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INVESTMENT MANAGEMENT

CHINA A-SHARES FROM TOP TO BOTTOM

A combined macro and micro approach harnesses the true potential of China's vast A-share market, says Gary Cheung

It is easy for investors to burn their fingers in the Chinese A-share market. Its heavy retail investor base can be fickle, often catching professional managers unaware. Morgan Stanley's China equity team has developed a two-pronged approach to navigate often-choppy waters.

The Morgan Stanley China A Equity strategy is concentrated, typically holding between 25 and 35 stocks. The focused portfolio favours stocks with high growth potential that can ride through the ups and downs of China's volatile market.

The strategy has delivered alpha since 2011, outperforming in the down market of that year and the rebound that followed in 2012 and 2013. When the A-share market rose over 46% in 2014, the strategy still outperformed.

Generally the portfolio is fully invested to capture potential market upside, but market sentiment can also turn quickly, so the team must be aware of downside risk. Portfolio cash levels rose significantly in May and June 2015, and at the beginning of 2016 before the two major corrections. That helped to preserve investor capital.

'Our approach is a true top-down, bottom-up approach,' says portfolio manager Gary Cheung. As a strategy that relies on a strong macro view and detailed company-specific analysis in a market of over 2,800 stocks, Cheung and his team spend much of their time meeting with companies, their suppliers and competitors to get an in-depth view of each business's prospects. They also spend significant time with policy advisors and sector experts.

That mix of fundamental and qualitative views is important. While much larger, more diverse and liquid than the offshore H-share universe, 80% of A-share trading is done by retail investors, giving the market distinct characteristics.

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'A-share investors are less driven by valuation. They are more sensitive to sentiment, so prices frequently over- or undershoot. By measuring sentiment as well as actual numbers, our framework makes the most of many of these inefficiencies,' says Cheung.

Under normal market conditions, the investment team tries to capture the drivers of sentiment, then employs a contrarian style to gain exposure to stocks that have oversold, providing their business models and fundamentals remain intact.

GARY CHEUNG
Portfolio Manager
Morgan Stanley Investment Management

The market also differs from others in its level of sell-side coverage. Cheung says there are 'more analysts than stocks', with many focused on the small caps that retail investors believe will deliver outsize gains.

'Retail investors like smaller companies with lots of upside potential. They are less concerned about downside risk,' he says.

That helps explain why Chinese small caps are generally valued higher than large caps – and why the China A Equity strategy normally avoids them. The investment team generally prefers larger, more prudent stocks that deliver on their promises.

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This characteristic of the Chinese market could eventually change, but Cheung warns that institutionalisation will take time. Even local buy-side managers like to produce good weekly or month-on-month numbers, a trait that perpetuates the short-term, volatile nature of the market.

Currently* Healthcare, Consumer Staples and Consumer Discretionary stocks make up just over half of the portfolio. It remains underweight in Energy and Materials. Industrials are an equal weight, with a diversified spread of stocks in toll roads, airports, power-grid equipment manufacturers, infrastructure and airports.

'We expect further monetary easing so bond yields will remain low and could go lower. We like businesses with high, stable cash flows and high dividend yields; they could be re-rated soon,' says Cheung.

Even within broad structural change stories, stock selection is crucial. Government policy can have a distinct and often speedy impact on the prospects for whole sectors, hence the strategy selling out of materials and construction in 2011 as stimulus changed direction, and selling out of wine producers as the anti-corruption drive took effect in 2012.

A selective approach also applies to the consumer sector, where rising incomes and the rapid adoption of more sophisticated tastes are driving the 'demand upgrade' theme. Tourism is another beneficiary of rising wealth, expressed through amusement parks, duty-free shops and airports.

The healthcare theme is interesting on several levels, thinks Cheung. Health spending is still below 6% of GDP, but growing as wealth increases. The pharmaceutical industry also remains highly fragmented, even the biggest of China's 7,000 drug makers have only a 3% market share. The government is keen to foster efficiency under its "good manufacturing practice" policy and consolidation is already underway. A similar trend is developing in drug distribution.

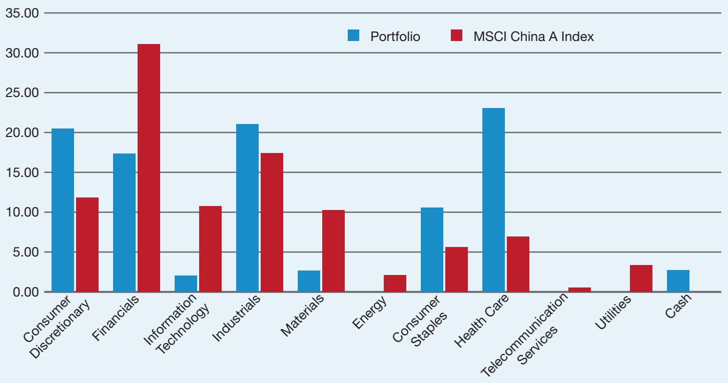
Elsewhere in the economy, reform is a complex task and the pace of change often leaves the market frustrated. Cheung takes a long-term view.

'We are positive on the long-term prospects for China. In the medium term, adjustments to the economy may take time to deal with obsolete assets, and reallocate human resources to more productive sectors,' he says.

Cheung currently thinks that high quality stocks are more reasonably priced since the correction. Again, selection remains his watchword.

'Valuations are still diverse; while over half of the MSCI China A index is now on price/earnings above 30 times, a good portion of the market is attractively priced and boasts robust growth potential. Therefore, being prudent and extremely selective is crucial when investing in A-share,' concludes Cheung.

Sector Allocations*



Source: Morgan Stanley Investment Management and MSCI. * Data as of June 30, 2016 would be subject to change on a daily basis.