



Liang Du

Chief Investment Officer
Prescient China
BBusSci & MBA (UCT), CFA, CQF



Tian Pan

Head of Product
Prescient China
BBusSci (UCT), FIA, CERA

QUICK VIEW

The second quarter of 2021 was an eventful period for China considering market performance as well as domestic political milestones. Chinese equity markets showed solid growth over the quarter, with healthy rotations by market participants. Our flagship Prescient China Balanced Fund produced a USD return of 4.2% for the period after fees, while our Prescient China Equity Fund (same strategy used for the equity portion of our China Balanced Fund) produced a USD return of 7.3% after fees for the quarter.

The major domestic event in China for the quarter was the centenary celebrations of the ruling Chinese Communist Party (CCP). At Prescient, we have our entire China investment team based on the ground in Shanghai, China. With first-hand experience of developments in China, for this quarter, we wanted to bring a different perspective compared to conventional English media coverage.

CENTENARY CELEBRATIONS FOR THE CCP – COMMUNISTS OR CAPITALISTS?

July 1st, 2021 was the 100-year anniversary since the founding of the Chinese Communist Party (CCP), the ruling party in China since 1949. Typical English language media coverage has been fairly consistent across various media outlets, focusing on sensational headlines and lacking objective detail. With this in mind, we thought we would take the opportunity to cover a few interesting concepts highlighted in President Xi (pronounced “she”) Jinping’s centenary celebration speech.

These concepts should sound familiar to many Chinese readers, but we suspect they are quite unfamiliar to Western investors due to the significant differences in English language media coverage of China. In covering these concepts, we hope that our readers and clients will gain a deeper understanding of modern China, Chinese perspectives and thinking and the politically delicate issues of Hong Kong and Taiwan. Of course, this then leads to China's relations with the rest of the world.

President Xi's speech starts with a brief history of China and the role the CCP played in modern China:

For thousands of years, China played a central role in the world, being one of the largest economies on earth, yet by the early 19th century China, under its imperial monarchy system, closed to the outside world, fell drastically behind. When Imperial China attempted to halt the illegal opium trade by the British in the late 1830s, it led to the Opium Wars, where the British first punished China by military force in 1840 and forced the first of many Unequal Treaties onto China. With Imperial China getting weaker, the country was divided and colonised by many of the Western powers of the time. The CCP was founded in July 1921, after the Russian revolution of 1917 and when China as a nation was divided and *arguably* at its weakest. Through many sacrifices, struggles and revolutions, the CCP was finally able to "topple the mountains" of imperialism and bureaucratic capitalism to secure the independence of the Chinese nation.

It also managed to finally eliminate opium trade, more than 100 years later in the 1950s.

The second part of the speech moves onto the accomplishments and history of the Chinese economy:

The Chinese economy was established based on the principles of Marxism (*with historic influence from the Soviet Union*). Through advanced reform and opening of the economy, China developed its economic model into a unique style of "Socialism with Chinese characteristics".

What is this unique style of socialism? We view it as a strong market-driven economy with largely competent government involvement and support, so perhaps "Capitalism with unique Chinese socialist characteristics" is a better description for Western readers. Capitalism is somewhat of a politically incorrect word in China, but to get perspective, social benefits in China still have a long way to go to catch up to "capitalist" Australia, as an example.

Since 1949, China has changed from a centrally planned economy to today's socialist market economy; from an isolated country to an economy highly integrated with the rest of the world; from a poor, undeveloped and backward country to today's second-largest economy in the world. China has drastically improved the living standards of 1.4 billion people from merely subsisting to a level of "moderate prosperity". (*IMF GDP per capita (nominal) for 2021 at USD 11,819, more than double South Africa's USD 5,444*) This achievement shows China is "standing up and growing prosperous".

The third part of President Xi's speech talks to the future:

China aims to become a prosperous nation, with a focus on improving the livelihoods of its citizens while maintaining its "unique Chinese socialist system". President Xi talks to continuously working on the "Five-sphere Integrated Plan" and "Four-pronged Comprehensive Strategy".

Five-sphere Integrated Plan

- The five spheres are Economic, Political, Cultural, Social and Ecological development.

Four-pronged Comprehensive Strategy

1. Comprehensively build a moderately prosperous society
2. Comprehensively deepen reform – following scientific principles
3. Comprehensively govern the nation according to the rule of law
4. Comprehensively strictly govern the Party (CCP)

The overall aim is to promote coordinated modernisation of China across all components of the nation. A commitment was also made where China will remain committed to promoting peace, development, co-operation and mutual benefit with other nations.

President Xi emphasised that China never have, and never will, bully other nations but at the same time it will not accept being bullied and dictated to by any other nation. That China is eager to learn what other cultures have to offer and welcomes constructive criticism but will not accept “sanctimonious preaching” of a few (*referring to the US and selected allies*). With this, continued military modernisation is necessary to ensure it can protect the country and its citizens. (*The military part expectedly was the focus of many English media publications.*)

On the politically sensitive topics of Hong Kong and Taiwan, President Xi confirms that China will stay true to the letter and spirit of “One Country Two Systems” political structure for Hong Kong and Macao and re-iterated that resolving the “Taiwan issue” for final “reunification” with the Mainland as an unwaivering objective of the CCP.

The above is a selectively summarised version of President Xi’s speech that we felt would be interesting and useful for investors. We would like to cover some crucial points about China that perhaps many people in the West misunderstand. China is far from being a fragile country where the people hate the government and is on the brink of collapse. On the contrary, we have always maintained our view that China is a stable nation and investment destination. The CCP government has strong support from the vast majority of Chinese citizens, young and old. Even the older generation who suffered under the devastating cultural revolution acknowledge that China is currently on the correct development path. The younger generation, on the other hand, have only known improved prosperity and opportunity.

The Chinese people as a whole view themselves as the “good guys”, as they have worked hard for decades to pull themselves out of extreme poverty. Historically, having been looked down on by foreign nations since the opium war times, China has finally found its dignity after the “Century of humiliation” (yes, you can google this) and can now stand proud of its achievements.

China’s current development strategy is more comprehensive than portrayed; it is not only economic but also cultural and environmental. In recent times, the CCP’s success, including arguably the best COVID-19 response globally, means support for the government is at an all-time high. Government intervention in many areas such as online education, gaming and anti-monopoly practices for dominant technology companies are seen as positive interventions domestically given the high degree of trust in the government.

We believe China under the CCP government is going to be around for the foreseeable future. The CCP itself, having governed China since 1949, has gone through many changes and has a successful track record of adapting to change. Although not often heard of in the West, the CCP has helped build a stronger and more united modern China than most people see through the filtered lenses of traditional media. China today is certainly not the communist China it was in 1949; how capitalist China is today is debatable. At Prescient, we are excited to see the future progress of modern China under the “unique socialist” system that will most likely change beneath the surface to adapt to future changes in the world.

CHINESE MARKETS & MANIA STOCKS

After a weak Q1, Q2 was comparatively great, with the CSI300 index up almost 6% for the quarter. Even though the index performed strongly, beneath the surface, certain stocks suffered greatly.

We have been speaking about mania stocks for the past five months, and we are glad to report that initial changes are certainly happening in the Chinese market. One of the mania companies we previously pointed out was SF Holdings, one of the best Chinese logistics and delivery companies.

SF Holdings



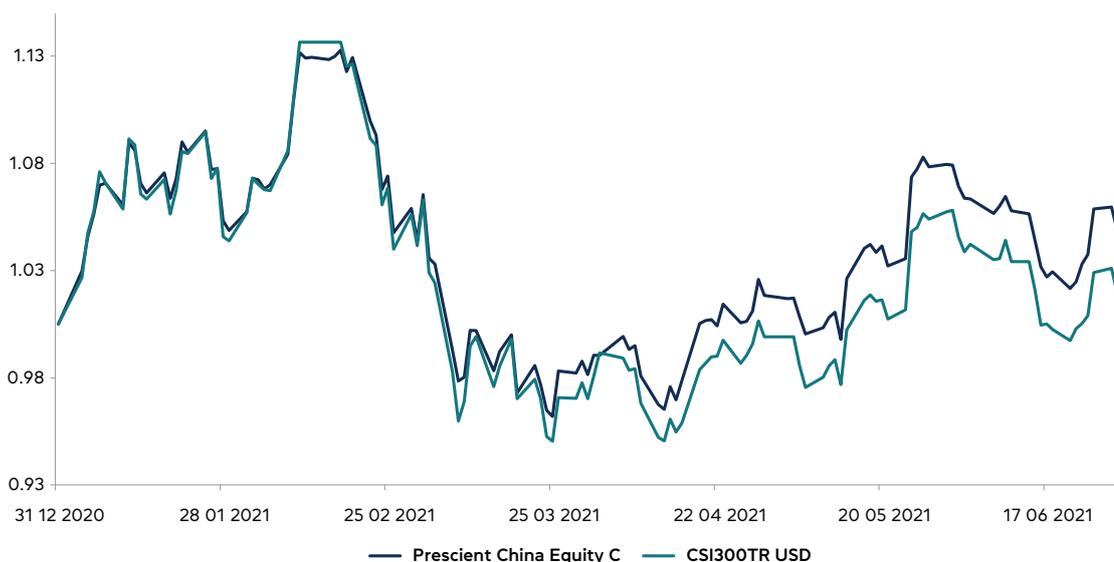
Source: Prescient, Bloomberg (as at 9 July 2021)

Being one of the favourite holdings of many active fund managers in China, SF holdings was trading at a price-earnings (PE) ratio of over 70, price-to-book ratio of 7 and a 12-month return of 155%, as at the end of January 2021. SF Holdings has corrected by over 45% since its peak, and the current PE ratio is still at 50. SF holdings is not a technology company, even though it has some great operational systems and assets. The same is true for a significant portion of stocks in China at the moment, which is why we remain cautious in our portfolio holdings and typically have underweight positions on similarly valued stocks.

FUND PERFORMANCE

By sticking to our investment process and avoiding mania stocks, our Prescient China Equity Fund was able to steadily gain some alpha over the quarter. Year-to-date, our China Equity Fund has outperformed the index by 2.6% after fees. Our Prescient China Balanced Fund also benefited as its equity portion follows the same strategy.

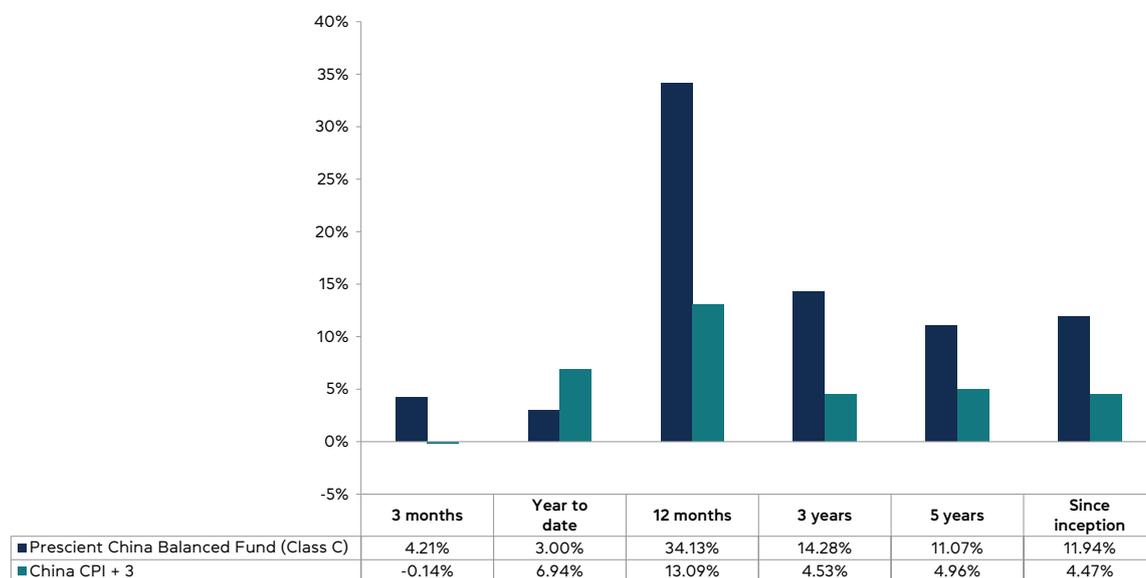
2021 year-to-date Prescient China Equity (Class C)



Source: Prescient, Bloomberg (as at 30 June 2021)

Despite a lot of media noise surrounding potential regulations of tech giants in China, Q2 2021 was a great quarter for the Prescient China Balanced Fund; the Fund was up 4.2% for the quarter and up 34.1% for the past 12 months in USD after fees.

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



	Fund	Benchmark
Highest rolling 1 year	116.02%	14.87%
Lowest rolling 1 year	-22.32%	-2.43%

Source: Prescient, Bloomberg (as at 30 June 2021)
Inception date: 31 March 2013

Our diversified approach and benchmark to mainland China (CSI300) rather than offshore China (MSCI China), where most technology companies are, resulted in smoother returns for the quarter as the impact of the correction in large technology shares such as Tencent on our portfolio was negligible.

LOOKING AHEAD

Where does the regulation go from here? China is the first country in the world to try and tangibly tackle the giant tech industry. It is focussed on two main areas; the first is the issue of monopolistic anti-competitive practices because monopolies result in higher prices and less competition. The second part is data privacy and the use of big data, ensuring that the data of individuals are protected and not used for nefarious purposes.

One of the reasons Didi has been raked over the coals is precisely because of the detailed (often proprietary and confidential) map data it has of China and the issues regarding the privacy protection of its users. Didi can hypothetically trace where any of its users are at any given time. What does this all mean? Well, if the investment thesis is based on monopoly profits, perhaps these profits will be harder to monopolise, meaning lower multiples for the tech giants. However, there is no doubt that reining in monopolies will result in the healthier development of the industry over the long term, more innovation and ultimately more productivity. Having said that, all of the big tech companies in China that have seen large corrections are now trading at far more reasonable levels compared to just six months ago.

SUMMARY

We continue to be positive about the long-term development of China and the Chinese financial markets. With such strong performance recently, do not be surprised if the market calms down a little; we certainly do not expect forward returns to be as strong as those experienced in the recent past. As one of the cheapest markets in the world right now and with one of the most stable governments combined with a lot of policy room to adjust, we do think that China remains one of the most attractive propositions to global portfolios.

Until next quarter, keep well and rational in these crazy market circumstances.

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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 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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