Why China Now?

A Discussion with Artisan Partners Portfolio Manager Tiffany Hsiao, CFA

PORTFOLIO MANAGER
Viewpoints

March 2021

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China is the world's second-largest economy but has historically been considered a challenging market to penetrate. Why should investors consider investing in China now?

More than ever, China is a key sustainable engine of global growth—especially in areas such as technology, health care and consumer products. China's economy is forecast to grow more than 8% in 2021—even on the heels of growing (albeit slower) in 2020 while the world slumped 3.5%. Looking forward, I believe there are both fundamental and technical catalysts that should drive China's equity market to outperform. Fundamentally, there are three key pillars for a virtuous cycle of innovation now firmly in place. From a technical perspective, after years of capital reform, China's inefficient equity markets—especially under-researched small- and mid-cap stocks—are ripe for institutionalization.

Can you talk more about the three key pillars you see driving this cycle of innovation?

The current cycle of innovation is a byproduct of an increase in patient capital; a large, diverse market; and a highly skilled labor force.

First, China's private funding has expanded at a 24% annualized rate for the past decade. This increase in patient capital is critical for supporting innovators to turn their disruptive ideas into real world solutions.

Second, one out of five Chinese households now has a disposable income over $25,000 a year. As of 2019, that is 107 million Chinese households—more than in the US—so there is plenty of diversity and opportunity for growth ahead in the Chinese consumer ecosystem.

The final pillar of China's virtuous innovation cycle is the scale of its human capital—both domestically trained and those who've returned home after decades abroad. Many top scientists who left China in the 1980s and 1990s thought they were leaving home for good. At that time, the thought of having 107 million affluent Chinese households embrace their innovation seemed like an unrealistic dream. Today, that entrepreneurial dream is being realized at a rate of 10,000 new startups per day in China. With patient capital, a scaled market and a deep human capital pool, I believe the stage is set for fundamental investors seeking innovative, fast-compounding companies in China.

You mentioned technical catalysts as well—could you expand on those?

From a technical perspective, China's decades-long effort to open its capital market is starting to bear fruit. Although the public equities market in China is still inefficient with high retail investor participation, the government's efforts are having an impact. Many of China's financial, accounting and capital markets standards are now in line with those of developed markets. The numerous accounting, listing and qualified foreign investor reforms are starting to attract a more orderly institutional investor base—which represents a new force to help close the structural inefficiency gap. That said, the Chinese equity market is still inefficient, with only one-third of companies having more than one analyst rating. Many of the remaining two-thirds are small- to mid-cap companies.

Do you think that introduces an opportunity for an investor like you? And how do you think about capitalizing on it?

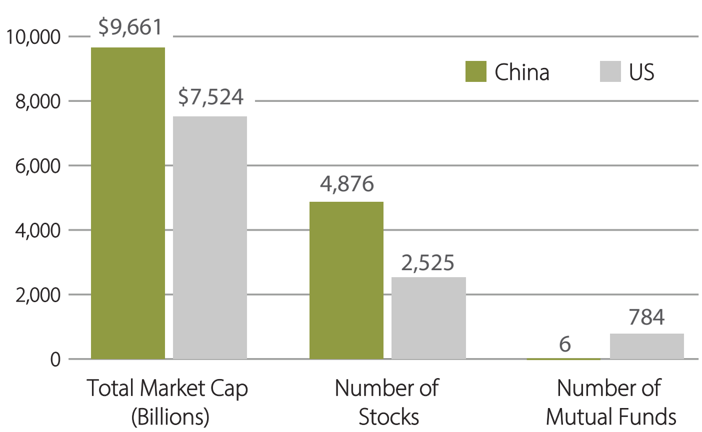
It absolutely introduces a meaningful opportunity, in my opinion. The Chinese small- and mid-cap market is the largest in the world. Two strong catalysts on the horizon—the aforementioned combination of a virtuous innovation cycle and the introduction of institutional investors—will disproportionately benefit those under-researched small- and mid-cap companies. This provides a strong share-price catalyst for businesses that have been on our radar for many years. Few investors are currently equipped with the skillsets required to tap this source of idiosyncratic, uncorrelated alpha.

Exhibit 1: Small- and Mid-Cap Markets in China and US

PUBLIC MARKET

Embedded structural inefficiencies create investment opportunities

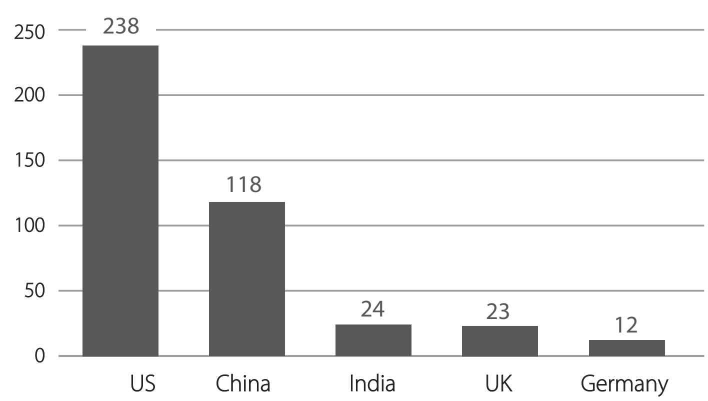
Small- and Mid-Cap Markets in China and US



PRIVATE MARKET

The world's second-largest private market has few long-term fundamental investors

Unicorns by Country



Sources: Bloomberg, Morningstar, CB Insights (www.cbinsights.com/research-unicorn-companies), as of 4 Nov 2020. Small- and mid-cap markets defined as companies with market capitalizations between $200MM and $20bn (USD). Number of Mutual Funds based on avg. mkt. cap for US funds within Morningstar's respective China Region, and Small Cap and Mid Cap categories, as of 4 Nov 2020.

What skillset do you think it requires to invest in this asset class?

Investors have to be able to properly assess the opportunities and the risks—which requires decades of fundamental due diligence experience, strong professional networks and a deep understanding of the cultural nuances between China and the West. For example, one of the most attractive parts of the technology investment universe in China is semiconductors—which represents half of global semiconductor consumption and has high barriers to entry due to design and manufacturing complexities. There is a strong advantage for investors with decades of investment experience in global semiconductor companies which allows them to identify parallels between China's development and other countries'. A deep understanding of how Western companies like Intel, AMD and NVIDIA built their semiconductor empires allows an investor to more effectively identify transformative and proprietary semiconductor companies in China that also have the potential to compete on a global scale.

How do you validate the quality of companies in China given relatively low transparency and disclosures?

In my experience, it is best to research publicly listed companies using a private equity due diligence approach. It's critical to triangulate information from public companies with information from private companies. China has over 6,800 companies listed, but it also has 40 million businesses—so investors speaking only to public companies are missing 99.9% of the picture. The recent rapid digitalization of China's economy has led to high-quality alternative data sets that can help supplement our research. With recent accounting reforms, the information quality in China has greatly improved. Given smaller companies' relatively straightforward business models and products, the mosaic is significantly more manageable to assemble than it is for mega-cap companies with complex business exposures.

How do you compare gaining China exposure through investing in multinationals to gaining it via direct investments in Chinese equities?

I believe the two methods offer different benefits—but investors can certainly benefit from direct exposure to Chinese companies. Total revenue exposure to China via the S&P 500® Index and the NASDAQ Composite is only roughly 3%—which is arguably too low given China is the world's second-largest economy.

Further, I believe direct exposure to local innovators who have customized solutions for China's large domestic market is a more efficient way to capitalize on China's growth. It's also less correlated to the US market: Over the last five years, the correlation of Chinese small- and mid-cap stocks to the S&P 500® Index is just 34%. Which means investors who add direct China exposure could potentially capture uncorrelated alpha.

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