CHINA A SHARES:
IN CONVERSATION WITH PORTFOLIO MANAGER SOPHIE EARNSHAW

China is an abundant yet complex country for investors. Director Qian Zhang chats with Portfolio Manager Sophie Earnshaw about the current economic landscape, how we invest, and balancing risks and opportunities.

As with any investment, capital is at risk.

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Qian Zhang (QZ): Hello. Welcome to this session for [the] China A Shares Strategy. My name is Qian Zhang, and I'm a Director in Baillie Gifford's Clients Department. Today, I'm joined by Portfolio Manager Sophie Earnshaw. Hi, Sophie.

Sophie Earnshaw (SE): Hi, Qian.

Current investment landscape

QZ: There is a feeling of anxiety on everything about China in [the] media nowadays, whether it's because of domestic regulatory concerns or geopolitical challenges, and this has undermined the global asset allocators' risk appetite in allocating to China.

As a Chinese equities manager, how do you think about the investment landscape in China now?

SE: Yes, thanks, Qian. It has been a really volatile period for investors in Chinese equities, I think a period of significant change, but also perhaps underappreciated continuity. So, when we think about the continuity, the opportunities in China have remained remarkably consistent. China is still the world's second-largest equity market, there're still around 4,000 listed companies there, and it's also a very growthy market.

So, a lot of the world's growth companies are actually Chinese. It's also very inefficient and I'd say short-term, so it's actually an ideal hunting ground for investors like ourselves at Baillie Gifford, that are focused on growth and focused on the long term.

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But there have also been some changes. I think the complexity of investing in China comes from, I'd say, the geopolitical context and the domestic regulatory and governance context, and there we have seen some changes.

So, in October, we had the National Congress meeting, where we saw further consolidation of political power. That was taken remarkably negatively by the market, and we think that negative interpretation discounted a number of significant positives.

I'd say the most significant positive was the government's ability, post-consolidation of power, to make changes, to respond really directly and swiftly to China's economic weakness.

And you fast-forward a couple of months, and that's exactly what we've seen. So, rather than a sharp ideological turn to the left, we've seen the government implement a really pro-growth agenda and dismantle two of the biggest constraints to growth, namely Zero-Covid and the Three Red Lines.

We've also seen the government reiterate a huge amount of support for the private sector, and the regulatory environment remains stable since May.

QZ: But from our side, all these changes appear to be quite abrupt and sometimes quite confusing as well. Many of our clients have asked us, has China just become too unpredictable to invest? What do you think?

SE: Yes, I think that tension between short-term volatility and long-termism has always been a real key, a key feature of the Chinese market. And I think at times of volatility, it's really important to remember what our purpose is, and to remember or have a clear idea of what we think generates alpha.

And for us, long-term returns of equity portfolios, we think, are driven by owning a small number of the very best growth companies, and holding them for a long period of time.

For example, in our A Shares Fund, the opportunity set is around 4,000 companies, and we only own 25 to 40, and we aim to own them for the next five to ten years.

Now, doing that, you have to be able to think long-term, and you have to be able to, I'd say, look through the noise.

How we invest

QZ: It sounds like an easier-said-than-done task. How do you look through the noise?

SE: Yes, it's a great question. We've been investing in China at Baillie Gifford for almost three decades now, and over that period we've observed a set of principles, or a conceptual framework, that we think pertains when one is investing in China. So, these principles, there're four of them.

The first would be, China is committed to long-term development and wealth creation, and that continues under Xi Jinping.

Second, that development or that wealth creation will be delivered in a uniquely Chinese way, and that means trying to harness some of the real benefits of free-market capitalism whilst also mitigating against some of the real excesses.

The third principle would be, the state and the private sector, or the state and the market, are both absolutely vital in terms of delivering or driving China's long-term development. But because of China's unique political system, there are going to be periods when those two, the state and the market, get out of balance, and we should expect that.

And the fourth principle is really, although those periods of imbalance are painful, we think you can look through them. Why? Because of that overarching goal of the Chinese government, which is development. That goal, we think, is incredibly, or very, conducive to long-term investment returns. And as we've seen, the government remains incredibly pragmatic and willing to roll back policies that don't contribute to that long-term goal.

QZ: So, it's apparently a quite large universe, as you describe, with thousands of stocks. How exactly do you find that exceptional growth company, that you mentioned, into a small portfolio?

SE: So, how do we go about finding the most exceptional growth companies? We don't think that traditional sources of financial information, last quarter's earnings, that kind of thing, are particularly useful.

Instead, what we've tried to do is build up a network of academics, industry experts, visionary founders, private companies, all of which think along our long-term time horizon. So, utilising those helps us to really figure out what are the big-picture long-term trends within China, and what are the companies that are likely to benefit from them?

I can give an example, if that would be helpful. For example, in the environmental space or the renewable energy space, we have a partnership with Shanghai Jiao Tong's Low Carbon School. The work that they've been doing with us has really helped us to understand, what does the green transition mean in a Chinese context? What are the big opportunities that arise from that?

Speaking to visionary founders, both within China and globally, helps us to get an understanding of competitive advantage and barriers to entry.

And then, going back into the nitty-gritty, thinking about alignment, utilising our network of due diligence providers in China and globally, again, helps us to understand things like management alignment, which is incredibly crucial when you're investing in China.

QZ: That's obviously a lot of information. How do you then translate all this information you get into portfolio construction?

SE: For that, you need a really intensive filter. And so, here we use our 10-question stock research framework. The first question is really China-specific. What we found from investing in

China for over two decades is, companies that generate alpha typically operate in a sweet spot, and that sweet spot is between, that they benefit from policy tailwinds, so they're aligned with the government over the long term, but they also have a very strong profit motive.

So, the first question that we ask tries to get to the heart of that policy tailwind. The question is, does this company contribute to, or benefit from, China's economic, societal, or environmental development? And what is the global context?

The second couple of questions get us to think really about the opportunity, and here we've put a growth hurdle there. So, can this company at least double its sales over the next five years, and what will happen beyond that?

The next couple of questions really hone in on the profit motive. What is the company's competitive advantage?

How do we think about this in a cultural sense? What is the company's financial profile, and how is that likely to develop?

And then the final couple of questions deal with valuation. How can this company be worth five times more, over five to ten years? How is our view different from the market? And typically, that difference to the market, time horizon is a big part of the answer there. We're aiming to hold companies for five to ten years, whereas the average market participant in the A-shares market will typically hold a stock for five months.

Balancing risks and opportunities

QZ: Many of our clients have come across to us, saying a lot of the macro comments they come across for China tend to be quite cautious, due to the regulatory concerns and geopolitical challenges we talked about. And this is perhaps quite contentious, we would say.

[This] might explain why, relatively, the valuation of Chinese stocks we see are quite cheap, compared with their peers in the rest of the world. But you mentioned a lot of the growthy companies in the world are actually listed in China. Which part of the picture [are we] missing?

SE: It's one of the things about China. These broad generalisations about China I think miss really quite big opportunities.

So, we've commissioned some work looking at company fundamentals over time, and what we've found from this work, is that China is still a place that really offers up high-growth companies.

If you look at companies with starting market cap over two billion, one in ten Chinese companies have grown their profits by over five-fold over the last five years. Now, this compares globally to only 6 per cent of global companies, and only 6 per cent of US companies. So, from the bottom up, China is still a really fantastic place to find very high-growth companies.

I think the second point that I'd make is that, for us, the real question isn't, will China's GDP continue to grow, and at what rate? We all know that China's GDP is slowing, and will continue to slow.

The question for us is really, how is China changing, and what are the opportunities that these changes are throwing up? And there, I think there are a lot of opportunities.

Giving a couple of examples, the middle class in China continues to grow, and within that, the cohort of Generation Z consumers are really interesting. They're exhibiting vastly different consumption habits and brand preferences, relative to their older peers.

Renewable energy is another really exciting structural growth trend within China. China, I think, now has two-thirds of the world's battery capacity, two-thirds of the world's solar capacity.

Another interesting theme would be, China's population is aging, but what does that mean? It means that China really needs to continue investing in healthcare, and it also really needs to continue investing in productivity growth and innovation. So, there's a whole host of really exciting themes, we think, that are underappreciated.

QZ: Can you share with us some of the companies that you really like under these themes?

SE: Yes. So, Proya. This is a good example. Proya is a domestic beauty, skincare brand, that is very much exposed to the growing middle class and Generation Z. Companies like CATL and LONGi, these are two companies that've really helped China deliver that battery capacity and that solar capacity that I just talked about.

Companies such as Inovance or Megmeet are, I think, really helping China move up the productivity curve, and they're taking huge strides in robotics and in industrial automation.

QZ: I think my key takeaways after listening [to] you would be, it seems that from a macrolevel, China is very widely discussed, and seems to be a source of concern for a lot of investors as well. But the vast microlevel, company-level opportunities, are still pretty much unknown and under-owned by a lot of investors.

So, as you said, these opportunities will need patience throughout volatile times, and having the right, you called it, 'conceptual framework' for investing in China is crucial. And also, retaining that company-by-company focus is going to be important as well.

So, we all agree that investing in China has become a bit more complex, but I suspect from what you said, more optimistically, there's still a lot of opportunity this changing China is going to bring to us. Thank you very much for your answers, Sophie.

SE: Thanks, Qian.

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