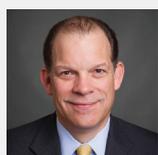




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China Unexplored

Going beyond the obvious seeking tomorrow's winners



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China: why it pays to look for the overlooked

When thinking of China, most investors will be familiar with the mega-cap stocks that dominate the MSCI China Index. They will likely already have allocations to these companies as part of their emerging markets or Asia exposure. However, as we have noted previously the investment universe for China is multiple times larger than the mega-caps and warrants a deeper look as a standalone strategy for your China exposure. A holistic approach to the full opportunity set of investable stocks available in China, regardless of where they are listed, could enable you to maximize alpha generation within your portfolio.

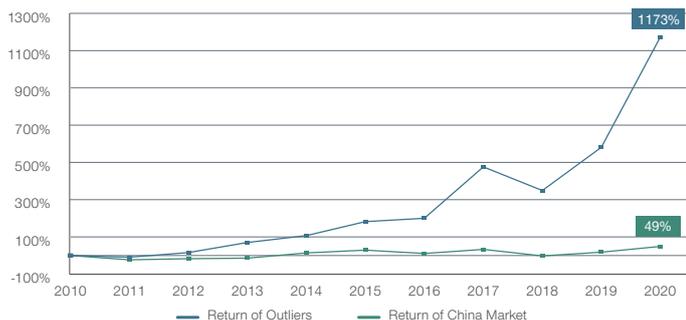
By focusing on the less well-known or under explored areas of the market, research-driven active managers can uncover idiosyncratic companies in nascent growth stages while simultaneously exploiting the inefficiencies that lie in these under-researched parts of the market.

Outliers: critical source of alpha generation

The narrowness of the recent performance of China’s stock market mirrors the experience of other markets where a relatively small number of companies have delivered spectacular returns driving up the wider market.

Analyzing the past 10 years of performance for the Chinese market (to 31 December 2020), we noted that there are very few companies that we would consider to be such outliers (defined as those companies delivering at least 20% p.a. share price returns). In fact, of the 2,494 listed companies at the start of the period, we estimate that there were only 86 companies (3%) which achieved ‘outlier’ status. However, they accounted for an astonishing 87% of the broader market’s total gains over that period (see Fig. 1).

Fig. 1: The majority of market return has been driven by outlier companies



Past performance is not a reliable indicator of future performance.

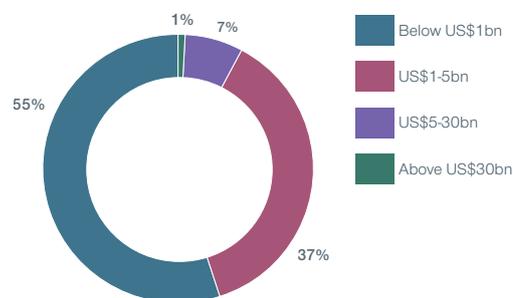
Outliers: stocks compounded at 20%+ CAGR during 2011-2020
 China Market: 2494 Chinese stocks listed before 2011
 Sources: Goldman Sachs, FactSet. Financial data and analytics provider FactSet. Copyright 2022 FactSet. All Rights Reserved.

Examining their characteristics it is evident that they have some common traits, however – perhaps the most significant is that all but one started out with a market cap below US\$30 billion at the beginning of the review period. The average starting market cap was just US\$2 billion.

China is an economy and market that is constantly changing. The status quo does not last long. While disruption is commonplace, the majority of assets under management invested in China appear concentrated in the overcrowded mega-cap space. Most investors seem to be ignoring the many diversified sources of alpha across this vast opportunity set that offers scope for more balanced alpha generation and better up/down capture. As such, we believe it is important to look outside of today’s dominant mega-caps to unearth the companies that will become tomorrow’s winners.

By taking such an approach, investors can benefit from access to innovative companies that operate in niche or early-stage industries,

Fig. 2: Outliers by market cap



As at 31 December 2020
 Sources: Goldman Sachs, FactSet. Financial data and analytics provider FactSet. Copyright 2022 FactSet. All Rights Reserved.

or in more traditional industries that may be highly fragmented where through consolidation they can take market share and experience rapid growth. This can be powerful since China is home to many nascent industries where market leaders have less than 5% market share. It also means exploring opportunities across the full supply chain. Taking electric vehicles (EV) as an example, it’s not about buying an EV manufacturer, but about buying a company that makes the components that go into the EV – from glass, to headlamps, to semiconductors.

Smaller market caps are not inherently riskier than larger market caps

Crucially, delving deeper in China doesn’t necessarily mean investing in small, illiquid or riskier stocks. Instead, we would put it another way: it means having the forward-looking vision to invest in what may be tomorrow’s mega-caps while they are still in the early stages of their development.

China is a highly liquid market, driven in part by the behavior of local retail investors. There are approximately 500 companies with a market capitalization between US\$5-30 billion, and thousands more in the US\$1-5 billion bracket. Our analysis of volatility among Chinese stocks above and below US\$30 billion market cap, shows that both groups displayed different characteristics at different periods, but notably when the <US\$30 billion bucket exhibited more volatility than the >US\$30 billion bucket, it tended to be lower than when the larger cap stocks went through a period of heightened volatility. In the case of China, investors should not jump to the conclusion that smaller cap stocks exhibit higher volatility.

In our view, the deeper reaches of the China equities market offer access to tomorrow’s mega-caps that can complement many investors’ existing allocations. Fundamental investors with a longer-term investment horizon who can identify those companies where change and growth are under-appreciated or undiscovered, have the potential to construct a diverse portfolio of uncorrelated, and idiosyncratic, growth opportunities.

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