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Fund Update

Latest Views on China

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Martha Wang shares her investment strategy, performance and positioning of FF-China Focus Fund, and her views on the Chinese market as the leadership contest draws to a close.

INVESTMENT APPROACH

- My bottom-up stock picking approach could be categorised as Growth at a Reasonable Price (GARP):
    - I look for industry leaders, with high barriers to entry and low costs of production.
    - Analysis of management is fundamental to my approach, and I seek company management with a flexible mindset and strategy; these are essential for capturing market share and driving earnings growth in China's rapidly changing environment.
    - However, valuations are particularly important due to the cyclical nature of the Chinese stock market.

STRATEGY

- I continue to pursue investment opportunities underpinned by three secular dynamics in China:
    - Consumption potential, especially opportunities stemming from lifestyle changes
    - Industrial upgrading and industry consolidation
    - The spread of economic dynamics from coastal to inland regions
- These structural drivers mean I still prefer the consumer and information technology sectors. In addition to these long-term positions, I am also interested in quality industrial cyclicals, which are trading at attractive valuations.

PERFORMANCE

- The fund has underperformed its benchmark over the last 12 months till 31 October 2012. Holdings in the consumer-related sectors have detracted over the last year.
    - The high conviction holding in **Yantai Changyu Pioneer** Wine detracted from returns. It retreated following a decline in sales and unpublished media reports about ingredients and chemicals in its wine. However, I continue to hold the position in view of strong underlying factors supporting wine consumption in China, such as increasing income and changing lifestyle.
    - Sportswear company, **Li Ning**, succumbed to a profit warning. I continue to hold the stock as it stands to benefit from private equity firm TPG Capital's involvement in turning around the business.
- The fund has also suffered due to its exposure to US listed Chinese stocks and Chinese A-shares. Both of these share classes have underperformed other Chinese share classes over the last year. **Baidu** and online media firm **SINA** fall in to this category. I believe that these share classes offer an interesting valuation opportunity and I have taken advantage of the recent share price weakness to accumulate additional positions.

CURRENT POSITIONING

- FF-China Focus Fund is overweight the consumer and IT sectors due to the structural reasons mentioned above.
- I remain underweight telecoms as I think that government regulations constrain growth. In addition, competition continues to increase and it is clear that margins are beginning to suffer.
- More generally, a structural underweight in government-regulated sectors is maintained as regular intervention by authorities curtails their long-term growth. That said, in energy I have bought selected stocks that will benefit from market dynamics in the natural gas sector, but retain an overall underweight position.
- I maintain the underweight in the financials sector as lower lending rates may compress net interest margins. More recently, I reduced exposure to property and insurance names, although **Ping An Insurance** and **China Overseas Land and Investment** continue to be among my top holdings. I favour the former due to its diversified operations and the latter, being a state-owned company, is better positioned among its peers in terms of financing, land allotment and pre-sale permits.

OUTLOOK

- China is likely to be impacted primarily by two factors, macroeconomic policies and corporate earnings, but the market has already priced in these risks:
    - On the macroeconomic front, we should continue to see further policy easing along with structural reforms to address China's issue of sustainable growth.
    - In terms of corporates, we have seen earnings cuts in the past 12 months. However, we may be close to an earnings trough in the near-term as we are starting to see an improvement in the macro environment and a softening of input costs. Nevertheless, corporates will need to adjust their growth model given the change in the economy's growth pattern.
- Over the <u>short-term</u>, the growth outlook for China in 2012 is widely expected to range between 7% and 8%. Although this is a decline from the recent past, it is still a healthy and enviable growth rate compared to its developed market counterparts. In the near term, the economic cycle will be influenced by the policy cycle. More liquidity has been injected into the market and loan growth has accelerated in recent months, adding to my conviction.
- Over the <u>medium-term</u>, with export growth likely to decline, China's economy is expected to slow to high-single-digit from double-digit growth. However, I believe that the government will be willing to accept a lower GDP growth rate as it will **<u>focus on the quality rather than quantity of GDP growth</u>**. This means a continued focus on the domestic consumer and further enforces the structural growth opportunities in consumer related stocks.
- The forthcoming leadership change has been a headwind to market performance as political uncertainty has discouraged investors. The conclusion to the leadership transition should encourage investors to re-enter the Chinese markets and may also trigger a pick-up in the implementation of the Five-Year Plan. Overall, the conclusion of the leadership contest is a positive for the Chinese market and there are many companies with strong fundamentals, which have been indiscriminately punished by political uncertainty, trading at attractive valuations.

Important Information