Baillie Gifford™

China
Q4 investment update

January 2024

Investment manager Linda Lin and investment specialist Ben Buckler give an update on the China and China A Shares strategies covering Q4 2023.

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Ben Buckler (BB): Hello, everybody. Thank you for joining us here on what is our quarterly update for China and the China A Share Strategies. I'm Ben Buckler, one of the investment specialists on the [strategies], and I am very excited today to be joined by Linda Lin, a partner of the firm, and one of the managers on both of these strategies.

Linda has just returned from being in our Shanghai office for the last four years. So hopefully today we can look at both the global elements of looking at China, but also have some of that local input as well. Welcome Linda.

Linda Lin (LL): Thank you.

BB: I might start by throwing the tricky question at you of 2023. We started the year with much expectations. We had a Covid recovery. We had the consumer expected to come back. We had regulation arguably now turning from a headwind into a tailwind. The same could be said of Q4. And yet we sit here in both 2023 and Q4, the market was down suggesting that the kind of expectations weren't met. I might just throw it your way to see what you think happened last year.

LL: Thanks, Ben. Firstly, it's nice to be back. I probably see off from that our focus remains on funding the best growth companies in China, which involves [being] very active and engaged [with] a small number of companies, not trying to draw broad generalisations of the big picture in China. But it's also right [that] the market has been dominated by the concerns over the domestic economy recovery, the regulation backdrop and the geopolitical risk over the year.

When we're talking about the domestic economy, as much of it is about consumer confidence. Chinese consumers, they have money, but [they're] not spending it. In a weaker economic condition, the private companies are not investing or hiring. The troubles over [the] property sector remain an overhang for some time. I think that things have improved gradually in 2023, but the market doesn't like gradual.

We continue to expect a recovery in 2024, giving a more stabilising property market and the expectations and the valuations for China are so low now. So there is a chance that we get [a] positive surprise.

BB: It definitely looks more exciting for 2024 from here. Domestic economy again recovering, but gradually. Geopolitics arguably is looking more positive after the meeting that Xi had with Biden last quarter, albeit we should probably acknowledge Taiwan elections coming up, so there'll be a lot of noise around that space. But the main one, I think, is this regulatory backdrop, and that's what's concerned a lot of people.

What are the companies telling us about the regulatory backdrop, particularly in big tech, where for the last two or three years it's really been quite problematic?

LL: Yeah, I think for big technology companies, it has been a very tough few years for them. Even though we think most of the policies are positive for long term sustainability, there's no doubt [that] poor communication about the regulation implementation [is putting] a big risk premium over this asset class. So for the big tech [companies], interestingly, the big change we have seen and also heard learning from the founders in the past year – especially after July when the new premier Li Qiang spent some time with those founders – [is that] the general tone is getting more positive.

I think those founders think the policy towards private companies actually changed to the positive side of the story. We got the same message from meeting the new Alibaba chairman, Joe Tsai, in our Edinburgh office in November. This will bode well for the companies in our portfolio like Alibaba and Tencent. Two of them are still going to be very important players in China's digital transformation in the next decade.

So there's ample room for them to grow if the confidence is back, and they will be growing at a much cheaper valuation. So I will say I'm becoming more confident about the policy for big tech, but we are having growing concerns for the financial sector, [in] which both of our strategies are underweight, and also for health care where we should be more stock specific and doing more work.

BB: I think that's probably right, trying to understand that regulation is much more like a pendulum that will shift between innovation and regulation dependent upon the different sector, the different relevance to the government, for example, and its own goals.

LL: Yeah.

BB: For big tech, I'll just go back to what you're saying because that seemed to be the direction of trend. That's what Bytedance were telling us, as you say, that's what Alibaba said. But then at the end of Q4, we had this draft proposal for online gaming that seemed to have taken the wind out of Tencent, NetEase and companies in that sector.

Do you have any quick thoughts on that? Because I know many will point to that as being just another step in the regulatory cycle.

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LL: Firstly, I think it’s all about communication and also for us it's too early to draw a final conclusion. As you’re probably aware, a day after that announcement the regulator came out to emphasise that the announcement actually was for seeking the advice from stakeholders and trying to improve the sustainability of the industry. And then they immediately issued some of the gaming licenses to the companies, including NetEase and Tencent.

So I think after a few years the market has zero tolerance of any government interference. What is worth [mentioning] is that Tencent's management team doesn't think this announcement will change the underlying business model for the gaming industry in China, but it has drawn a clear boundary for the companies who are actually providing the services to younger gamers.

BB: I think it is clearly a problem more of communication than it is of actual regulation. And from what we hear, the person responsible for that draft proposal is no longer in his job as well. So as that's moved on and I should probably say for our clients that when we look at performance over Q4, despite the problems that happened by Tencent and NetEase, actually they don't show up as top contributors or top detractors during the quarter and therefore it washes its face a little bit.

If I maybe just extend the performance discussion a little bit longer, and clearly for both Q4 and 2023, an environment in which you have a slow domestic economy where people are hiding in state owned enterprises and sectors like utilities and financials are the top performers, that's not typically a good environment for growth managers with a governance focus. Would it be worth just maybe saying a few of your thoughts around how that plays out?

LL: Sure. Firstly, I think the performance is not what we would have expected, but like you said, there are some reasonable arguments for us to see locally. I think firstly the local investors are hiding in the SOEs, giving this market uncertainty. But for those types of companies, they are either lacking growth or they are having many governance issues. That's not the type of the company we like.

Secondly, we think there is an over focus on the macroeconomic condition. You probably agree with me how much we have heard about the property sector in China. But both of our strategies have very little exposure to [this]. So the market is trading on sentiment rather than the fundamentals. But this doesn't change our goal to fund the next generation of future winners in different industries [that] can outpace peers. And we need to stay patient with them.

I'm also comforted by, for most of [the] companies in our portfolios, the operational performance [is] very strong. What we have seen is a derating in the portfolio.

BB: Can I perhaps test you a little bit further? So I think that's the most exciting bit for us is that, you know, we can almost ignore what people are saying about the macro, it doesn't matter about first quarter GDP numbers, fundamentally, these disruptive secular trends that deliver long term returns are evident in China, and many Chinese companies are leading that globally.

So the kind of areas that we get excited about are not necessarily the ones that often get talked about more broadly. If we're looking at 2024, our portfolio, what excites us, what we've been doing, perhaps we can say a little bit about that.

LL: Sure. The key point to make here is we are a growth manager, excited that there are some reasons to get excited at [the] macro level, because China actually contrasts with the rest of the world. But more importantly, regardless of macro, there are some companies creating lots of wealth. That's what we should stay [focused] on. The glance across the portfolios actually can tell us a much more positive story, rather than one painted big picture of the macroeconomics of China.

Some of our portfolio companies show very strong revenue growth in this quarter, including PDD and Moutai, and some of the companies actually show a very strong journey to profitability, for example, Megmeet. Our A Share Strategy has a lot of exposure to several growth areas, including the rise of domestic brands, future energy transition, advanced manufacturing and automation. And for our China Strategy, we [have] exposure to the platform companies now enjoying [a] much better regulation environment.

So during this quarter, we add to PDD to bring it to a more conviction level to show our confidence in its long term strengths. And in [the] auto sector, we are changing our weighting in different holdings to show what we like in the long run; the strong local brands with technological advances. So we added to BYD by selling Geely.

And also there are some more interesting areas where we're exploring the new ideas, including the humanoid robotic area. By learning from our global holding Tesla, we think this area will bring huge supply chain opportunities in the next few years. That excites us.

BB: But I know myself from speaking to our Shanghai team just how excited they are about some of the things that they have on their agenda coming up. But as you say, with valuations, fairly low domestic economy starting to pick up, geopolitics potentially improving around better communication, we hope that that brings together to make 2024 the year that we thought 2023 was going to be.

Hopefully that is an insightful understanding of how we saw last year and Q4, as well as what makes us excited about the year ahead. We thank you for joining us. Goodbye.

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China (including China and China A Shares strategies)

Annual past performance to 31 December each year (net%)

	2019	2020	2021	2022	2023
China A Shares Composite*	N/A	89.5	-2.8	-29.0	-24.4
MSCI China A Onshore Index	N/A	40.3	4.2	-27.1	-11.5
China Equities Composite	33.9	60.8	-18.2	-27.7	-19.5
MSCI China All Shares Index**	21.5	33.6	-12.8	-23.5	-11.4

Annualised returns to 31 December 2023 (net%)

	1 year	5 years	10 years	Since inception
China A Shares Composite*	-24.4	N/A	N/A	3.9
MSCI China A Onshore Index	-11.5	N/A	N/A	0.8
China Equities Composite	-19.5	0.5	3.5	N/A
MSCI China All Shares Index**	-11.4	-0.8	2.3	N/A

*Inception date: 28 February 2019.

**(MSCI All China prior to 27 November 2019, MSCI Golden Dragon prior to 2 May 2019).
Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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