CHINA A-SHARES – AN UPDATE WITH THE MANAGER

Investing in China brings both opportunity and risk. Here, Sophie Earnshaw, manager of the China A-shares Strategy, discusses how she navigates this conundrum.

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Qian Zhang (QZ): Hi. My name is Qian Zhang, and I'm a director in Baillie Gifford's Clients Department. Welcome to this video session on the China A-shares Strategy. Getting China right is likely to be one of the most important tasks for every investment professional in seeking returns for the next decade. But investing in China poses a conundrum. On one hand, China's state dominating system poses specific macro risks, but on the other hand, it's a rich hunting ground for growth opportunities.

When looking at listed companies with a market cap of two billion, not above, 1 in 10 Chinese companies have grown their profit by fivefold in the past five years, versus 1 in 20 globally. As long-term stock pickers in Baillie Gifford, we find the A-share market is increasingly offering us unique and exciting investment ideas that aren't found elsewhere.

In today's session, we invited Sophie Earnshaw, Investment Manager of our China A-shares Strategy, to share her views on the asset class, how she picks stocks, and navigates between the risks and opportunities in China. So, Sophie, thank you for joining us today.

Sophie Earnshaw (SE): You're welcome.

QZ: The first question we'd like to ask is on the asset class level. If I'm an asset allocator, looking for the long-term returns, why does an allocation to China A-shares make sense?

SE: Ok well, I think an allocation to China A makes sense for a number of reasons. So, first, size. The A-share market is the second largest stock market in the world with over 4,000 listed companies. These companies are the backbone of China's economy, the second largest economy in the world. Second, I see growth potential. So, these companies represent a large portion of the growth opportunities available globally. For example, more than a quarter of the world's most growthy companies are listed in the A-share market. Third, scarcity. So, if you want exposure to new China and to China's next decade of growth engines, you need exposure to A-shares. For example, stocks with exposure to industrial upgrading, IT and advanced materials, and renewable energy are only found really in the A-share market. Fourth, diversification. So, MSCI ACWI's A-share weighting is less than 1 per cent. Even in emerging markets (EM) A-shares are still less than 4 per cent of the benchmark. So, investing in global funds or EM funds doesn't give you A-share exposure. And A-shares are actually a rare diversifier from an asset allocation perspective, so correlation to global and US equities is generally below 0.5.

QZ: Thanks. You mentioned several unique new China themes. While most of the world is actually expecting China's GDP growth to slow down, after many years of very fast development, are you expecting these themes to grow throughout cycles?

SE: Yes. So, in Baillie Gifford, we've always been interested in innovation and disruptive change, no matter where it might occur. And it's actually this intellectual curiosity that continues to draw us to China, and the innovative companies and investable themes that it produces. Now, the types of companies we're investing in, in the A-shares Strategy, are those that have big structural growth opportunities ahead of them.

So, these opportunities should persist, regardless of the overall level of GDP growth in China. I'll take some examples. So, the first would be the green revolution. Now, this opportunity could be, we think, much larger than the opportunity historically in e-commerce or the platform economy. And this is because the opportunity here is global, as well as local.

So, let's take solar. Around 80 per cent of the global solar supply chain is in China, from the production of polysilicon, to cells, to modules, to inverters. The green revolution, therefore, globally needs China, and this has already provided us with great investment opportunities in A-share companies like LONGi Green Energy and Sungrow Power.

China also dominates the production of new generation batteries. So, these are essential in transitioning our cars, machines, and power tools away from fossil fuels. So, close to half of the world's electric vehicles (EV) fleet is in China now. The speed of adoption is incredibly impressive, so around 25 per cent of China's new car sales are now EVs. This is up from 3 per cent only three years ago. And remember, again, this is the largest automobile market in the world. As with solar, the battery supply chain is incredibly China-centric.

And that's given us, again, great investment opportunities in companies like CATL, a leading battery maker, and Zhejiang Sanhua, a company that makes heating systems for cars, as well as homes and factories. Now, people may not have heard of a lot of these companies, which actually brings me on to what China is calling 'little giants'. So, these are companies that are developing advanced expertise in a whole host of strategic areas, like advanced manufacturing, industrial upgrading, environmental technology, and semiconductors.

Now, these companies don't typically make the headlines, but they're very much exposed to some of the bigger picture growth trends that I mentioned. They also have technological edges in niche areas, which means that their growth should be profitable, whilst alignment with policymakers is also strong. Therefore, despite flying below the radar, a lot of the little giants we've come across have been growing their revenue and earnings at phenomenal rates.

And as you said earlier, our analysis of company fundamentals, over time, continues to point to China as a place to find high growth companies.

QZ: That's very good to hear. And you mentioned that, it's true, most of the A-shares' stocks are not very well known by international investors. Can you talk about how you do your research on these companies?

SE: Yes. There are more than 4,000 listed A-share stocks, and we only own 25 to 40 of them in our A-share Strategy. So, our process is all about discovery, not coverage. So, the A-shares Strategy is purely stock driven, focusing on a small number of exceptional growth companies with the potential of delivering outlier returns.

So, we're looking for potentially five times upside in the shares over five to ten years, and for the majority of this growth to come from operational performance. Our approach is also very long term, and this is in sharp contrast with the extreme short termism of the A-share markets. We believe companies that meet our growth and quality hurdles are rare, but that they will be the major driver of portfolio returns in the long run.

Investing passively in this market by owning an index doesn't make sense to me, as it gives you large exposure to state owned and low-growth enterprises. For us, stock picking is absolutely crucial, as it allows you to pick the very best companies that China has to offer. And I'd say being able to stick to our long-term philosophy is also critical, as the outlier growth we're looking for won't be linear.

But how do we do this? So, we believe to perform differently, we need to think differently.

So, instead of relying on quarterly earnings reports or Wall Street, we try to differentiate our sources of information. So, we rely instead on a network of academics, industry experts, founders, and private companies, both in China and globally, who crucially think along the same timeframe as us. So, we have a local research platform in Shanghai. This brings us closer not only to the companies in which we invest, but also to local academia, which helps us to understand the policy trajectory in key sectors. And then out with Shanghai, we also draw upon Baillie Gifford's global network of academics, founders, and industry experts, which further deepens our insight. And we believe it's actually this combination of local, on the ground insight with global perspectives that gives us an important edge.

Baillie Gifford's, I think, long history of research in growth companies, its reputation as a patient, long-term investor, as well as our strong academic connections not only deepens our understanding of big picture trends within China and the competitive environment, in which Chinese companies operate, but it also provides geopolitical context and encourages global best practice, when we think about, for example Environmental, Social and Governance (ESG) in relation to our Chinese holdings.

QZ: Well, thank you for sharing your enthusiasm about stock picking in China. On one hand, yes, indeed, there is an exciting opportunity set, as you mentioned, but on the other, China does tend to polarise opinions nowadays and for the most recent two years, we have actually lived in quite a tough macro environment. Can you also share with us how the team navigates through some of the specific China-related risks?

SE: Yes. I think there are three main China specific risks, and I think these are domestic policy and geopolitics, ESG, and then macro. So, first on domestic policy, and geopolitics. One of the things we've learnt from investing in China for almost three decades is that one needs to invest in companies that have clear policy alignment, as well as a profit motive.

So, it's why, when we analyse Chinese companies the first question we ask is, does this company contribute to or benefit from China's economic, environmental, or societal development? And what is the global context? So, if the answer to the first part of this question is no, and we don't think the company is broadly aligned with China's next decade of policy priorities, we typically don't invest.

Now, the second part of the question deals with geopolitics. So, how are the companies we invest in likely to be impacted by things like sanctions, an escalation of tension in the Taiwan Straits, chip constraints, supply chain reshoring, etc. But here, how do we gain insight into both parts of this question? That's crucial, I think. And here, I'd refer you back to the network of on-the-ground local sources and global contacts that we've built up over almost, as I said, three decades of investing in China.

The second risk factor I'd say is ESG. So, our universe is one of around 4,000 companies, yet we invest in only 25 to 40. Why is that? Well, it's because we're only looking to invest in companies that have the highest standards of ESG and are committed to further improvement. Now, we think ESG matters when you're investing on a 5 to 10 year time horizon, as it contributes to returns. Companies that treat all stakeholders well are likely to deliver higher returns to shareholders. So, running a concentrated portfolio and only investing in the best of the best, allows us to avoid some of the ESG pitfalls that are associated with the broader index, and, we hope, deliver higher returns to clients.

Third, I'd say macro. So, our focus is on finding companies that can deliver outlier growth potential. So, companies that can increase the size of their business fivefold over a 5 to 10 year time horizon.

Now, the vast majority of the 4,000 listed companies in the A-share index won't meet that growth hurdle, and we're only looking to invest in those with the potential to do so. So, it's why, in our 25 to 40 stock portfolio, we have no direct exposure to lower-growth sectors, such as property, banks, or energy. Instead, we've got large holdings in sectors where growth is likely to be strong, regardless of the overall level of GDP growth. So, sectors like new energy, industrial upgrading, advanced manufacturing, and domestic brands.

I think, more broadly, I'd note that it's been a very difficult two years for most China investors, and there remain risks around the asset class that are very difficult to forecast. So, it's likely that volatility will remain high for the foreseeable future. I'd say that drawdowns in this market are not uncommon and should be expected over shorter periods. It's why, again, it's incredibly important, particularly when investing in China, to have a long-term mindset.

Now, that being said, sentiment appears to be remarkably negative at the moment. One step that I think demonstrates this is as follows. China's weighting in MSCI ACWI, a global index, is less than just one American company, and that company is Apple. Now, that doesn't feel quite right to me for a country, which has given us the one of the biggest economic miracles of our time, is still committed to growing the wealth and income of its people, and has invested huge amounts in research and development and in building leading-edge next generation infrastructure.

Here, an example that illustrates. So, China has around 75 per cent of the world's 5G stations. Now, if you think… this is how I think about it, 3G brought us Tencent and Alibaba, 4G brought us Byte Dancing and live streaming e-commerce. What will 5G bring us? Autonomous driving, fully automated factories, what else? I think we need to be open minded about the opportunities that China presents to bottom-up stock pickers.

And let's not forget, China still has at its disposal a resource that no other country has, and that's a vast population that has lived through unprecedented amounts of change, and consequently, has developed an astonishing propensity for adopting and adapting to innovations at a speed and scale that's actually unmatched really anywhere else on earth.

QZ: That's really true, but would you think the timing is now for a reallocation to China A-shares.

SE: Well, Baillie Gifford doesn't pretend to be good at market timing, and things can always get worse. But what I would say, is that sentiment does appear to be very negative towards Chinese assets at the moment. More importantly, at the portfolio level, we're seeing a disconnect between the valuation and the fundamental operational progress of the companies we hold. For example, the average forecast earnings growth of our portfolio is around 65 per cent higher than three years ago, but the multiples are lower. So, operational performance has not necessarily been rewarded.

QZ: Thanks, Sophie. That's a very good note to end on. I hope everybody has found this helpful. If you have any questions, feedback, or follow-ups, please do get in touch. Thank you very much.

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Annual Past Performance to 30 September Each Year (Net %)

	2018	2019	2020	2021	2022
China A-Shares Composite	N/A	N/A	68.8	17.4	-31.7
MSCI China A Onshore Index	N/A	N/A	31.7	18.4	-27.3

Annualised returns to 30 September 2022 (Net %)

	1 Year	Since Inception
China A-shares Composite	-31.7	12.1
MSCI China A Onshore Index	-27.3	3.4

Source: Baillie Gifford & Co and relevant underlying index provider(s), US dollars. Inception date: 28 February 2019.

Past performance is not a guide to future returns

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