China's A-share market will experience significant structural changes

This is the time to reshuffle equity investment portfolio and ChinaAMC is doing that to stay ahead of competition.

By Leanne Wang

There is a question regarding to what extent China's economy is going to slow down. China Asset Management Co., Ltd, the largest fund-management company in the country, believes a soft landing will take place amid's China's effort to transition its growth model.

This explains the correction A-share market has been experiencing, but it does not point to a gloomy outlook for the long run. Actually it is the time to restructure investment portfolio, says Gong Huaizhi, Deputy CIO at ChinaAMC and portfolio manager of ChinaAMC GARP Fund, an equity fund with RMB 20 billion of AUM.

Gong Huaizhi, Deputy CIO, ChinaAMC

Soft landing

The impetus supporting China's rapid development in the last 30 years is declining.

First of all, the dividends of reforms regarding land, housing and state-owned enterprises (SOE) has paid off, but these are not repeatable gains.

Population dividends are also disappearing. The rapid industrialization process has been supported by large population of young labour which will decline in 10 years and in the meantime the proportion of people aged above 60 will rise to from 13% to around 17%.

Since its WTO entry in the early 2000s, China has become the world's factory. However, with weakening demand from the US and Europe and rising costs of production and raw materials, the development of manufacturing industries is going to slow down.

Urbanization supports rapid development of heavy industries in China, such as petrochemical, steel, electric power and construction material. However, this process has been almost completed in major cities.

Though there is no obvious sign that China's overall economy is slowing down, but the soft landing has already been played out by capital markets. The correction of A-share market started in the second quarter and is now exacerbated by the uncertainties and fears in the US and Europe.

Macro policy

It has been the main task of the Chinese government's economic policy to control the rise in inflation this year.

Gong says inflation in China reached its peak in July and will start to come down, especially following corrections in the prices of major commodities. If this conclusion turns out to be right, the focus of Beijing's macro policy will go back to supporting economic development and adjusting the economic structure.

"That is not to say that policy will switch back to stimulating the economy immediately, but at least, I don't foresee the monetary policy will be tighter, which will alleviate the pressure on interest rates and liquidity in the capital markets," Gong notes. "The change of monetary policy will be confirmed towards the end of year; the Central Economic Work Conference in December will set the tune."

According to data released by the Ministry of Finance, in the first seven months this year, China's public fiscal revenue reached RMB 6,674 billion, which amounts to 74.4% of the annaul budget and 30.5% growth compared to the same period last year.

Meanwhile, China's public expenditure in the same period was RMB 5,138.5 billion, 51.3% of the year's budget and 29.7% more than this time in 2010.

The balance sheet and budget

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performance show that China's fiscal policy will become more aggressive in the rest of 2011.

Gong predicts that by September or October, China will increase fiscal expenditure to improve people's wellbeing in the areas such as social security housing, water conservancy construction, healthcare and education. He also expects the government to facilitate long-term sustainable development such as emerging industries, utilities and research and development in hi-tech industries.

Strategic emerging industries

China's proactive approach to transitioning its economic growth model is inked in the government's 12th five-year plan, which gives high priority to developing strategic emerging industries. This has brought new investment themes such as domestic consumption, urbanization and shifting industry to the west and to rural areas.

However, Gong finds the actual introduction of the plan is slower than expected, which he attributes to temporary problems over inflation.

"I believe the development will gather pace in the coming months, given CPI is likely to go down," he says.

Also, some 'black swan' incidents have made the government cautious with regard to certain new industries, such as nuclear power generation and high-speed railways.

However, China's determination to optimize its industrial composition will not change. Gong believes such the change of industrial composition will be reflected in a structural change of China's A-share market.

He points out, "The percentage of large-cap cyclical stocks, including financials, real estate, raw materials and traditional industries, will lose their dominance gradually; meanwhile, sectors such as consumption, advanced manufacturing and high-tech will keep gaining."

Gong expects to see more sub-segments emerge: "For instance, civil defense, urban gardening, intelligent transportation, industry automation as well as energy saving and environmental protection could all be new industrial sectors offering value for investors."

In addition, Gong also foresees the way people manage their wealth will change.

"When more people invest savings into stocks, combined with the increasing participation of institutional investors such as pension funds, the wealth effect will play out in the stock market again," he argues.

Investment strategy

Anticipating various changes down the road, Gong has modified the investment strategy of ChinaAMC GARP Fund.

In the past, the investment philosophy of the fund is pro-cyclical and industry rotation. He explains, "For instance, at the early recovery stage, we will invest in traditional upstream industries, such as property and automobiles; when the economy enters the booming stage, weighting of mid and downstream sectors would be increased; when the economy is overheating, we will invest in resources where there is a bottleneck."

Since last year, Gong has made radical changes to his portfolio

"We have significantly reduced the weights of traditional cyclical sectors such as financials and real estate but started to build positions in emerging industries and consumption-related sectors." He says that growth stocks make up majority of the fund's portfolio and the total weights of cyclical stocks have been gradually reduced to below 40%.

Expect surprises

Though no one would be able to predict when and what kind of 'black swan' event will happen, fund managers need to bear in mind that the development of emerging industries will not be a smooth journey.

Therefore, Gong takes a diversified approach when investing in emerging industries. "I include a basket of industries in the portfolio and never highly concentrate on particular sectors or individual stocks. When the Japan earthquake and railway disaster happened, we sold off the related stocks very quickly."

While the revised investment strategy is going to serve the fund portfolio for the long term, tactical allocation does change to respond short-term market conditions in order to grasp periodical investment opportunities.

He says, "Currently, the valuation discrepancy between defensive and cyclical stocks is getting wider. Consumption stocks are quite expensive now but the valuation of cyclical stocks is very low. If CPI drops more than expected and the economy shows obvious signs of slowing down and the government releases policy, we will buy some cheap cyclical stocks."

Meanwhile, Gong does not let go some investment opportunities emerging from transition of supply-demand situation of traditional industries, such as cement.

"Last year the government released the guidance of energy-saving and ejection-decreasing in cement industry, which means strict controls in new productive capacity and faster elimination of lagging product lines. Meanwhile the demand for cement still remains strong. Leading players' profit ratio has started to soar when supply became tighter."

All of which goes to show that the universe for Chinese fund managers continues to expand in line with the growth of capital markets.

Entire new industries are being created and encouraged by the government as it helps shift China toward a new economic model based on domestic demand. Yet the quality companies in older, more established sectors may also hold appeal. It is this growing flexibility and opportunity that makes running portfolios in China so exciting. ■

STAYING ON TOP

Holding 9.4% market share by the end of June 2011, ChinaAMC has for years led the industry both in terms of performance and scale.

The long-term performance of ChinaAMC funds is always top quartile, especially its ChinaAMC Large-Cap Select Fund, which is the best performing fund in China on both a three- and five-year basis.

Core to this consistent generation of returns is ChinaAMC's commitment to its internal, independent research.

Its 160-strong investment and research team is the largest and most stable in China, with annual employee turnover of less than 10%. Each of its fund managers has spent an average of seven years with the firm, a true accomplishment for such a young industry.

ChinaAMC is also a pioneer in international expansion: in 2009, it was one of the first mainland fund houses to set up a subsidiary in Hong Kong.