Investment Insights

Why research is so critical
when it comes to China investing

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Why research is so critical when it comes to investing in China

Key takeaways

- Chinese equities have had a volatile 2022 so far as the country has had to navigate COVID-19 restrictions, property debt concerns and supply chain constraints among many other headwinds
- China is becoming an increasingly selective market that requires investors to have robust on-the-ground research capabilities
- Capital Group was one of the first foreign investors in China, with a long track record of investing in the country since 1993

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It has been quite a topsy-turvy 2022 for Chinese equities so far. What are the key factors that have contributed to the volatility?

Even though we are only in the third quarter, it already feels like a long time given the number of key events that have taken place so far. This is particularly true for Chinese equities, which started off the year well but were then weighed down by regulatory tightening across sectors such as property, technology and private education.

Things quickly took a turn for the worse as the war in Ukraine prompted huge selling across most risk assets globally. Ongoing tensions with the US also put pressure on Chinese equities but two areas specifically felt the most impact. One is the potential delisting of Chinese companies listed on US stock exchanges if they do not take steps to comply with certain accounting rules established by the US Securities and Exchange Commission. Secondly, Chinese biopharmaceutical and drug companies experienced a sharp sell-off after the US Food and Drug Administration declined approval of select China-tested drugs. These factors have inevitably increased the risk premium associated with Chinese equities.

Yet before we could even take a breather, China has found itself battling another wave of COVID-19 since late first quarter. The country's zero covid policy and the subsequent implementation of citywide lockdowns generated a lot of uncertainties because of their debilitating impact on supply chains and economic activities. Top government officials have already said the country is keeping its growth targets for the year flexible after seeing its economy grew only by 0.4% year-on-year in the second quarter. The bigger fear is whether a slowdown in China could potentially find its way into the global economy given the country's sheer size and prominence when it comes to driving global growth.

Chinese equities did experience a strong rally from late April to late June due to increasing efforts to loosen policies and support the economy. But it remains to be seen whether China will enter "full-stimulus" mode as policies so far have been fairly targeted and that has contributed to the lingering sense of uncertainty especially when it comes to sectors that have borne the brunt of the volatility. The key issue here is the government's zero COVID-19 policy. Pandemic-related restrictions are slowing the velocity of money within the Chinese economy so there is little point for Beijing to go full-throttle when it comes to stimulus measures now.

Chinese equities: It's been a bumpy ride

Index	Returns (%)			
	1-month	**3-month**	**Year-to-date**	**1-year**
Shanghai Composite Index	0.5%	0.3%	-12.0%	-10.9%
Shenzhen Composite Index	-1.8%	3.5%	-17.1%	-13.6%
Hang Seng Index	-2.0%	-6.2%	-15.5%	-24.2%

Data as at 31 August 2022. Source: MarketWatch

That's a lot for investors to navigate in a short period of time. Which of these developments do you believe to be short-term or, conversely, structural?

Let's start with COVID-19. Based on our experiences over the past few years, case counts tend to ebb and flow with time. Consequently, the repercussions of citywide lockdowns are likely to alleviate once the number of new COVID cases start to decline, which is why I do not see COVID-19-related issues turning permanent although there will obviously be short-term pain for the people, businesses and the economy. The more important issue is to try and understand what does China's zero covid policy means going forward. Top government officials have recently urged all regions and departments to be resolute in overcoming economic difficulties as they co-ordinate China's response to the virus and strive to maintain social stability. Once the current outbreak is under control, we should be able to attain a better understanding of the direction and economic impact of China's COVID policies.

With regards to the uncertainties surrounding regulatory reforms in China, recent policies suggest that the end of the cycle could be in sight. The policy tone coming out of Beijing has already been easing for months. We have seen the People's Bank of China making moves to cut the reserve requirement ratio (RRR) for banks and Vice Premier Liu He publicly pledging support for tech firms to pursue listings both at home and abroad as well as support the healthy development of the platform economy[1]. In addition to the technology sector, we are also seeing supportive measures for the property sector as the country's five-year loan prime rate was lowered by 15 basis points in May and August, respectively. These are the largest reductions for the country's main mortgage interest rate since 2019 and will directly reduce the borrowing costs on outstanding mortgages.

When it comes to the property sector, I believe the combination of bond defaults and mortgage boycotts has strengthened the case for more easing policies. We have seen China dial up its support measures in recent months and is reportedly setting up a real estate fund to support distressed developers. China certainly has the room and ammunition to implement stronger and broader growth-oriented policies. It would not surprise me to see a comprehensive easing package that would include more fiscal support for infrastructure, greater loosening of property policies, stronger support for consumption as well as better regulatory transparency to restore market confidence. If you look at how the government has been responding recently, the intention is certainly there for the government to support the domestic economy. In terms of longer-term policies, many eyes are now on the outcome of the 20th National Congress of the Chinese Communist Party (scheduled in October), which will decide the country's development trajectory for the next 5-10 years.

How should investors approach Chinese equities given the complexities?

China remains a fertile ground for investors but we have to be cognizant of the fact that the risk premium associated with the country has gone up. It has become an increasingly selective market that requires investors to have on-the-ground research capabilities supported by comprehensive macro, political, sector and forensic analysis to look through regulatory reforms, COVID-19, geopolitical tensions and supply chain disruptions.

When investing in China, we need to be thinking carefully about the policy tailwinds or headwinds individual sectors or companies could face. The Chinese property and technology sectors are examples of what could happen when the regulatory and policy environment becomes more challenging. The opposite also holds true so putting on the right pair of political lens and being able to understand the motivations behind Beijing's development agenda is critical. In this case, it is about understanding how different industries and companies fit

1. Liu was speaking at a 17 May 2022 meeting convened by the Chinese People's Political Consultative Conference (CPCC). Platform economy refers to digital platforms that facilitates economic and social activities.

into China's vision of "common prosperity", which incorporates quality growth, social wellbeing and sustainability. But even within sectors that we believe would benefit from policy tailwinds, it is important to be selective because ultimately it is the long-term fundamentals of a company that we are investing in. Different companies in the same industry can have different business models, management track record of strategic execution, technological expertise as well as operational risks. They should therefore be studied and understood individually before determining whether there is a compelling investment thesis.

Another area that investors can focus on is understanding how companies are evolving to mitigate the different types of regulatory, geopolitical and supply chain risks we mentioned. Following reports that Beijing is discussing with American regulators the logistics of allowing on-site audit inspections of Chinese companies listed in New York, we have seen select Chinese healthcare companies listed in the US switching to US and global auditors. Others are remapping their supply chains to start sourcing more materials locally. We need to be constantly monitoring how companies are adapting to different external factors and analysing how these changes would impact their businesses and therefore investment thesis.

Deep local and global research capabilities

Source: Capital Group

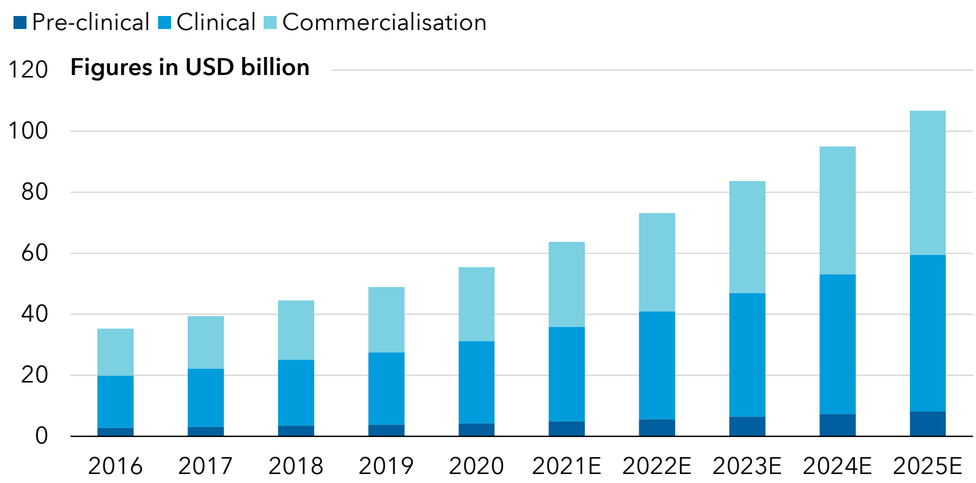
Any sectors that are currently experiencing strong policy tailwinds?

One area that has got strong policy momentum is automotive and, in particular, electric vehicles (EVs). Supply chain disruptions because of COVID lockdowns have negatively impacted the operations of auto manufacturers and component suppliers in recent times. But the announcement of a nationwide auto stimulus plan in May, which includes car purchase tax cuts, shows how much China values the industry. China already dominates many parts of the EV supply chain such as batteries, components manufacturing and raw materials refining. Ultimately, China has big ambitions in the global technology race and EVs are a big part of that. Another reason why China is keen on developing the EV industry is the fact that these energy efficient vehicles tie in with the country's broader environmental agenda. So, what we have is a best of both worlds situation where extending its EV leadership is beneficial for the country on multiple fronts.

Thinking along the same lines, renewable energy is another sector that has got Beijing's backing having unveiled its plan to reach carbon neutrality by 2060. Similar to EVs, many Chinese companies are market leaders across various segments of the renewable energy space such as biofuels, solar inverters, solar panels and wind turbines. One common misconception is that China's leadership in EVs and renewable energy is only possible due to the hugely favourable government policies and subsidies. While the government has been critical in creating a favourable environment for these industries to grow, we should not overlook the strong technological expertise many of these Chinese companies possess. Ningde-based Contemporary Amperex Technology Co., Limited (CATL), for example, is not only the largest lithium battery maker in the world[2] but also a leading player in the development of battery-related technologies.

Another segment that could see more Chinese companies flex their muscles is health care, where Chinese contract research organisations (CROs) and contract development and manufacturing organisations (CDMOs) are supported by a strong talent base, increasing technological edge, cost advantages and an influx of venture capital.

The global drug development market is expected to grow across all segments



Source: 2021 Frost & Sullivan Report on the Pharmaceutical Industry

It is a sector that benefits from the strong outsourcing demand of large pharmaceutical companies (due to rising drug development costs and growing need to improve supply chain resilience) and key players such as Wuxi Biologics are riding on the growth momentum to expand their capacity globally. The sector was under intense scrutiny earlier in the year after investors were spooked by the US Commerce Department's decision to add two subsidiaries of Chinese CDMO Wuxi Biologics into its Unverified List (UVL). That triggered a massive sell-off across the sector, which, in hindsight, was overdone as the UVL was the result of a COVID-related administrative/logistical issue and has little impact on Wuxi

2. Based on EV-mounted batteries sold globally in 2021. Source: SNE Research

Biologic's businesses. While geopolitics can be hard to ignore especially when it comes to investing in EM and China, there are instances where it is important for investors to look through the noise. In the case of CDMOs like Wuxi Biologics, the benefits of successful drug development far outweigh political interests as evidenced by the sheer number of contract wins from pharmaceutical companies in the first half of 2022[3].

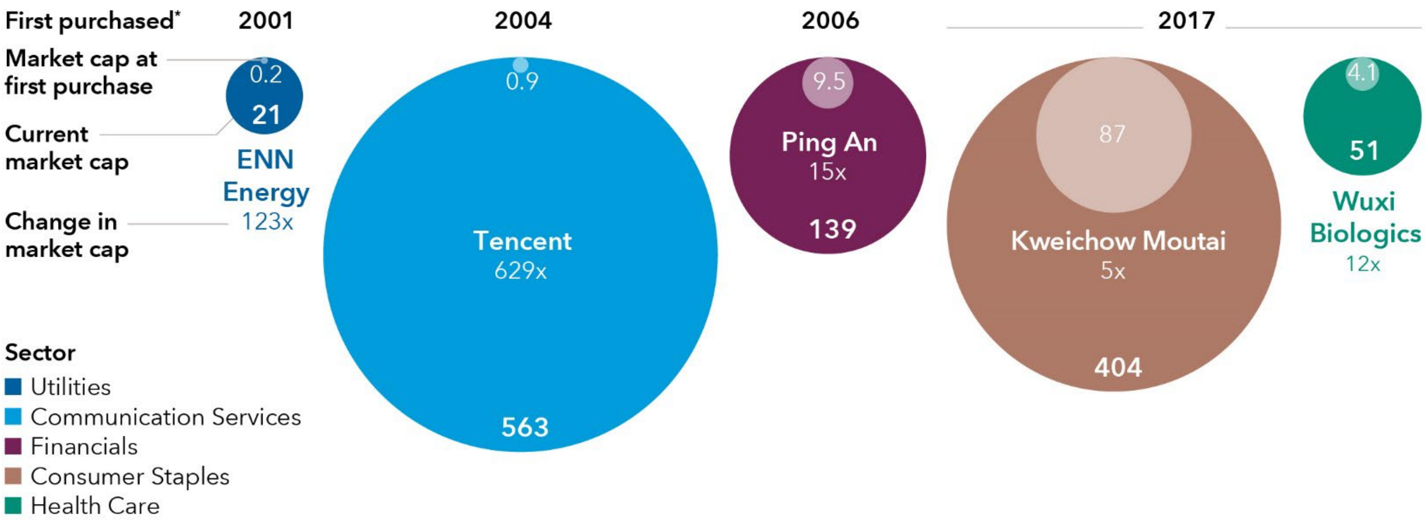
What is Capital Group's advantage when it comes to investing in China?

Capital Group was one of the first foreign investors in China, with a long track record of investing in China since 1993. Our deep knowledge and experience investing in China builds on our long-term emerging markets experience, having launched the world's first Emerging Market Equity strategy for the World Bank in 1986, and other dedicated emerging market strategies over the years.

Throughout our history of investing in China, we have invested in a number of companies that have experienced multi-fold expansion in their market capitalisation since they were first purchased. In other words, we have been an early identifier of some of China's key emerging leaders.

Long-term growth potential is our key focus

Market cap of Capital Group's largest investments in Chinese companies (in USD billion)



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*Data as at 31 December 2021 in USD terms. *Date of first purchase by Capital Group.

The strength and depth of Capital Group's investment research has always been one of our key competitive advantages and we remain committed to growing our resources in what has now become the second-largest economy in the world. Currently, we have more than 50 investment professionals that speak Chinese and more than three dozen professionals who are directly focused on China[4]. These are portfolio managers, analysts and economists covering China from various offices including Hong Kong where we have had a presence since

3. Wuxi Biologics recorded 59 new integrated projects in the first half of 2022. Source: Wuxi Biologics 2022 interim results
4. Data as at 31 December 2021. Source: Capital Group

1983. One of the enhancements we have made to our dedicated China resources is the development of a team of "China Industry Specialists," which has become an integral part of our investment group. We currently have nine China Industry Specialists, one China Affairs Director and a China Forensic Accounting Analyst who are based in Shanghai[5]. The China Industry Specialists are each assigned a specific industry of responsibility such as technology, consumer, health care, and automotive. They spend the vast majority of their time meeting with a broad network of local industry and government contacts applicable to uncover new or shifting insights and provide deep industry knowledge and research to decision makers across investment groups.

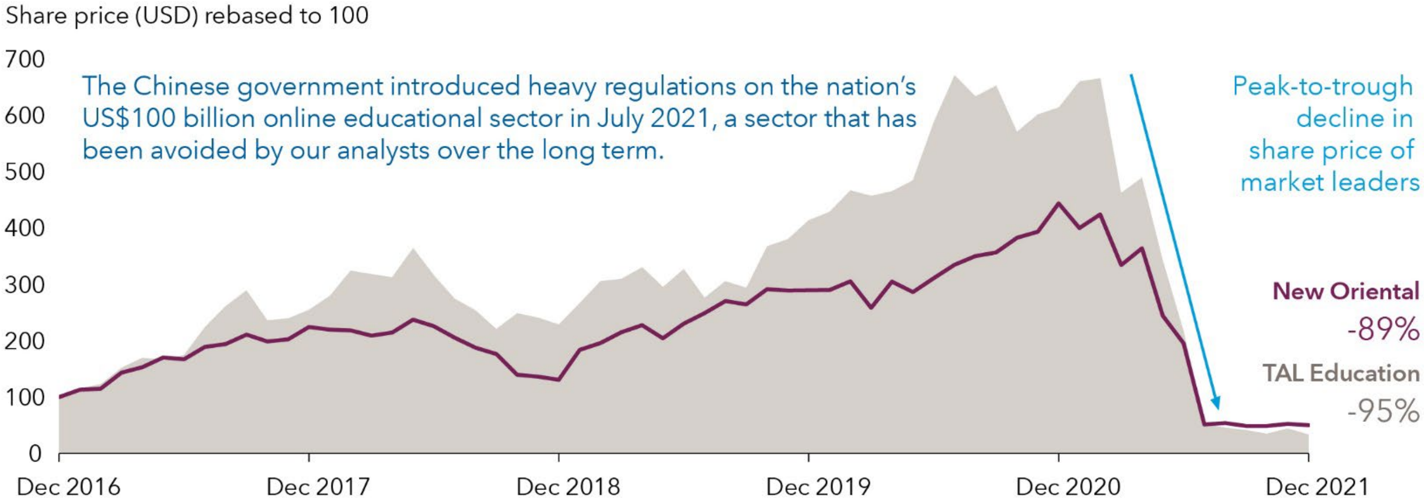
In terms of how to capitalise on opportunities and mitigate risks, we believe the key to success in investing in China is access to robust on-the-ground research. As well as forensic accountants, we have the benefit of input from industry experts, economists, foreign policy experts and offices of analysts. This allows Capital Group to conduct more than 1,500 one-on-one meetings with companies in China and Hong Kong since the start of 2021 of which over 320 were conducted onsite despite the prevalence of lockdown restrictions across this period[6]. It is the breadth and depth of Capital Group's research capability that helps uncover trends and identify investments opportunities early, so we can capture gains from small companies that could become very large companies.

Ultimately, Capital Group's investment research efforts are organised on a global basis as we believe that to understand a company in a specific jurisdiction, we must understand that industry globally. We achieve integration between equity, macro and fixed income research through a system we call 'clusters' which comprise groups of analysts who share common coverage of a specific industry or related industries. A dedicated macroeconomic team provides an additional layer of strategic insight. Research decisions are therefore made by bringing together information collected all over the world to create investment theses about companies.

A prime example of how Capital Group benefitted from this global integration of knowledge can be seen in 2021 when we avoided holding Chinese educational stocks even before the government's reform of the after-school tutoring sector. Many of our analysts and portfolio managers had invested through similar private educational cycles in South Korea, which gave us insights as to what could potentially happen in China. South Korea's sprawling 'shadow' education system goes back to decades and there had been numerous attempts by the South Korean government to restrict after-school tutoring since the 1980s. Given how the private education sector had been heating up in China prior to the overhaul in 2021, our analysts deduced there was a high probability that the Chinese government would eventually step in on similar grounds of social well-being and recommended portfolio managers to avoid Chinese educational stocks. It was an excellent recommendation that led to a brilliant outcome and served as a great reminder of the importance of having globally integrated research.

5. Data as at 31 August 2022. Source: Capital Group
6. Data as at 31 July 2022. Source Capital Group

Avoiding China's online education sector



Source: Datastream, Capital Group

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- **If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease. Currency hedging seeks to limit this, but there is no guarantee that hedging will be totally successful.**
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