Baillie Gifford™

China
Q3 investment update

October 2023

Investment manager Sophie Earnshaw and investment specialist Qian Zhang give an update on the China and China A Shares strategies covering Q3 2023.

Your capital is at risk. Past performance is not a guide to future returns.

Qian Zhang (QZ): Hello, everyone. Welcome to Baillie Gifford's quarterly video update on China strategies. As a reminder, we have two China strategies. The All-China strategy aims to invest in the best growth companies in China, a portfolio typically with 40 to 80 stocks, no matter where they're listed. And our China A Shares strategy is a more concentrated portfolio, typically with 25 to 40 stocks of the highest growth companies in China, and listed domestically in A-share.

My name is Qian Zhang. I'm an investment specialist. Today I'm joined by Sophie Earnshaw, one of our portfolio managers for both strategies. Hi, Sophie.

Sophie Earnshaw (SE): Hi, Qian.

QZ: So, Sophie, let's start with the recent macro news about the Chinese economy. How do you think that could impact the short-term and also the long-term performance of the portfolios?

SE: Yes, so we've seen a stream of very negative news about China's macro economy over the quarter. Slowing growth, high youth unemployment and troubles in the property sector. This has weighed on shares more broadly and impacted our performance. And as you know, our investment time horizon is much longer than one quarter. But I think what we would say is that we think this extreme pessimism about the Chinese economy is probably misplaced.

We're seeing a severe downturn in the Chinese property market, and this is impacting private sector investment and sentiment more broadly. It's leading some commentators to make comparisons with the US subprime mortgage crisis and with Japan's property boom and bust.

We think both comparisons are actually very stretched. If you look at China relative to those other markets, one thing that stands out is, Chinese income growth has grown faster over the past 20 years than the property price appreciation. So that's the first point. Second, Chinese households are not overleveraged. And third, this statistic is really quite staggering, actually, around one-third of Chinese households are buying property with cash.

QZ: Yes, well, I could relate to that with my own friends and families, but it is apparently very different from homeowners in the west. So, if the problem is not with Chinese households, where are the problems and how are the policymakers responding to it?

SE: So the problem is really with a number of private sector property developers. These property developers have built up a lot of debt over the past ten years. And the question now is, will this debt result in broader financial instability?

We don't think it will for a number of reasons. I mean, first, all of this debt is onshore. China operates a somewhat closed capital account. Second, most of it, has been issued by state-owned banks. These state-owned banks are effectively arms of the government. So the debt operates in a sort of closed loop. And this is important because it means that the government can stagger the pace of recognition of bad debts. And this is important because it gives the economy time to recover and time to grow out of some of its problems, and that's what we think is probably most likely going forward.

In addition to that, the debt itself, or the amount of debt, will probably limit the government's ability to offer a very large stimulus package. But easing at the margin is very likely, and that's what we've seen. So, do we think a full-blown financial crisis or broader financial instability is likely? No, we definitely don't.

The only other point I'd make here is that, over the short term, returns can very much be driven by macro or by politics. But in the long term, we believe that it's actually the operational performance of companies that really drive long-term returns.

And here, particularly when it comes to the portfolio, we're seeing some encouraging signs, particularly from some of our largest holdings.

QZ: Why don't we expand a bit more on that point on operational progress. Given the recent context, do you see for some of the portfolio holdings, that the fundamentals and the share prices further apart?

SE: In some cases, yes. Although we don't own any direct exposure to property developers, we have seen that the weakness in the property sector had a knock-on impact on consumer sentiment.

But we think that's changing. And one of the pieces of evidence for that is actually the results from some of our largest eCommerce companies in the quarter. So, for example, Alibaba. They returned to double-digit revenue growth. They posted their best quarterly numbers for the last two years. PDD, for example, delivered around 65 per cent revenue growth. And in addition to that, actually the regulatory tone or the regulatory backdrop is becoming much more supportive for these big platform companies. And so we think that they're offering, actually, growth and value now. So that's on the one hand.

On the other, we have seen some companies being weak in share price terms in response to weakness in their fundamentals. Glodon is a good example here. It's a detractor for both portfolios. Weakness in the property sector impacted Glodon's ability to sell some of its construction related software. So it was weak over the quarter. But we think that the longer-term opportunity for Glodon, which is really about digitalising the construction space in China, is very much intact.

QZ: Yes. So it's that again, the gap, or the contrast between the long-term fundamental case, and the short term share price movement.

So why don't we come to some of the key discussions you had with the team in portfolio construction during the quarter. Have you made any changes?

SE: One of the areas that we discussed during the quarter was batteries and the solar industry, or more broadly, renewable energy exposure. And as you know, China has a lot of world-leading companies there. But it's also built up quite a lot of capacity in both industries in quite a short time. So we spent a lot of time going back over each of our individual holdings here, re-evaluating their competitiveness and their longer-term profitability.

For both portfolios, CATL is our largest holding in the renewable energy space, and we remain very comfortable with that. So CATL, for example, its R&D budget is actually double the rest of the industry combined due to its phenomenal scale. It's much more profitable at lower price points than a lot of its other competitors, and now it's only trading on around 15 times price earnings.

We did, however, for the A-share portfolio, do some name rotation. We sold Wuxi Lead, and we bought Sungrow. We think this gives us better or greater exposure to the fast-growing energy storage market and also increases our diversification within the renewable energy space.

QZ: So you mentioned about regulatory tone changes and apparently that has been a key worry for a lot of the Chinese investors in the past. Have the recent changes impacted any of the portfolio construction?

SE: Yes. So as I said, we think the regulatory backdrop for the platform and technology companies has actually improved a lot. The rectification campaign appears to be receding. And now the backdrop, we think, is much more positive. So as a result, we've added to Alibaba, Tencent, PDD and KE Holdings. We funded those additions from reductions to some of our larger holdings in the financials and healthcare space where we think the regulatory backdrop is worsening slightly at the margin.

QZ: I see. Thanks for those updates in the portfolio activities. So, for clients who have stayed investing in Chinese strategies for the past two years, performance has been quite challenging. Keen to learn, what's your thinking on the future prospects going from here?

SE: Yes, so we understand that clients' patience is being very much tested, and I think in this context it's important to go over the reasons behind the challenging performance and then cover what's changed and what hasn't changed.

In terms of the backdrop, we've had really three key factors that have been significant headwinds to performance over the last couple of years. So Covid, the regulatory clampdown and geopolitics. Covid is now over and we think it's only a matter of time before Chinese households start spending those pent up savings that they accumulated during the Covid period.

The regulatory backdrop, as I said, we think has improved a lot. The rectification campaign has receded and actually has been replaced by an accumulation of, actually, quite pro-growth policies. And then finally, geopolitics. I think we can expect geopolitics to continue to remain a headwind, particularly given we're moving into an election year in the US next year. But I think now that dialogue has been resumed and official visits have been resumed between China and the US, actually a worst-case scenario is very unlikely.

QZ: I see. It's quite important to recognise these changes in the headwinds that we had in the past 2 to 3 years. But on the other hand, what hasn't changed?

SE: What hasn't changed? Well, we're still finding a real abundance of bottom-up opportunities, very exciting, high-growth companies led by founders and very professional management teams in a whole host of different industries. So, you know, renewables, semiconductors, automation, robotics, domestic brands.

QZ: That's a good point to end on. And I believe with the current undemanding valuation, and also the operational growth you mentioned, we do see the future prospects a little brighter.

Thank you very much for joining us. We hope this was helpful for you, and see you next quarter.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

China (including China and China A Shares strategies)

Annual past performance to 30 September each year (net%)

	2019	2020	2021	2022	2023
China A Shares Composite*	N/A	68.8	17.4	-31.7	-13.5
MSCI China A Onshore Index	N/A	31.7	18.4	-27.3	-5.2
China Equities Composite**	-0.5	52.0	2.5	-38.4	-4.0
MSCI China All Shares***	-3.0	32.4	1.4	-31.6	0.6

Annualised returns to 30 September 2023 (net%)

	1 year	3 years	10 years	Since inception*
China A Shares Composite*	-13.5	-11.5	N/A	5.9
MSCI China A Onshore Index	-5.2	-6.6	N/A	1.5
China Equities Composite**	-4.0	-15.4	5.0	N/A
MSCI China All Shares***	0.6	-11.3	3.1	N/A

*Inception date: 28 February 2019

**Inception date: 28 February 2006

***(MSCI All China prior to 27/11/19, MSCI Golden Dragon Prior to 02/05/19).
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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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com
62529 10037388

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