China Update

What does the Year of the Dragon bode for China?

The Year of policy easing in China

At 8% forecast GDP growth[1] for 2012, China's economy is not about to see a hard landing. In fact, it **remains an attractive market** relative to the rest of the world. Our view is that 2012 will mark a year of slower, more moderate growth for the Chinese economy given declining Europe and US external demand and corresponding drop in domestic activities. However, with net exports contributing to less than 1% of real GDP growth in 2010[2], we do not expect the impact to be significant.

After tightening for the last two years, the slowdown should not come as a surprise as China continues its 'rebalancing act' of focusing more on domestic consumption and investments to **achieve more stable growth**. To appropriately slow down the growth rate while adjusting the industry and economic structure will help China achieve the sustainable development it needs.

Monetary policy tightening and other anti-inflation measures have since **eased inflation**. Policymakers now have **more room to drive growth by loosening monetary policy**. And they have been quick to act, cutting its bank reserve requirements for the first time in nearly three years on last December. This suggests that policy-makers are beginning to worry about the downside risks in the economy and we believe more needed liquidity will be injected into the economy through further reserve requirement ratio (RRR) cuts this year.

2012 risk/reward outlook looks good

Despite the fact that most of what is weighing on global equities originated from Europe and the US, Chinese equities fell more than European or US equities in 2011 due to strong risk aversion. As we move towards the end of the tightening period, an uplift in market sentiment will allow investors to focus more on fundamentals. We believe that Chinese equities will gain strength quickly when this happens and loosening policies kick in.

Overall, **Chinese corporates are expected to deliver earnings growth of around 10-15%[2]** in 2012. The extremely low price-to-book ratio of Chinese stocks, at 1.4x compared with a 2.0x historical average (see chart below), seems unreasonable in light of the average return on equity (ROE), now closer to the top end of the historical range.

MSCI China Index: Price-to-book ratio (PBR) and Return on Equity (ROE)

Source: Daiwa Capital Markets, MSCI, IBES, 8 December 2011

[1] Source: Haver, CEIC, IMF, UBS estimates, 10 January 2012

[2] Source: Bloomberg, Henderson Global Investors, 11 January 2012

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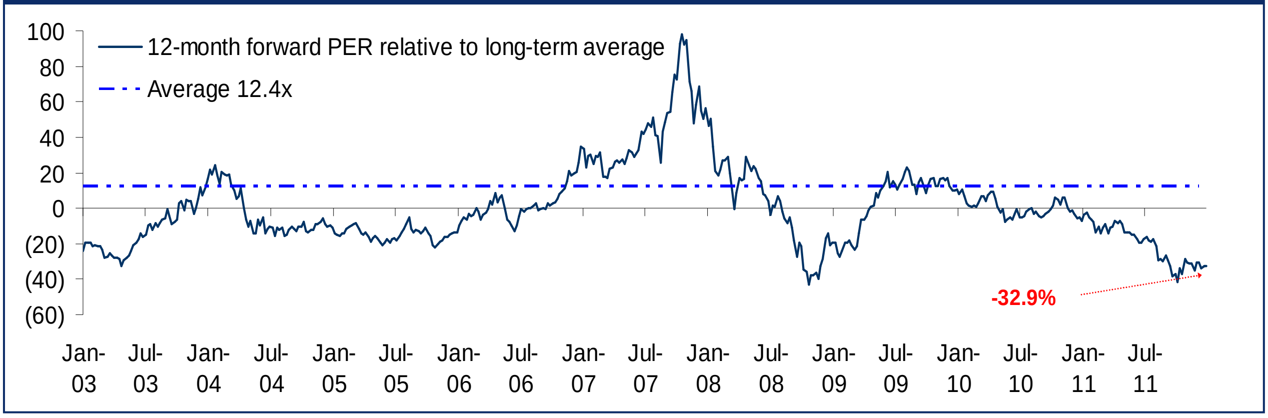
And with the possible **loosening of monetary conditions in China**, Chinese stocks now trading at 8.6x 2012 P/E[3] and at a significant discount of 33% to its own long term average (see chart below), presents a strong investment case from a valuation perspective. This compels us to believe that the 2012 risk/reward outlook for China looks relatively optimistic, depending on how the Euro debt crisis evolves.

MSCI China Index: Price-earnings ratio (PER) relative to average since 2003



Source: Daiwa Capital Markets, MSCI, IBES, 29 December 2011

How do we capture the bright spots in China's economy?

The Henderson Horizon Fund – China Fund is currently focused on **large cap growth stocks** as they tend to lead in a market rally. We do not intend to fully invest in cyclicals (industrials, materials) until we see a sustained improvement in data points on fixed asset investment and consumption, indicating a clear uptick in economic activity.

Share prices of Chinese banks have languished amidst the vigorous tightening campaign over the past 2 years, currently trading around 0.9x - 1.5x P/B[4]. The start of a monetary easing cycle may conversely trigger a re-rating of the banking sector. Share prices jumped 9-30%[5] from early December to mid January as the RRR cut alleviated concerns of non-performing loans (NPL). We think there is a **near term trading opportunity in the bank sector**. Amongst the big banks, we prefer CCB, ICBC; Citic Bank and China Minsheng Bank are our top picks among smaller banks.

Even though demand for energy and commodities is expected to grow modestly as China's economy slows this year. The easing of inflation may allow policymakers to further roll-out gas pricing reform, downstream product pricing deregulation which **could potentially drive up the stock prices of oil and gas companies**. Amongst them, we like Petrochina and CNOOC.

Structural long term trends favour the consumption sector in China and we expect consumption growth to remain robust in 2012 underpinned by more **pro-consumption policies** adopted by the government e.g. increasing disposable income for urban residents, creation of more service sector jobs, etc. Massive household savings, as evidenced by RMB 33 trillion (or above 80%) of GDP[6] in household deposits in the banks should also serve as a cushion for household consumption. in China. We favour consumer stocks but only at decent multiples, like car manufacturer Brilliance China Automotive and luxury goods maker Prada.

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[3]Source: MSCI China Index, Bloomberg, 11 January 2012
[4]Source: Bloomberg, 11 January 2012
[5]Source: Bloomberg
[6]Source: Daiwa Capital Markets, 30 November 2011

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Summary table of our key sector overweights and underweights as well as stock picks		
Overweights	Banks	CCB, ICBC, Citic Bank, China Minsheng
	Insurance companies	Ping An Insurance
	Consumer discretionary	Brilliance China Automotive, Prada
	Energy	Petrochina, CNOOC
Underweights/ Shorts	Utilities	Hong Kong and China Gas

Conclusion

The primary risk for 2012 is an escalation of the crisis in the Eurozone. While the outlook for investment markets remains uncertain, there is great long-term value to be found in the equity markets. Remember, the best time to invest often feels like worst times. It is important for investors to build a diversified portfolio, remain vigilant to the ever changing market outlook and be prepared to adapt investment strategy and asset allocation as necessary. In a world of constrained and volatile investment returns, there also remains a strong case for investors to focus on investments with resilient and stable growth.

Until the overhang from the Eurozone debt crisis is lifted, periodic bouts of negative news flow will offer opportunities to build positions in China stocks that we have identified as being attractive on a medium-term perspective.

Note: Reference to individual companies or any securities should not be construed as a recommendation to buy or sell the same.

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- The Fund primarily invests in equity securities and equity instruments of companies listed in China, Hong Kong and Taiwan and may also invest in companies incorporated elsewhere that have significant assets, business, production, trading activity or other interests in China, Hong Kong or Taiwan.
- The Fund may invest a substantial amount of its assets in companies in China (emerging market) which may involve a higher concentration of risk and also may experience higher risks of economic, political, regulatory and social development changes. Investments in emerging market may be less liquid and more volatile than funds that invest in developed and more geographically diversified markets.
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- The Fund typically holds long and short positions mainly through the use of FDI combining with direct investments and its total gross market exposure may exceed 100%. Such investment strategy and the use of FDI are inherently volatile and depending on market condition, the Fund could potentially be exposed to additional risk and costs should the market move against it and incur losses consequently.
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