PRESCIENT CHINA BALANCED FUND QUARTERLY COMMENTARY

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ENDLESS STIMULUS – AN ENDLESS BULL MARKET?

Q1 2021 saw a minor correction in the Chinese equity market, with the benchmark CSI 300 down around 1% in CNY. However, beneath the surface, the market has seen quite a large rotation. During Q3 and Q4 of last year, we mentioned the concept of 'mania' stocks. With over 4,000 stocks listed in China, more than 80% of active managers are only invested in roughly 70 – 80 of these stocks.

Although these are typically good companies, the investment case becomes weak when they're trading at PE ratios of between 50–150 and price-to-sales ratios of over 10. The rally of the portfolio of mania stocks resulted in the momentum factor trouncing all other investment factors over the past 18 months, with Q1 2021 being the exception. The rotation out of the portfolio of mania stocks and into the saner segments of the market finally began in Q1 2021.

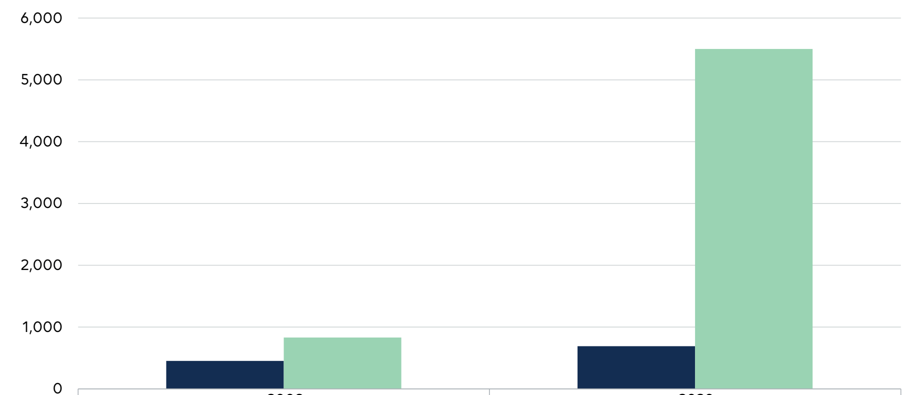
Overall, we view Chinese market valuations as reasonable, with certain sectors – such as consumer discretionary and technology – a bit more on the expensive side. Our diversified equity process is well suited for the current market environment.

With the Chinese economy recovering strongly, ongoing stimulus in China has been reducing. In fact, monetary policy in China has become more neutral, as it should be with strong economic growth expectations. Given this environment, a narrative has been building around how the US will outperform China and the Chinese market will fall from this point forward due to a lack of stimulus.

While we cannot say with certainty that such narratives are false, historically when Chinese stimulus was high, commentators also said the stimulus driven market rally was unsustainable. In other words, the Chinese market will always fall according to some commentators. Fortunately, actual market performance and our real experience over the past eight years prove otherwise.

Digging a little deeper, we compared the US and China's reactions to the 2008 global financial crisis with the COVID-19 crisis in 2020. The charts *Fiscal stimulus in Billions USD* and *Fiscal stimulus as a percentage of GDP* show fiscal stimulus in absolute numbers, as well as a percentage of GDP.

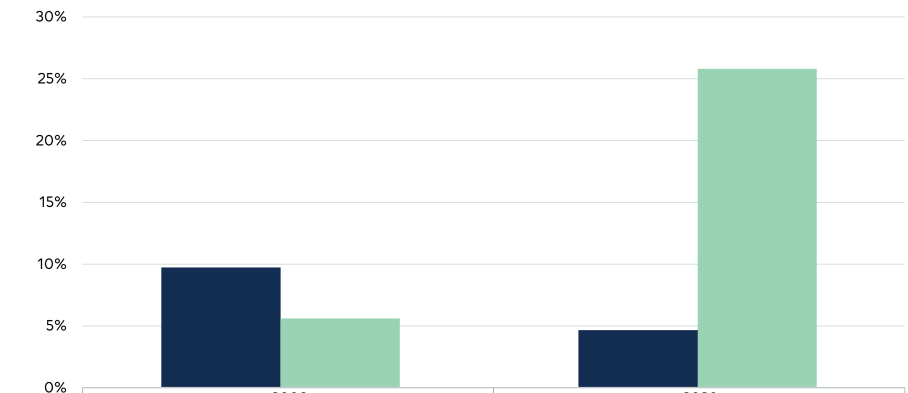
Fiscal stimulus in billions USD



	2008	2020
China	453	690
US	831	5500

Sources: Prescient, Bloomberg (as at end March 2021)

Fiscal stimulus as a percentage of GDP



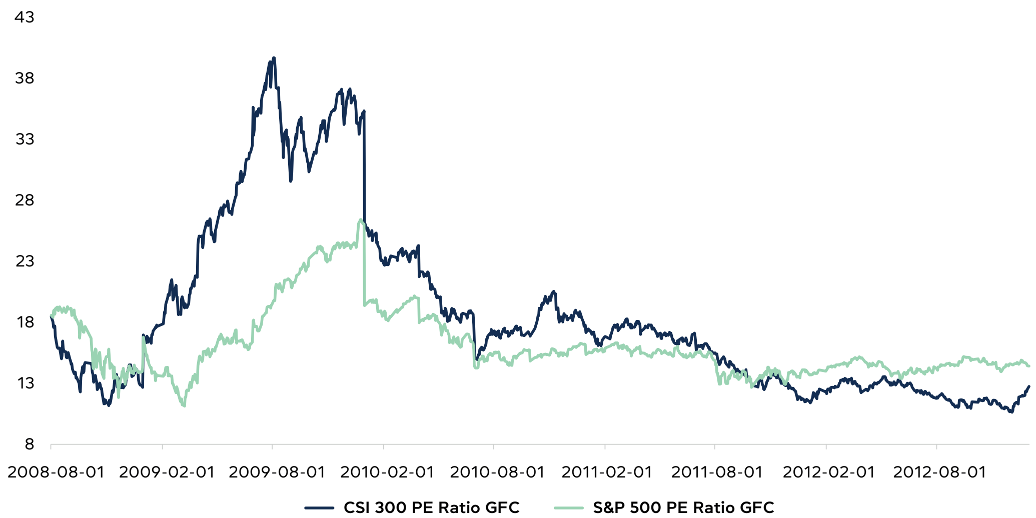
	2008	2020
China	9,87%	4,69%
US	5,65%	26,28%

Sources: Prescient, Bloomberg (as at end March 2021)

In 2008, facing an unprecedented drop in GDP growth, the Chinese government released a fiscal stimulus package of roughly US$453 billion, almost 10% of China's GDP at the time. During the same period, the US – facing a potential collapse of their financial system – came through with a US$831 billion fiscal stimulus package, which was around 5.6% of their GDP.

With significantly more stimulus in China compared to the US, the Chinese stock market went on an unprecedented rally, with PE ratios rising from 13 during the crisis to almost 40. US PE ratios, on the other hand, went from 13 to around 23 as a result of the stimulus. While both markets initially recovered well, the Chinese market produced returns that were almost double that of the US – thanks to the recovery on the back of a much larger stimulus package. However, the rally ran out of steam by late 2010, when China had to deal with the effects of large falls of overvalued stocks, overvalued properties and a major accumulation of debt in the financial system. Meanwhile, in the US, the more prudent stimulus was enough to get the economy growing again, setting it up for a bull market that lasted for the better half of the next decade.

PE ratio GFC



Source: Bloomberg (as at end March 2021)

So, what happened in 2020 when the US was spending over US$5 trillion in stimulus? The PE ratio of the US market exploded from around 15 during the crisis to 34 so far, with almost all measures pointing to it being the most expensive market in history. Is it different this time? We don't think so. If endless stimulus and low interest rates mean endless growth, Japan should be the most successful nation on earth, and a post-2010 China would not have had to deleverage. Is the US really that special?

PE Ratios after COVID-19

Source: Bloomberg (as at end March 2021)

Those who forget history are very likely to repeat its mistakes. Some commentators have said that the US is only expensive because of technology stocks. As such, China isn't as cheap as it seems. China also has a large technology sector and a consumer sector that is just as expensive. On an equivalent basis – if we exclude expensive technology stocks from the US and China – the US will still be at almost double the valuation of China.

Circling back to the Chinese market: we observe the following and are incorporating it into our asset allocation:

1. Valuations are high relative to China's history, but cheap relative to peers. In a world of low interest rates, valuations aren't extreme and should there be a meaningful correction from current levels, we will be adding equity exposure to our allocation.

2. On the economic front, we are currently in the strongest economic rebound since the stimulus of 2010. Despite the COVID-19 pandemic, China resumed production the fastest among the developing nations and with other nations on lockdown, its exports have been strong. Added to that, more than 100 million Chinese tourists also travelled internally, which boosted domestic demand.

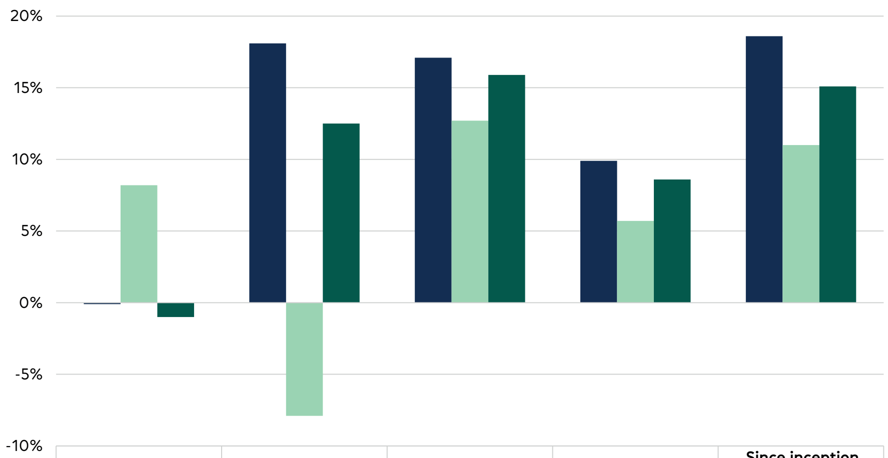
3. Sentiment is currently neutral, with flows still quite strong.

The Archegos collapse in the US highlights the extremes of momentum trading that we've seen in the past 18 months. Archegos' strategy was nowhere near unique – they merely took it to an extreme level. On a smaller scale, we've seen similar strategies across many 'star' managers' portfolios. With mania stocks currently falling out of favour in China, our process of having a diversified portfolio, combined with fast and efficient asset allocation decisions, positions us very well for the current market environment.

FUND PERFORMANCE

Post the fast-changing world of 2020, the Fund has done very well over the past 12-month period. The rand has been exceptionally strong relative to the USD, strengthening by around 25%; and even against the CNY, it strengthened by around 15%. Despite the rand's strength, the Fund was up 18.1% in ZAR for the past year – outperforming inflation by a wide margin; and the 65% equity / 35% fixed income index by 5.6%.

Prescient China Balanced Fund (USD C class) in ZAR net of fees (0.9%) – Returns annualised



	3 months	1 year	3 years	5 years	Since inception (1 April 2013)
Prescient China Balanced Fund	-0.1%	18.1%	17.1%	9.9%	18.6%
China CPI + 3%	8.2%	-7.9%	12.7%	5.7%	11.0%
65/35 Composite Index	-1.0%	12.5%	15.9%	8.6%	15.1%

Source: Prescient (as at end March 2021)
35/65 Composite Index: 65% CSI300 and 35% CSISTTNI

Our portfolio of well-diversified Chinese equities avoids concentrated mania stocks. Combined with dynamic asset allocation, it puts us in a good position to outperform. We believe returns from here are likely to be lower than the past eight years, simply due to the much higher valuations overall. Having said that, we are still quite comfortable that with our investment process, the Chinese market will produce exceptional-inflation beating returns going forward.