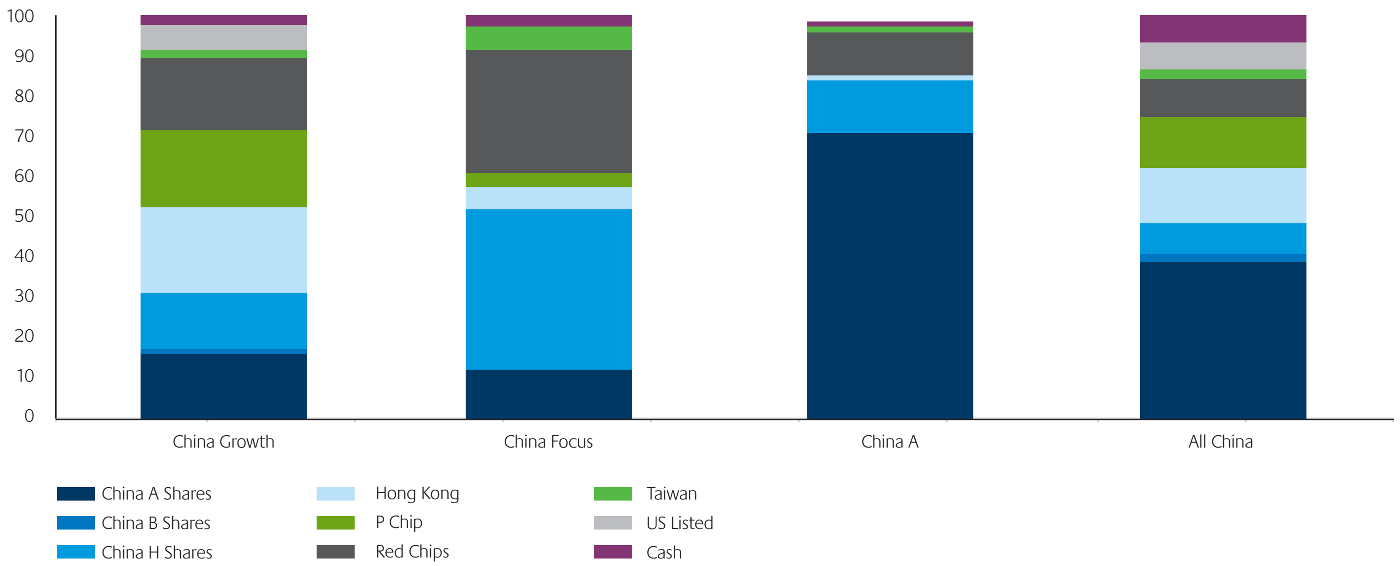
During these periods of market volatility, state-owned banks and brokers are often conscripted into 'national service', with state-mandated trading designed to support stock prices. National service can also be called upon to lift market sentiment ahead of important dates in the political diary.

These interventions distort the price discovery mechanism and lead to an inefficient market over the shorter term. However, this presents an attractive opportunity for active investors to generate alpha – by investing over a longer-term time horizon, using a fundamentally-driven investment approach and employing robust valuation models to identify mispriced stocks.

### First State China Fund Range

| | China Growth | China Focus | China A Share | All China |
|---|---|---|---|---|
| Inception date | May 1992 | January 2008 | October 2009 | March 2017 |
| Portfolio manager | Martin Lau | Quanqiang Xian | Quanqiang Xian | Winston Ke |
| Benchmark | MSCI China | MSCI China | MSCI China A | MSCI China All Shares |
| Number of holdings | 40-70 | 20-40 | 10-50 | 20-50 |
| Minimum market cap | Nil | USD1.5 billion free float | Nil | Nil |
| Typical A-share allocation | 20% | 15% | 70-80% | 40% |
| Fund structure | Dublin VCC | Dublin VCC | Dublin QIAIF | UK OEIC |

### First State China Fund Range




Source: First State Investments, as at 31 October 2018

## About the team

First State Stewart Asia is an autonomous investment management team within First State Investments, with offices in Hong Kong, Singapore and Edinburgh. The team manages US$23 billion (as at 30 September 2018) across a range of Asia Pacific and Global Emerging Market equity strategies on behalf of clients globally.

We are conviction-based, bottom-up stock selectors with a strong emphasis on proprietary research. Our goal is to identify high quality companies to invest in for the long term. We look for founders and management teams that act with integrity and risk awareness; and dominant franchises that have the ability to deliver sustainable and predictable returns over the long term.

We are conservative investors and define risk in terms of the permanent loss of capital, rather than deviation from any benchmark index. We believe that by investing in quality companies and holding for the long term, the risk to capital is greatly reduced.

## Investment approach

In summary, our investment approach is based on:

- Bottom-up stock selection
- Quality companies
- Strong valuation disciplines
- Long-term investing
- Absolute return mindset
- Benchmark indifference



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